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The Business Situation

Industrial production, nonfarm employment, and wage and salary payments increased in May for the first time since the beginning of the recession, and some further improvement may have taken place in June. Modest improvements do not, of course, rule out the possibility that the economy may bump along somewhat above or below current levels for some months to come. While the worst of the business decline may be over, the timing and vigor of the recovery still remain uncertain.

The Federal Reserve Board's index of industrial production advanced 1 point in May, after having dropped 19 points, or 13 per cent, in the preceding eight months; the strength came mainly from higher steel and automobile output. Subsequent weekly reports for June indicate at least no decline in total production, and in some industries an improvement. The most notable recovery in June was recorded by the steel industry, which raised its operations to some 63 per cent of capacity, about one-sixth above the May tonnage but still about one-fifth below that of a year ago. Much of the rise in steel output appears to have been in response to hedge buying in anticipation of a steel price increase in July. As a result, the cutbacks during the July vacation period may be more extensive than usual; in the first week of July output was scheduled to decline to 52.7 per cent of capacity. However, the need of various steel consumers to replenish their very low inventories, which also contributed to the June increase in output, may not yet have been fully satisfied.

Automobile assemblies in June were maintained at about the May level, account being taken of seasonal influences. But present industry plans for an early model change-over suggest that auto output will be cut back during July and August. The petroleum industry, on the other hand, appears to have the worst of its slump behind it and has succeeded in greatly reducing its previously excessive inventories. Both crude oil output and petroleum refining edged up further in June, and another advance in domestic crude oil flow is in prospect for July.

The seasonally adjusted total unemployment rate in May fell for the first time in over a year, to 7.2 per cent of the labor force from 7.5 per cent in April. Similarly, the number of wage and salary earners in nonagricultural establishments in May registered the first seasonally adjusted rise since the beginning of the recession. Nonetheless, employment in manufacturing fell once again, although by the smallest amount since June 1957. Since mid-May, the total of insured unemployed has dropped sharply, apparently indicating a continuation of a more-than-seasonal increase in employment. However, the usual expansion of the labor force at the end of the school year is believed to have greatly exceeded new job opportunities in June.

The May upturn in employment was accompanied by a lengthening in the workweek and, as wage rates were steady, total payrolls (after seasonal adjustment) rose slightly, after having fallen continuously since August. Total personal income, strengthened by a further increase in government transfer payments, advanced again in May, to a level less than 1 per cent below the August 1957 peak. In June, the flow of personal incomes felt the stimulus of the recently voted military pay increases. These increases, together with the newly approved higher salaries for Government employees, which will become effective in July, will mean an addition of some $1½ billion to the annual personal income stream. Moreover, since most of these pay raises are retroactive to the beginning of the year, Government workers will also receive lump sum payments totaling about $350 million during July and August. For individual Government workers these lump sum payments will mean significant windfalls, some of which might well be spent on major durable goods.

The protracted decline in the sales of durable goods came to a halt in March and was followed by a slight pickup in the April-May period. As retail sales of nondurable goods also turned up—from a much smaller dip—total retail sales averaged 3 per cent above the February-March lows and matched the average of April and May a year ago. In June, department store sales and automobile sales appear, according to data for the greater part of the month, to have matched the May pace. The steadiness of consumer spending is the more heartening as it has not been supported by an expansion of credit; in fact, consumer instalment credit has been declining since February (on a seasonally adjusted basis). The reduction in instalment credit and an increase in liquid savings may both be viewed as favorable omens, since they indicate that consumers are now in a stronger position from which to step up their purchases.

Recent trends in business inventories have also been encouraging. Inventories have been drawn down at an unprecedented pace in this recession, but by now the liquidation of inventories may well have slowed somewhat. As a result, this drag on production may have ceased, for even a reduction in the rate of inventory liquidation means that fewer goods are supplied from stocks instead of from new production. Since inventories are held to meet cur-

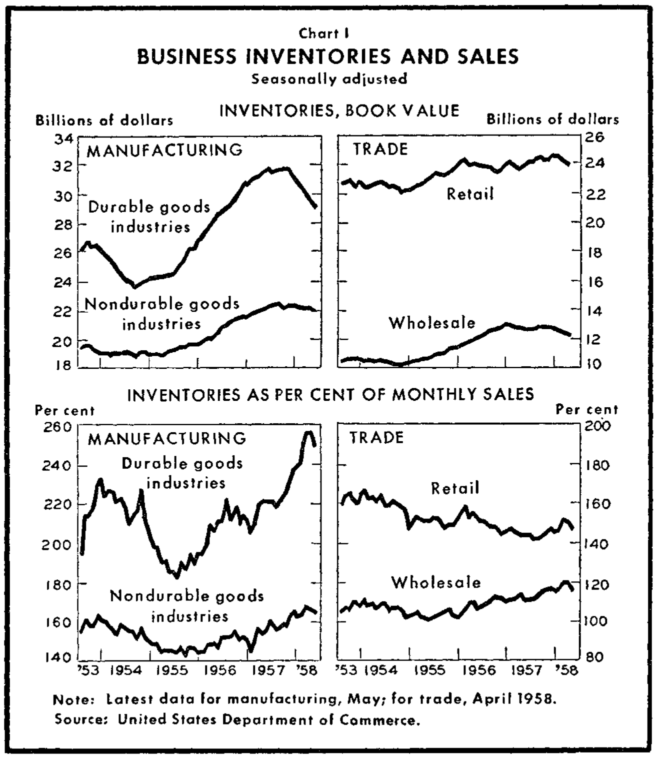


Chart I
BUSINESS INVENTORIES AND SALES
Seasonally adjusted
Note: Latest data for manufacturing, May; for trade, April 1958.
Source: United States Department of Commerce.

rent and anticipated sales, the relationship of inventories to sales provides some indication of prospective inventory movements. Until recently, inventory-sales ratios continued to grow, as sales dropped more rapidly than inventories (see Chart I). In April the ratios declined at both the retail and wholesale trade levels, reflecting increases in sales together with further sharp cutbacks in inventories. In manufacturing, the ratio was unchanged in April but declined in May. While past inventory-sales ratios are not necessarily a firm guide for the future, it is significant that the retail inventory-sales ratio in April was at the lowest level in the past seven years, except for a part of 1957. In contrast, manufacturers' stocks as compared with sales remain near their all-time peak, substantially above past levels. On balance, there seems to be little doubt that inventories—notably in the manufacturing area—will continue to be drawn down for some time, although probably at a reduced rate.

Plant and equipment expenditures, on the other hand, are likely to exert downward pressure on the economy for some time. The drop in fixed capital spending from the peak in the third quarter of 1957 to the first quarter of this year has been sharper than was foreseen earlier, according to the latest survey conducted by the United States Department of Commerce and the Securities and Exchange Commission (see Chart II). While businessmen plan to reduce their capital spending further during the remainder of this year, the presently anticipated reduction would be some 3-4 per cent in each of the last three quarters of 1958 as against an actual drop of 11 per cent in the first quarter. As was expected, the survey showed that capital spending plans for the whole of 1958 were revised down, to a level 4 per cent less than the amount anticipated for 1958 in the previous Commerce-SEC survey released in March and 17 per cent below the record outlays of 1957.

Despite the continued decline in business spending on new plant construction, construction activity as a whole shows signs of an upturn, as home building and public construction are picking up. Private nonfarm housing starts in May recorded the second consecutive increase, the seasonally adjusted annual rate rising above 1 million. At the same time, the upsurge in Federal Housing Administration and Veterans Administration-mortgage applications continued, indicating a further expansion in starts under these programs in coming months. Moreover, brighter prospects for public construction are suggested by May data for construction contract awards released by the F. W. Dodge Corporation. The outlook for highway construction, in particular, seems encouraging. According to a recent survey, a jump of one third in contract awards for State and toll-highway projects appears to be in prospect for 1958 as compared with 1957.

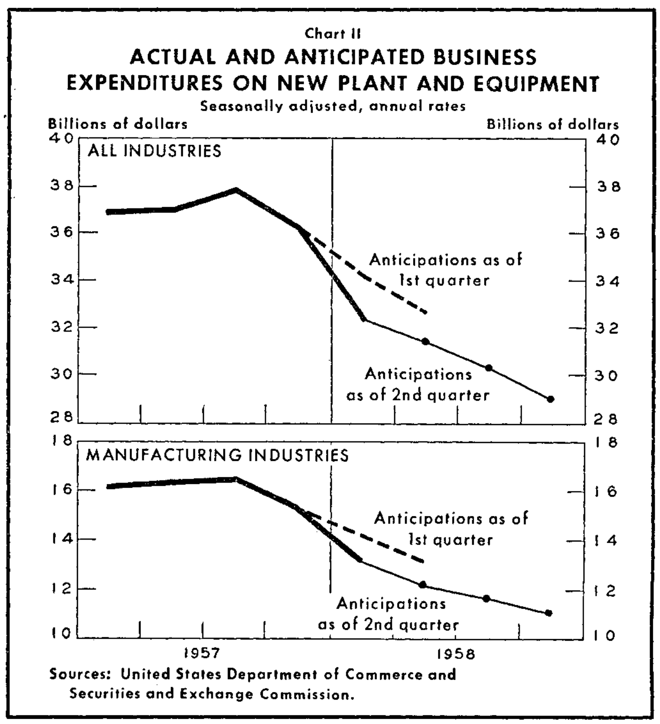


Chart II
ACTUAL AND ANTICIPATED BUSINESS EXPENDITURES ON NEW PLANT AND EQUIPMENT
Seasonally adjusted, annual rates
Sources: United States Department of Commerce and Securities and Exchange Commission.

Money Market In June

Ample reserve availability was maintained during June as large-scale purchases of Government securities by the Federal Reserve System counterbalanced the reserve-draining effects of various market influences. Chief among the factors absorbing free reserves was a sharp rise in required reserves, reflecting the further marked expansion (partly seasonal) of member bank credit and deposits.

The money market was characterized by considerable churning, largely because of the Treasury's borrowing and refunding operations and quarterly tax and dividend payments; while the market was relatively easy during the month as a whole, there were tendencies toward firmness from time to time, particularly when securities dealers' financing needs and tax borrowing demands converged on the money market banks. Partly in reflection of these occasional pressures, Treasury bill rates moved upward during the first three weeks of the month from the low levels at the start of the period. Rates declined again toward the end of June, and the three-month bill was bid at the close of the month to yield 0.75 per cent as compared with nearly 1 per cent on June 23 and 0.58 per cent at the end of May.

In the capital markets, attention was focused in the early part of the month on the Treasury's cash and refunding offerings, which were given good initial receptions. Total subscriptions for the new money offering of about $1 billion of 3¼ per cent bonds maturing in 1985 came to approximately $2.6 billion, while the attrition on the $9.5 billion refunding operation was less than 4 per cent. Later in the month the bond market atmosphere turned heavy, and sharp price declines were registered when conjecture in the press as to System credit policy, and the improvement reported in certain business statistics, triggered heavy offerings of speculative holdings of the new Treasury issues. A steadier tone developed toward the end of June, but longer term Treasury issues closed the month with net losses of up to 2½ points, and prices of corporate and municipal issues also declined.

MEMBER BANK RESERVE POSITIONS

Free reserves of member banks averaged $483 million during the four statement weeks ended June 25, thus remaining in the range of approximately $400-600 million that has prevailed in recent months. Daily average borrowings from the Federal Reserve Banks rose slightly to $148 million, reflecting higher borrowing around the middle of the month to accommodate the substantial churning in reserve positions. The effective rate on Federal funds transactions was generally below the 1¾ per cent discount rate, however, and often was as low as ½ or ¼ per cent.

A combination of rising required reserves and net changes in operating factors absorbed reserves steadily and in large volume during June. Required reserves alone increased by some $720 million over the period covered in Table I, as member bank credit and deposits expanded further—in part because of seasonal and other temporary factors. The largest increases were in the weeks of June 18 and 25, when bank loans to Government securities dealers rose sharply, corporations borrowed to pay taxes, and banks credited Treasury Tax and Loan Accounts for their purchases of the new long-term Treasury bonds. A seasonal rise in currency in circulation also absorbed reserves during the month. In addition, purchases of gold by foreign central banks and related foreign account transactions absorbed about $290 million; this was less than in the preceding two months, but it boosted the total reserve loss from this source since mid-February to about $1.4 billion.

Table I
Changes in Factors Tending to Increase or Decrease Member Bank Reserves, June 1958
(In millions of dollars; (+) denotes increase, (—) decrease in excess reserves)

Factor	Daily averages—week ended				Net changes
	June 4	June 11	June 18	June 25	
Operating transactions					
Treasury operations*	+ 38	− 10	− 23	+ 19	+ 24
Federal Reserve float	+ 89	− 54	+ 221	− 12	+ 244
Currency in circulation	− 174	− 65	− 18	+ 95	− 162
Gold and foreign account	− 30	− 28	− 118	− 115	− 291
Other deposits, etc.	− 127	+ 32	+ 4	+ 132	+ 41
Total	− 204	− 127	+ 67	+ 121	− 143
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 141	+ 197	+ 190	+ 310	+ 838
Held under repurchase agreements	—	+ 6	+ 95	+ 10	+ 111
Loans, discounts, and advances:					
Member bank borrowings	+ 15	+ 50	− 9	− 76	− 20
Other	+ 1	− 1	—	—	—
Bankers' acceptances:					
Bought outright	− 1	+ 3	+ 1	—	+ 3
Under repurchase agreements	—	—	—	—	—
Total	+ 157	+ 254	+ 278	+ 243	+ 932
Total reserves	− 47	+ 127	+ 345	+ 364	+ 789
Effect of change in required reserves†	− 55	− 54	− 289	− 320	− 718
Excess reserves†	− 102	+ 73	+ 56	+ 44	+ 71
Daily average level of member bank:					
Borrowings from Reserve Banks	134	184	175	99	148‡
Excess reserves†	537	610	666	710	631‡

Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† These figures are estimated.

‡ Average for four weeks ended June 25.

To offset the above-mentioned drains on free reserves during June, the Federal Reserve System added $891 million to its outright holdings of Treasury bills between May 28 and June 25. In addition, a sizable amount of reserves was released through repurchase agreements with Government securities dealers. These agreements were written mainly around the middle of the month, thus mitigating seasonal pressures in the money market when dealers' financing needs were temporarily augmented because of the Treasury's debt operations and the quarterly tax date.

GOVERNMENT SECURITIES MARKET

Developments in the first half of June centered around the Treasury's cash borrowing and refunding operations. The terms of these operations, announced on May 29, were generally well received, although there was some surprise in the market over the fact that a long-term bond was offered for cash. The cash offering, a 3¼ per cent bond maturing in 1985, was priced at 100½ to yield 3.22 per cent, with a 20 per cent downpayment required on all subscriptions. Subscription books were open only on June 3, and total subscriptions for the $1 billion offering came to about $2.6 billion. Allotments amounted to 60 per cent of subscriptions for savings-type investors, 40 per cent for commercial banks, and 25 per cent for others, with subscriptions of up to $5,000 awarded in full. Total allotments came to $1,132 million (including $100 million for Government investment accounts), and final payment and delivery took place on June 18. In "when-issued" trading, the new bond briefly pushed to a premium of about 1 point over the issue price but later in the month dropped more than 1 point below the issue price, as Treasury notes and bonds generally moved lower. By the end of the month a firmer tone had developed and the new bond closed at a par bid.

The initial market reception of the $9.5 billion exchange offering was also quite favorable. Holders of $4.4 billion of 2⅞ per cent notes, $4.2 billion of 2⅜ per cent bonds, and about $900 million of the partially tax-exempt 2¾ per cent bonds were offered a choice of either a 2⅝ per cent bond maturing in February 1965 or a 1¼ per cent certificate maturing in May 1959. Subscription books were open June 4-6, during which period the "rights" to the exchange commanded increasing premiums ranging up to 100$^{14}/_{32}$. Exchanges into the bond totaled nearly $7.4 billion, while holders of $1.8 billion of the maturing issues elected to take the new certificate—leaving only about $350 million to be redeemed for cash on June 16. The marked preference for the bond substantially exceeded expectations and exchanges into the bond reportedly included a considerable amount of speculative or "weak" holdings. Initially, the new bond was bid at a premium of over ⅜ point, but later in the month the price declined sharply to as low as 99¼ as a number of the temporary holders sold out. By the end of the month, selling pressures had subsided and the new bonds were bid at 99$^{18}/_{32}$. The new 1¼ per cent certificates, for which subscriptions had been relatively light, retained a premium over par, although this gradually declined to close the month at a bid of 100⅛.

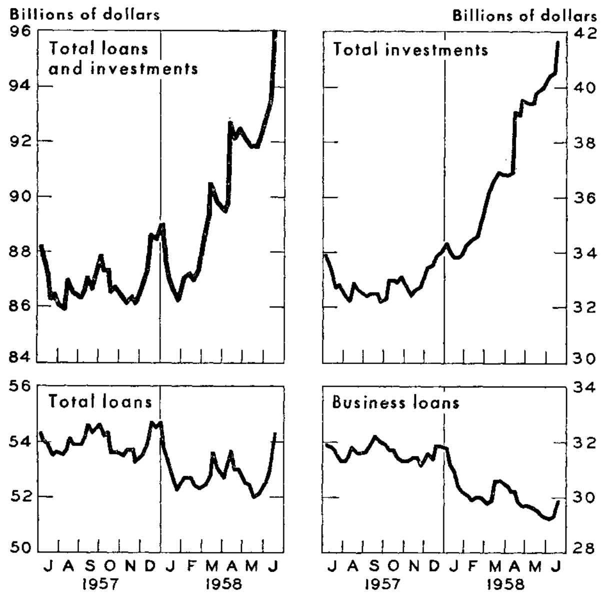
Prices of other Treasury bonds and notes were fairly stable in the opening days of June but declined sharply around the middle of the month and then steadied again toward the close of the period. In general, prices of these issues followed the new Treasury securities, but basically the declining prices reflected the sensitivity of the market to some indications that the business recession may be reaching bottom and to press reports conjecturing that further moves to ease credit may now be less likely. Over the month as a whole, longer term issues, maturing in fifteen or more years, recorded losses of up to 2½ points. Prices at the end of the month were more than 3 points below the highs reached earlier in the year.

Treasury bill rates climbed higher during the first three weeks of June despite large purchases by the Federal Reserve System. Private demand for bills tapered off because of the low rate levels reached at the end of May, while market supplies—and dealer holdings—were increased as a result of seasonal liquidity needs. Toward the end of the month, rates dropped again as System buying continued and private demand revived. In the first auction of the month, held on June 2, the average issuing rate was 0.723 per cent, up by 9 basis points from the four-year low of 0.635 per cent a week earlier. In the next three auctions the average issue rates pushed up further to 0.841 per cent, 0.953 per cent, and 1.006 per cent—the latter auction being the first in six weeks in which the rate exceeded 1 per cent. In the final auction of the month, on June 30, the average rate declined again to 0.768 per cent, and three-month bills were bid to yield 0.75 per cent.

OTHER SECURITIES MARKETS

The markets for corporate and municipal securities held fairly steady through the first half of June, despite the Treasury's billion dollar long-term cash offering. Later in the period, however, the general weakness in Treasury issues also spread to these markets. An estimated $330 million of corporate bonds was marketed for new capital purposes, while State and local issues amounted to about

LOANS AND INVESTMENTS OF WEEKLY REPORTING MEMBER BANKS



Note: Wednesday levels; latest data are for June 18.

MEMBER BANK CREDIT

Further large additions to member bank credit were recorded during June, extending the sharp advances made earlier this year. Since the beginning of 1958, as indicated in the accompanying chart and in Table II, the net rise in loans and investments of weekly reporting member banks has been $7 billion or about 8 per cent. In the comparable periods during each of the past three years, loans and investments of the reporting banks had either been virtually unchanged or had declined.

The rise in bank credit this year has been concentrated in investment holdings, particularly of Government securities, as the banks worked to strengthen their liquidity positions. At the same time, the volume of loans has declined slightly, as the pronounced downtrend in business borrowing has been largely offset by increased securities loans. In the comparable 24-week period of 1957, reporting banks reduced their investments by $1.0 billion, while loans increased by about the same amount.

During the four weeks ended June 18, as shown in Table II, loans and investments of the weekly reporting

$455 million. In addition, about $90 million in securities of foreign governments or international authorities was sold in the United States market during June. For the first half of 1958 corporate and municipal bond flotations were an estimated $7.3 billion—about $1 billion more than in the first half of 1957.

Investor response to new offerings during June was mixed. Certain issues were distributed quickly, but a number of others moved quite slowly, and a prospective $150 million industrial offering was postponed because of market conditions. Several Aa-rated utility bonds were sluggish when reoffered to yield 3.80-3.85 per cent, but later in the month a similar issue was well received at a 3.95 per cent yield. According to Moody's Investors Service, the average yield on seasoned Aaa-rated corporate bonds was 3.62 per cent at the end of June, as compared with 3.57 at the start of the month. Over the same period, average yields on Aaa-rated municipals rose from 2.71 to 2.78 per cent.

In the market for private short-term debt instruments, interest rates for the most part remained at the low levels reached earlier this year. On June 11, commercial paper dealers announced another cut in rates—the fifteenth this year—of ⅛ per cent on all maturities. This reduced the offered rate on 4 to 6-month paper to 1½ per cent.

Table II

Changes in Principal Assets and Liabilities of the Weekly Reporting Member Banks

(In millions of dollars)

Item	Statement week ended				Change from Dec. 31, 1957 to June 18, 1958
	May 28	June 4	June 11	June 18	
Assets					
Loans and investments:					
Loans:					
Commercial and industrial loans	− 137	− 119	+ 106	+ 574	−1,922
Agricultural loans	+ 4	+ 1	+ 7	+ 9	+ 58
Securities loans	+ 123	+ 578	+ 394	+ 595	+1,715
Real estate loans	+ 21	− 4	+ 36	+ 17	+ 109
All other loans (largely consumer)	+ 27	− 30	− 4	+ 31	− 333
Total loans adjusted*	+ 39	+ 424	+ 537	+1,223	− 406
Investments:					
U. S. Government securities:					
Treasury bills	+ 77	− 39	− 190	+ 592	+ 439
Other	+ 160	+ 235	+ 117	+ 591	+5,537
Total	+ 237	+ 196	− 73	+1,183	+5,976
Other securities	+ 21	+ 214	+ 136	+ 48	+1,431
Total investments	+ 258	+ 410	+ 63	+1,231	+7,407
Total loans and investments adjusted*	+ 297	+ 834	+ 600	+2,454	+7,001
Loans to banks	− 38	+ 158	+ 26	− 103	+ 898
Loans adjusted* and "other" securities	+ 60	+ 638	+ 673	+1,271	+1,025
Liabilities					
Demand deposits adjusted	+ 763	+ 252	+1,414	+ 334	+ 547
Time deposits except Government	+ 131	+ 76	+ 195	+ 31	+3,725
U. S. Government deposits	− 363	− 363	− 761	+2,624	+2,575
Interbank demand deposits:					
Domestic	− 19	+ 616	− 14	+ 58	− 894
Foreign	− 48	− 26	+ 98	+ 17	− 134

* Exclusive of loans to banks and after deduction of valuation reserves; figures for the individual loan classifications are shown gross and may not, therefore, add to the totals shown.

banks increased by $4.2 billion. The $2 billion rise in investments partly reflected bank acquisitions of the new Treasury securities, while the $2.2 billion rise in loans largely represented increased borrowings by corporations to meet quarterly tax obligations and expanded borrowings by brokers and dealers—mainly against Government securities. Indirectly, the sharp rise in borrowing by Government securities dealers was also a reflection of increased liquidity needs around the tax date, as corporations sold securities to dealers, or terminated the arrangements under which they had been lending short-term funds to dealers, in order to pay taxes.

International Monetary Developments

MONETARY TRENDS AND POLICIES

The shift toward an easing of monetary policies abroad, which began earlier this year, became more pronounced last month. The central banks of Belgium, Italy, the Netherlands, Japan, the United Kingdom, and West Germany all reduced their discount rates, thus bringing to sixteen the foreign discount rate reductions since the beginning of the year (see table). In general, these reductions have reflected the marked lessening of inflationary pressures, a leveling-off or even decline in industrial production, and in a number of instances a substantial improvement in balance-of-payments positions.

BELGIUM. The decrease in the discount rate of the National Bank of Belgium to 4 per cent from 4¼, effective June 5, appears to have been made primarily in view of the continued increase in gold and foreign exchange reserves. Official reserves increased by $170 million equivalent, or by some 20 per cent, during January-May, in part through inflows of short-term capital attracted by relatively high Belgian interest rates. At the same time, there has been a slackening of domestic economic activity, with industrial production running about 6 per cent below a year ago.

Changes in Foreign Central Bank Discount Rates in 1958
(In per cent)

Date of change	Country	New rate	Amount of change
January 17	Germany (Fed. Rep.)	3½	−½
January 24	Netherlands	4½	−½
March 20	United Kingdom	6	−1
March 25	Netherlands	4	−½
March 27	Belgium	4¼	−¼
March 28	Ireland	5½	−½
April 19	Denmark	5	−½
May 3	Sweden	4½	−½
May 22	United Kingdom	5½	−½
May 31	Ireland	5	−½
June 5	Belgium	4	−¼
June 7	Italy	3½	−½
June 14	Netherlands	3½	−½
June 18	Japan*	7.665	−0.73
June 19	United Kingdom	5	−½
June 27	Germany (Fed. Rep.)	3	−½

* "Basic" rate for commercial bills.

ITALY. The lowering of the Bank of Italy's discount rate to 3½ per cent from 4, effective June 7, was the first change in the rate in over eight years and reportedly was prompted by the desire of the authorities to stimulate the domestic economy. Signs of slackening activity, which had already been noted in the bank's annual report for 1957, include a slowing-down in the expansion of industrial production, an actual drop in iron and steel output, a substantial decrease in shipbuilding, and a contraction in both residential and industrial construction. Moreover, imports during the first quarter of 1958 were 13 per cent below a year previous, reportedly as a result of a substantial drop in the volume of raw material imports.

NETHERLANDS. The reduction in the Netherlands Bank's discount rate to 3½ per cent from 4, effective June 14, appears primarily as an adjustment to prevailing money market conditions. From mid-March, before the previous reduction, to early June the three-month Treasury bill rate fell from 3¼ per cent to 2¾ and the call money rate from 2¾ to 2¼. The greatly enhanced liquidity of the Amsterdam money market reflects the recent decline in Dutch economic activity. During the first quarter of 1958 industrial production was 5 per cent below January-March 1957, and unemployment in May was more than twice that of a year earlier, although still less than 3 per cent of the labor force. In addition, gross private investment this year is expected to be 10 to 15 per cent below 1957. The contraction in output has contributed heavily to the 20 per cent drop in Dutch imports during January-April from the corresponding period of 1957. The import drop, in conjunction with unchanged exports, has caused a substantial improvement in the Dutch trade balance and a sharp rise in official gold and foreign exchange holdings; in mid-June such holdings amounted to $1,230 million equivalent, or 19 per cent more than at the end of 1957.

JAPAN. The Bank of Japan, effective June 18, reduced its principal discount rate (applicable to commercial bills) to 7.665 per cent from the peak rate of 8.395 per cent, which had been reached in six successive steps during the postwar period.[1] The combination of monetary, fiscal, and import-control measures (including two discount rate increases) adopted in the spring of 1957 to combat the inflationary pressures then rampant have checked the boom and improved the country's external position. Industrial production has declined this year, while unemployment has risen and inventories of semimanufactures and manufactures have increased. First-quarter imports were almost 40 per cent below the all-time high reached in April-June 1957. As a result, the substantial balance-of-payments deficits disappeared late last year, and international reserves have been expanding since October.

UNITED KINGDOM. The ½ per cent reduction in the Bank of England's discount rate to 5 per cent, effective June 19, restores the rate to the level obtaining before last summer's sterling crisis led the authorities in September to adopt sharply restrictive monetary controls, including a 7 per cent discount rate. Since then, British gold and dollar reserves have risen sharply and on May 30 reached $3,039 million, the highest level since September 1951. Internally, industrial production has remained virtually unchanged since late 1957 and is believed to be considerably below capacity, and unemployment has risen gradually. The discount rate reduction had been anticipated by the market virtually since the previous reduction on May 22. The average Treasury bill tender rate, which stood at 5.20 per cent on May 16, dropped sharply to 4.82 on May 23, declining further to 4.51 on June 13 and 4.29 on June 20. Recent official statements likewise had pointed in the direction of some relaxation of monetary restraints. The Chancellor of the Exchequer repeatedly had raised the question whether British production could be expanded without generating renewed inflationary pressures. Although on one occasion last month he declared that the time "to take the brakes off . . . is approaching very rapidly now", he stressed that the government's policy hinged very much on the outcome of wage negotiations during the next few months. On June 18 the authorities raised, retroactive to April 15, the initial depreciation allowances on new investment to 30 per cent for machinery and other industrial equipment and to 15 per cent for industrial building, from the 25 and 12½ per cent rates originally set in the 1958-59 budget.

GERMANY. The German Federal Bank lowered its discount rate to 3 per cent from 3½, effective June 27, in the fifth successive ½ per cent decrease since September 1956. The reduction appears to reflect primarily efforts to influence the over-all interest rate structure so as to discourage the inflow of foreign funds. After losses in November-February, German official reserves have been increasing once more since March, the March-May gains amounting to $275 million equivalent; early in June reserve holdings had again reached the $5,690 million peak of last fall. A large part of the recent increase has been ascribed to flight capital as well as to funds attracted by the prevailing interest rate differential between Germany and other foreign centers. The discount rate reduction was also reportedly influenced by a desire to stimulate domestic demand.

EXCHANGE RATES

American-account sterling quotations moved lower during June, with a notable easing shortly after midmonth and substantial declines toward the month end when seasonal factors sharply accelerated the demand for dollars in London. The market generally was characterized by continued uncertainty associated with unsettled British labor problems and the Middle East situation. However, the rate strengthened somewhat after the June 19 announcement of a reduction to 5 per cent from 5½ in the Bank of England's discount rate and again at the month end when dollar demand in London slackened. On June 30 American-account sterling was quoted at $\$2.80\frac{13}{32}$ as compared with the opening rate of $\$2.81\frac{25}{32}$ on June 2 and a low of $2.80 on June 27.

Discounts on sterling for future delivery narrowed gradually during most of the month in a quiet and rather small market but widened toward the month end with the decline in spot quotations. On June 30 discounts on three and six-month sterling were 2 and $3\frac{27}{32}$ cents, respectively, equivalent to 2.860 and 2.764 per cent per annum.

Transferable and securities sterling also eased during June with noteworthy declines toward the month end. On June 30 the rates stood at $\$2.78\frac{11}{32}$ and $2.78½, respectively. Transferable sterling was occasionally well offered from the Continent, while securities sterling strengthened temporarily at midmonth when investor interest in British oil and paper stocks developed.

The Canadian dollar fluctuated between $1.03¾ and $1.04 during most of June; market activity generally was on a reduced scale, although there was some demand for

[1] The Bank of Japan maintains a differential discount rate structure, with the discount rate on export bills (currently 5.84 per cent) the lowest rate at which banks can borrow from the central bank. Moreover, each bank can borrow only a certain maximum (determined by a complex formula based on the assets and liabilities of each bank) at the lowest rates, and must pay a higher rate for additional accommodation.

Canadian dollars from London and the Continent and occasional offerings of United States dollars by Canadian commercial interests. Toward the month end, however, the announcement and placement in the New York market of a Canadian bond issue, along with the expectation of additional offerings and a renewed demand for the Canadian dollar from London and the Continent, carried the rate as high as $\$1.04\frac{15}{32}$, the highest since October 1957; by June 30 the rate had eased to $\$1.04\frac{19}{64}$.

The French authorities announced on June 23 the abrogation of the 20 per cent surtax on purchases and sales of foreign exchange. Effective that date, the basic rate for the United States dollar was raised from 350 francs ($0.002857) to 420 francs ($0.002380); equivalent adjustments were made in the official franc rates for other currencies.

The Financing of Small Business: Part III

This is the third in a series of three articles analyzing the financing facilities available to small business, with special reference to conditions in the Second District.[1] The present article discusses the maturity distribution of business loans at Second District banks and alternative sources of short-term and long-term funds for small business. In addition to the data obtained from the statistical survey of business loans outstanding at Second District member banks on October 16, 1957, a good deal of information was also gathered on this subject from interview programs conducted last fall with bank and nonbank lenders to small business. Among those interviewed were commercial banks, commercial finance companies, factors, insurance companies, large corporations that extend trade credit to their smaller customers or suppliers, and equity investors in small business ventures.[2] (A similar interview program among small business borrowers is now in its initial stages.)

MATURITY OF LOANS

Term loans, that is business loans with an original maturity exceeding one year, increased by much more than did short-term loans at Second District member banks between October 5, 1955 and October 16, 1957, the two survey dates. In both years over half of the dollar volume of business loans was in short-term form, but there was a substantial rise in the ratio of term loans to total business loans between these two years. Moreover, smaller borrowers sharply increased the share of their business loans in term form between 1955 and 1957. As would be expected, the absolute increase in the dollar amount of term loans was greatest for the largest borrowers, but these firms increased their term loans by less than the expansion in their short-term bank borrowings, so that the proportion of their loans in term form declined.

The total dollar volume of term loans at Second District banks increased by $2.2 billion or 53 per cent between 1955 and 1957, while short-term loans rose by $1.5 billion or 24 per cent; $1.2 billion of the $2.2 billion rise in term loans was in the form of one to five-year credits, a 66 per cent expansion, while maturities over five years rose by $1.0 billion or 44 per cent. (See Table I.) As a result, loans with an original maturity exceeding one year rose from 40 per cent of the total dollar volume of business loans outstanding at Second District member banks in October 1955 to 45 per cent two years later. In the nation as a whole this increase was from 34 per cent to 38 per cent. With respect to the number of loans outstanding, the proportion of term loans to total business loans similarly increased in the Second District, from 34 per cent in 1955 to 41 per cent in 1957.

In part, this increased emphasis on term lending arose from the character of aggregate economic activity during the 1955-57 period, which was marked by a rapid upsurge in business expenditures for fixed plant and equipment. Such capital outlays give rise to a demand for longer credits than are provided by traditional short-term bank loans that are designed primarily to finance seasonal swings in inventories and other short-term working capital needs. However, the expansion in the demand for term credits on the part of borrowers is only a partial explanation for the rise in such loans; equally important was a willingness

[1] As with the two preceding articles, in the May and June issues of this *Review*, the present article is based upon the broad inquiry into this subject that was carried out by the Federal Reserve System in the latter part of 1957. The two previous articles were devoted primarily to presenting the findings of the statistical survey of business loans outstanding at Second District member banks on October 16, 1957, and to comparing the results with those obtained from a similar statistical survey conducted two years earlier.

[2] The over-all nation-wide results were summarized in *Financing Small Business*, published as a committee print by the Committees on Banking and Currency and the Select Committees on Small Business of the United States Congress. The results in the Second District parallel the findings for the country as a whole unless special mention is made to the contrary.

on the part of commercial banks to extend sound term loans when circumstances indicated their applicability.

Between 1955 and 1957 the smaller sized concerns expanded the proportion of their bank borrowings in term form by much more than did larger businesses. For example, as Table I indicates, although total borrowings at Second District banks by the smallest sized firms—those with assets of less than $50,000—actually declined by $11 million or 3.9 per cent between 1955 and 1957, their term borrowings increased by $25 million or 23 per cent; loans of one to five-year maturity rose by 31 per cent and longer credits by 14 per cent. The decline in the total loans extended to these firms was thus entirely attributable to a $36 million or 21 per cent fall in their short-term indebtedness to Second District banks.

Similarly, term lending to all borrower size-groups with assets under $5 million expanded sharply, while their short-term loans either remained fairly stable or contracted. The change for firms of asset size $50,000-$250,000 was particularly striking—their short-term loans declined by $44 million or 7 per cent between 1955 and 1957 but their term loans increased by $103 million or 53 per cent, with loans of one to five-year maturity rising by 49 per cent and longer credits by 56 per cent.

On the other hand, the largest businesses, those with assets of over $100 million, increased their short-term loans by a larger amount than the rise in their term credits. The short-term loans of these concerns at Second District banks expanded by $1.2 billion or 75 per cent, while their loans of over one-year maturity rose by $950 million or 67 per cent. The next-to-largest size-group, firms of asset size $25-100 million, increased both their short and long-term borrowing by about equal dollar amounts. As Table II indicates, the proportion of term loans to total business loans declined slightly for the two largest borrower size-groups, despite the over-all rise in this ratio for all borrowers taken together.

All size-groups of banks contributed to the over-all advance in term lending, with the smallest banks making the largest increase in the proportion of their term loans to total business loans. The smallest banks, those with deposits of less than $10 million, expanded the dollar volume of their term loans to borrowers of all sizes to 42 per cent of total business loans in 1957 as compared with 34 per cent in 1955. (See Table II.) The largest banks, those with deposits of $1 billion or more, also expanded their term loans markedly, to 48 per cent of their total business loans in 1957 from 43 per cent in 1955. While the smaller banks are, as would be expected, almost completely oriented to lending to small business, it is noteworthy that many of the very largest banks have active small business loan departments or instalment credit departments which cater to small firms. Thus the smallest and the largest banks were both particularly prominent in the expansion of term loans to small borrowers; the largest banks increased the proportion of their term loans to total business loans for the smallest sized group of borrowers from 39 per cent to 61 per cent, and the smallest banks expanded their proportion of term lending to total loans for such borrowers from 36 per cent to 47 per cent.

There was little change in the distribution of term loans by industry. Over the past two decades the largest dollar volume of term credits has consistently been extended to transportation, communication, and other public utilities firms and to petroleum, coal, chemicals, and rubber producers. Taken together, these two groups of firms accounted for slightly more than half of the dollar volume of term loans extended in the Second District in 1957, just as

Table I
Maturities of Business Loans Outstanding at Second District Member Banks October 16, 1957, by Size of Borrower

Asset size of borrower (in thousands of dollars)	Amount of loans (in millions of dollars)				Number of loans (in thousands)				Percentage increase, or decrease (−), 1955-57							
									Amount of loans				Number of loans			
	1 year or less	1 to 5 years	Over 5 years	All maturities	1 year or less	1 to 5 years	Over 5 years	All maturities	1 year or less	1 to 5 years	Over 5 years	All maturities	1 year or less	1 to 5 years	Over 5 years	All maturities
Under 50	139	79	53	271	50.8	41.0	7.6	99.3	−20.5	30.5	13.5	−3.9	−17.1	69.5	17.1	8.1
50–250	605	123	172	901	53.5	20.0	9.9	83.3	− 6.8	48.7	56.4	7.0	− 1.3	105.0	47.7	18.1
250–1,000	856	130	103	1,088	16.7	5.0	2.1	23.8	1.3	40.8	6.9	5.4	3.2	78.9	47.6	16.6
1,000–5,000	1,049	269	169	1,487	5.7	1.5	0.7	7.8	− 6.5	33.8	43.0	3.2	6.5	36.5	105.3	16.3
5,000–25,000	1,223	610	519	2,352	2.5	0.8	0.4	3.7	20.6	58.3	25.7	29.8	33.9	95.9	2.3	38.8
25,000–100,000	1,140	461	895	2,497	1.1	0.3	0.5	1.9	56.9	81.7	33.7	51.3	45.8	77.4	81.2	58.6
100,000 and over	2,737	1,124	1,239	5,099	1.3	0.4	0.6	2.3	75.4	87.1	52.8	71.6	27.3	33.8	−8.8	17.2
Not ascertained	134	190	308	632	5.8	4.9	2.2	13.0	−46.4	49.5	125.0	22.9	−52.5	−74.6	86.2	−60.5
Total—all borrowers	7,883	2,987	3,458	14,328	137.4	73.9	23.9	235.1	24.3	65.6	44.0	35.8	−10.1	27.1	37.6	3.0

Note: Because of rounding, the figures do not necessarily add to the totals shown.

Table II
Term Loans as a Percentage of Dollar Amount of Business Loans at Second District Member Banks, 1955 and 1957, by Size of Borrower and Size of Bank

Asset size of borrower (in thousands of dollars)	Banks with total deposits of (in millions of dollars)								All banks	
	Under 10		10 to 100		100 to 1,000		1,000 and over			
	1955	1957	1955	1957	1955	1957	1955	1957	1955	1957
Under 50	36.2	46.7	37.1	44.2	40.2	44.9	38.8	61.0	38.1	48.8
50–250	35.4	44.6	31.1	37.9	27.5	38.5	8.5	13.4	22.9	32.8
250–1,000	17.9	25.8	28.5	30.4	25.2	30.2	12.3	11.6	18.2	21.4
1,000–5,000	6.7	16.0	17.8	20.8	29.1	34.3	20.3	28.3	22.1	29.4
5,000–25,000	3.2	—	30.2	20.9	37.4	41.2	45.6	49.8	44.1	48.0
25,000–100,000	—	—	12.7	18.8	37.2	29.1	58.6	58.4	56.0	54.3
100,000 and over	49.0	—	18.2	4.4	35.5	32.7	49.3	47.9	47.5	46.3
Not ascertained	40.0	47.3	29.6	54.2	39.0	66.5	54.5	83.8	51.3	78.8
Total—all borrowers	33.6	42.0	29.1	33.9	32.7	35.8	42.5	47.9	39.9	45.0

they had in 1955. Metals and metal products concerns, the third largest category of term borrowers, received 13 per cent of the total dollar volume of term loans made by Second District banks in 1957, slightly more than the 11 per cent they had obtained in 1955.

With respect to the number of term loans, service firms and retail trade accounted for about half of the term loans in 1957, also about the same as in 1955. The only significant change occurred with respect to real estate firms, the third largest category of term borrowers by number of loans; they received 12 per cent of the number of term loans in 1957 as compared with 7 per cent in 1955. However, the dollar volume of their term borrowings constituted only 6 per cent of the total extended by Second District banks in 1957, the same proportion as in 1955. The industries mentioned above as accounting for about half of the dollar volume of term loans in 1955 and 1957, i. e., public utilities and petroleum and related products, together accounted for less than 10 per cent of the number of term loans in both years. Conversely, retail trade and service firms, the largest borrowers with respect to the number of term loans, together held only about 10 per cent of the dollar volume.

ALTERNATIVE SOURCES OF SHORT-TERM FUNDS

The pattern of bank lending between 1955 and 1957 partially reflected the limited access of smaller firms to the securities markets. Larger firms were able to obtain a high proportion of their long-term funds through the securities markets and from insurance companies and other financial intermediaries, while small concerns relied to a greater extent upon the banks. On the other hand, the short-term credit needs of smaller businesses were met to an increasing extent outside the banks, either through the channels of trade (interbusiness) credit or through commercial finance companies and factors.

The interviews conducted by the Federal Reserve System late in 1957 indicate that the volume of trade credit expanded substantially between 1955 and 1957, primarily in the form of increased open book credit. The enlarged flow of trade credit from large to small business between 1955 and 1957 in part reflected competitive pressures which induced large firms to finance their smaller customers sufficiently to prevent a cutback in orders merely because of lack of ready working funds. Trade credit was also used for promotional purposes by many large businesses and as a device to broaden and consolidate their channels of distribution.

Credit extended to small business by commercial finance companies and factors also increased greatly between 1955 and 1957. By and large the customers of commercial finance companies and factors are small concerns that are unable to qualify for bank accommodation. The finance companies and factors have strong bank-borrowing power and in effect they borrow from the banks (or in the open market) and pass the funds on to smaller businesses. They lend primarily on the basis of the accounts receivable of their clients, but have recently expanded rapidly in the area of equipment financing as well. Available statistical data and interviews with commercial finance companies and factors indicate a large expansion in their credit extensions between 1955 and 1957. In light of the rapid growth in short-term lending to small firms through trade credit and from commercial finance companies and factors, it is possible that total short-term borrowings of small business in the Second District may actually have expanded between 1955 and 1957, notwithstanding the decline in such credits received by the smaller concerns from Second District banks.

THE PROBLEM OF LONG-TERM FUNDS

Despite the expansion in term loans extended by banks to small business in recent years, most interview respondents, including bankers as well as others, were of the opinion that the main financial problem for most small firms was difficulty in obtaining long-term rather than short-term funds. Although small firms have acquired a substantial volume of long-term funds, they would have liked an even larger amount, so that there generally has been an unsatisfied margin of demands for longer term loans on the part of small business. For example, the interviews revealed that a large fraction of the loan applications rejected by banks involved the question of long-term funds, in one form or another.

During the course of the interviews the banks were requested to estimate the relative frequency with which various reasons occur for rejecting loan applications from small business. They were asked to consider not only formal rejections of loan applications by a loan officer or a loan committee, but all rejections, including those applications—however informal—that are screened out on first contact. Almost all of the banks interviewed listed inadequate owner's equity in the business as a frequent reason for rejection of loan applications; this was mentioned as a frequent reason for denial of loan requests more often than such factors as questionable management ability or a poor earnings record. "Requested maturity too long" was also mentioned as a frequent or occasional reason for rejection by a large number of banks as a matter of general bank policy, indicating the reluctance many banks still feel regarding extending term loans.

The reluctance to extend loans of "too long" a maturity to a small firm and the downgrading of its credit-worthiness because of inadequate owner's equity are often two aspects of the same problem. A firm in which the owner has insufficient equity would be likely to need long-term credit, but a bank would feel most reluctant to extend long-term funds to just such a business. While banks today are more willing to extend long-term funds than they were two decades ago, they still have no desire to "go into partnership" with their customers; in general, a firm can obtain long-term funds only if it already has an adequate equity base.

The greatest share of equity capital for small business probably comes initially from the savings of the individual entrepreneur and his relatives and friends. Retained earnings can then be used as they accrue, but, if opportunities for growth are to be fully exploited, it will often be necessary to raise more funds than can be acquired in these ways. At this stage of a concern's development—after it has exhausted its ready access to equity capital but before it has grown large enough to hope to tap the public securities markets—it is often necessary for the owner to seek external equity funds from outside sources. Most such external equity capital for small business comes from individual investors or small informal groups of investors. A few closed-end investment companies also buy into promising concerns from time to time, and some specialized venture-capital firms are continuously in search of opportunities. Nevertheless, wealthy individuals are the principal source of negotiated venture-capital investment.

A number of such investors, including closed-end investment companies and specialized venture-capital firms, were interviewed in the Second District as part of the nation-wide survey of lenders and other suppliers of funds to small business. Almost all respondents reported that most applicants for equity funds could not pass the initial screening process; most stated that about 90 out of 100 firms seeking equity capital are rejected after a first exploratory interview. Eight or nine of the remaining ten are likely to be turned down at some later stage in the screening process, with only 1 or 2 per cent considered as worthwhile investment risks. When they came across such a promising growth situation, equity investors reported that they often found many others competing with them to supply the funds, In their view, the shortage seemed to be of good investment opportunities rather than of funds.

The two most important reasons for rejection were given as inadequate management and lack of satisfactory growth potential. The latter is particularly important to prospective equity investors because of the illiquidity of their investment until the firm either grows large enough to have its securities publicly traded or is sold to, or merged with, a larger company. Most investors do no wish to remain "locked in" for longer than about three to five years, although a few stated that they were occasionally willing to wait as long as eight or ten years before realizing their gains.

In view of the high degree of risk involved, most interviewees reported that they sought a 15 to 20 per cent annual appreciation on an investment. However, few seemed to have achieved these results on an over-all basis in recent years, despite the fact that extensive screening presumably removed all but the best prospects. Loss experience and expenses of screening and supervision offset a substantial portion of the gains from successful ventures, so that average returns turned out to be surprisingly modest. As a result, a number of investors have abandoned investing in smaller businesses, where the loss record seems to have been highest, and have turned to investment in larger concerns.

The interviews with equity capital investors touched only the surface of the field, and further inquiry is undoubtedly necessary before any firm conclusions are drawn. But the evidence gathered thus far tends to suggest that the amount of outside capital going into venture investment in small businesses may well be close to all that can be warranted on purely economic grounds, as measured by the test of relative net earnings. On the other hand, the rather high rate of return expected by most equity capital investors before a project is considered a worthwhile venture would automatically exclude most conventional trade and service firms because of lack of satisfactory growth potential. Similarly, the general desire of investors to realize on an investment within three to five years might effectively prevent many promising small manufacturing concerns from acquiring equity funds. With the ever-increasing complexity of technology, and under existing conditions of production and marketing, this may be too brief a period in which to expect a small enterprise to mature.

Mutual Savings Banks in the Capital Markets

Savings deposits held at mutual savings banks doubled between 1945 and 1957. Nevertheless, the long-run decline in their share of total institutional savings[1] continued during this period. Because of the concentration of their investment activity on residential mortgages, savings banks have, however, played an important role in the postwar residential mortgage market and particularly in the market for Veterans Administration-guaranteed mortgages. At the end of 1957 they held about one sixth of all residential mortgages and one fourth of all VA mortgages outstanding.

MUTUAL SAVINGS BANKS IN HISTORICAL PERSPECTIVE

Mutual savings banks were first organized early in the nineteenth century as a public-spirited attempt to provide people of limited resources, particularly wage earners, with a practical means of accumulating savings in small amounts. The savings banks emphasized safety of principal, the relative ease of withdrawing deposits, and the principle of mutuality, under which all earnings not needed to cover expenses and additions to reserves were distributed to depositors. During the nineteenth century the savings banks strongly entrenched themselves in the northeastern part of the country and became the most important single type of savings intermediary. In 1880, for example, savings banks accounted for about three fifths of total institutional savings. In the northeastern part of the country, and particularly in New York, Massachusetts, and Connecticut, this ratio was substantially higher.[2]

[1] Institutional savings is defined as the sum of time and savings deposits with commercial and mutual savings banks, shares in savings and loan associations, and reserves of life insurance companies.

[2] J. Lintner, *Mutual Savings Banks in the Savings and Mortgage Markets,* Boston, Harvard University, 1948, pp. 463-70.

Since the turn of the century, however, the relative importance of mutual savings banks as savings intermediaries has been declining with few interruptions. Among the more significant factors underlying this decline has been the emergence and growth of alternative types of savings outlets, including life insurance, savings and loan shares, and time deposits in commercial banks as well as (in more recent years) pension funds and Savings bonds. Moreover, the savings banks never secured a firm foothold outside the New England and Middle Atlantic States, and since the 1920's these States have been growing more slowly than the rest of the country. The more rapid long-run growth of savings in commercial banks and savings and loan associations partly reflects their better representation in the faster growing sections of the country, although they have also made inroads in the States in which the savings banks are concentrated. Moreover, the outstanding safety record of the savings banks has become less important as a competitive influence with the introduction of deposit insurance under the Federal Deposit Insurance Corporation and share insurance under the Federal Savings and Loan Insurance Corporation.

POSTWAR INVESTMENT EXPERIENCE

Mortgages have constituted the principal investment outlet of savings banks during the postwar period. Whereas mortgages comprised only one fourth of total savings bank assets in 1945—partly reflecting the scarcity of these securities during the war years—by 1957 this proportion had increased to a historical high of three fifths (Table I). The great bulk of the mortgages acquired during this period was secured by residential properties. The relative

Table I
Assets of Mutual Savings Banks, End of 1945 and 1957

Asset	Amount (in billions of dollars)		Per cent	
	1945	1957	1945	1957
Total assets	**17.0**	**35.1**	**100**	**100**
U. S. Government obligations	10.7	7.6	63	22
Mortgages	4.2	20.9	25	60
Residential	3.4	18.8	20	53
Veterans Administration	*	7.7	*	22
Corporate securities	1.2	4.3	7	12
State and municipal obligations	0.1	0.7	1	2
Cash	0.6	0.9	4	3
Other assets	0.3	0.7	2	2

Note: Mortgage loans and total assets are net of valuation reserves. Because of rounding, the figures do not necessarily add to the totals shown.

* Less than $50 million or 0.5 per cent.

Sources: Federal Deposit Insurance Corporation; National Association of Mutual Savings Banks; Board of Governors of the Federal Reserve System; S. B. Klaman, *The Volume of Mortgage Debt in the Postwar Decade*, National Bureau of Economic Research, Technical Paper No. 13, 1958.

importance of corporate securities in mutual savings bank portfolios also increased sharply, accounting for about 12 per cent of total assets in 1957 as compared with 7 per cent in 1945. The relative importance of United States Government securities, on the other hand, fell from about three fifths of total assets in 1945 to one fifth in 1957.

This replacement of Government securities with private securities in the investment portfolios of the savings banks paralleled the experience of the other major types of lending institutions. In the case of the mutual savings banks, however, the process of readjustment was less marked in the early postwar period and sharper in later years than was the case with most other institutions.

Considerable light may be thrown on the postwar investment experience of the savings banks by comparing their sources and uses of funds during each of three four-year periods with those of savings and loan associations (Table II).[3]

During the years 1946-49, net acquisitions of mortgages and other private securities by the savings banks fell short of their net inflow of funds and the balance was placed in Government securities. By contrast, all of the other major types of financial institutions liquidated Government securities during this period (the volume of such securities held by the public declined by about $34 billion). The savings and loan associations, for example, liquidated about $1 billion of United States Government securities, their net mortgage acquisitions exceeding their net inflow of savings capital by about the same amount. As a result, the ratio of cash plus Government securities to withdrawable liabilities fell moderately, from 73 per cent to 64 per cent, in the case of savings banks; in the case of the associations the decline was from 39 per cent to 19 per cent.

Underlying the divergent experience of the two types of institutions during this period was the generally strong competition for mortgages and other high-grade investments—reflecting mainly the ample liquidity of lending institutions—and the fact that the savings banks were at a marked disadvantage in this competition. The demand for mortgage credit was heavily concentrated in the relatively fast-growing South and West, while for the most part the savings banks did not have legal authorization to acquire mortgages in these regions. They did increase substantially their holdings of corporate securities (their holdings roughly doubled over the 1946-49 period), but the supply of these securities eligible for savings bank investment was limited.

During the succeeding 1950-53 period, however, net mortgage acquisitions by the savings banks exeeded their net inflow of deposits and were more than double their acquisitions in the preceding period, while a substantial volume of corporate securities also was acquired. To finance these acquisitions the savings banks liquidated $2.2 billion of Government securities. The savings and loan associations, on the other hand, increased their holdings of Governments by a moderate amount. The ratio of cash plus Government securities to withdrawable liabilities declined from 64 per cent to 42 per cent for the savings banks, compared with a drop from 19 per cent to 15 per cent for the associations.

This turnabout reflected a number of interrelated factors. Perhaps the most important development was the authorization given to savings banks in New York State and Massachusetts, which became effective in 1950 and 1951, to make Federal Housing Administration and VA loans on a nation-wide basis.[4] Moreover, following the March 1951 "accord" between the Federal Reserve System and the Treasury, yields on competing securities rose materially. Federally underwritten mortgages (particularly VA mortgages) thus became less attractive to commercial banks and life insurance companies and the competition for them subsided somewhat. Furthermore, since the savings banks had reduced their holdings of Government securities by only a small amount during the earlier postwar years, they were in a better position to make further reductions during this period. The savings and loan associations, on the other hand, were not in a position to make so large a reduction in their holdings of liquid assets as in the previous period because these holdings already had been substantially reduced.

[3] A further discussion of savings and loan associations will be found in "Savings and Loan Associations in the Mortgage Market", this *Review*, July 1956.

[4] Savings banks in New York State and Massachusetts account for about three fourths of savings deposits in all mutual savings banks.

The bulk of the net mortgage acquisitions of the savings banks during this period consisted of Federally underwritten (particularly VA) mortgages, which were used extensively in the faster growing regions. Mutual savings bank holdings of VA mortgages increased from 1.1 billion dollars at the end of 1949 to 3.1 billion dollars at the end of 1953, at which time these holdings comprised almost one fifth of the total outstanding.

The tendencies that developed during the 1950-53 period continued during the following four years. As in the previous period, the savings banks liquidated Government securities to make room for mortgages (and corporate securities); the associations, however, added to their holdings of Governments. The ratio of cash plus Government securities to withdrawable liabilities fell sharply, from 42 per cent to 27 per cent for the savings banks; in the case of the associations, the decline in this ratio was much smaller.

The savings banks continued to concentrate on VA mortgages during the 1954-57 period. Holdings of VA mortgages by all savings banks increased by $4.7 billion to $7.7 billion on December 31, 1957, the first figure comprising about a third of the total increase in VA loans. About one third of the $7.7 billion total was secured by properties located in States in which there are no mutual savings banks.

Table II
Sources and Uses of Funds of Mutual Savings Banks and Savings and Loan Associations, Selected Periods, 1946-57
(Amounts in billions of dollars)

Source or use	1946–49		1950–53		1954–57	
	Mutual savings banks	Savings and loan associations	Mutual savings banks	Savings and loan associations	Mutual savings banks	Savings and loan associations
Sources of funds—total	**4.5**	**6.9**	**7.9**	**12.0**	**9.6**	**21.6**
Net inflow of deposits or savings capital	3.9	5.1	5.1	10.3	7.3	19.2
Capital accounts*	0.5	0.5	0.4	0.8	0.5	1.5
Liquidation of U. S. Government obligations	—	1.0	2.2	—	1.6	—
Increase in indebtedness	—	0.2	—	0.5	—	0.4
Other	†	0.2	0.1	0.4	0.2	0.6
Uses of funds—total	**4.5**	**6.9**	**7.9**	**12.0**	**9.6**	**21.6**
Increase in mortgages‡	2.3	6.2	6.3	10.3	8.2	18.2
Increase in U. S. Government obligations	0.8	—	—	0.5	—	1.2
Increase in corporate securities	1.1	—	1.0	—	1.0	—
Increase in State and local Government securities	†	—	0.3	—	0.3	—
Increase in cash	0.3	0.4	0.1	0.6	− 0.1	0.6
Increase in other assets	0.1	0.2	0.2	0.7	0.2	1.6
Memorandum						
Ratio, cash and U. S. Government obligations to deposits or savings capital (end of period)	63.8	18.8	41.7	15.0	26.7	12.6

Note: Because of rounding, the figures do not necessarily add to the totals shown.
* Includes capital stock, surplus, undivided profits, and reserves.
† Less than $50 million.
‡ Adjusted for mortgage-pledged shares in the case of the savings and loan associations; net of valuation reserves in the case of the mutual savings banks.
Sources: Federal Deposit Insurance Corporation; National Association of Mutual Savings Banks; Federal Home Loan Bank Board.

RECENT DEVELOPMENTS

The sources and uses data shown in Table II are helpful in showing broader tendencies, but the use of four-year periods inevitably has the effect of obscuring shorter run developments. During 1957, for example, the portfolio changes of the mutual savings banks diverged markedly from the changes during the three immediately preceding years. For one thing, their net deposit inflow was somewhat lower than during 1954-56, reflecting the greater competition for savings by commercial banks following the increase in the maximum interest rate that could be paid by banks on time deposits at the beginning of 1957.

On the investment side there was a sharp rise in net acquisitions of corporate securities during 1957 and a corresponding decline in the annual addition to mortgage loans. Of the $1 billion of corporate securities that savings banks added to their holdings during the entire 1954-57 period, about $800 million was acquired last year. This was a record increase for a single year. Net mortgage acquisitions, on the other hand, fell to $1.4 billion last year as compared with an average of $2.3 billion in the three preceding years. Underlying this development was the sharp increase in the supply of corporate bonds and the marked rise in yields obtainable on these securities at the same time that the maximum allowable interest rate on VA mortgages was held unchanged at 4½ per cent.[5]

During the first quarter of 1958 the expansion of corporate security holdings continued unabated. Net acquisitions of these securities amounted to about $300 million, compared with about $200 million in the first quarter of last year, while net mortgage acquisitions were little changed from last year and well below the first-quarter figures for 1955 and 1956. At the same time, savings banks are again actively seeking to expand their mortgage acquisitions. Savings deposits have risen markedly this year. Furthermore, corporate bond yields have fallen sharply since their 1957 highs (yields on newly offered Aaa-rated corporate bonds declined by about 1 percentage point between September 1957 and May 1958), while in April the maximum allowable interest rate on VA mortgages was raised to 4¾ per cent. Preliminary data for April and May indicate that these developments already have resulted in a larger volume of mortgage acquisitions; further increases are likely if residential construction, which in recent months has shown signs of improving under the stimulus of easier credit terms and greater availability of mortgage credit, continues to advance.

[5] The relative unattractiveness of the 4½ per cent rate was only partly offset by the practice of "discounting" these mortgages.