Monthly Review

TWELFTH FEDERAL RESERVE DISTRICT

FEDERAL RESERVE BANK OF SAN FRANCISCO

August 1956

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REVIEW OF BUSINESS CONDITIONS

Preliminary employment data suggest some leveling off in business activity in the Twelfth District during July. Nonagricultural employment, after accounting for seasonal variations, remained stable at the high June rate. On the other hand, insured unemployment (seasonally adjusted) rose significantly above the June rate. These July developments are in contrast to those during the first half of 1956; employment increased and unemployment declined during each of the first six months.

It appears that a high level of retail trade was a major factor contributing to strength in the District economy. Preliminary data (seasonally adjusted) indicate a rise in District department store sales in July. Despite declines in automobile sales, total retail trade in June was above June 1955. Although separate District figures are not available, sales data for the eleven western states as a whole, of which District sales account for about 85 percent, indicate that total retail sales during the first six months of 1956 were at a level significantly higher than during the same period last year.

Total construction activity in the District, as suggested by dollar value of building permits issued, was somewhat higher in July than in the same month a year ago. This result reflects large demands for nonresidential building, which more than offset a drop in residential building. Preliminary estimates indicate that total building activity in the District for the first half of this year was significantly above the corresponding year-ago figure.

Demands for bank credit in the District also reflect this high level of business activity. Data from weekly reporting member banks show an increase in business and real estate loans during both June and July, but the dollar increase in total loans was less than in June. Member banks sold securities in June and July to meet this demand for loans and to repay, in part, borrowings from the Federal Reserve Bank. Whereas member banks in the District had net borrowed reserves in June (that is, borrowings from the Federal Reserve Bank exceeded excess reserves), they had free reserves (excess reserves larger than borrowings) in the first half of July 1956 which were greater than those of the same period in 1955.

Retail sales continue at record but stable rate

Total retail trade, despite declines in automobile sales, continued to be a major source of strength in the economy. Nationally, a preliminary estimate indicates no change in retail sales from June to July. Sales in June, after adjustment for seasonal variation, were at the record rate set in May. Department store sales in July, however, exceeded the June peak. Reduced sales by automobile dealers continued in July, as in the previous six months of the year, to be offset by increased sales by other types of durable goods outlets. According to the advance estimate, food and apparel outlets, after accounting for seasonal differences, experienced declines in July. In June, seasonally adjusted sales at nondurable goods stores in the nation were at a record pace, with all kinds of nondurable goods outlets sharing in the high level of sales. For the first half of 1956, total retail sales were 4 percent above the corresponding half of 1955.

Available data suggest much the same pattern of trade in the District during July. A preliminary estimate shows a significant rise in District department store sales (seasonally adjusted) in July, which was also the case for department store sales nationally. Sales at District department stores in June were about 3 percent above the same month of 1955. This June rise was largely accounted for by similar percent increases in Arizona, California, and the Pacific Northwest. New passenger car registrations in California during July dropped about 24 percent below the July 1955 figure. Except for January, California automobile registrations during each of the first seven months of this year have been substantially below the corresponding monthly figures for 1955.

Department of Commerce estimates of retail trade in the eleven western states suggest that retail sales were stronger in the District than in the nation during the first half of the year. During June, large retail outlets in the West rang up

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sales which were about 5 percent above June a year ago, compared with a slightly smaller figure for the country as a whole. Most of the regional strength was accounted for by substantial increases in food and apparel sales. Furniture store sales in June were somewhat below a year ago. For the first six months of 1956 total sales by large stores in the West were somewhat more than 6 percent above the same period a year ago, compared with a somewhat less than 5 percent increase in the country as a whole. As in the nation, declines in automobile sales during the first six months in the West seem to have been offset, to some degree at least, by increases in sales of other durable goods.

Nonresidential building activity continues strong in the District

A preliminary estimate of the value of total building permits issued suggests a significant increase in construction activity in the District during July compared with the same month a year ago. The rise in nonresidential construction more than offset a large decline in residential building activity. Building developments in California followed the same pattern. For the first six months of 1956 the dollar value of total building permits issued was significantly above a year ago. On the other hand, residential building activity during the first half of 1956 was substantially below the same period of 1955.

Further evidence of strength in industrial construction in this region is indicated by scattered local reports. The value of industrial construction and expansion in Los Angeles County in June was much larger than in June of last year. The dollar volume of new plant and expansion building in Los Angeles County during the first half of this year was more than double the amount announced for the corresponding period in 1955 and was the largest recorded for any half-year period. Construction activity in earthworks and waterways seems to be a leading factor in announced plans for industrial construction in the West.

Weakness in the regional demand for residential construction is reflected by declines in requests for appraisals for Government-guaranteed loans from offices in this District. Requests for FHA appraisals showed a sharp decline from May to June and were well below June 1955. Requests for VA appraisals were also down substantially from May to June and were about 60 percent below June a year ago.

District nonagricultural employment stable at high June rate

A preliminary estimate shows that nonagricultural employment (seasonally adjusted) in the District during July remained near the high June rate. At the same time, insured unemployment in the region also increased 3½ percent. Nonfarm employment leveled off in California but slipped in Washington by one-half of one percent. Total unemployment in California rose nearly 2 percent in July, while in Washington it declined by more than 7 percent.

After adjusting for seasonal factors, total civilian employment showed a slightly less than one percent increase, while total unemployment rose by somewhat less than 2 percent in the Pacific Coast states from May to June. Insured unemployment in the District (seasonally adjusted) declined 6 percent in June, compared with a 5 percent decline in May. These aggregate movements were the result of an increase in total employment and no change in unemployment in California; an increase in employment and a decrease in unemployment in Oregon; and no change in employment and a significant increase in unemployment in Washington. California employment showed an upward trend during each of the first six months of 1956, whereas employment in the Pacific Northwest tended, in general, to move downward during the winter months and to recover in the spring months.

Total nonagricultural employment, after accounting for seasonal variability, rose about one percent in the District during June. This increase reflected small rises in all District states except Washington, which showed a decline, and Idaho, where employment continued at the May rate. This June increase is a continuation of the upward trend in District nonagricultural employment which has manifested itself during each of the first six months of the year.

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Total manufacturing employment, after seasonal adjustment, showed a slight increase in this region in June, reflecting increases in California, Oregon, and the Intermountain states, coupled with a decline in Washington. For the District as a whole, total manufacturing employment also showed a slow but upward trend during each of the first six months of 1956.

The Washington picture is brightened somewhat by expected increases in manufacturing employment in the Seattle area, which accounts for about two-fifths of the state total. Besides the usual seasonal increases in such fields as food processing and lumbering, continued expansion in aircraft and fabricated metals is also expected to contribute to a tightening of the labor market in the Seattle area during the third quarter. The United States Department of Labor now classifies Seattle as an area where job opportunities for local workers are slightly in excess of job seekers.

California employment in automobile assembly operations has generally followed the national picture. Continued declines in employment reflect both the previously noted decrease in sales and the usual seasonal slowdown for the changeover to new models. Reduction in employment due to 1957 model changeovers is expected to last from July into September, with full scale production of new models getting underway in late September or October. Paring of automobile dealer inventories since the early spring peak will probably be an important factor in strengthening production of new model cars. Seasonally adjusted figures for the nation show a $90 million decrease in automotive inventories in June, a decrease somewhat greater than that in May but smaller than the April decline.

With the thirty-five-day strike in the steel industry over, steel mills in the nation are pushing to restore full operations. The industry estimates that it will require several weeks yet to fill delivery pipe lines, especially for structural and reinforcing steel. For the week beginning August 13, steel producers in the nation were estimated to be operating at about 86 percent of capacity, compared with 58 percent in the previous week. Preliminary figures for the month preceding the steel strike indicate a small decline in steel ingot production in the Twelfth District during June. This decline followed a small dropping off of production in May. These small declines in May and June reflect problems in production scheduling at near-capacity outputs rather than any market weaknesses.

District nonagricultural employment in other than manufacturing industries also showed stability at high levels during June. Construction employment, reflecting the over-all strength in building activity, increased nearly one percent in June, although Washington and Nevada had declines. During the first half of 1956, construction employment in the District showed continued month-to-month increases. District employment in trade, services, government, and mining activities was, after seasonal adjustment, at about the same rate as in May. Except for some minor "ripples" in service, government, and mining industries, all kinds of nonagricultural employment shared in the continued slow upward trend in monthly total employment during the first half of 1956.

Demand for loans continues strong in District

Bank credit developments in the District during July continued to show strong demands for funds by the private—particularly the business—sector of the economy. In general, member banks in the District reduced their holdings of United States Government and other securities in order to meet demands for loans, add to their excess reserves, and reduce their borrowings from the Federal Reserve Bank. Total loans from weekly reporting member banks in this District increased $48 million from June 27 to August 1. However, this dollar increase in July was substantially below the previous four-week June increase and the year-ago four-week July increase. The July 1956 increase in loans was largely due to rises in commercial and industrial loans and in real estate loans. In contrast, commercial and industrial loans declined during July 1955 when nearly all of the total increase was accounted for by rises in real estate and consumer loans.

Loans by reporting member banks to manufacturing and mining industries increased by more than $62 million from July 3 to August 1,

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nearly three times the increase during July a year ago. Loans to lumber and forest products industries showed the biggest increase. Wholesale traders decreased their indebtedness to member banks in July compared with a small increase in July 1955. The reduced demand for automobile credit in the currently depressed regional market was reflected, in part, by the fact that sales finance companies decreased their debt to District reporting member banks by about $228 million from July 3 to August 1, compared with a $5.3 million decline in their indebtedness a year ago.

The high level of building activity led to increases in real estate loans. Real estate loans from reporting member banks increased $41 million from July 3 to August 1, somewhat above the dollar increase during the four-week period of July a year ago. Judging from the category "other" loans in the reporting series, banks decreased their holdings of consumer loans compared with a sizable rise in July 1955.

To help finance the increase in loans, reporting member banks reduced their holdings of both government obligations ($116 million) and other securities ($52 million) from July 3 to August 1. In contrast, reporting member banks increased their total holdings of both United States Government and other securities substantially during July of last year. The past July reduction in United States Government obligations represented sales of long- and intermediate-term as well as short-term securities. Sales of securities by member banks were also higher in July than in June.

Member banks in the District apparently also used funds from the sale of securities to reduce the amount of borrowings from this bank and add to their excess reserves during the first half of July. Average daily excess reserves were $45 million and borrowings were $19 million in the first half of July. This compares with $18 million in excess reserves and $34 million in borrowings during the second half of June and $35 million in excess reserves and $16 millon in borrowings during the first half of July 1955. Thus, through the sale of securities, District member banks strengthened their reserve positions in early July compared to late June and early July a year ago.

Twelfth District Bank Loans to Small Business

SMALL business exemplifies for most people the essence of the enterprise system, and it does in fact play a very important role in the production and distribution of goods and the performance of many services in our economy. According to the 1954 Census of Manufactures, businesses with from one to nineteen employees comprise almost two-thirds of the total number of manufacturing establishments. The predominance of small business is even greater in other fields. For example, according to the 1948 Census of Business, two-thirds of the retail firms employed two persons or less. In the personal, business, and repair services industry, firms with two or fewer paid employees comprised over 80 percent of the total number of such firms.

The success of all types of business, both small and large, is somewhat dependent on the credit available to them. However, some financing methods, such as capital issues, are less practicable for small businesses than for larger firms; and, consequently, credit extended by commercial banks has been an important source of funds to small business. This article will deal with the amount, maturity, and interest rates of loans of Federal Reserve member banks to various types of small business.

The estimates of small business loans are based on the results of a survey of business loans conducted by this bank and the Federal Reserve System on October 5, 1955. The survey and estimates of loans to all businesses are described more fully in the June 1956 issue of this *Review* and the April 1956 *Federal Reserve Bulletin.* For the purposes of this article, small business has been defined as follows: manufacturing and mining firms with total assets under $1 million; wholesale trade firms, total assets under $250,000; retail trade, services, public utilities, construction, real estate and all other industries,

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total assets under $50,000. The 1946 survey of commercial and industrial loans, with which some comparisons will be made, used the same asset size classifications. In that survey, manufacturing and mining concerns with assets under $750,000 were included in the small business category, but all other size groups were the same in both surveys.

Loans to small business by Twelfth District member banks amounted to over $600 million on October 5, 1955. These loans represented only 17.6 percent of the dollar amount outstanding of all commercial and industrial loans at District member banks, but they accounted for over one-half of the number of total business loans. A 14 percent increase in the dollar volume of small business loans in the postwar decade stands in contrast to an over-all growth of 104 percent in total business loans in the District. The number of Twelfth District loans to small businesses declined 4 percent in the same period, while the number of total business loans increased 39 percent. On the other hand, small firms in the nation as a whole increased their borrowings in both number of loans and dollar volume by about 50 percent. As a percentage of the dollar amount of all commercial and industrial loans at Twelfth District member banks, small business loans decreased from 31 percent in 1946 to 18 percent in 1955. A similar, but less sharp, decrease, from 22 percent to 15 percent, occurred in the nation. The number of loans to small businesses decreased in the same period from 76 percent to 53 percent of all commercial and industrial loans at District member banks. Nationally, the number of business loans made to small businesses fell from 76 percent in 1946 to 59 percent in 1955.

In 1946, Twelfth District banks, which possessed only 13 percent of the total assets of all member banks in the nation, held almost one-fifth of all small business loans. In 1955, only 14 percent of the nation's small business loans were held by Twelfth District member banks, while the asset ratio remained unchanged. However, banks in this District extended approximately the same proportion of total member bank credit to business in the United States on the two survey dates. Thus, it would seem that in the West many small businesses were being established in 1946, with a resultant strong demand for funds; and the disproportionately rapid growth in the Twelfth District economy may have increased the average size of firms in the District more rapidly than in the nation. There are other possible explanations for the decline of small business loans. For example, it appears that small borrowers may be relying less on bank credit for expansion and more on retained earnings and trade credit. There may also be fewer firms in the small business category because of a general increase in the price level, with a consequent rise in asset values. Furthermore, the rate of new business formation, at a very high level in 1946, had declined by the survey date in 1955.

In the District the average size of small business loans increased from $5,675 in 1946 to $6,743 in 1955. Much of this increase can probably be traced to an increase in the price level. The average size loan to all businesses also increased from $13,786 in 1946 to $20,219 in 1955. In the nation as a whole, the average size of loan extended to small business was $5,904 in 1955, compared with $5,615 in 1946.

TABLE 1

LOANS TO SMALL BUSINESS BY BUSINESS OF BORROWER 1946 AND 1955

(in thousands)

	1946		1955	
	Number of loans	Dollar amount of loans	Number of loans	Dollar amount of loans
All businesses	94.7	537,420	90.7	611,659
Manufacturing and mining:	20.3	238,200	29.3	369,011
Food, liquor, and tobacco	3.8	91,650	5.0	88,433
Textiles, apparel, and leather	1.4	13,670	2.0	23,293
Metals and metal products	5.1	42,530	8.5	98,558
Petroleum, coal, chemicals	0.6	7,730	1.5	32,001
Other manufacturing and mining	9.5	82,620	12.3	126,727
Trade:	48.7	227,050	28.0	131,467
Wholesale (including commodity dealers*)	14.1	147,310	9.1	79,234
Retail	34.6	79,740	18.9	52,232
Other:	25.7	72,170	33.4	111,182
Sales finance companies	[1]	490	0.1	1,091
Transportation, etc.	5.2	14,320	2.7	6,799
Construction	6.1	22,700	4.4	12,077
Services	11.1	23,730	17.5	69,511
Other**	3.3	10,930	8.6	21,704

*Loans to commodity dealers on October 5, 1955—191 loans, $460,660.

**Includes loans to real estate firms on October 5, 1955—2,690 loans, $8,825,240.

[1] Less than 0.05.

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Shifts in loan shares by business of borrower

As shown in Table 1, shifts occurred among the major groups of small business firms (manufacturing and mining, trade, and other) in the Twelfth District in the shares of loan totals, both in dollar amount and in number of loans. Manufacturing and mining concerns increased their dollar share of small business loans from 44 percent in 1946 to 60 percent in 1955 and at the same time decreased their share of the number of loans from 51 percent to 32 percent. In the nation as a whole, small manufacturing and mining firms increased their shares in both dollar amount and number of loans. These small firms differed from all businesses in this category in that the latter decreased both their dollar and number share of all loans to business in the District as well as in the nation. About one-third of the amount outstanding at Twelfth District member banks and 93 percent of the total number of loans to all firms engaged in manufacturing and mining was extended to those firms with total assets under $1 million. The average size of loans to small business borrowers in the manufacturing and mining group was higher than the average size loan to all small business, probably reflecting the larger size and larger capital needs of these firms. Within the manufacturing and mining group, the largest single segment of small business borrowers at Twelfth District member banks on October 5, 1955 was that classified as "all other manufacturing and mining" (lumber, furniture, paper, printing and publishing, and stone, clay, and glass manufacturers). Credit extended to this group was one-fifth of the dollar volume and 14 percent of the number of loans to all small business borrowers.

In both the District and the nation, small retail and wholesale trade firms decreased their share of total dollar volume and number of small business loans during the past decade. Wholesale and retail firms also decreased their borrowings in this District in absolute terms. A part of this decrease may be accounted for by the difference in the dates of the two surveys—late November 1946 and early October 1955. Trade firms' borrowings usually exceed repayments in the period from October through November.

"Other" small businesses increased their share of total small business loans both in dollar amount and in number of loans in the District and the nation. More than one-half of the loans in this category in the District were made to service firms. Loans to small service firms increased from 4.4 percent of the amount outstanding to all small businesses in 1946 to 11.4 percent in 1955. The share of the number of loans to these borrowers almost doubled—from 11.7 percent to 19.2 percent — in the same period. The growth in loans to service firms was probably a direct effect of the increased disposable income in the postwar period. It is also likely that service firms are those which find it most difficult to grow in size and thus, despite the rapid growth in the District, have not moved into larger size groups to the extent that other types of firms may have during the same period. The nature of their business involves personal contact with the consumer and thus obviates the extensive use of machinery and other capital goods. It is this latter kind of investment which contributes much to the shifting of firms from one size group to another.

TABLE 2
INTEREST RATES TO SMALL BUSINESS BY BUSINESS OF BORROWER
(percent per annum)

	All loans	Short term	Long term
All business	5.91	5.56	6.44
Manufacturing and mining:			
Food, liquor, and tobacco	5.36	5.21	5.65
Textiles, apparel, and leather	5.97	5.98	5.89
Metals and metal products	5.66	5.38	6.40
Petroleum, coal, chemicals	5.05	5.06	5.04
Other	5.81	5.37	6.44
Trade:			
Wholesale	5.84	5.76	6.17
Retail	6.85	6.13	7.87
Other:			
Commodity dealers	5.91	5.88	6.00
Sales finance companies	5.03	5.06	4.84
Farms, consumer, etc.	8.49	7.06	8.67
Construction	6.93	6.08	8.23
Real estate	5.63	5.56	5.65
Services	7.06	6.26	7.39
All other	6.25	5.71	6.96
BY SIZE OF BANK			
All banks	5.91	5.56	6.44
$1 billion and over	6.16	5.90	6.44
$500 million—$1 billion	6.07	5.48	7.10
$250 million—$500 million	5.44	5.22	5.97
$100 million—$250 million	5.50	5.37	5.77
$ 50 million—$100 million	5.66	5.27	6.47
$ 20 million—$ 50 million	5.78	5.76	5.81
$ 10 million—$ 20 million	6.15	5.56	6.66
$ 2 million—$ 10 million	6.06	5.77	6.38
Less than $2 million	6.60	6.40	6.67

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Small business loans vary by size of bank

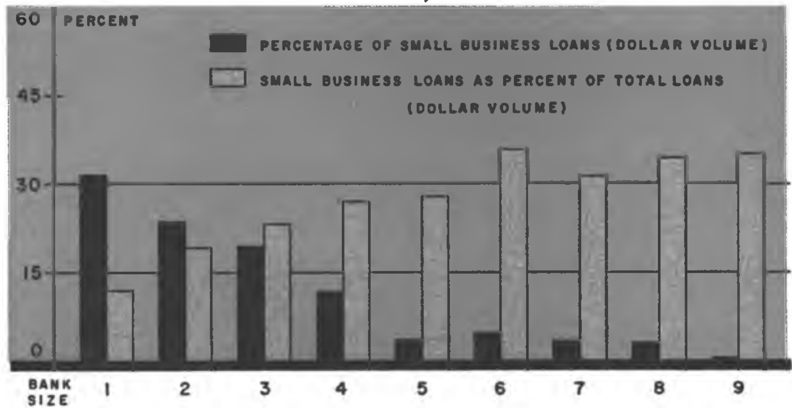
In the Twelfth District on October 5, 1955, almost two-thirds of the loans to small commercial and industrial firms were made by banks with total deposits over $250 million. Generally, small business loans tend to be concentrated, in both dollar amount and number, in the portfolios of the larger banks. (For example, following the black columns in either Charts 1 or 2, a descending line could be drawn showing the variation in proportion of either dollar or number share of each bank size.) On the other hand, at the smaller banks, a larger part of their total dollar holdings of commercial and industrial loans consisted of loans to small business (Chart 1, blue columns). At all size banks the proportion of business loan portfolios represented by the number of loans to small business was an almost constant 50 percent (Chart 2, blue columns). The average size of loan to small business ranged from a high of $10,624 at banks with total deposits of $250-$500 million to $2,617 at banks with less than $2 million deposits. It would be expected that the smaller banks would make smaller individual loans, in part because of their location in the smaller cities. However, the average size of loans at the largest banks, with deposits over $1 billion, was $5,630, less than that at all banks except those with deposits under $20 million. Branch offices, which are included in the size class of the total branch system, probably account for many of the small loans reported in this category.

At Twelfth District member banks with deposits over $2 million, more small business loans were made for less than one year than for a longer term. On the other hand, the smallest banks, those with total deposits under $2 million, held three times the dollar amount in long-term loans that they held in short-term loans.

Chart 1

LOANS OUTSTANDING TO SMALL BUSINESS BY SIZE OF BANK

OCTOBER 5, 1955



Note: Size of bank was determined by total deposits as of October 5, 1955. Branch offices were considered the same size as the system to which they belonged. Bank size groupings by total deposits are as follows: 1) $1 billion and over; 2) $500 million-$1 billion; 3) $250 million-$500 million; 4) $100 million-$250 million; 5) $50 million-$100 million; 6) $20 million-$50 million; 7) $10 million-$20 million; 8) $2 million-$10 million; 9) less than $2 million.

Interest rates depend more on business of borrower than on size of lender

Small businesses paid approximately 1.2 percentage points more for credit extended them (5.91 percent) than did all businesses combined (4.74 percent). Small businesses may be new businesses and therefore present a greater risk to the lending institution. Small firms, it was found in the 1946 survey, also had more loans secured than unsecured. The need for security probably evidences greater risk and in that survey these secured loans were made at higher interest rates than unsecured loans. Also, the servicing costs to the bank of a loan remain fairly constant regardless of the size of the loan. Therefore, the charge to the borrower included in the interest rate is larger in proportion to his interest in the case of the smaller loan than for larger loans.[1] In addition, of course, the smaller businesses do not have the alternatives available to the larger ones—shopping around among the banks of the state or the nation, issuing commercial paper, or entering the capital markets directly.

[1] Data developed in the 1946 commercial and industrial loan survey indicated that the size of loan is one of the most important determinants of interest rates. The relationship for the data in the 1955 survey will be discussed in a subsequent article.

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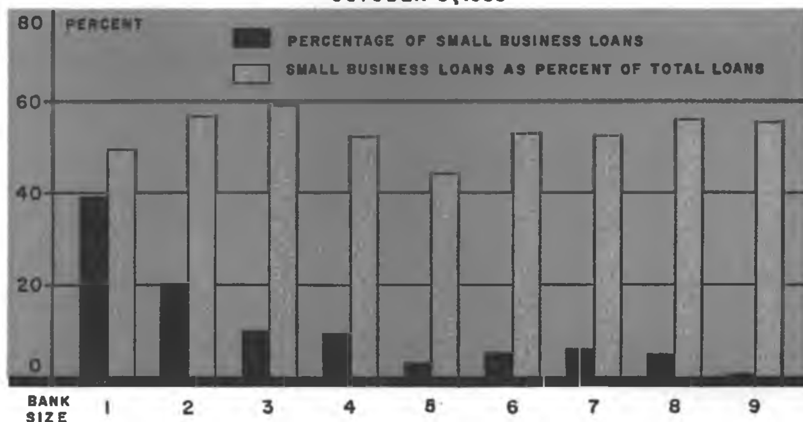
By type of business, small transportation, communication, and public utility firms paid the highest average interest rate (8.49 percent) in the District (Table 2). These loans were made primarily to unincorporated firms for more than one year. The lowest average rate (5.03) was paid by small sales finance companies, whose average size loan was $10,328 and who borrowed almost exclusively for less than one year. Generally, short- or long-term rates to corporate small businesses were lower than those to unincorporated borrowers, possibly because the corporations were somewhat larger than the unincorporated businesses. However, short-term rates to small corporate textile, apparel, and leather firms, and to commodity dealers were higher than long-term rates to these firms. Corporate retail firms with assets under $50,000 paid higher interest charges on long-term loans than did partnerships or sole proprietorships in this field.

CHART 2

NUMBER OF LOANS TO SMALL BUSINESS BY SIZE OF BANK

OCTOBER 5, 1955



Note: Size of bank was determined by total deposits as of October 5, 1955. Branch offices were considered the same size as the system to which they belonged. Bank size groupings by total deposits are as follows: 1) $1 billion and over; 2) $500 million-$1 billion; 3) $250 million-$500 million; 4) $100 million-$250 million; 5) $50 million-$100 million; 6) $20 million-$50 million; 7) $10 million-$20 million; 8) $2 million-$10 million; 9) less than $2 million.

Interest rates paid by small businesses varied less by size of bank than by business of borrower. The highest average interest charged (6.60 percent), by banks with total deposits of less than $2 million, was only 1.6 percentage points greater than the lowest rate, paid to banks of the $250-$500 million size class. In general, small businesses paid higher interest rates for long-term loans at banks of all sizes than they paid for loans with maturities of less than one year. Small corporate firms, however, paid 5.9 percent for short-term loans and 5.6 percent for long-term loans at banks with deposits over $1 billion.

Term loans more important in District than in nation

Term loans (business loans with a maturity of more than one year) were a larger portion of small business loans in the District than in the nation. In the District, term loans constituted about one-third of total loans both for small businesses and for all business borrowers. In the nation as a whole, 28 percent of the loans to small business were term loans, while all borrowers made one-third of their loans on this basis. In some industries, small-business term borrowings were a larger proportion of all loans to small firms than were term borrowings of all sizes of businesses. For example, while all real estate firms borrowed 29 percent of their total loans for more than one year, small companies of this type made 75 percent of their loan agreements on this term basis. The food, liquor, and tobacco and the retail trade industries also showed a large difference in small-business term borrowings as compared with their counterparts of all sizes.

Summary

It would appear that since 1946 small business debt has increased in dollar volume but decreased in both number of loans and its share of the total of the business loan portfolios of Twelfth District member banks. Of the dollar volume, the share of the manufacturing and mining and the "other" sector of commercial and industrial firms has increased, while trade firms

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have decreased their indebtedness to member banks. The larger the lending bank, the greater its share of dollar volume and number of all bank loans to small business, but the smaller proportion these loans were of the banks' total business loan portfolios. The interest paid on loans to small business seemed more dependent on the business of the borrower than on the size of the lending institution, the form of business organization, or maturity of the loan.

The International Finance Corporation

WITH the completion on July 20 of this year of final action by France and the Federal Republic of Germany for membership, the way was paved for the inauguration of the International Finance Corporation (IFC). With the addition of these two nations, a total of 31 nations[1], including the United States, had acceded to the organization. As a result, the condition specified in the Articles of Agreement of the Corporation, that at least 30 nations accounting for a minimum of $75 million of the total authorized capital of $100 million must join the organization before it could come into existence, had been fulfilled. The IFC, an affiliate of the International Bank for Reconstruction and Development (World Bank), was formally organized by July 26. Each member was required to pay in full by August 23, 1956 for its subscribed share of capital stock, in either gold or dollars; the United States share is $35.2 million.

The International Finance Corporation is the first international organization authorized to make investments without governmental guaranties for repayment and in any form it considers appropriate, with the single exception of an investment in capital stock. The World Bank is empowered to make long-term loans abroad but requires a guaranty from the government of the borrower. The United States Export-Import Bank, a Government corporation, also extends long-term loans abroad, but in many cases it may require a governmental guaranty. Neither institution, moreover, is permitted to provide venture capital. As a consequence, a need has been felt for an institution with broader lending powers and, even more important, one which might act as a stimulant to private investment from foreign and domestic sources for the development of certain types of industries, especially in the underdeveloped countries.

[1] The members are Australia, Bolivia, Canada, Ceylon, Colombia, Costa Rica, Denmark, Dominican Republic, Ecuador, Egypt, El Salvador, Ethiopia, Finland, France, Germany, Guatemala, Haiti, Honduras, Iceland, India, Japan, Jordan, Mexico, Nicaragua, Norway, Pakistan, Panama, Peru, Sweden, the United Kingdom, and the United States.

The omission from the IFC charter of the guaranty requirement is one of the most noteworthy features of that document. The practice of the World Bank, and the Export-Import Bank in some instances, of requiring a guaranty has produced complaints from potential borrowers. It has worked a hardship on private enterprise in the borrowing countries in some cases. This has been true, for example, in those countries where it has been difficult to separate a Government guaranty from Government ownership or domination. It may also have the effect of diverting resources from private to public enterprises and may result in a distribution of available resources among competing uses other than that which would result from purely economic considerations.

IFC helps bridge investment gap

A postwar development that has contributed to the need for a greater flow of capital to productive private enterprise abroad is the fact that most of the United States postwar private foreign investment, as well as that of other nations, has been concentrated in direct investments, in which investors have a voice in management. In the case of the United States these direct investments have been in manufacturing, mining, smelting, agriculture, and petroleum, whose products can be sold in world markets, preferably for hard currencies. These types of investment promise a quick return because they earn foreign exchange directly and thus reduce the problem of nonconvertibility which has discouraged much of the private foreign investment in recent years. But the economic sectors in the less developd coun-

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tries that need fostering are those which produce for local consumption and do not contribute directly to foreign exchange earnings. Industries of this type, however, may, and often do, save foreign exchange by reducing the need for imports. Public funds have been available for basic facilities but have not been advanced for enterprises manufacturing for domestic markets. While enterprises of this latter variety oftentimes are eligible for loans from the World Bank or the Export-Import Bank in all other respects, they lack sufficient equity investment to qualify. There exists, therefore, a real need for funds for the development of productive capacity in certain fields of capital goods and consumer durables and nondurables manufacture which will provide greater diversification in the underdeveloped countries. In many instances the building up of such capacity is necessary to complement the development of foreign exchange-producing enterprises.

For these reasons, various member governments of the United Nations formulated plans for the International Finance Corporation, whose primary purpose is to help fill the gap in private investment, not solely with its own limited resources but by lending encouragement to private investors, both foreign and domestic.

Organization and operation of the IFC

Membership in the IFC is open only to members of the World Bank. The close relationship of the Bank and the IFC is reinforced by the fact that the President of the World Bank is ex officio the chairman of the Board of the IFC, and those Directors of the Bank who represent at least one member of the IFC serve as the Corporation's Board of Directors. This tie-in between the IFC and the Bank will facilitate the coordination of the policies of the two organizations. The IFC plans to rely rather heavily on the staff and facilities of the Bank in order to cut down administrative expenses and minimize duplication and will reimburse the Bank for its services. Under no circumstances, however, is the Corporation permitted to borrow from the Bank.

The IFC is empowered to make investments in productive private enterprises to supplement private capital in cases where such capital is not available in sufficient volume on reasonable terms. Although securities purchased may carry the right to participate in profits, they cannot include voting or management rights. In addition, the IFC will act as a clearing house for the exchange of information on the investment climate, conditions, and opportunities. The Corporation will also direct its efforts towards the improvement of conditions for private investment in member countries.

The Articles of Agreement of the IFC set forth the terms under which the Corporation is authorized to make investments in the territories of its member countries. These investments may take any form deemed appropriate by the Corporation—with the important stipulation that the IFC should not invest in capital stock, either preferred or common. Other than this restriction, the Corporation can arrange whatever terms it wishes for its participation in the profits of the enterprise, without any responsibility for management or any voting rights. Since the authors of the IFC charter contemplated the eventual sale of these securities to private investors, the investments may carry a provision for conversion into capital stock if it would facilitate their sale. The profit-sharing arrangements of IFC, and IFC-induced, investments have the added advantage of imposing a smaller burden on the debtor nation's balance of payments than a fixed-interest investment that necessitates annual payments. In the latter case, a transfer problem may arise each year when the fixed payments are due, while remittance of profits can be postponed if foreign exchange reserves are low. For the individual enterprise, the ability to service the debt out of profits rather than to meet a rigid schedule of payments would provide clear advantages, particularly during the formative period.

The IFC can finance its operations from two sources: the capital subscriptions of the members and the sale of its own obligations to the public, which is permitted under Section 6, Article III of the charter. In addition, the Corporation anticipates that it will sell its investments to private investors when the enterprise concerned has achieved a stable and profitable earnings record. In this manner, funds will be released for additional investments elsewhere. Initially, the IFC

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does not plan to issue its own obligations but will rely on the paid-in capital funds of its members. The capital contributions now available from the 31 members total $78.4 million.

In addition to the provision that no government guaranty is required for IFC investments, no restrictions are placed on the expenditure of the proceeds of the Corporation's investments. Affirmative approval of the recipient country is not required, but no investments will be undertaken if any official objection is made. The IFC, as an international organization, will have certain privileges and immunities, which may be waived in the event that it finds itself in an unfair competitive position in relation to other private industries. IFC investments, however, will have the same status as investments by private investors. This equality of treatment does not preclude the negotiation of agreements with the host country for special arrangements for the transfer of earnings or for the purchase of necessary exchange like any other private investor.

IFC loan policy in process of formation

Although the IFC has opened for business only very recently, a number of applications for IFC funds have been received; and some principles of loan policy have been enunciated. There is no specific statement in the charter as to the type of enterprise eligible for IFC financing, other than that it must be a "productive, private enterprise." Nevertheless, it would appear, from various interpretations and sources,[1] that the IFC intends to concentrate primarily on investments in industrial enterprises, although investments in agricultural, financial, commercial, and other businesses will also be undertaken. No investments will be made for so-called "social" purposes such as housing, hospitals, and similar public welfare activities. Public utilities, transportation systems, and other basic facilities also will not benefit directly from IFC financing programs for several reasons. The amounts involved in the construction of such facilities are too large for the resources of the IFC, and there are frequently limitations on the profits of these enterprises which diminish their attraction for private investors. Furthermore, other organizations such as the World Bank are better equipped to finance this type of project. Concerns engaged in prospecting for petroleum or minerals will probably not receive aid from the IFC because the capital requirements for such ventures are high and the risks great. Beyond these guides, the Articles of Agreement state that the investments of the Corporation should be diversified—both on a geographical basis and by type of enterprise.

The IFC plans to proceed conservatively in its investments in the early years of its operation and does not anticipate quick returns on them. The size of individual investments is not specified; however, the limits imposed by the available capital will probably result in a preference for numerous small loans rather than a few large loans. The principal consideration of the IFC will be a diversified portfolio. The IFC may invest in either a new or an existing enterprise. There are no provisions in the charter that specify that new private capital must be invested along with that of the IFC. But it is generally expected that additional private capital will be invested in such enterprises. In the process of making investments, the IFC will consider the project both in terms of its future success and the attractiveness of the investment to private investors. No requirement is contained in the charter as to priority among purchasers when an investment is sold. As a rule, the IFC will probably give other private investors in the enterprise the first choice of refusal and will take into consideration the situation in the local capital markets before placing their investment on the market.

The future of the IFC

The success of the International Finance Corporation will be measured largely by the volume of private foreign investment induced by IFC operations rather than by the actual dollar amount of its own investments, which will be limited by the authorized $100 million capital fund and future issues of its own obligations. It is hoped that the example of its own favorable experience will encourage private investors to increase their investments and thus overcome their reluctance based on previous unfavorable experi-

[1]*Articles of Agreement of the International Finance Corporation and Explanatory Memorandum* as approved for submission to Governments by the Executive Directors of the International Bank for Reconstruction and Development, and *The Journal of Commerce*, New York.

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ences during times of stress and under the handicaps of trade and exchange controls. If the IFC stimulates the flow of private investment from both foreign and domestic sources, the main objective will have been accomplished.

But there are many problems to be faced and solved. One of the major difficulties that has confronted private foreign investment in the postwar years has been the fear of nonconvertibility and expropriation. Despite improvement in some countries recently, IFC investments must contend with these same barriers. The prestige of IFC and the World Bank behind the Corporation's investments, however, may stimulate action to improve the investment climate in the recipient country. Successful enterprises assisted by IFC financing can also be expected to demonstrate the advantages of attracting foreign capital. Improvement in the balance-of-payments situation of many of the underdeveloped countries in the past several years, moreover, provides a more favorable setting for private investment.

The ability of the IFC to generate significant private interest in foreign investment depends to some extent upon profit rates in alternative investments. In the postwar period, profits have been high in the capital-exporting nations, necessitating an even higher rate of profit to attract funds abroad and to compensate for the additional risks that might be incurred in foreign investment. Domestic sources of capital for investment, especially in the less developed countries, have also been slow to invest funds in enterprises producing for domestic consumption when high rates of profit are obtainable in export industries or in the purchase and sale of real estate. As a consequence, the payment of commensurately high rates of profit might be necessary to attract private capital in the industrial enterprises in which the IFC invests. It should also be pointed out that the "productive" enterprises in which the IFC plans to invest are not necessarily synonymous with the most profitable enterprises.

The continued operation of the IFC hinges partly upon the Corporation's success in turning over its funds by sale of its investments to private investors. The problems here are very similar to those experienced by the World Bank and the Export-Import Bank in sales from their loan portfolios. The earlier maturities and the higher quality paper held by the two Banks are more easily placed with private investors, while the less desirable obligations tend to remain unsold. This situation might also arise in the sale of IFC investments, with the high quality and successful investments readily disposed of and the less desirable investments left in the hands of the Corporation. Once the IFC investments are sold, moreover, the protection of the IFC will be lost —possibly to the disadvantage of the private investor.

Although the activity of the IFC in the early years of its existence is likely to be somewhat limited in scope, the formation of the International Finance Corporation is a significant step towards encouraging an increased flow of private investment both from capital-exporting countries and from domestic sources. As the future of the organization becomes clearer and as the initial problems are solved, its role in international finance will also be enhanced. There are provisions in the IFC charter which permit increases in authorized capital, and the issuance of the Corporation's own obligations will provide additional resources. Should the movement of private investment funds prove adequate in the long run, the corresponding reduction in the need for the IFC will provide the real indicator of the organization's effectiveness.

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BUSINESS INDEXES—TWELFTH DISTRICT[1]

(1947-49 average=100)

Year and month	Industrial production (physical volume)[1]							Total nonagricultural employment	Total mf'g employment	Carloadings (number)[2]	Dep't store sales (value)[2]	Retail food prices[3, 4]	Waterborne foreign trade[1, 5]	
	Lumber	Petroleum[3] Crude	Petroleum[3] Refined	Cement	Lead[3]	Copper[3]	Electric power						Exports	Imports
1929	95	87	78	54	165	105	29	....	....	102	30	64	190	124
1933	40	52	50	27	72	17	26	....	....	52	18	42	110	72
1939	71	67	63	56	93	80	40	....	55	77	31	47	163	95
1947	97	100	98	96	94	106	90	99	100	106	99	96	129	81
1948	104	101	100	104	105	101	101	102	102	100	104	103	86	98
1949	100	99	103	100	101	93	108	99	97	94	98	100	85	121
1950	113	98	103	112	109	113	119	103	105	97	105	100	91	137
1951	113	106	112	128	89	115	136	112	120	100	109	113	186	157
1952	116	107	116	124	86	112	144	118	130	101	114	115	171	200
1953	118	109	122	130	74	111	161	121	137	100	115	113	140	308
1954	112	106	119	133	70	101	172	120	134	96	113	113	131	260
1955	122	106	122	145	73	117	192	125	141	104	122	112	164	307
1955														
June	122	106	120	153	75	130	200	125	142	111	119r	112	152	299
July	119	106	128	157	71	40	191	125	141	99	123	113	171	368
August	123	106	127	160	67	91	196	126	142	106	122	111	189	349
September	118	106	132	159	70	128	196	126	141	107	126	112	174	363
October	116	105	129	155	72	131	197	126	142	104	126	112	152	348
November	110	106	123	128	67	128	206	128	145	98	125	112	143	325
December	123	106	120	130	63	119	198	128	146	98	123	112	164	328
1956														
January	129	106	130	135	70	134	199	129	146	107	130	112	136	354
February	125	106	128	145	77	129	204	130	146	99	124	111	126	323
March	117	105	128	149	77	131	219	130	146	103	128	112	150	395
April	119	105	122	160	82	140	203	130	146	105	131	113	175	397
May	118	105	129	173	74r	135r	211	131	147	107	122	113	....	....
June	117	105	125	....	80	136	215	132	148	105	126	114	....	....

BANKING AND CREDIT STATISTICS—TWELFTH DISTRICT

(amounts in millions of dollars)

Year and month	Condition items of all member banks[6]				Bank rates on short-term business loans[8]	Member bank reserves and related items					Bank debits Index 31 cities[3, 12] (1947-49=100)[3]
	Loans and discounts	U.S. Gov't securities	Demand deposits adjusted[7]	Total time deposits		Factors affecting reserves: Reserve bank credit[9]	Commercial[10]	Treasury[10]	Money in circulation[9]	Reserves[11]	
1929	2,239	495	1,234	1,790	......	− 34	0	+ 23	− 6	175	42
1933	1,486	720	951	1,609	......	− 2	− 110	+ 150	− 18	185	18
1939	1,967	1,450	1,983	2,267	......	+ 2	− 192	+ 245	+ 31	584	30
1947	5,358	7,247	8,922	6,006	......	− 302	− 510	+ 698	− 206	2,202	95
1948	6,032	6,366	8,655	6,087	......	+ 17	+ 472	− 482	− 209	2,420	103
1949	5,925	7,016	8,536	6,255	3.20	+ 13	− 930	+ 378	− 65	1,924	102
1950	7,093	6,415	9,254	6,302	3.35	+ 39	−1,141	+1,198	− 14	2,026	115
1951	7,866	6,463	9,937	6,777	3.66	− 21	−1,582	+1,983	+ 189	2,269	132
1952	8,839	6,619	10,520	7,502	3.95	+ 7	−1,912	+2,265	+ 132	2,514	140
1953	9,220	6,639	10,515	7,997	4.14	− 14	−3,073	+3,158	+ 39	2,551	150
1954	9,418	7,942	11,196	8,699	4.09	+ 2	−2,448	+2,328	− 30	2,505	168
1955	11,124	7,239	11,864	9,120	4.10	+ 38	−2,685	+2,757	+ 100	2,530	172
1955											
July	10,191	7,557	11,212	8,995	......	+ 10	− 193	+ 217	− 9	2,495	166
August	10,392	7,407	11,163	9,021	......	− 23	− 253	+ 200	+ 8	2,415	177
September	10,559	7,375	11,312	9,054	4.17	+ 17	− 148	+ 276	+ 18	2,541	173
October	10,665	7,487	11,465	9,067	......	− 43	− 245	+ 174	+ 15	2,417	171
November	10,931	7,238	11,665	9,005	......	+ 46	− 81	+ 205	+ 18	2,575	181
December	11,115	7,298	11,876	9,084	4.25	+ 8	− 434	+ 417	+ 17	2,530	183
1956											
January	11,193	7,143	11,794	9,070	......	+ 84	− 322	+ 136	− 99	2,554	188
February	11,323	6,819	11,233	9,095	......	− 87	− 76	+ 95	− 7	2,488	179
March	11,476	6,731	11,112	9,103	4.34	+ 71	− 178	+ 188	+ 35	2,516	183
April	11,669	6,730	11,530	9,099	......	+ 82	− 270	+ 371	− 7	2,578	190
May	11,837	6,566	11,144	9,139	......	− 22	− 233	+ 217	+ 47	2,498	182
June	12,030	6,482	11,262	9,294	4.44	+ 5	− 405	+ 341	+ 32	2,404	186
July	12,157	6,396	11,392	9,233	......	− 6	− 143	+ 240	− 8	2,519	197

[1] Adjusted for seasonal variation, except where indicated. Except for department store statistics, all indexes are based upon data from outside sources, as follows: lumber, National Lumber Manufacturers Association and U.S. Bureau of the Census; petroleum, cement, copper, and lead, U.S. Bureau of Mines; electric power, Federal Power Commission; nonagricultural and manufacturing employment, U.S. Bureau of Labor Statistics and cooperating state agencies; retail food prices, U.S. Bureau of Labor Statistics; carloadings, various railroads and railroad associations; and foreign trade, U.S. Bureau of the Census. [2] Daily average. [3] Not adjusted for seasonal variation. [4] Los Angeles, San Francisco, and Seattle indexes combined. [5] Commercial cargo only, in physical volume, for Los Angeles, San Francisco, San Diego, Oregon, and Washington customs districts; starting with July 1950, "special category" exports are excluded because of security reasons. [6] Annual figures are as of end of year, monthly figures as of last Wednesday in month. [7] Demand deposits, excluding interbank and U.S. Gov't deposits, less cash items in process of collection. Monthly data partly estimated. [8] Average rates on loans made in five major cities. [9] Changes from end of previous month or year. [10] Minus sign indicates flow of funds out of the District in the case of commercial operations, and excess of receipts over disbursements in the case of Treasury operations. [11] End of year and end of month figures. [12] Debits to total deposits except interbank prior to 1942. Debits to demand deposits except U.S. Government and interbank deposits from 1942. p—Preliminary. r—Revised.

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NEW BOOKLET AVAILABLE DESCRIBING FEDERAL RESERVE OPEN MARKET OPERATIONS

A new booklet, FEDERAL RESERVE OPERATIONS IN THE MONEY AND GOVERNMENT SECURITIES MARKETS by Robert V. Roosa of the Federal Reserve Bank of New York, is now available. It presents a picture of the setting and methods of carrying out Federal Reserve open market operations, which are a major instrument of monetary policy. The necessary background is given by a description of the money market, with its instruments and institutions, and the Government securities market and its interrelationships with the money market and the other parts of the capital market. There is a detailed study of the functions of the "Trading Desk," the informal name for the Securities Department of the Federal Reserve Bank of New York, which serves as the information post and operating arm of the Federal Open Market Committee. This comprehensive account of the details of Federal Reserve System open market operations will be an aid in analysis of the relations between open market activities and general credit policy.

This booklet is the fourth in a series that the Federal Reserve Bank of New York has published over the past five years. The first was on factors affecting bank reserves, the second on the money market, and the third on the Treasury and the money market. The aim in all of these publications has been to draw together materials that are, for the most part, generally well known within the Federal Reserve System, but have not yet found their way into the published literature available to students of money and banking.

Copies of the new booklet, as well as of the earlier studies, may be obtained by addressing requests to the Federal Reserve Bank of San Francisco.

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