SHORT-TERM BUSINESS CREDIT IN THE RECOVERY

Bruce J. Summers

Short-term business credit is watched both as a financial indicator and as a gauge of business activity. Traditionally, attention has been focused on large commercial banks and the commercial paper market as the primary sources of such credit. This narrow view, however, neglects the role of smaller banks and finance companies—both significant suppliers. A comprehensive measure of short-term credit must include (1) commercial and industrial (C&I) loans of *all* commercial banks (2) finance company business credit and (3) nonfinancial company commercial paper.[1]

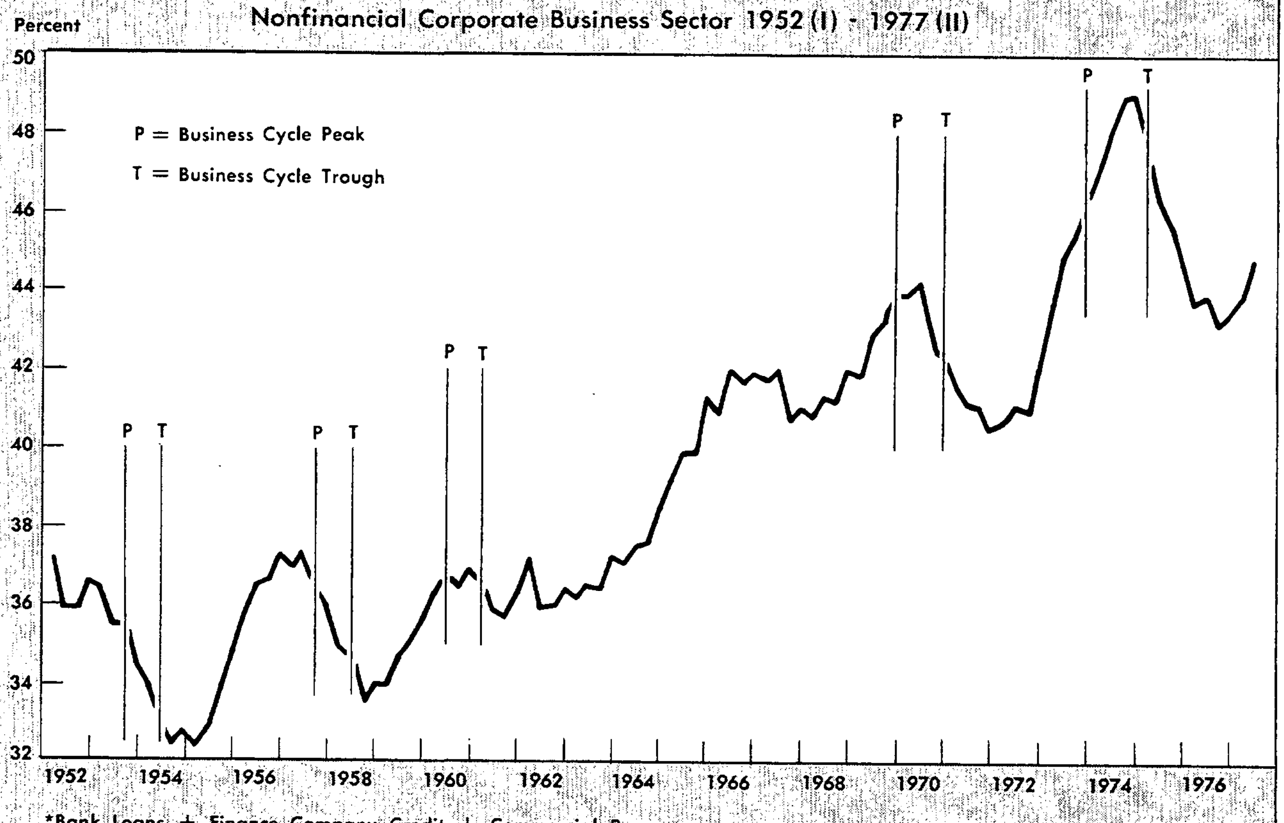
[1] Significant amounts of C&I loans and finance company business credit have intermediate and long-term maturities. This should be kept in mind as a qualification whenever these series are used as part of a short-term credit proxy.

The pattern of debt financing followed by nonfinancial companies is closely related to the business cycle. Short-term credit grows in importance relative to long-term credit in business recoveries, while the opposite is generally true during recessions. This pattern is evident in Chart 1, which plots the ratio of bank loans, finance company credit, and commercial paper to total short-term and long-term borrowings. As the chart illustrates, however, the recent experience is somewhat unusual. In the latest business cycle, short-term sources of credit were favored until late in the recession. The short-term to total debt ratio reached a peak of 49.0 percent in the fourth quarter of 1974, a year after the business slide had begun. It then declined sharply, the decline continuing through the first five quarters of the recovery.

Chart 1

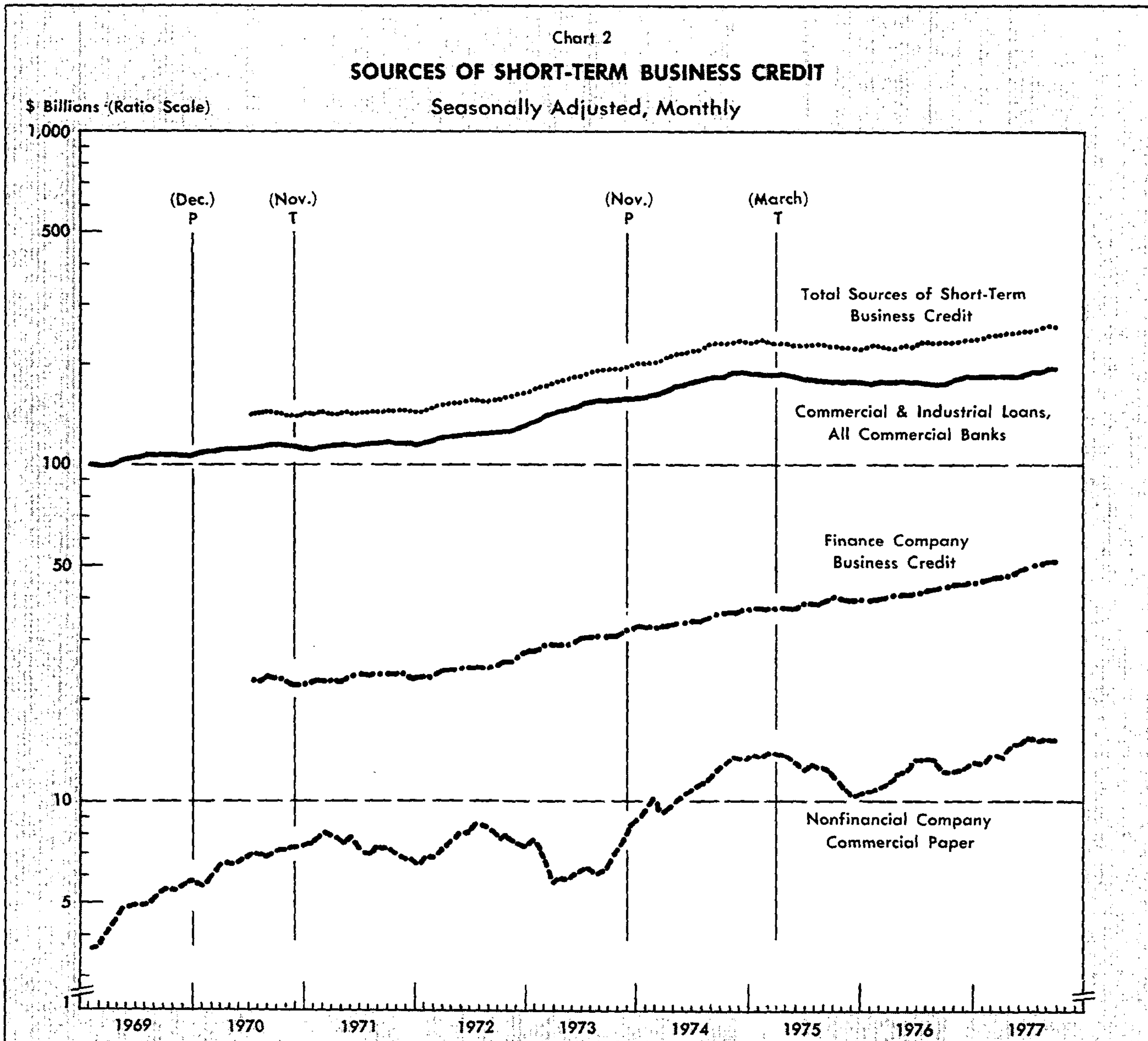
RATIO OF CORPORATE SHORT-TERM CREDIT OUTSTANDING TO TOTAL CREDIT OUTSTANDING*

Nonfinancial Corporate Business Sector 1952 (I) - 1977 (II)



*Bank Loans + Finance Company Credit + Commercial Paper / Total Short-Term + Corporate Bonds

Source: Federal Reserve Bank of Richmond.

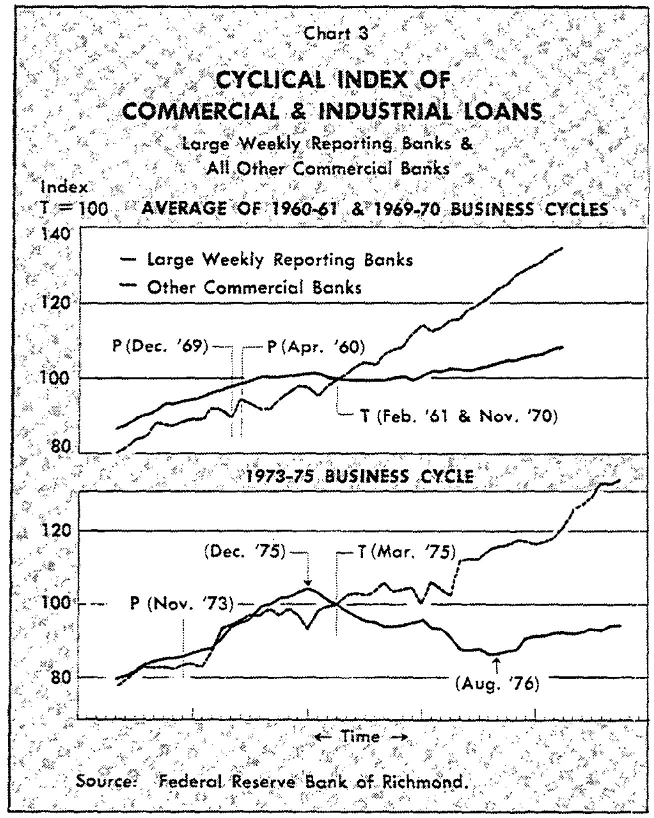


Sources: Commercial and Industrial Loans, Federal Reserve Bulletin; Finance Company Business Credit, Board of Governors of the Federal Reserve System, Release G. 20 (levels seasonally adjusted by Federal Reserve Bank of Richmond); Nonfinancial Company Commercial Paper, Federal Reserve Bank of New York, News Release.

Demand for short-term business credit has been increasing since March 1976, and has been brisk since late in that year. This is shown in the top line of Chart 2, which is the sum of the three components of a comprehensive measure of short-term credit. Analysts looking only at large banks and the commercial paper market would have overlooked this expansion in its early stages, and would now be underestimating its strength. A narrowly defined monthly proxy including only C&I loans of large weekly reporting banks and nonfinancial company commercial paper indicates that short-term business credit peaked in December 1974, fell through September 1976, and then rose $13.5 billion between September 1976 and October 1977. The more comprehensive measure that includes the three components shown on Chart 2 indicates, by comparison, a peak in January 1975 and a trough in March 1976. From March through September 1976 this comprehensive measure increased $5.4 billion. From September 1976 to October 1977 it has increased $35.6 billion, over two and a half times the increase in the narrowly defined proxy. This increase is close to the $34.0 billion raised in 1974, the largest yearly increase on record. The behavior of the comprehensive proxy of course reflects the behavior of its individual components, as discussed below.

Commercial and Industrial Loans In the past two cycles, C&I loans of all commercial banks have shown strength prior to the peak in economic activity, temporarily paused at the peak, and then increased well into the recession period before dropping off. The degree and timing of these swings, however, vary greatly by bank size and location. For example, business loans at large banks in financial centers, such as New York City, experience the greatest cyclical variation. Also, the turning points for loans at large money center banks lag those for loans at large regional banks [3].

Business lending for the large weekly reporting banks taken as a group behaves quite differently than that at the smaller banks, as shown in Chart 3. Over the past three cycles, declines in C&I loans were concentrated entirely at large weekly reporting banks. Continuously increasing lending at the smaller, non-weekly reporting banks has tended to dampen the C&I loan cycle shown on Chart 2. For example, from December 1975 to August 1976—the peak and trough months respectively for the large weekly reporting bank index plotted at the bottom of Chart 3—C&I loans fell $11.3 billion. This decline was substantially offset by an $8.4 billion increase at smaller commercial banks.



Finance Company Credit Finance companies specialize in several types of business financing, including commercial vehicle and retail equipment financing, accounts receivable financing, factoring, and most importantly, wholesale financing of vehicle dealer inventories. Their primary customers have traditionally been medium and small sized firms [1]. Business credit outstanding at finance companies increased during the recent recession through January 1975. It then leveled off before resuming its rise in April. Since January 1976 finance company business credit has expanded very rapidly, led by gains in retail equipment and commercial vehicle, and wholesale automobile, financing. The gain from January 1976 to October 1977 has been $14.1 billion.

Commercial Paper The outstanding volume of nonfinancial company commercial paper, while relatively small, is subject to wide cyclical variation. For the nearly 500 nonfinancial companies that are active in the market, commercial paper issues meet the same types of needs as do bank loans. In both cases, credit demand is a function of seasonal credit requirements, as well as credit market conditions that make long-term financing temporarily unattractive. Commercial paper issues and bank loans are substitutes, and relative interest costs help determine their relative utilization. Generally, the prime rate moves more sluggishly than does the paper rate, and consequently commercial paper becomes an attractive substitute for bank loans in periods of declining interest rates. This helps explain why commercial paper reaches cyclical peaks later than C&I loans [2], as is shown in Chart 2.

Nonfinancial company commercial paper outstanding declined from a peak of $14.0 billion in March 1975 to a cyclical low of $10.4 billion in November 1975. A favorable rate differential relative to bank loans has subsequently encouraged growth in commercial paper, the outstanding volume rising to $15.1 billion by October 1977.

References

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3. Summers, Bruce J. "A Time Series Analysis of Business Loans at Large Commercial Banks." *Economic Review*, Federal Reserve Bank of Richmond, (May/June 1975), pp. 8-14.