BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

May 20, 1976

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached for your information is a memorandum prepared in the Board's Division of Research and Statistics in response to a question raised at the April FOMC meeting.

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 18, 1976

To Mr. Lyle E. Gramley

From Banking Section (Paul W. Boltz) PWB

Subject: Inventory Changes, Bank Loans and the Financing Gap

On a GNP basis, nonfarm business inventories increased at a $10 billion annual rate in the first quarter of 1976, following four consecutive quarters of contraction. Despite the swing to inventory accumulation, business loans at banks declined during the first quarter at around a $10 billion annual rate.

A check of the historical data on comparative movements in business loans and inventories does not provide definitive information with regard to the uniqueness of the first quarter of 1976. A reliable business loan series (defined to exclude loans to finance companies) is only available back through 1959, and these data show that business loans never contracted during any quarter from 1959 through 1974. However, between those years, inventories declined in only two quarters (1960 IV and 1961 I). Thus, there is some precedent for the first quarter 1976 experience in the sense that between 1959 and 1974, inventories and business loans moved in opposite directions in two previous quarters. However, given the limited number of declines in either series, the first quarter of 1976 does look unusual.

An unpublished and somewhat less reliable series on business loans is available for the period 1952 to 1958. This series does show a high degree of contemporaneous positive correlation between business loans and changes in inventories. During the 1952 to 1958 period, inventories contracted in nine quarters, and business loans contracted in each of those nine quarters and only those nine.

During 1975, the internal cash flow of businesses (retained earnings plus capital consumption allowances) exceeded the sum of fixed and inventory investment. This "negative" financing gap contributed to the reduction in business borrowing at banks last year. In the first quarter of 1976, although a "positive" financing gap re-emerged--$9.0 billion at an annual rate--it was small relative to the external financing needs of business during the late 1960's and early 1970's. In addition, other factors that had depressed loan demand last year were still present in the first quarter. Specifically, the spread between the prime lending rate at banks and the rate on prime commercial paper remained very wide, and borrowing by nonfinancial businesses in the commercial paper market expanded at a $2.8 billion rate during the first quarter. Even more important, first-quarter capital market financings of businesses (i.e., net new offerings of notes and bonds as well as equities) were at a $27 billion annual rate. Taken together, these alternative sources of funds easily covered the financing gap and permitted a further paydown of bank loans.