

ECONOMIC ASPECTS OF INVENTORY AND RECEIVABLES FINANCING

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When one speaks of inventory and receivables financing, he thinks primarily of the financing by non-farm business enterprises of their stocks of raw materials, goods in process, and finished goods, and of their credit sales to customers. Defined broadly, of course, these terms include the financing of stocks of goods held by households, farms, institutions, and government, as well as business, and of any credit extended by such units.

This article, however, will confine itself to the financing of inventory and receivables in the narrower sense. As to the financing of these types of business assets, the article is concerned with the part played by financial institutions, principally commercial banks, although other sources of funds, such as undistributed earnings and trade suppliers, are also used for this type of financing.

I

THEORETICAL IMPLICATIONS OF INVENTORY AND RECEIVABLES FINANCING

The primary economic significance of the financing of business inventory and receivables relates to its function as an aid to business activity. Such financing enables capable business men who are without adequate funds to initiate or expand their activity. It also provides business men with a flexible source of funds to finance seasonal and other temporary requirements for funds and thus enables them to operate on a minimum amount of permanent capital. This financing is most often accomplished (1) by the channeling of funds through financial institutions from persons who are willing to lend but unwilling or unable to go into business themselves, and (2) by the "creation of funds" by commercial banks.

In a broader sense, however, the economic significance of the financing of business inventories and receivables results from the effects of the bank credit created for providing such financing. In this sense it becomes important to consider the general economic effects of the creation of funds through the extension of bank credit.

The fact that banks create funds and the explanation of the manner in which such funds are created are now quite generally accepted. In brief, this creation of funds is possible because of the small amount of cash which individual banks have

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to keep on hand relative to the volume of their deposits. This economy in cash results from the widespread use of checks as a means of payment and of bank deposits as a form of liquid assets. The debts of one bank to another resulting from check writing and depositing largely cancel out.¹

There is much less agreement, however, as to the types of business financial needs banks should satisfy by credit creation. Many students and practitioners of banking still adhere to the principle that banks should make only self-liquidating, short-term, commercial loans—that is, loans to finance the purchase of goods, the sale of which will make possible the repayment of the loan in a short period of time, say ninety days. According to this theory, banks presumably should not make all types of business inventory loans, but only those business receivables loans based on debts of other businesses. Such receivables could be paid off from the proceeds obtained from the subsequent resale of the goods acquired. Receivables loans based on debts owed by householders, however, depend for repayment only on the general earning power of the householders, for the goods purchased by householders are presumably purchased for consumption rather than for resale.

This theory, like the practice of commercial banking itself, originated in England and became a major tenet of the "banking," as contrasted with the "currency," school of thought on monetary matters in that country during the controversy prior to the modification of the structure and operations of the Bank of England as incorporated in the Bank Charter Act of 1844.² The adherents of the banking school, although they failed to grasp fully the fact and nature of deposit creation by the commercial banking system, did contend that the volume of bank credit—primarily bank notes at that time—should vary with the needs of business, defined essentially as needs for financing the acquisition of commodities. Adherents of the currency school, on the other hand, and presumably most "monetary" experts prior to this time, felt that the volume of bank credit should be relatively fixed, varying only as a currency based on gold and silver alone would vary.

The English banking-school view of the proper function of banks also began to be reflected in this country during the first half of the nineteenth century, and, as will be elaborated in a later section of this article, later became embedded in our banking tradition and ultimately in our banking legislation. The concept has been known by various terms, but most often as the "commercial-loan" or "qualitative" theory of credit. One of the principal later proponents of this theory of banking was Professor H. Parker Willis, of Columbia University, and it has been developed and expanded by many of his students.

The principal contention of holders of this theory of banking is that if banks make only short-term commercial loans, the additional purchasing power created will be accompanied in the main by an additional supply of goods available for purchase, and as a result society will be protected against crises caused by the is-

¹ For the classic treatment of the manner and extent to which the commercial banking system creates money or credit, see C. A. PHILLIPS, *BANK CREDIT*, c. III (1921).

² 7 & 8 VICT., c. 32.

suance of an excessive amount of bank credit. Those adherents maintain, as a corollary, that this practice will keep the banks in a liquid and sound financial position.

Critics of this theory of banking, on the other hand, deny that the restriction of banks to short-term commercial lending will insure against excessive issuance of bank credit. Their rebuttal is based primarily on the fact that this view neglects both the quantitative and the turnover aspects of the credit created, and that a change in velocity has the same effect on the economic system as a corresponding change in the quantity of credit. The English economist D. H. Robertson has put this most aptly, in objecting to the theory "that every batch of goods is entitled to be born with a monetary label of equivalent value round its neck, and to carry it round its neck until it dies," by saying that the monetary value of a commercial loan (that is to say, the bank deposits resulting from a loan) is rather "very much untied and 'runs about the city.'"³ The corollary advantage of a liquid banking system, as claimed by protagonists of the banking school, is also dismissed by these critics on the ground that a substantial volume of short-term commercial loans cannot be liquidated in case of an over-all decline in business activity without running the risk of accentuating that decline and impairing the solvency of many individual business enterprises.

These critics maintain positively that quantitative instead of, or at least as well as, qualitative aspects of credit creation must be considered in order to understand the economic effects of the creation of bank credit. The proponents of this point of view have increased in number during the twentieth century, and a discussion of the economic effects of the creation of bank credit must now lean heavily on their conclusions concerning the credit-creation process. From the point of view of this school, it follows that business-inventory financing by banks will have no effect on the economic and financial system of the country appreciably different from that of any other type of bank financing, and it would be impossible even conceptually to isolate the magnitude of its separate effect.

This theory appears reasonable when one looks at the financing process from the point of view of the business borrower instead of the bank lender. Business enterprises always have available a pool of funds obtained from many sources which they put to a variety of uses. In addition to (1) the undistributed portion of their cash-sales dollars, represented by current undistributed earnings and depreciation and other reserve allowances, and (2) their accumulated liquid assets from prior years' earnings, businesses also obtain funds from trade suppliers, banks, and sales of securities. Resources are expended primarily to accumulate inventories, finance accounts receivable, purchase machinery, and build plant.

It is extremely difficult and often impossible to allocate specific sources to specific uses of business funds. Even if such an allocation were possible, it is doubtful just how significant it would be. For example, one business concern might obtain a bank

³ As quoted in LLOYD W. MINTS, *A HISTORY OF BANKING THEORY* 261, 262 (1945).

loan to finance inventory accumulation. Another might draw down accumulated cash balances to finance inventory purchases and then borrow from a bank to replenish its working cash balance. Thus although both concerns might require and use funds for identical purposes, the reasons the two concerns would give for uses of specific funds would differ.

In conclusion, it is impossible to isolate clearly the immediate economic effects of business inventory and receivables financing from the effects of other types of bank lending and investing. It is even impossible to be certain that financing so designated is actually used by businesses to acquire inventories or carry receivables. Individual types of financial transactions of businesses cannot be treated separately; they must be viewed as a whole in order to ascertain the relative importance of different sources of funds in financing total business operations.⁴ The importance of these conclusions concerning the need for an over-all view of business finance in assessing the effect of any specific type of financing on the economy as a whole will become apparent in the final section of this article, which comments briefly on inventory and receivables financing in the current inflationary period.

II

HISTORY OF INVENTORY AND RECEIVABLES FINANCING

Business-inventory financing is as old as banking itself. It arose in a period when manufacturing was still conducted, as the origin of the term implies, "by hand" in small units requiring little capital or credit. The principal short-term credit requirement in this period came from middlemen engaged in commerce, whose primary function was to distribute goods from producers to consumers. This was the type of financing which gave rise to the term "commercial" banks.

Thus, originally, bank loans were made solely to traders and merchants, and the proceeds of these loans were used only for the purchase of commodities. Generally, the loans were secured by bills of exchange drawn on specific lots of goods. It was somewhat later that inventory loans to manufacturing companies became accepted banking practice, and then only because it was thought that such loans, too, would be self-liquidating through the subsequent sale of the goods purchased with the proceeds of the loan.

Although commercial banks for many years have made business loans secured by inventory deposited in terminal public warehouses, around the turn of the century they began to make business-inventory loans on the basis of what are referred to as "field-warehouse receipts." In this type of financing the inventory remains on the premises of the business borrower, but comes under the custody of a warehouseman chosen by a special company known as a "field-warehousing company." This comparatively new financing method, now carried on by commercial banks, commercial finance companies,⁵ and warehousing companies themselves, has in-

⁴The "sources-and-uses-of-funds" analysis of the accountant is often extremely useful for this purpose.

⁵Commercial finance companies are non-bank agencies that lend money to business primarily on the basis of liens on inventory and receivables and chattel mortgages on machinery and equipment.

creased significantly the availability of working capital to business enterprises, for it enables financial institutions to make loans to such enterprises for the purchase of inventory that is too bulky to move to terminal warehouses or to which the borrower needs ready and frequent access.

The practice of field-warehouse financing grew steadily during the first few decades of this century, but experienced its greatest growth during the Thirties and especially during the years of, and immediately after, the Great Depression. It is a relatively expensive type of financing, and is most frequently resorted to by businesses in a weak financial position. Its growth during the depression was due both to the fact that businesses, particularly those in a weak financial position, required a large volume of working-capital financing and to the fact that banks were eagerly seeking additional outlets for their funds. Bank interest in this type of financing during these years was increased by the adoption in an increasing number of states of the Uniform Warehouse Receipts Act and additional judicial clarification of this Act.

The current volume of financing of business inventories on the basis of field-warehouse receipts is probably smaller than the pre-war volume. This decrease has occurred because of (1) the improved financial position of most businesses, which enables them to utilize less costly methods of financing; (2) the continuing shortage of some materials and supplies that make up inventories suitable to the field-warehousing technique; and (3) the availability of alternative, more attractive, outlets for the funds of financial institutions.⁹

Business-receivables financing, like business-inventory financing, is an old, established practice. However, this type of financing was originally carried on not by banks but by agencies known as "factors." Such agencies, actually in existence in Europe since the late Middle Ages, were originally trading companies and performed only selling and merchandising functions for producers. Gradually, however, they began to provide funds to clients by purchasing outright the latter's open accounts.

Factors were quite important in this country as early as the era of the colonies, when they acted as selling representatives for English companies. Later they became, and still remain, relatively important in the textile industry, both because of the significance of foreign mills and because of the need for special attention to changing styles and tastes in this industry. As a result of the importance of foreign suppliers and the import trade in textiles, factors early became located in Boston and New York City and continue to be concentrated in these areas.

The financing of business receivables by factors is almost always on what is called a "notification" basis—that is, the customers of the borrower are informed that they now owe a third party rather than the party from whom they had acquired goods or services. As the business demand for receivables financing expanded into industries other than textiles, however, a demand arose for financing on a non-notification

⁹ See Smith, *Security Pledged on Member Bank Loans to Business*, 33 FED. RES. BULL. 673 (1947).

basis, primarily because of the lack of familiarity of the borrowers' debtors with the practice of selling receivables and the consequent reluctance of these debtors to make payments to a financing agency. Non-notification receivables financing developed prior to World War I but experienced its greatest growth during the Thirties. It was conducted first by commercial finance companies, being adopted by a substantial number of commercial banks only during the depression of the Thirties.

The growth of receivables financing by commercial banks, like the growth of field-warehouse financing of business inventories, was due primarily to the weakened financial condition of businesses, their resultant increased need for financial assistance, and the plethora of lending capacity in the banking system. The volume of receivables financing, unlike that of field-warehouse financing, is probably larger now than it was before the war, but the relative growth of such financing in the postwar period has not been as large as that of other types of business loans. The failure of receivables loans to grow as much as other business loans is also undoubtedly due primarily to the improved financial position of businesses and their greater reliance on cheaper forms of credit. It is also probably due in part to the large proportion of total business sales that are now being made on a cash or short-term basis, as a result of the improved financial condition of individual consumers.

III

VOLUME OF INVENTORY AND RECEIVABLES FINANCING

The quantitative data on the volume of business inventory and receivables financing from financial institutions are sparse, and what data are available must be used with care lest they be misinterpreted. Since no specific data on the purposes of business borrowing are available, one can only draw inferences as to such purposes from the types of security used as collateral for business loans. Inferences drawn from such data on the volume of financing for any specific purpose are particularly tenuous, because a large number of business loans are obtained on an unsecured basis. Moreover, as was pointed out in an earlier section of this article, it is extremely doubtful how meaningful it is to allocate specific sources to specific uses of business funds.

But with these caveats in mind, some idea of the magnitude and character of business-inventory financing can be obtained by examining the available data on bank loans, since most business-inventory financing by financial institutions is conducted by commercial banks. As can be seen from Table 1, Federal Reserve member banks, which hold over 90 per cent of the business loans of all banks, had 35,000 loans secured by inventory outstanding on November 20, 1946, the latest date for which such data are available. These loans amounted to 1.2 billion dollars, which was 9 per cent of the total business-loan volume of member banks at that time. On the same date these banks had 239,000 unsecured loans on their books, amounting to over 7.3 billion dollars. The proceeds of many of these unsecured loans and undoubtedly the proceeds of many loans secured by collateral other than

TABLE 1

NUMBER AND AMOUNT OF OUTSTANDING BUSINESS LOANS OF FEDERAL RESERVE MEMBER BANKS SECURED BY INVENTORY, RECEIVABLES, AND OTHER SECURITY; AND UNSECURED, NOVEMBER 20, 1946*

Type of Security	Number of Loans	Amount of Loans	Percentage Distribution	
	(In thousands)	(In millions)	Number	Amount
Secured, total.....	410	\$5,799	61.1	48.8
By inventory.....	35	1,195	5.2	9.0
By receivables.....	13	190	1.9	1.4
By other security.....	362	4,414	54.0	33.4
Unsecured.....	239	7,322	35.6	55.3
No information.....	22	116	3.3	0.9
All business loans.....	671	\$13,237	100.0	100.0

*SOURCE: 33 FED. RES. BULL. 665 (1947).

inventory also were used for the purpose of carrying stocks of goods. Since total business borrowing from banks is now (August, 1948) over 30 per cent above that of November, 1946, and since the dollar volume of business inventories, as estimated by the Department of Commerce, increased about 30 per cent from the end of November, 1946, to the end of June, 1948, the volume of bank financing of inventories is probably also considerably larger. A major part of the increase in business inventories was of course financed internally by retained earnings and accumulated liquid assets rather than by bank loans.⁷

Medium-size and large companies in manufacturing and wholesale trade, as Table 2 indicates, are responsible for the largest proportion of the total amount, and small retail-trade concerns are responsible for the largest proportion of the total number of bank loans secured by inventories. This is understandable in view of the importance of inventory holdings in the day-to-day operations of these types of enterprises. Inventory-secured loans to retail-trade stores are largely on the basis of trust receipts, assignment of title, or chattel mortgages, while those to manufacturing and wholesale-trade companies are most often on the basis of warehouse receipts.

The average volume of business-inventory loans outstanding in 1941 and secured by field-warehouse receipts was estimated at about 150 million dollars.⁸ About 90 per cent of these loans were held by commercial banks, the remainder being held primarily by commercial finance companies and warehousing companies themselves. As of November, 1946, this method of financing business inventories was less common than it had been before the war, probably, as was pointed out in the previous section, primarily because businesses were stronger financially and could

⁷ From the end of November, 1946, to the end of June, 1948, when the volume of business inventories increased about 11½ billion dollars, the volume of bank loans to businesses for all purposes, not just for inventory financing, increased about 4 billion.

⁸ NEIL H. JACOBY AND RAYMOND J. SAULNIER, FINANCING INVENTORY ON FIELD WAREHOUSE RECEIPTS 32 (1944).

TABLE 2

PERCENTAGE DISTRIBUTIONS OF NUMBER AND AMOUNT OF OUTSTANDING BUSINESS LOANS OF FEDERAL RESERVE MEMBER BANKS SECURED BY INVENTORY AND RECEIVABLES, BY BUSINESS AND SIZE OF BORROWER, NOVEMBER 20, 1946*

Business and Size of Borrower	INVENTORY		RECEIVABLES	
	Percentage Distribution Based on:		Percentage Distribution Based on:	
	Number	Amount	Number	Amount
Business:				
Manufacturing and mining	20.8	31.6	40.2	50.3
Wholesale trade	28.9	58.6	22.8	21.5
Retail trade	45.4	6.1	14.2	7.8
All other†	4.9	3.7	22.8	20.4
All borrowers	100.0	100.0	100.0	100.0
Size (total assets, in thousands of dollars)				
Under 50	47.2	5.2	50.4	11.6
50 to 250	34.7	19.6	35.4	37.0
250 to 750	10.8	17.9	9.5	22.8
750 to 5,000	5.3	22.1	3.9	20.1
5,000 and over	2.0	35.2	0.8	8.5
All borrowers	100.0	100.0	100.0	100.0

*Source: 33 FED. RES. BULL., 671, 674, 677, 678 (1947).

†Includes public utilities (including transportation), services, construction, sales finance, forestry, fishing, and real estate.

use less costly methods of borrowing.

In accounts-receivable financing commercial banks occupy a less important position as compared with other financing institutions than in inventory financing. According to the latest available data (for 1941), commercial banks are responsible for only about 35 per cent of business-receivables financing⁹ in contrast with their position as the source of most business-inventory financing. Factoring companies, which are solely, or at least primarily, engaged in the actual purchase of accounts receivable, were the principal lenders in this field in 1941, being responsible for about 45 per cent of such financing. Commercial finance companies conducted the major portion of the remainder of the business.

As of the end of 1941 the outstanding volume of business-receivables loans probably amounted to approximately 350 million dollars, of which 135 million were bank loans secured by receivables. As of November, 1946, the dollar volume of such bank loans had increased to 190 million, as is shown in Table 1. This was a considerably smaller rate of increase than that of total business loans of banks between 1941 and 1946 and, like the relative decline of field-warehouse financing during the same period, was also undoubtedly due to the improved financial position of business enterprises and their resultant reliance on cheaper forms of credit.

⁹ RAYMOND J. SAULNIER AND NEIL H. JACOBY, ACCOUNTS RECEIVABLE FINANCING 3, 4 (1943).

Manufacturing and wholesale-trade concerns are responsible for the largest dollar volume of bank loans secured by receivables, just as they are responsible for the largest volume of bank loans secured by inventory. However, small and very small enterprises—those with total assets under 250 thousand dollars—rather than medium-size and large ones are the most important borrowers on the basis of the dollar volume of loans secured by receivables.

IV

THE FEDERAL RESERVE SYSTEM AND INVENTORY AND RECEIVABLES FINANCING

Since 1913, when the Federal Reserve System¹⁰ was superimposed upon the existing structure of bank regulatory agencies, governmental supervisory power over inventory and receivables financing by commercial banks as well as over other bank activities has been divided between the System, the Comptroller of the Currency, and the forty-eight states. In 1933 the Federal Deposit Insurance Corporation was authorized with additional and separate powers over banking. In spite of such a division of powers, the Federal Reserve System as the central bank of the country is generally considered the dominant bank regulatory agency, and its policies and actions regarding inventory and receivables financing by banks can be taken as representative of those of governmental agencies in general.

The position of the Federal Reserve System on the question of what types of business financing its member banks should engage in has never been stated explicitly. Moreover, the System's actions do not indicate a clearly defined position. The wording of the Act establishing the System¹¹ and the early actions of the System were probably more consistent with the "qualitative" than with the "quantitative" theory of the control of credit—that is, more consistent with the theory that banks should restrict their lending to "self-liquidating" commercial transactions. Later amendments to the Act and actions of the System are more consistent with the thesis that quantitative as well as qualitative control is necessary and desirable.

When the System was established, the traditional instrument of central bank control was the discount rate—that is, the rate charged private banks by the central bank for additional funds. By this device private banks that had made all the loans their existing funds would permit could rediscount some of these loans with their Reserve Bank and obtain additional lendable funds. Since the original Act and subsequent rulings and interpretations restricted the rediscount privilege to short-term loans for the purpose of financing self-liquidating transactions, the System was put in a position which enabled it to exercise some influence over the character of bank financing.

¹⁰ The phrase, "Federal Reserve System," is used here to include the Board of Governors of the Federal Reserve System in Washington; the twelve Federal Reserve Banks, each located in one of the twelve Federal Reserve Districts into which the country is divided; and the Federal Open Market Committee, which is made up of representatives of the Board and some of the Banks. It does not include the private banks that are members of the System nor the Federal Advisory Council, which as a rule consists of one member banker from each Federal Reserve District.

¹¹ 38 STAT. 251 (1913), as amended, 12 U. S. C. §221 *et seq.* (1940).

The demand for funds through rediscounting, however, was relatively small in the first years of the System. Even after the entry of the United States into World War I, when the demand for funds increased sharply, banks did not rediscount substantial amounts of eligible commercial loans in order to obtain additional funds. Instead, they took advantage of another provision of the Act, added in 1916,¹² which enabled them to borrow on the basis of promissory notes secured by Government obligations. Indeed, the System encouraged this practice by establishing rates for such borrowing that were somewhat lower than the coupon rates on Liberty bonds. Thus, early in the life of the System, the method of making funds available to member banks deviated from the requirements of strictly qualitative credit control.

Then, in the Twenties, the Federal Reserve System began to use another instrument of quantitative rather than qualitative credit control known as "open-market operations." By open-market operations is meant the purchase or sale of United States Government securities by the System. In purchasing securities, as in 1924 and 1927, the System provided additional funds to member banks which were used to reduce private-bank indebtedness to Reserve Banks; in selling securities, as in 1923, 1925, and 1928, the System absorbed funds and made it necessary for private banks to increase their debt to Reserve Banks. The use of this instrument, coupled with changes in the discount rate, affected the volume of bank lending during the Twenties, but open-market operations in and of themselves did not materially affect the character of such lending.

In the Twenties, as well as subsequently, a third method of credit control, which can be termed "moral suasion," was exercised by the System. Such influence has been exercised through frequent releases and other publications and through periodic examinations of member banks by field examiners.

In its Annual Report for 1923, for example, the Board of Governors of the Federal Reserve System stressed its preference for "productive credit" as contrasted to "credit for either investment or speculative purposes."¹³ In the late Twenties the Board, in its Annual Reports, in the monthly *Bulletin*, and in other publications, stressed the danger of excessive speculative loans, particularly in so far as such loans restricted the availability of funds for commercial purposes.¹⁴ A more recent example of moral suasion by the publication of views and opinions is the joint statement issued on November 24, 1947, by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Executive Committee of the National Association of Supervisors of State Banks.¹⁵ This statement stressed the role of continued bank-credit expan-

¹² 39 STAT. 753 (1916), as amended, 12 U. S. C. §347 (1940).

¹³ TENTH ANNUAL REPORT OF THE FEDERAL RESERVE BOARD 33 (1923).

¹⁴ Under date of February 2, 1929, for example, the Board addressed a letter to the Federal Reserve Banks which stated in part: "The extraordinary absorption of funds in speculative security loans, which has characterized the credit movement during the past year or more, in the judgment of the Federal Reserve Board, deserves particular attention lest it become a decisive factor working toward a still further firming of money rates to the prejudice of the country's commercial interests." 15 FED. RES. BULL. 94 (1929).

¹⁵ 33 FED. RES. BULL. 1465 (1947).

sion in the current inflationary period and strongly urged bankers to "curtail all loans either to individuals or businesses for speculation in real estate, commodities, or securities," and to confine further bank-credit extension to "financing that will help production rather than merely increase consumer demand."

As for the influence of bank examiners, the laws under which they operate with regard to the amount and kinds of loans to be made by banks and the kinds of collateral to be accepted are in the main expressed in very general terms. Their influence on bank lending practices is exercised by their contacts with numerous individual bankers and their communication to these bankers of the views of the regulatory agencies on the general economic and credit situation as well as by their written reports on individual bank examinations.

Since the early Thirties the changes both in the banking laws and in the administration of those laws have tended to be consistent with the quantitative theory of credit control. During the depression, for example, a number of member banks of the Federal Reserve System ran out of assets eligible for rediscounting with, or for borrowing from, the System. Such banks could meet their deposit-withdrawal requirements only by borrowing from the Reconstruction Finance Corporation, an agency organized early in 1932 for the purpose of tiding distressed businesses and financial institutions over a critical situation, and later through temporary emergency provisions for borrowing from Reserve Banks on sound assets. Later, the Banking Act of 1935 gave the Federal Reserve Banks permanent authority to lend to member Banks on sound security satisfactory to the banks.¹⁶ Moreover, the Board of Governors prefaced its interpretation of that authorization with the general statement that "the guiding principle underlying the discount policy of Federal Reserve Banks is the advancement of the public interest" and that "in passing upon applications for discounts of advances of member banks, Federal Reserve Banks are expected to consider not only the quality of the paper submitted [kind of loan rediscounted or used as collateral] but also whether or not it is in the public interest . . ."¹⁷

Along with these trends toward quantitative control, however, there was also evidence, at least among the framers of banking law, of a view that the System should be a source of only certain types of funds. Thus in 1934 when many businesses, especially small ones, were finding it extremely difficult to obtain funds from their usual sources, the Congress amended the Federal Reserve Act to empower Federal Reserve Banks under certain conditions to make direct, as well as to guarantee, advances to established commercial and industrial enterprises, but only for "working capital" purposes.¹⁸ Such purposes would presumably include inventory and receivables financing.

Thus to date the Federal Reserve System has affected the volume more than the types of lending of its member banks. Such powers as it has over the character of

¹⁶ 49 STAT. 705 (1935), 12 U. S. C. §347b (1940).

¹⁷ 23 FED. RES. BULL. 977 (1937).

¹⁸ 48 STAT. 1105 (1934), 12 U. S. C. §352a (1944).

member-bank loans are quite limited. The System's effect on specific kinds of loans is most often exercised indirectly by the release of views and opinions.

V

INVENTORY AND RECEIVABLES FINANCING IN THE CURRENT INFLATIONARY BOOM

In spite of the February decline in many commodity and food prices, as this article is being written (August, 1948) the threat of continuation of the inflationary business boom, in part the result of probable larger armament expenditures, is still of major concern. The aggregate demand for goods and services on the part of domestic and foreign consumers, businesses, and governments has been, and still is, in excess of the aggregate supply of such goods and services. As a result, prices have risen considerably and sharply.

This aggregate demand for goods and services stems from past saving, current income, and new credit. The total liquid-asset holdings of individuals and businesses at the end of 1947, for example, have been estimated at 237 billion dollars, almost three and one-half times the volume held at the end of 1939.¹⁹ Similarly, the national income during the first quarter of 1948 was at a seasonally adjusted annual rate of 215 billion dollars, or more than two and one-half times that of 1940, the pre-war year of highest income.²⁰ Finally, bank loans rose almost one-half, or from 27 to 40 billion dollars from mid-1946 to mid-1948.²¹

An important factor in this increase in total bank loans was the rise in loans to business enterprises. A major portion of these new loans to businesses, in turn, was undoubtedly for the purpose of financing inventory accumulation and receivables. As was discussed in an earlier section of this article, such data on purposes of borrowing are of doubtful significance because of the difficulty of allocating specific sources of business funds to specific uses of such funds.

The primary cause of the inflation to date has been World War II and the Government debt that resulted from the way in which the war was financed. Current credit developments, however, have contributed to the inflationary pressures. Bank-credit creation is both a cause and an effect of a rising price spiral. As prices rise, businesses need more and more funds for working- as well as for fixed-capital purposes. As a result of obtaining additional funds, businesses increase their expenditures and give added impetus to the price rise.

Thus, although any given business loan, particularly if made for such working-capital purposes as inventory or receivables financing, might in itself aid in the production or distribution of goods by a given business concern, it could do so only by bidding resources away from another enterprise or from consumers. In a period like the present, when all of the available raw materials, labor, plant, and equipment in the country are being utilized to practical capacity, most increases in bank credit

¹⁹ 34 FED. RES. BULL. 658 (1948).

²⁰ Survey of Current Business, August, 1948, p. 5, and National Income, Supplement to Survey of Current Business, July, 1947, p. 25.

²¹ MIDYEAR ECONOMICS REPORT OF THE PRESIDENT 97 (July, 1948).

merely put funds in the hands of additional potential producers or distributors which enable such producers or distributors to compete with others who already have sufficient funds to take the available goods off the market. As a result, prices are bid up further, and the supply of goods is merely shifted from a consumer or from one potential producer to another potential producer, with total production remaining practically the same. Even if such shifting is desired for military purposes, it might better be accomplished by direct Government controls rather than by price increases.

Under the full-employment conditions that exist in this country today, total production can increase materially only if the supply of raw materials or the supply or productivity of labor, plant, or equipment increases, and all of these changes occur slowly. Under these conditions, and recognizing the fact that sharp changes in the volume of business investment in inventory, receivables, and other assets have been contributing factors in past fluctuations in business activity, it would be desirable for that part of the large current volume of business investment that is not considered essential for preparedness to be spread out over time instead of being concentrated in the present inflationary period.

Moreover, even business loans that do result in increased total production may be inflationary. Funds created by bank lending are not automatically canceled; such funds, once spent by the original borrower, no matter how productive the initial transaction, may be used by subsequent holders in many inflationary ways.

In exceptional cases there may be good reason for a new non-military business inventory or receivables loan under present circumstances, but most new loans of this kind as well as other kinds are highly undesirable at this time. Indeed, in view of the extraordinarily high current price level and volume of business sales, most concerns with inventory or receivables on hand financed in whole or part by bank or other debt would do well to liquidate that debt at the earliest opportunity. Such debt liquidation, unless replaced by other new debt creation, would not only help to ease the general inflationary pressures of the present but would put such individual enterprises in a stronger position to face the financial adjustment which will in time follow the current boom conditions.