Volume Title: Trends and Cycles in the Commercial Paper Market

Volume Author/Editor: Richard T. Selden

Volume Publisher: NBER

Volume ISBN: 0-87014-399-9

Volume URL: http://www.nber.org/books/seld63-1

Publication Date: 1963

Chapter Title: Introduction to "Trends and Cycles in the Commercial Paper Market"

Chapter Author: Richard T. Selden

Chapter URL: http://www.nber.org/chapters/c1918

Chapter pages in book: (p. 1 - 5)

1
Introduction

Commercial Paper in Perspective

Commercial paper consists of short-term promissory notes issued by businesses and offered on the more or less impersonal open market. In the United States a market for such notes has existed for at least a century and a half. Commercial paper is a uniquely American institution; other countries have relied instead on the bill of exchange as the principal form of short-term business debt.

Like other aspects of society, credit markets change as time passes. It is not surprising, therefore, that today's commercial paper bears little resemblance to the paper of a century ago. Up to the closing decades of the nineteenth century, commercial paper consisted largely of trade notes received by manufacturers, wholesalers, or jobbers in payment for goods shipped to other firms. The recipients of the notes endorsed them over to banks, to their own creditors, or to note brokers who in turn sold them to banks. Thus commercial paper was almost exclusively two-name paper, the maker being the buyer of goods and the payee being the seller; denominations were in odd amounts, reflecting the value of particular shipments of goods. Nowadays commercial paper consists of single-name notes issued in round denominations ($5,000 and up) and unrelated to shipments of goods. More often than not the issuer is a finance company.[1]

[1]A great deal has been written on early developments in the commercial paper market. See Albert O. Greef, *The Commercial Paper House in the United States*, Cambridge, Harvard University Press, 1938, and Margaret G. Myers, *The New York Money Market*, Vol. I, New York, Columbia University Press, 1932, and references cited therein. On the commercial paper market of the 1920's, see Benjamin Haggott Beckhart, *The New York Money Market*, Vol. III, Part 2, New York,

Despite its venerable age, commercial paper is a comparatively minor form of debt today. Less than 400 American business enterprises obtain funds in the commercial paper market, and there are only ten paper dealers. Nor are the dollar magnitudes impressive. As of the end of 1962, outstanding paper was in the neighborhood of $6 billion—an amount that was sizable alongside the $2.6 billion in bankers' acceptances but small in relation to total corporate debt ($174 billion, not counting $50 billion of trade debt), business loans of banks (about $49 billion), and Treasury bills outstanding ($48 billion).

Yet for several reasons the commercial paper market has a significance beyond its size. First, throughout the postwar period commercial paper has been enjoying a vigorous boom. Outstanding paper more than doubled between 1951 and 1959, and it nearly doubled again from December 1959 to December 1962. If these growth trends continue much longer, commercial paper may well become a major element in our financial system.

Second, it is true that most corporate borrowers make little or no use of commercial paper, but this form of debt is nevertheless important to one class of borrower, finance companies. And since finance companies are major providers of consumer credit, the commercial paper market is a significant channel through which funds flow to households.

Third, commercial paper has significance for students of commercial banking. A century ago banks were the main holders of paper, and paper apparently made up a large part of bank earning assets. In the 1920's banks continued to be the major paper holders, but commercial paper had been supplanted by customer loans, call loans, acceptances, and government securities in bank portfolios. Since then the composition of the commercial paper market has changed gradually as finance companies have replaced the traditional issuers of paper and commercial banks have fallen behind nonfinancial corporations as paper holders. Moreover, since 1961 many banks have become open-market *borrowers,* as well as lenders, by providing negotiable time certificates

Columbia University Press, 1932; Roy A. Foulke, *The Commercial Paper Market,* New York, The Bankers Publishing Co., 1931; and W. H. Steiner, "The Commercial Paper Business," *Federal Reserve Bulletin,* August and September 1921. More recent developments in the market have been traced up to 1956 by Donald P. Jacobs, "Sources and Costs of Funds of Large Sales Finance Companies," *Consumer Instalment Credit,* Part II, Vol. 1, Washington, Board of Governors of the Federal Reserve System, 1957, and up to 1959 by Ernest Bloch, "Corporate Liquidity Preference," unpublished Ph.D. dissertation, New School for Social Research, 1961.

of deposit to nonfinancial corporations. These certificates of deposit resemble commercial paper in many respects.

Along with these changes in the role of the banks in the commercial paper market, there have been related changes in the demand for bank loans. Until the last few years finance companies had always relied on bank credit for a major portion of their funds, and these loans were an important segment of bank loan portfolios. Since the late 1950's, however, finance companies have tended to substitute paper debt for bank debt, since there has often been a significant cost advantage in favor of paper. This tendency has placed the banks under considerable competitive pressure. Thus conditions in the commercial paper market have influenced, in some degree, conditions in the bank customer loan market by providing substitute sources of funds to commercial bank borrowers.

Fourth, commercial paper has significance as a liquid asset. Holdings of commercial paper serve in some measure as a substitute for money; accordingly, they permit higher ratios of spending to cash (i.e., higher velocity of circulation of money) than would otherwise exist. The recent growth of the commercial paper market probably has contributed modestly to the rising trend in velocity that has characterized the postwar period.

Finally, the commercial paper market provides a manageable case study of the operation of financial markets and of their development over time. Such studies are worthwhile in themselves, but even more so because they can contribute to our understanding of business cycles. Despite a long history of business cycle theorizing in which monetary and credit variables have played major roles, there is a paucity of empirical studies of the financial aspects of cycles. This lack will be remedied in part when other studies now in progress at the National Bureau are completed, but much remains to be done.[2] Hopefully the present study contributes some relevant knowledge in this area.

Plan of Study

This report, which is part of a study of money flows through agencies that provide consumer credit, examines the commercial paper market mainly from the point of view of the major borrowers at present,

[2] See the staff reports of Phillip Cagan, Joseph W. Conard, James Earley, Milton Friedman, and others in the Bureau's 43rd Annual Report, *The Uses of Economic Research*, New York, 1963.

finance companies.[3] As the title suggests, attention is directed both to cyclical fluctuations and to longer-period changes. Chapters 2 and 3 describe the commercial paper market as it existed around 1920 and the transformations that have taken place since then. Chapter 4 investigates commercial paper as a source of finance company funds, primarily since the end of World War II. This is done mainly by analyzing end-of-year balance sheet data furnished the National Bureau by forty-two sales finance and twenty-eight personal loan companies over the period 1946-60. In Chapter 5 demand and supply conditions in the commercial paper market are analyzed. Chapter 6 examines the cyclical behavior of commercial paper during 1953-61, and Chapter 7 consists of a summary of findings and a few concluding observations on the significance of the commercial paper market. Various supplementary statistics pertaining to commercial paper are provided in several appendixes.

Commercial paper is beset with terminological problems that must be faced at the outset. Paper may be placed either through a dealer or directly by the borrower. For brevity, I shall refer to the former as "dealer paper," and to the latter as "direct paper." I shall follow the practice of the Federal Reserve Bank of New York[4] in treating "commercial paper" as the sum of dealer and direct paper, even though the two components differ in several important respects.

Commercial paper is often classified by type of borrower. The usual dichotomy is "finance-company paper" versus "industrial paper," where "industrial" is understood to include retailers and other nonfinancial enterprises as well as manufacturers. The situation is complicated somewhat because many manufacturers and retailers have formed finance subsidiaries. Commercial paper of these subsidiaries is regarded here as finance paper, not industrial paper.

There are also problems in classifying finance companies. The practice generally followed in this study is to classify them as sales finance, personal loan, or business finance companies. Sales finance companies "are engaged principally in purchasing instalment paper

[3] The larger study, in turn, is a portion of a broad consumer finance research project being conducted by the National Bureau. The other aspects of consumer credit covered in the project include finance rates and costs, state legislation, and the consumer's use of credit.

[4] *Commercial Paper*, monthly releases.

which arises from retail sales of passenger automobiles or other consumer goods or from outlays for residential repair and modernization."[5] Business finance companies are firms whose receivables consist mostly of debts of businesses; factors, commercial finance companies (i.e. firms that specialize in accounts receivable financing), and companies that finance instalment purchases of capital goods comprise this category. The main problem arises among personal loan companies, whose receivables are mostly cash loans to consumers. The Federal Reserve Board has split this group of firms into consumer finance companies, which are principally engaged in making personal loans under state small-loan laws, and other personal finance companies, which make most of their loans under other legislative authority. In general I shall not make use of this distinction.

A further complication has been introduced by the equating of finance and direct paper in many discussions.[6] The practice is understandable, since all direct paper is finance paper and most finance paper is directly placed. However, not all finance paper is direct paper, and it will be shown that finance companies now dominate the dealer market as well as the direct market. Accordingly, finance paper shall mean notes issued by finance companies, whether placed directly or through dealers.

Finally, commercial paper transactions are sometimes described as sales and purchases of paper and sometimes as borrowing and lending of funds. Thus an increased (decreased) demand for paper means an increased (decreased) supply of funds. For the sake of simplicity, the discussion that follows is stated largely in terms of the borrowing and lending of funds.

[5] "Survey of Finance Companies, Mid-1960," *Federal Reserve Bulletin*, October 1961, p. 1140.

[6] See the monthly tables in the *Federal Reserve Bulletin*. The Bankers Trust Company has adopted the same usage in its annual publication, *The Investment Outlook*.