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SOME OBSERVATIONS ON THE LIQUIDITY POSITION OF MANUFACTURING CORPORATIONS IN WORLD WAR II

WHILE AN EXHAUSTIVE ANALYSIS of the implications of the present liquidity position of manufacturing corporations is beyond the scope of this study, a few observations are in order, to indicate the economic significance of the results obtained in Chapter 8.

The question that is likely to be raised first concerns the meaning of the absence of a considerable amount of excess liquidity, as shown by our sample of large manufacturing corporations, so far as the problem of reconversion from war to peacetime production is concerned. If the results obtained for our sample are indicative of the situation of all large manufacturing corporations,¹ then it may, at first glance, appear, that not much of their cash and marketable securities is free to be spent on reconversion. But this conclusion is not warranted.

First, our analysis merely reveals that in 1943 large corporations did not hold considerably more liquid funds than were required to provide for payments that could be expected at that time. The position in which the corporations will find themselves at the end of the war is quite another matter. Their liquid funds (particularly in the form of government securities) will be higher than they were in 1943. On the other hand, it is doubtful that their payments will increase as much as liquid funds, considering that an expansion of the economic system from the 1943 level can at best be a slow process and that price controls undoubtedly will still present some obstacle to price and wage advances.

¹ A comparison through the year 1942 of our sample of large manufacturing corporations with a larger sample of 890 manufacturing corporations, which the Board of Governors of the Federal Reserve System put at the disposal of the Financial Research Program for this purpose, indicates that the larger group shows, on the whole, the same tendency as the smaller sample. For the larger group the figures for the ratio of average cash plus marketable securities to payments from 1937 to 1942 are, in percent, 10.8; 14.7; 15.7; 16.5; 13.7; 14.9. (For similar ratios for sample B, see Chapter 8, Table 4.)

Second, liquid funds may be set free by a reduction of certain kinds of payments against which corporations have to hold particularly high liquid funds. Foremost among them are tax liabilities. A reduction of these liabilities following a reduction of tax rates would release a considerable amount of cash or marketable securities which could be used for reconversion purposes. The same is true for liquid funds held against claims by the government arising out of the renegotiation procedure, or funds held to provide for the possibility of retroactive wage rises. Wage increases are not so likely to occur in the precarious employment situation which may arise immediately after the war.

Third, many companies may expect that during the period of reconversion their revenue from sales will fall off for a period of some months, since sales to consumers can replace sales to the government only after a time lag, the length of which is determined by the time required for reconversion to peace production. During this intermediate period payments for reconversion purposes will have to be made. But although receipts from sales to consumers will not come in immediately to fill the gap created by the decline or cessation of government orders, a corresponding decrease of total receipts will not necessarily occur. Receivables from the government will fall due, and very substantial refunds will be paid to the companies under various provisions of the income and excess profits tax laws. The largest source of funds, however, will be the compensation that corporations will obtain upon war contract termination. They may obtain up to 90 percent of terminated war contracts within a period of thirty days after proper application has been made. In the meantime corporations, because of the funds which they can expect from their claims, may draw on the liquid funds then available even though by so doing they may cause the ratio of liquid funds to payments to fall below the level maintained in 1943.²

Fourth, any decline in the volume of payments during the transition period will set free liquid funds which, before the decline, were tied up by the volume of transactions. The volume of payments is not likely to remain so high, per unit of time, during the

² If the funds from the government come in with a time lag and the corporations in the meantime deplete their liquid funds, part of the funds received from the government must, of course, be used to replete their liquid funds.

reconversion period as under war conditions. For instance, General Motors estimates its peak employment during the war at 530,000 persons, but the peak employment after the war at 375,000. This suggests that the decline in payments for this company will be considerable, and that funds will be set free which can be used in the period of transition even if the ratio of liquid funds to payments is not allowed to fall below that maintained in 1943.

Whether that part of marketable securities and cash in the hands of the companies which can be spent on reconversion, together with the funds that they will obtain on war contract termination and under various provisions of the income and profit tax laws, is sufficient to provide for reconversion needs is a question on which a vast literature has arisen.³ The main purpose of such studies is to find out whether or not corporations will need outside funds from the banks and the capital market. It is not our intention to add an estimate of our own. It will suffice to point out some of the assumptions on which such estimates must be based.

The first assumption concerns the volume of business to which the corporations will reconvert, since the reconversion expenses themselves depend on the level of activity which is assumed after reconversion. Inasmuch as an estimate of reconversion expenses requires the application of the sources and uses of funds analysis, a further assumption has to be made about the structure of the balance sheets of corporations after reconversion, which for the most part can be based only on the structure of prewar balance sheets. Yet in many cases methods of production and even the products themselves will have changed; corporations will not convert backward but forward. Assumptions about the postwar price level, taxes, the present state of fixed equipment, standards of conservative financial practice as reflected in balance sheets, and many other factors enter into such estimates. In view of all these difficulties it is hazardous to try to discover whether corporations

³ See, for instance, S. Morris Livingston and E. T. Weiler, "Can Business Finance the Transition?" *Survey of Current Business*, February 1944, pp. 9-11; Frederick C. Dirks, "The Rising Liquidity of Manufacturing Companies and Its Implications for Financing Postwar Conversion," *Journal of the American Statistical Association*, June 1944, pp. 207-17; several press releases of the Securities and Exchange Commission (Statistical Series, Release No. 739 and 742); *Federal Reserve Bulletin*, July 1944.

will need outside funds for reconversion; the result depends on these basic assumptions, which pave the way for a wide variety of answers.

Such estimates as are made apply to the corporate universe. If they could be made accurately, they would indicate whether all corporations *taken as a unit* do need (or do not need) funds from outside. Within the corporate universe there are, of course, great differences between individual companies and industries. Corporations which have to reconvert largely to a different kind of production may be short of funds whereas others, for which the reconversion problem is slight, may have more funds than they need. Even if the funds available for reconversion are sufficient for the corporate universe, many individual companies will need "outside" funds, whereas others can supply such funds because they will have more than they need for their own reconversion. The investigation in the preceding chapter has shown that differences exist with respect to liquid funds (excluding what the corporations will obtain from the government) between such groups as large manufacturing corporations on the one hand and medium-sized and small manufacturing corporations on the other.

In view of the current discussion of the reconversion problem, a point that should be emphasized is that the speed with which conversion to peacetime production can be carried out does not depend on whether the companies have sufficient funds or need to borrow. Borrowed funds are just as good as the corporations' own funds from this point of view. But even the total of liquid funds (including borrowed funds) available for conversion tells us little about the possibilities of a rapid conversion to peacetime production. The rapidity of conversion is mainly (though not entirely) a production problem.

From the point of view of the economic system as a whole, the ease of conversion obviously depends on the quantity of goods and the amount of equipment which can be readily shifted to peacetime production, either within the concerns that possess the goods or by transfer to other concerns that can utilize the materials. Even if all corporations are extremely liquid, it will nevertheless be difficult, or even impossible at first, for some of them to obtain the materials and machine parts which they will need. For example, many corporations will have to wait several months while

their raw materials are being processed by other corporations. In all probability, some unemployment will exist, since many concerns may not be able to employ their full complement of men while making adaptations in respect to plant and machinery.

Difficulties arise in attempting to obtain any quantitative estimate of the size of the portion of wartime equipment and stocks of goods in factories and warehouses when the war ends, which can be converted to the production of peacetime goods either at once or within a short space of time. Conditions in regard to inventories will vary greatly from industry to industry: some inventories will be nonspecific and will be readily shifted; others, such as ammunition, will be obsolete; and still others, such as substitute materials, will suffer a severe decline in market value even if they do not become obsolete. In many cases the necessary materials will be entirely lacking and stocks will have to be built up again from the beginning.

The conversion of fixed equipment to the production of peacetime goods, on the other hand, does not present so formidable a problem as might appear at first sight. Many of the machines and tools have deliberately been constructed with an eye to "versatility" and can be adapted to other uses by some relatively simple technical adjustment, such as the changing of a part. Moreover, a considerable quantity of old peacetime equipment has only to be taken out of storage and reinstalled. Many concerns expect to be able to make these adjustments within a few months.⁴ Again, not all industries will be affected to the same extent. Undoubtedly, excess capacity and obsolescence will be characteristic of some industries, while others will be hampered by a scarcity of equipment because of the suspension of repairs and replacements during the war. The development of new techniques of production, and even of new products for which the future consumer demand cannot now be forecast, adds to the difficulty of predicting the effect of the readjustment on individual industries and concerns.

When the problem is considered from the standpoint of the *individual* corporation, the ease with which the shift can be made will depend first of all on the degree of convertibility of the corporation's physical assets (machines, stocks of raw materials, and

⁴ See, General Motors Corporation, *Annual Report for 1942*, p. 63, and the returns of a questionnaire sent out by the Federal Reserve Bank of Philadelphia.

goods-in-process) to peacetime production within its own plants. This ease will depend also on the individual corporation's financial liquidity position, which measures ability in money terms to acquire materials and other means of production. The liquidity of individual corporations and their access to bank credit will therefore affect their relative positions⁵ in bidding for supplies and other factors of production when the war is over. In this sense the liquidity position (including the access to bank credit of each individual concern) is important. But it remains true that the aggregate of corporate funds (including bank loans) available for reconversion is no measurement of the capacity of the economic system as a whole to accomplish a speedy conversion to peacetime production. Only in so far as the spending of large liquid funds on the part of all corporations (and consumers) may provide the stimulus for the conversion can we attach importance to the total volume of funds (including bank loans) available for reconversion.⁶ But the physical condition of the productive apparatus in the economy sets a limit to the speed of reconversion.

This last point indicates another problem that arises in connection with the reconversion problem. If corporations draw on their liquid funds in the reconversion period, they will sell marketable securities partly to the banks, which gives rise to new deposits. The same is true if they borrow from the banks. Even if at the close of the war the Treasury were to cease borrowing from the banks⁷ and thus stop one source of inflation, the corporate universe (and also consumers), by drawing on its liquid funds or by borrowing from the banks, could open a new one.

It may be contended that the inflationary danger emanating from this source is under the control of the monetary authorities, since they can always prevent the banks from buying additional securities or from lending by keeping reserves down; and that

⁵ The advantage of having larger liquid resources than other concerns may be reduced if rationing of materials and machine parts is maintained during the period of readjustment.

⁶ For a detailed discussion of the reconversion problem see, A. D. H. Kaplan, *The Liquidation of War Production* (Committee for Economic Development, New York, 1944).

⁷ The Treasury will need funds for the purpose of contract termination. But even if it should obtain the money by inflationary borrowing, this borrowing could not be counted fully as an additional source of inflation, since part of the funds may be used by business enterprise to build up its liquidity which will have been lowered by drawing on cash and by selling marketable securities for the purpose of reconversion.

the sale of securities by corporations (and consumers) to investors other than commercial banks do not start inflationary tendencies,⁸ because they do not lead to the creation of additional deposits. Therefore, provided the monetary authorities want to prevent inflation, there apparently is no reason to fear it as a result of an attempt of corporations and consumers to liquidate their marketable securities or to borrow from the banks.

Such reasoning is misleading. Theoretically, the monetary authorities could control the inflationary danger arising from the sale of marketable securities by corporations (and consumers) or from private borrowing. But they could do so only if they were willing to let the prices of government securities fall and to shoulder the responsibility of curbing a stimulus that would otherwise encourage the conversion to peacetime production.

It has been pointed out that the amount of funds that may be absorbed by the postwar conversion process cannot be gauged accurately. Whether corporations will have to make use of bank loans and other funds from outside sources, in addition to liquidating part of their cash and their marketable securities, cannot be estimated now. But if the assumptions are made that the liquid funds in the hands of corporations, together with what they receive from the government, are sufficient for conversion to peacetime production, and that banks will be able to take over the marketable securities liquidated by corporations, it follows that the tendency for large industrial corporations to become more and more independent of commercial banks, which characterized the interwar period, will be strengthened still further.

Our study of cash balances in the thirties shows clearly what the consequence of such a development would be. If enterprises are independent of bank credit,⁹ fluctuations in business activity will not lead to variations in bank loans and total deposits; instead they will express themselves in the monetary sphere, by a changing velocity of the circulation of money.¹⁰ In other words, the phe-

⁸ This statement is subject to the qualification that other investors do not purchase these securities with balances formerly held idle.

⁹ From the point of view of the economic system as a whole this means that the bulk of bank deposits is based on government securities.

¹⁰ Those who believe that the monetary authority, by an appropriate policy of selling securities to or retiring them from the banks, can avoid business cycles need not accept this conclusion.

nomenon of "free" cash, observed for large corporations in the depression of the thirties, will become the rule for periods of business contraction in the near future. In addition, it is likely that the relative distribution of the total means of payment in a period of depression will change in favor of business enterprises, and in a period of upswing, in favor of consumers.

SUMMARY

- (1) Whether liquid funds already in the possession of corporations together with what they obtain from the government are sufficient for the reconversion of corporations to peacetime production cannot be accurately forecast at the present time.
- (2) The speed of reconversion to peacetime production for the economic system as a whole is not only a financial but also a production problem. The physical condition of the production apparatus at the time when reconversion begins on a large scale sets a limit to the speed of reconversion.
- (3) If corporations use their liquid funds for reconversion purposes or borrow from the banks, and if consumers liquidate their securities, an inflationary source is likely to be opened up which will be difficult for the monetary authorities to control.
- (4) If reconversion to peacetime production can be accomplished without recourse to bank loans, business fluctuations in the immediate future are likely to express themselves in the monetary field by changes in the velocity of circulation of money instead of by changes in bank loans and deposits.