



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

December 18, 1975

CONFIDENTIAL (FR)
CLASS II-FOMC

To: Federal Open Market Committee

From: Murray Altmann

Attached for your information is a copy of a briefing on corporate profits presented to the Board of Governors on December 8, by Mrs. Martha Scanlon. Also attached is a follow-up memorandum to Chairman Burns from Mrs. Scanlon.

These materials are being circulated to the Committee in accordance with the instructions of the Chairman at the last FOMC meeting.

Attachments

Board Briefing
Martha Scanlon
December 8, 1975

CORPORATE PROFITS

Corporate profits, by whatever concept measured, increased very substantially in the third quarter. Based on preliminary Department of Commerce estimates, the increase was close to 20 per cent at a quarterly rate. Whereas, normally, profits tend to react strongly to changes in economic growth, the magnitude of the recent recovery in earnings is greater than in previous postwar recessions. This strength reflects the unusually strong increase in GNP in the third quarter, corporate pricing policies, and large productivity gains.

To place current profit movements in perspective, it is useful to compare the recent downturn and subsequent surge with profit behavior in previous postwar cycles. Corporate profits in recent years are shown in Chart 1. The top line of the chart is profits before taxes for all corporations; the second line is profits before taxes for domestic nonfinancial corporations (foreign and financial institution profits are excluded); the third line is profits before taxes, excluding inventory profits, for domestic nonfinancial corporations.

As indicated by the top two lines of the chart, total profits of corporations have shown considerable volatility in the recent downturn and recovery. Following record highs in the third quarter of 1974, profits for all corporations fell approximately 36 per cent below this peak in the following two quarters. Nonfinancial corporations recorded

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an even larger decline of 42 per cent, between the third quarter of last year and the first quarter of this year. The magnitude of these declines is much larger than in any previous post war recession.

However, as you are aware, corporate profits in 1974 were greatly inflated by the rise in inventory profits. The very rapid reduction in profits in the current recession primarily was due to the marked shrinkage in these inventory profits, which dropped from an annual rate of \$51 billion in the third quarter of 1974 to \$7 billion in early 1975. In the last two quarters, inventory profits have risen somewhat, but they still remain well below their 1974 levels.

When inventory profits are excluded--as in line 3 of the chart--the figures indicate much more modest declines in operating profits or profits plus IVA. For nonfinancial corporations, pretax profits plus IVA fell approximately 10 per cent in the most recent downturn. This contrasts with previous recessions, when such profits declined between 16 and 30 per cent. Moreover, in most instances, the decline in real product was considerably less severe during these earlier cycles.

On the other hand, the surge in earnings in the last two quarters has been much stronger than in any other postwar recovery, whether inventory profits are included or excluded. Chart 2 shows the percentage increase in nonfinancial corporate profits excluding inventory

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gains for the six postwar recovery periods. Starting from the profit trough (which is plotted at the origin), the chart indicates the cumulative percentage increase in profits that occurred in subsequent quarters of the recovery period. The latest recovery is shown by the dashed line on the chart. The profit low in this recession came in the first quarter of this year. One quarter later, profits had risen 14 per cent above this low; and the third quarter preliminary estimates are 40 per cent higher than the first quarter trough. For other postwar cycles, the recovery in profits was much less rapid. In 3 out of 5 postwar recoveries, pretax profits plus IVA were less than 40 per cent above their trough 4 quarters later. Thus, it appears that a substantial amount of the recovery in profits that is typical for economic upturns in general has already occurred in the early stages of the current recovery.

The third quarter surge in profits reflects partly an increase in total real output. In addition, there has been a substantial jump in the share of corporate output represented by profits. This is illustrated in Chart 3. Profit share, as shown in Chart 3, is defined as the ratio of pretax domestic profits plus IVA to gross product originating in the nonfinancial corporate sector.

As the chart indicates, there is a strong cyclical movement in this measure as well as a longer run downtrend. Since 1969, this ratio has fluctuated around a depressed level. The profit

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share generally declines in a recession as a result of rising unit costs; and rises in a recovery as productivity gains accompany rising output. In the most recent cycle, there has been less of a decline in the profit share during the downturn than in other postwar recessions; while the subsequent rise has been much more rapid than in previous strong cyclical recoveries.

In part, this movement in profit shares reflects the behavior of corporate prices in the most recent cycle. Despite large amounts of excess capacity and slack in the economy, there has been less price decline and more price increase than in previous postwar cycles, suggesting manufacturers have been more successful in maintaining profit margins during the downturn. Moreover, in a number of industries where margins had eroded, firms raised prices even with relatively small or no gains in demand.

Furthermore, as a result of the unusually large increase in real output early in the recovery, productivity has risen sharply--at close to a 12 per cent rate for nonfinancial corporations in the third quarter. These productivity gains contributed to the marked rise in the profit share in the last quarter--to its highest level since 1969--and were only partly reflected in a reduction in the rate of inflation.

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Additional increases in the profit share are not expected to be large. As slack is taken up in the economy, further increases in output will very likely be accompanied by much smaller increases in productivity.

It should be noted that the surge in profits in the last two quarters has improved over-all corporate cash flow and liquidity. Liquidity ratios for nonfinancial corporations have returned to '73 levels from '74 lows. But it is not clear how much additional rebuilding of liquidity corporations intend.

It should also be noted that there has been considerable divergence in the performance among individual industries. In general, preliminary data suggest the strongest increases in profits have been registered in manufacturing--particularly among producers of durable goods. Railroads, airlines and utilities have also reported strong gains. But comprehensive data on individual industry performance will not be available until a later date.

Before closing, I might add that major revisions in the National Income Account figures are expected later this month. These revisions will affect the level and movements in corporate profits since the late '50s, but my understanding is that the pattern of developments shown in recent quarters will not be significantly changed.

CHART 1
CORPORATE PROFITS
Seasonally Adjusted Annual Rates

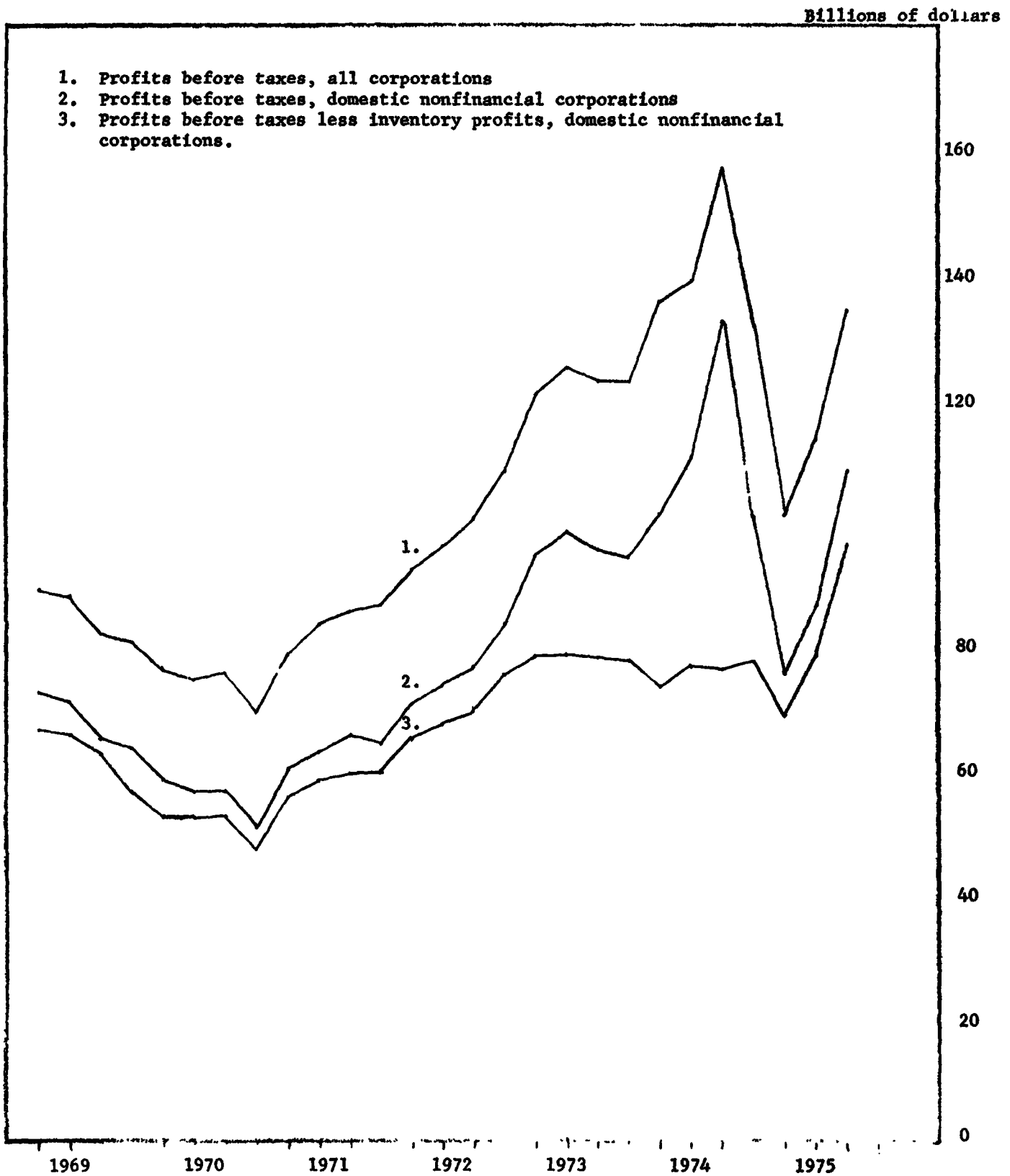


CHART 2

PROFITS IN CYCLICAL RECOVERIES Cumulative Percentage Increase from Profit Trough

(Profits before taxes less inventory profits,
domestic nonfinancial corporations, SAAR)

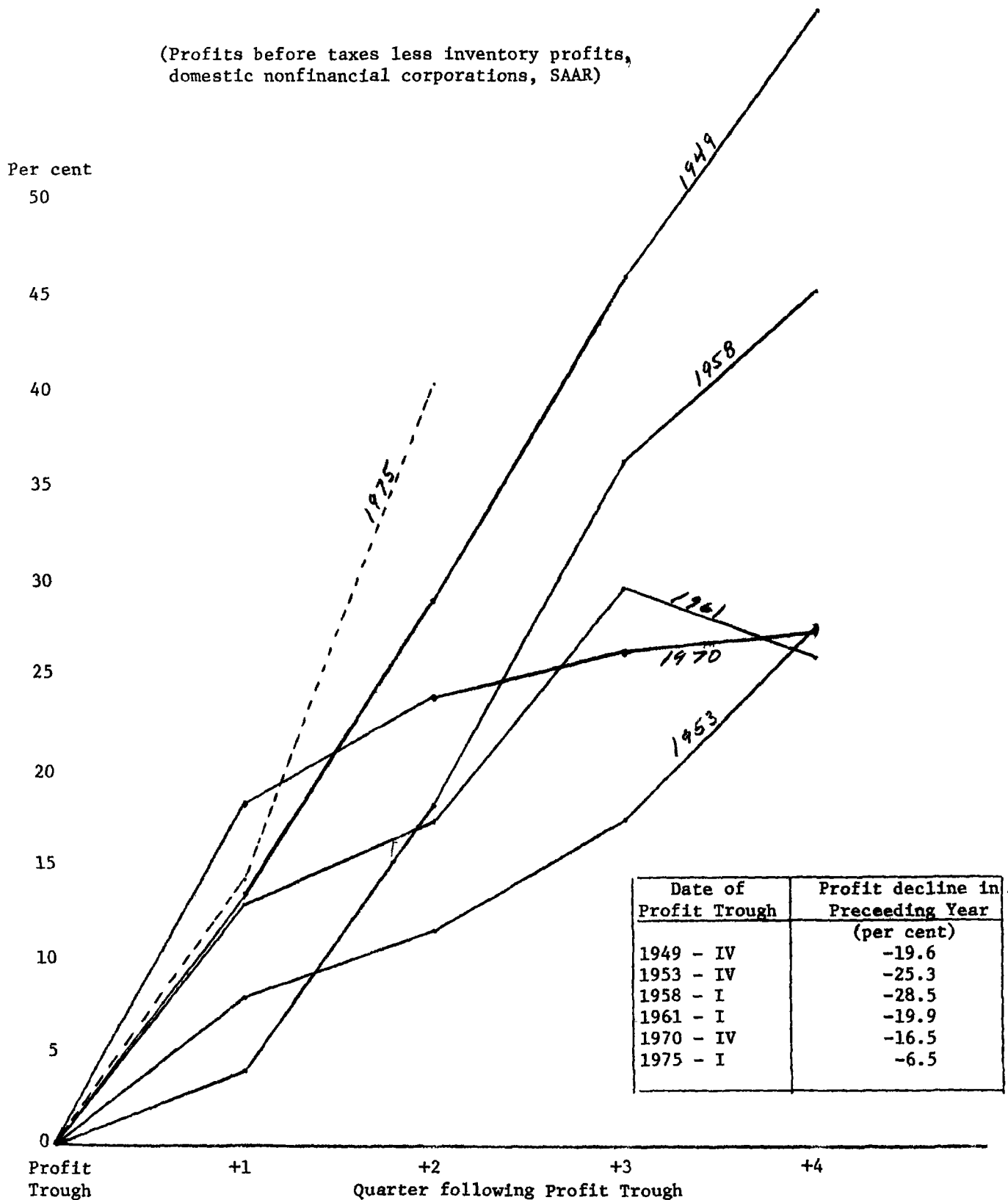
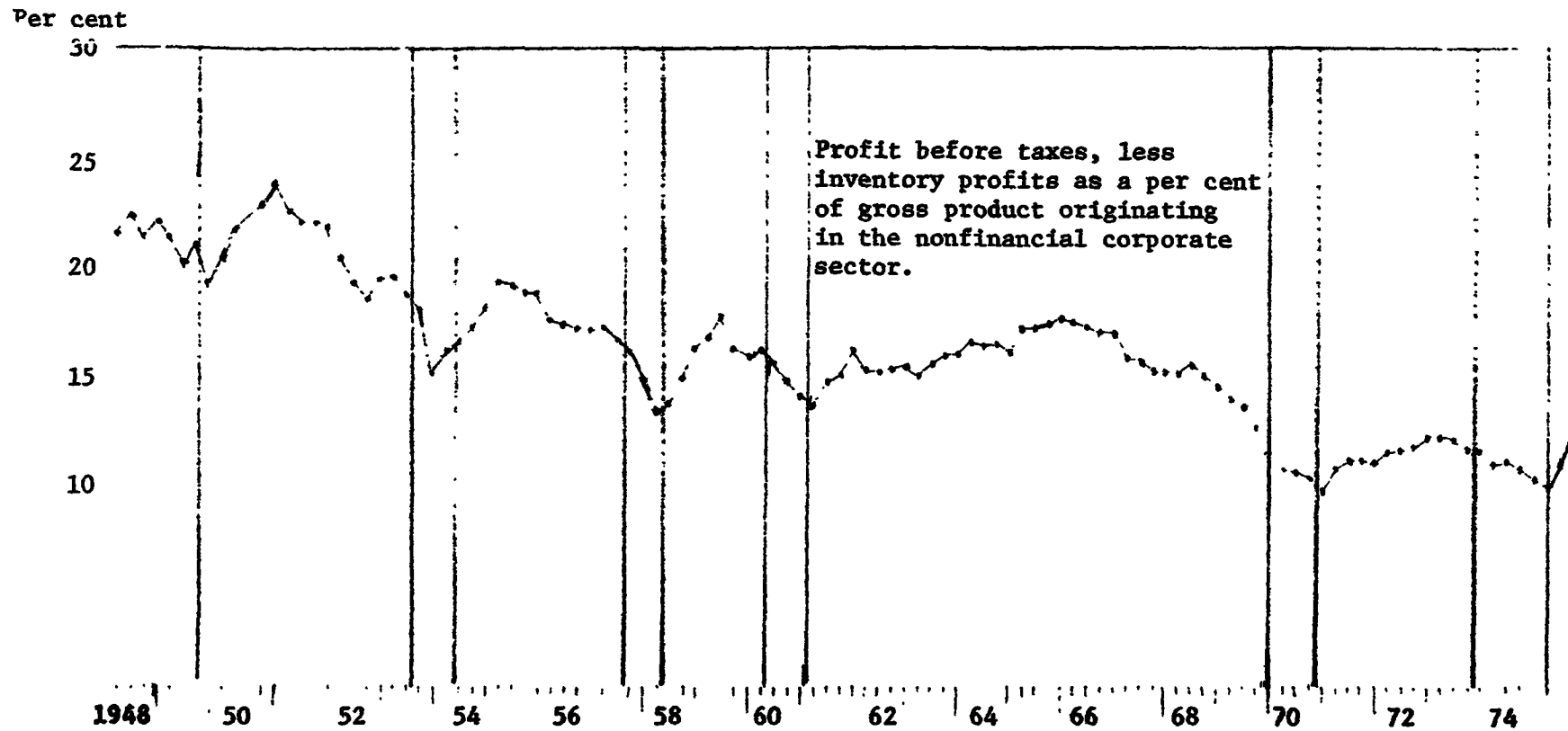


CHART 3

PROFIT SHARE
Domestic Nonfinancial Corporations



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 9, 1975

To Chairman Burns

Subject: Corporate Profits

From Martha Scanlon *MS*

At Monday's briefing on corporate profits, the question was raised about movements in profits after taxes. (The charts used in the briefing showed changes in profits before tax or PBT.) Attached are three charts identical to those shown in the briefing, but which are based on after tax profits (PAT). For comparison, a copy of the briefing and charts showing movements in pretax profits are also attached.

Changes in PAT reflect essentially the same behavior as pretax profits. In particular, total profits after tax declined sharply in the recent recession--more sharply than in previous cycles. When inventory profits are excluded, however, PAT show a much more moderate decline and more rapid recovery than in earlier cycles. Since the third quarter of last year, PAT plus IVA have risen continuously, reaching record levels in most recent periods.

CHART 1A

CORPORATE PROFITS AFTER TAXES
Seasonally Adjusted Annual Rates

Billions of dollars

160

1. Profits after taxes, all corporations
2. Profits after taxes, domestic nonfinancial corporations
3. Profits after taxes less inventory profits, domestic nonfinancial corporations.

140

120

100

80

60

40

20

0

1969

1970

1971

1972

1973

1974

1975

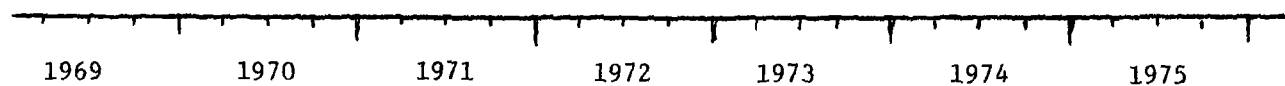
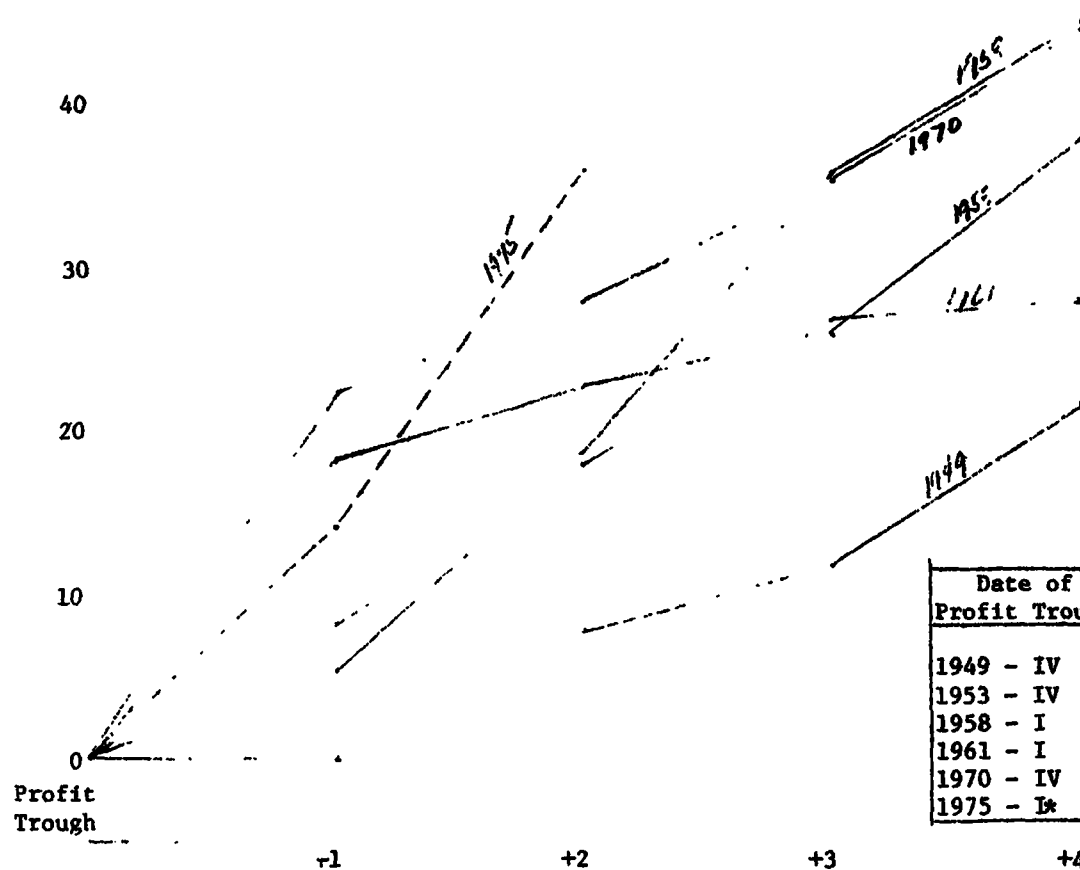


CHART 2A

PROFITS IN CYCLICAL RECOVERIES
Cumulative Percentage Increase from Profit Trough

(Profits after taxes less inventory profits,
domestic nonfinancial corporations, SAAR)

Per cent
50



Date of Profit Trough	Profit decline in Preceding Year (per cent)
1949 - IV	-20.0
1953 - IV	-29.1
1958 - I	-27.0
1961 - I	-22.9
1970 - IV	-12.2
1975 - I*	27.3

Quarter following Profit Trough

* Date of trough in profits before taxes. PAT plus IVA trough occurred in third quarter of 1974--a decline of 36 per cent from a year earlier. PAT plus IVA in the third quarter of 1975 were 128 per cent above the previous year low.

CHART 3A

PROFIT SHARE
Domestic Nonfinancial Corporations

