MONETARY POLICY, FINANCIAL LIQUIDITY, AND THE OUTLOOK FOR CORPORATE PROFITS

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One of the most striking features of the economic scene in 1966 was the considerable reduction in liquidity of financial institutions, business firms and the general public. Since last November, one of the principal objectives of monetary policy has been the restoration of financial liquidity -- along with making credit more generally available.

However, the methods used by the major lending and spending sectors of the economy to rebuild liquidity have produced significant changes in the level and structure of interest rates. For example, the demand for liquid assets -- especially by financial institutions -- has pushed short-term rates down substantially below last fall's peak. On the other hand, the efforts of corporations to restore their liquidity by borrowing in capital markets in record volume have tended to push up long-term rates from the low points reached earlier this year.

But behind these global developments in liquidity, a number of important changes have occurred in specific sectors of the economy:

- Commercial banks (which have had sizable inflows of time deposits but have faced a more subdued demand for loans) have added substantially to their holdings of tax-exempt securities. At the same time, they have adopted an especially cautious attitude toward negotiable certificates of deposit.

- Other financial intermediaries (e.g., savings and loan associations and mutual savings banks) have also experienced particularly large inflows of funds. However, a considerable proportion of the gains has been used to repay the institutions' own debts or to acquire securities -- rather than to expand mortgage loans.
In the business sector, corporations have used a sizable share of the proceeds of capital market borrowings to rebuild financial assets, to cover Federal tax liabilities made unusually large through the acceleration of collections instituted last year, and more recently to repay bank loans. However, the continued high rate of investment in facilities in the face of declining corporate profits has also been a principal force behind the record volume of borrowing by corporations.

Naturally, the recent downtrend in corporate profits has engendered much unhappiness in the business community. In view of the modest increase in total output (and actual -- though small -- declines in industrial production) so far this year -- combined with significant advances in labor costs per unit of output -- the basis of this pessimism is not hard to find. However, the actual decline in corporate profits during the first quarter of this year may not have been as large as indicated by some of the earlier estimates. Moreover, when viewed in a somewhat longer perspective, the outlook for corporate profits may not be quite as unpromising as some observers have suggested.

**Monetary Policy and the Restoration of Liquidity**

The expansive monetary policy adopted by the Federal Reserve System last November has had its effects throughout the financial system. In the five months following the overt shift in policy, commercial bank credit expanded at an annual rate of 12 per cent -- sparked mainly by the growth of time deposits at a 16 per cent annual rate. Savings and loan associations have also enjoyed extremely large inflows, which from November through March rose at a seasonally adjusted annual rate of 8.8 per cent. During the same period, inflows to mutual savings banks expanded at an annual rate of 9.1 per cent.
The counterpart of these flows is a noticeable strengthening in the liquidity position of consumers. While they have sharply expanded their savings through intermediaries, they have not stepped up direct acquisitions of market securities. At the same time, their borrowing in short-term and in mortgage markets has remained low.

With financial institutions in a far more liquid position, the availability of credit to potential borrowers has also expanded considerably. Simultaneously, most market rates of interest have declined substantially from their 1966 highs. The declines have been especially marked in short-term rates: currently these rates are almost 2 percentage points below the peaks set last September. On the other hand, long-term rates declined more slowly following the shift in monetary policy. Moreover, since February, they have risen considerably in the wake of heavy market flotations: for example, at the end of last week the Aaa corporate new issue rate stood only 30-40 basis points below last September's high.

Undoubtedly, much of the huge volume of flotations this year reflects a real current need for funds by numerous firms and state and local governments. On the other hand, some of the borrowing in long-term markets apparently has been undertaken in anticipation of a revival of economic expansion later in the year which many believe might usher in another period of monetary restraint. Obviously, I cannot comment on this latter expectation. But in passing, I would like to observe that when so many borrowers try to squeeze into the market at the same time they should not be surprised that the consequence is a / in long-term interest rates.
Thus, the most recent experience demonstrates again that the interplay of supply and demand in the market place remains the basic determinant of interest rates. This is not to suggest that monetary policy has not had an influence on the outcome. Through policy actions, the monetary authorities have had a substantial impact on the level and structure of interest rates. Undoubtedly, this will continue to be the case when the needs of the economy require changes in the stance of monetary policy. But the recent behavior evidence of long-term rates presents clear that private decisions on how and when to use the volume of bank reserves made available by the monetary authorities also will have a major effect on the distribution and cost of credit.

**Liquidity Position of Commercial Banks**

Commercial banks have been particularly successful in their efforts to improve their liquidity positions. Since November, loans have accounted for less than half of the growth in bank credit. In contrast, in the first 11 months of last year, the expansion of loans exceeded total asset growth as banks liquidated securities to meet the demand — especially of business customers. Reflecting the attempt to rebuild liquidity, banks have added almost $9 billion to their securities, on a seasonally adjusted basis, since last November. However, a noticeable change has occurred in the composition of the banks’ securities portfolio. At the end of April, 1967, the banks held about $56 billion of U.S. Government issues, representing roughly 51 per cent of all securities owned. At year-end 1965 and 1966, Federal Government issues amounted to 56 per cent and 53 per cent, respectively, of their total holdings.
But at the same time, bank holdings of participation certificates (PC's) have increased in importance. For example, during the first quarter of this year, the banks made net acquisitions of about $4 billion of PC's, at a seasonally adjusted annual rate.

A particularly sharp increase has occurred in the banks' holdings of state and local government obligations. In the first quarter, these holdings climbed by approximately $7 billion, at a seasonally adjusted annual rate, compared with an increase of $3.4 billion in the first quarter of 1966 and a net liquidation of $2.5 billion in the fourth quarter. In fact, commercial banks absorbed about two-thirds of the net expansion of state and local government issues during the first quarter of this year, compared with one-third in the full year 1966. A sizable amount (over $1 billion) of the increase in the banks' holdings of municipals in the first quarter of this year consisted of short-term issues, which again is indicative of the banks' efforts to rebuild their liquidity.

Of course, we can never measure bank liquidity with any degree of precision. However, several rough indicators do suggest that bank liquidity has improved greatly. For example, by the end of March, the loan-deposit ratio of all banks was 65.4 per cent, down 1.4 percentage points from last September's high. This is nearly half the average drop from peak to low point in this ratio during those periods since 1951 when monetary policy shifted from restraint to ease. But this ratio combines all forms of loans and deposits, and it hence leaves much to be desired as a liquidity indicator.
A better measure would distinguish between the liquidity of the Little quantitative banks' assets and the liquidity of their liabilities. Information on the maturity of portfolios is available, although we can make some reasonable estimates. For example, the Federal Reserve Bank of Cleveland provides us with one of the very few sources of term loan data. These figures show that for the Cleveland District term loans as a percentage of total business loans (after rising sharply to over 48.5 per cent in the second half of 1966) have declined during the first four months of this year. In April they accounted for only 46 per cent of business loans. If similar developments have occurred in other districts, bank loan portfolios are now considerably more liquid than they were last year.

We also know the maturity structure of Government securities at weekly reporting banks. Again, however, the Cleveland Federal Reserve Bank provides us with the only data on the maturity structure of municipals held by a group of banks in its District. Since most of the securities (other than U.S. Government issues) held by all banks are municipals, we can use the Cleveland District ratio to estimate the liquidity (i.e., under 5-year maturities) of other securities held by weekly reporting banks in the country as a whole. Taking the ratio of U.S. Government and other securities due in less than 5 years to total loans and investments, we find that the portfolio liquidity ratio of weekly reporting banks has expanded rather sharply -- from about 14 per cent last fall to over 16 per cent in March. The present ratio is about the same as that which existed in the fall of 1965, but it is still considerably below that (roughly 30 per cent) which prevailed in 1961.
Attitude Toward CD's

The critical question, however, is not whether liquidity has risen by any finite amount, or is below some past peak. Rather, the key question is whether the ratio is such that banks feel relatively comfortable. After all, in the 1960's banks have developed new sources of liquidity from the use of time deposits (especially CD's) and other borrowings. At present rate levels and within the existing ceilings on rates payable, banks could greatly augment their holdings of liquid assets -- if they desired -- by aggressively seeking CD's. However, in March and April, banks purposely set CD rates at relatively non-competitive levels to modify inflows, suggesting by implication that they felt no particular strain to add to their liquid assets.

If we turn to the liability side of bank balance sheets, we can see that the sharp growth in time deposits has been a major source of the funds used by banks to rebuild liquidity. The increase was particularly sharp until mid-February, with over one-half of the increase coming from CD's. Since then, CD growth has moderated, but consumer-type time have deposits/continued strong and savings deposits/increased.

Negotiable CD's had climbed by almost $3 billion from the end of November to mid-February to a total of about $19 billion; from mid-February to the end of April, they expanded by only $100 million. Why the banks have adopted this cautionary approach is an interesting question.

The main reason apparently was that banks were already content with their liquid assets and felt under no pressure to augment
their inflow, particularly with other forms of time deposits remaining so strong. In addition, loan demands have remained relatively weak as businesses financed themselves so heavily in capital markets, thus reducing in turn the need for banks to seek funds. Finally, after 1966, some banks -- particularly in key money markets -- may be somewhat more skeptical about using CD's as a source of funds, having lost $3.1 billion of them from last August to late November. On the other hand, in recent weeks, there have been modest increases in CD rates offered for longer maturities; but it is still too early to tell if these will develop into sustained efforts to gain additional funds on a somewhat longer term basis.

There are also indications from bank liabilities that commercial bank deposits are now in somewhat more stable forms. The average maturity of CD's (at 3.7 months) is back to pre-restraint levels. Moreover, consumer-type time deposits (which proved less volatile in 1966 than corporate money) have also increased as a share of bank liabilities.

On balance, if I were to hazard a guess, I would suggest that banks will again find it desirable to bid strongly for corporate and other large time deposits if the strength of loan demand justifies such action. In my judgment, the negotiable CD still is -- and will remain -- a viable money market instrument -- provided that interest rate ceilings are kept realistic in terms of competitive market yields.

**Liquidity Position of Other Financial Institutions**

Savings and loan associations in the first quarter of this year experienced an increase in their share capital of about $10 billion at
a seasonally adjusted annual rate. This was their best performance since 1964. However, also during the first quarter, S&L's repaid almost $3 billion of Home Loan Bank borrowings and reduced by nearly $1 billion their outstanding loans at commercial banks. Moreover, they made sizable additions to their holdings of cash and U.S. Government securities relative to savings capital. Their efforts to rebuild liquidity, however, limited their mortgage acquisitions. Thus, in the first quarter of this year, S&L's holdings of mortgages on 1- to 4-family homes rose by just over $3 billion, at a seasonally adjusted annual rate, or about the same pace as in 1966 as a whole.

The S&L's repayment of loans from the FHL Banks has also enabled the latter to retire $1.8 billion of their own outstanding debt which matured during the first four months of 1967. In addition, during the same period, the FHL Banks were net buyers of $1.7 billion of U.S. Treasury bills. Consequently, the financial sector of which S&L's are the fulcrum -- in effect -- has channeled $3.5 billion of funds into the short-term debt market. This has been one of the principal causes of the substantial decline in short-term interest rates. Most recently, however, the S&L's have been adding to their mortgage holdings at a faster pace, and this trend will undoubtedly accelerate as the year progresses.

Rebuilding Liquidity in the Business Sector

During the first four months of this year, business firms increased their bank loans by $3.7 billion, or by a relatively rapid 14 per cent seasonally adjusted annual rate. However, their tax payments during
this period, reflecting the acceleration in collections which began last year, were also extremely high. After allowing for tax bills turned in, the cash tax payments amounted to $35 billion during the January-April months, or one-third more than in the same period in 1966. Thus, against this background, the expansion in bank loans to business appears relatively modest.

Over the same period, however, businesses sold about $7.5 billion of long-term securities (including private placements). Several factors seem to have induced them to offer such a record volume of issues. For one thing, it provided them with funds to help pay their large tax bills. In addition, such financing fostered a desired re-structuring as well as a rebuilding of their financial/positions. From December to mid-February, this was done mainly through the acquisition of CD's; since then they have concentrated on other types of open market paper.

Moreover, while some bank loans undoubtedly have been repaid from capital market borrowings, probably of equal importance was an effort to minimize/bank borrowing in order to preserve credit lines if monetary policy should again become restrictive. Clearly, the experiences of 1966 are still very fresh in the minds of many firms. Indeed, the effort of some businesses to broaden their sources of funds by establishing themselves in alternative markets has been an important factor in the sharp expansion of the volume of dealer placed commercial paper. In the first quarter of this year, the total outstanding in the market rose by $1.3 billion, seasonally adjusted, and probably rose further in April.
Finally, the continued pressure of a high level of investment activity on internally generated funds was also a prime factor behind heavy long-term borrowing in the capital market. For example, expenditures by non-financial corporations for fixed investment in the first quarter exceeded by $7.2 billion (at a seasonally adjusted annual rate) the amount of funds generated internally through undistributed profits and capital consumption allowances. When the addition to inventories is included, total investment exceeded internal funds by $12.7 billion (at a seasonally adjusted annual rate) during the first quarter. Although this latter figure represents a sizable decline compared with the excess of close to $16 billion which prevailed during the last three quarters of 1966, it is about double the average recorded in 1965 as a whole. Thus, the liquidity position of corporations remains under considerable strain. Moreover, despite the substantial reduction in inventory accumulation which is currently taking place, outlays for fixed investment continue at a high level -- while corporate profits are declining. Thus, it might be both interesting and instructive to examine profit trends more closely.

The Current Profits Scene

After remaining almost unchanged throughout 1966, corporate profits declined in the first quarter of 1967. Yet the decline appears to have been less than some observers had expected and it may also have been smaller than first reports suggested. With real output declining and unit after-tax labor costs rising faster than unit prices, profit margins in manufacturing declined to about 5 per cent, and total manufacturing profits were 5 to 10 per cent below the level a year earlier.
Year-to-year declines in after-tax profits were especially sharp in some industries; they ranged from 25 to 40 per cent for motor vehicles, building materials, and textile products. But these large declines were partially offset by much smaller declines in a number of other industries and by year-to-year increases in some, such as nonelectric machinery, fabricated metals and petroleum. In some manufacturing groups, such as financial corporations and public utilities, profits probably declined little if at all.

All in all, the admittedly incomplete information now available would suggest that corporate profits after taxes were running at a seasonally adjusted annual rate of $45-46 billion in the first quarter of 1967, compared with levels of $48.7 billion for the first quarter of 1966 and $48.4 billion for last year as a whole. Thus, the first-quarter-to-first-quarter decline may have been in the neighborhood of 6–7 per cent -- rather than/approximately 10 per cent figure that has been given prominence in newspapers.

Because this most recent experience has assumed such a cardinal place in current assessments of the business outlook, it may be helpful to put the profit picture in better perspective.

**A Longer View of Corporate Profits**

An unusual feature of the economic expansion that began in 1961 was the prolonged rise in corporate profits and in profit margins. In each of the three previous periods of economic expansion since World War II, after-tax profits reached a peak annual rate of about $30 billion after the first year of general advance and then leveled off or declined as rising costs overtook previously rising prices.
In the most recent expansion period, however, profits rose almost steadily for five years, finally leveling off in early 1966 at an annual rate of close to $50 billion. Profits also grew relatively more than most other types of income. Thus, throughout 1965 and into 1966, the share of national income earned by the corporate sector exceeded 13 per cent of the total -- the first time it had done so for any extended period since the mid-1950's.

The long advance in profits reflected, probably more than anything else, the absence of the imbalances in price-cost relationships which in previous expansions had produced sharp but short-lived increases in profit margins in the first year of rapid economic growth. Instead, materials prices and unit labor costs remained virtually stable while real output expanded substantially. Consequently, profit margins increased moderately but steadily over an unusually long period. From early 1964 through mid-1966, the ratio of after-tax profits to sales was at or above 5 1/2 per cent for manufacturing companies -- higher than it had been for many years, except for about a year in 1955-56, despite the dampening effect of depreciation liberalization on margins and the profit component of corporate internal funds in the later period.

But as 1966 progressed, pressures on capacity, materials and labor began to be reflected in the increases in unit costs that had theretofore been avoided. And as growth in real output slowed, the long rise in profits halted.
**Short-Run Outlook for Profits**

The probable course of profits over the remaining quarters of the year depends on a variety of factors that are as yet almost impossible to assess singly, let alone in combination. Real output seems likely to rise again, perhaps considerably. But this will bring only limited benefit to margins and total profits if unit costs continue to rise. One must recognize, however, that short of a precipitous fall -- which seems most unlikely -- profits remain at levels that are high by the standards of any time prior to 1965-66.