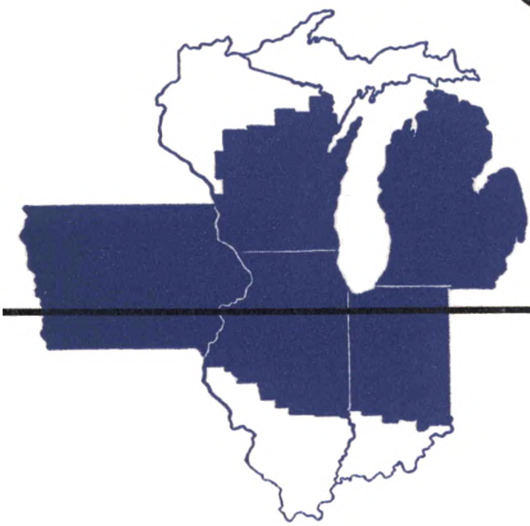
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1952 April

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THE Trend OF BUSINESS

CONTINUING HIGH-LEVEL PROSPERITY appears to be supported by strong props including rising defense expenditures, a huge volume of projected capital outlays and record or near-record consumer buying power. Nevertheless, more District businessmen seem to be viewing the future with pessimism than at any time since the start of the Korean War. Moreover, those who had anticipated a resumption of upward price pressure by this time have been forced to draw off a new trial balance of the strengths and weaknesses in the current outlook.

Bearish sentiment stems from a number of sources. Much of it can be traced to personal experience with depressed industries such as textiles, but even in more prosperous lines some managers have been concerned over a declining trend in new orders. Observers, generally, are influenced by the downward price trends which have been noted in some lines—especially imported raw materials—for a year or more (see chart). More recently opinion has been affected by the announcement of the stretch-out of armament production schedules, the ready availability of many types of goods which were expected to be in short supply, and the unfavorable comparison of over-all retail sales figures with the extremely high levels of early last year.

These dampening influences could be quickly reversed, insofar as they affect general business conditions, by steel, oil, or coal strikes or by dramatic changes on the international scene. Meanwhile, current business judgments are being formed in an economic atmosphere deadened by the heavy hand of the tax collector. Large first quarter Treasury surpluses appear to have had a depressing effect upon business in each of the postwar years. In 1951, for example, the avalanche of Federal receipts just prior to March 15 may have had an important role in ending the surge of inflation. As Government deficits are encountered in the months ahead the full force of the underlying factors of strength may become more apparent.

National security outlays of all kinds are expected to rise by over 15 billion dollars in 1952 to about 60 billion—four times the pre-Korea level. From June of 1950 to the end of last year almost 47 billion dollars in prime military contracts had been awarded. More than 21 per cent of this total went to firms whose main offices are located in District states. The Chicago Association of Commerce and Industry reports that since Korea upwards of 1,000 Chicago area firms have obtained contracts of one kind or another. Most important among recent awards in this area is the contract to Douglas to build twin-jet bombers at the O'Hare Field plant recently vacated by Fairchild.

Material allocations have been eased for makers of a variety of products. Additional steel has been made available in the second quarter for the completion of industrial and commercial construction projects already underway. Automakers can now have enough metal of all types to turn out over 1 million passenger cars in the April-June period—previous allotments had suggested an output of as little as 800,000 units.

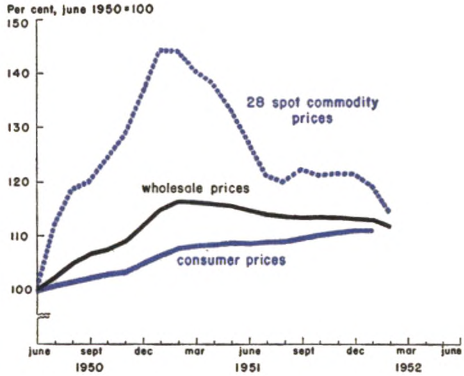
Employment in the District and the nation continues high despite marked weaknesses in some lines. Nonagricultural employment in the five-state area was more than 8.5 million at the end of 1951—a new record. Manufacturing employment, however, was down somewhat from a year earlier, primarily because of reduced output in the automobile industry. In general, unemployment is confined to unskilled or semiskilled factory workers. Moreover, fears of extensive unemployment generated by conversion to war production have been stilled by indications that most makers of hard goods will be allowed sufficient materials to meet demand in the months ahead.

Corporate profits after taxes for 1951 may turn out to be larger than expected. In a preliminary compilation, the National City Bank of New York reports that 2,195 large firms show 1951 net profits to be only 5 per cent below 1950. Excellent first quarter experience tended to buoy up the totals. Within the sample there are, of course, wide divergencies. Among the manufacturers the tire, paper, and oil groups show net income up 15-20 per cent whereas makers of textiles, glass, autos, and appliances are down 25-40 per cent. There is some prospect for improvement in earnings this year over current levels as a result of larger deliveries on defense orders, along with the possibility of eased restrictions on civilian output, stronger demand and lower raw material costs.

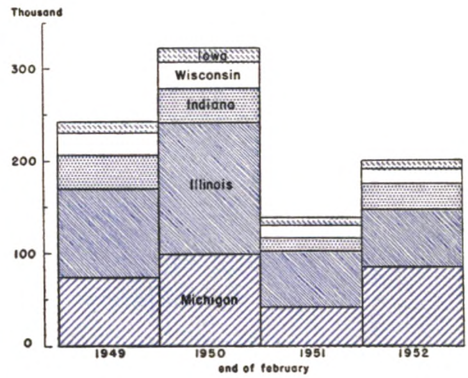
Some types of steel are in plentiful supply but many users still experience difficulty in filling their needs. In any case, ingot production continues to be scheduled at 100 per cent or more of theoretical capacity. High output has been aided by an improvement in scrap supplies which had been very short at the start of the year.

Aircraft deliveries are scheduled to mount rapidly after April or May towards the 1,200 per month goal set for the summer of 1953. Well before that time the important new aircraft plants being made ready in Eastern Michigan should be in production. In the meantime the machine tool shortage has been much improved. Shipments are running three times the pre-Korea level, and some shops have reduced overtime operations.

Price trends since Korea: *Raw materials jumped rapidly after June 1950, outstripping the rise in prices of processed goods. Since early last year wholesale and commodity prices have slumped, but over-all consumer prices continued their gradual rise until recently.*



Unemployment claims *in District states at the end of February were 45 per cent higher than in the same month last year, but still well below the totals for 1950 or 1949. Layoffs in automotive centers of Michigan and Indiana account for much of the increase.*



A million houses in 1952?

Home-building activity declined sharply from 1950 boom levels last year, but further substantial cutbacks are not in prospect.

DEMAND for better living accommodations continues strong in most areas. Housing starts in February were well above earlier winter months and only slightly below last year. Supported by high-level employment, record incomes, and growing liquid asset balances, demand seems strong enough to result in as many as 1 million nonfarm housing starts for the year as a whole.

Only a few months ago the big question mark in home building was the size of the cut which would be necessitated by shortages of strategic materials. In January, DPA Administrator Manly Fleischmann told Congress that available material supplies would permit home construction at an annual rate of only about 650,000 starts, beginning in the second quarter. When the new housing regulation came out in March, however, it moderately eased rather than tightened restrictions on builders' use of metals.

This change, apparently occasioned by an unexpected easing in the metal supply situation, removes one dark cloud from a generally favorable residential construction outlook. Basic building materials are mostly in ample supply, and available metal supplies probably can be stretched if the need arises. Construction costs have leveled, and the mortgage market has eased in the past six months. Finally, credit restrictions were relaxed last fall on moderately priced homes, thus widening the potential housing market.

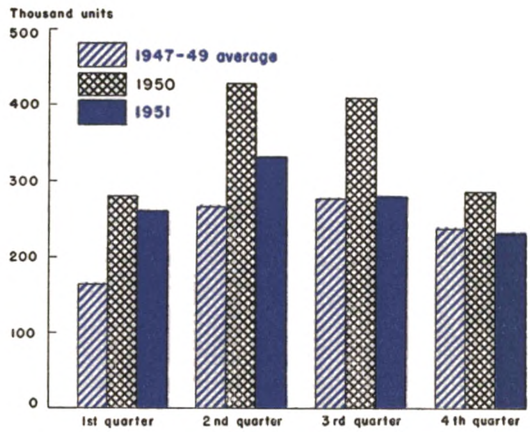
Home building off last year

When credit restrictions on mortgages were imposed in the fall of 1950, many builders thought the bottom would drop out of the postwar housing boom. Shorter mortgage maturities and particularly the larger down payment requirements were expected, in some quarters, to all but dry up the demand for moderately priced houses.

Actually, home-building activity last year turned out to be very good by almost any comparison. New nonfarm dwelling unit starts totaled 1,090,000, more than in any year except 1950 and 28 per cent above the governmental "target" of 850,000 units. The value of work put in place compared even more favorably with earlier years, reflecting rising construction costs and the large carry-over of unfinished housing from 1950.

The fact remains, however, that home construction dropped off sharply from the boom rate reached in 1950. Moreover, the difference between 1951 and 1950 widened as the year progressed. Housing starts in the first quarter

New housing starts declined to pre-1950 levels in the last half of 1951



were only 7 per cent below 1950; in the third quarter they were a third lower.

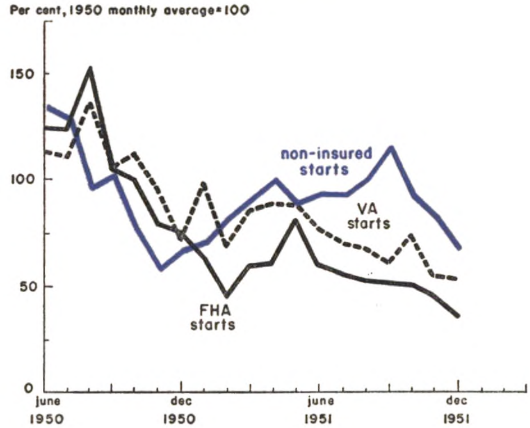
The reasons for this decline are not hard to spot. Liberal credit terms on FHA and VA mortgages were an important stimulus in the housing boom of 1950. During that year, however, these down payment and mortgage maturity requirements were tightened significantly, first on multi-family rental housing, then on small homes. Similar restrictions were placed upon new home purchases financed through conventional, noninsured mortgages. The effects of these restrictions did not become apparent for several months, however, since a large volume of mortgage commitments was made before expiration of the easier terms.

Another depressing factor on home building was the tightness of mortgage funds which developed last spring and has eased only gradually since then. Also, shortages of building materials using scarce metals have in some cases delayed construction of apartment buildings and may have hindered plans to build small homes. Finally, the urgency of housing demand has eased in some localities as a result of six years of high-level building activity and the marked rise in construction costs from pre-Korea levels.

Mortgage market easing

In two important respects, the residential building situation has improved since last summer. First, the problem of obtaining mortgage money promises to be less difficult in coming months than was the case during the past year. A large overhang of preregulation commitments has now been worked down, and investors are consequently becoming more active in the market for new mortgages. In addition, the net demand for new mortgage money has declined in response to the drop in housing starts and the larger down payments required. Finally, lending institutions have been enjoying a record inflow of savings during the past year, and the volume of monthly mortgage repayments continues to grow. More funds are, therefore, now available for new lending.

Conventionally financed housing starts held up better than FHA and VA starts last year



The reduced attractiveness of FHA and VA mortgages which resulted from the general increase in interest rates last year constitutes a continuing problem to home builders, however. Neither an increase in the fixed yields on these mortgages nor an appreciable decline in long-term interest rates seems likely to occur in the foreseeable future. Thus, investors will tend to favor the competitive investment outlets on which interest rates have risen.

A second factor of increased strength in the home-building picture is the relaxation in credit terms which occurred last September as a result of action by Congress and administrative agencies. Minimum down payments were lowered on homes selling for less than $15,000—most substantially in the $12,000 and under price class—and maximum mortgage maturities were lengthened from 20 to 25 years on homes selling for $12,000 and less. It seems likely that this action will stimulate home building in the lower price range, since considerably smaller financial resources are now required of small-home buyers. For example, a veteran is now able to buy a $12,000 house for $960 down, as compared with $1,900 before.

How about demand?

The question remains as to whether the basic demand for housing will continue strong through 1952. In the six years since the end of World War II, new nonfarm housing starts have totaled 6 million units. In addition, a large number of dwelling units have been created through the remodeling of existing houses and apartments and the conversion of nonresidential buildings to dwellings.

That much of the pent-up demand for dwellings has been satisfied is indicated by the rapid postwar drop in the number of "doubled up" married couples. By the middle of last year, the proportion of married couples without their own household had fallen well below that of either 1940 or 1930.

This does not necessarily mean that the demand for new housing has been largely satisfied. Current demand is supported by a continued high marriage rate. Licenses issued last year totaled about 1,600,000, roughly the same as in 1949 and 1950.

In addition, the birth rate has been at record levels for the past six years. Last year there were 3,750,000 births, a new postwar high. Moreover, employment and income have advanced to new high ground during the past year, while liquid assets have continued to accumulate in the hands of the public. For these reasons, the pressure to move to bigger and better living quarters is substantial.

In some communities, the more intense demands for housing have already been satisfied, and home-building activity is likely to continue downward. This appears to be the situation in the Detroit area, for example. In other localities, such as Chicago, building costs are too high to take advantage of the liberalized credit terms on lower priced houses in an important way. In the nation generally, however, the demand for new houses and thus the level of residential construction seems likely to remain high through at least the current year.

Corn - pigs - pork

There will be less pork beginning this summer—and at higher prices . . . production cutback reflects the poor corn crop in western corn belt.

THAT EXTRA PORK CHOP you had for dinner last night, was no more than an idea in some farmer's mind as recently as ten months or so ago. At that time many hog producers made plans for expansion. More recently, however, the tightening feed supply, the sluggish hog market, and rising production costs have caused U.S. farmers to plan a reduction of one-tenth or more in the 1952 spring pig crop.

This development is important to farmers in the Midwest and to consumers generally. For five successive years the pig crop increased at an annual rate of 5 per cent, reaching a total of 102 million head in 1951. The largest gain was made in the North Central region, which normally accounts for three-fourths of the nation's hogs. It is in this area also that the sharpest reductions will be made in pigs raised, particularly in the western portion where corn supplies are relatively low and of poor quality. On balance, pork supplies per person this fall may be down about 15 per cent from a year earlier. Nevertheless, pork will still be the chief meat on consumer tables in 1952.

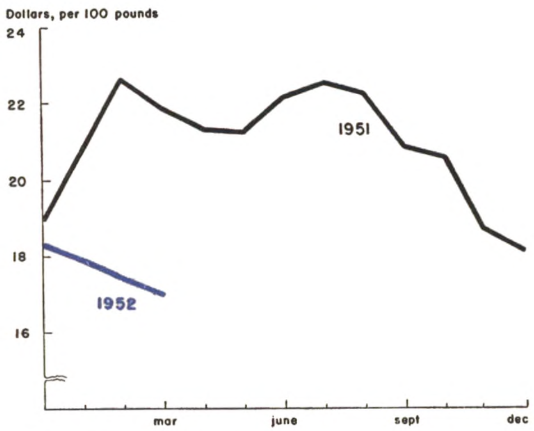
Undoubtedly, a partial explanation for the large consumption of pork lies in its relatively low price. Pork has been one of our cheapest meats. This was particularly evident in recent years when pork supplies increased relative to beef, further widening the already existing price differential. This trend promises to be reversed in 1952, however, as more beef is in prospect.

Cash receipts from sales of hogs are a prime item for corn belt farmers. This was the chief source of farm income for Iowa, Illinois, and Indiana in 1951. Iowa, the nation's top producer, received 40 per cent of its cash farm income from hogs. Receipts this year probably will not vary importantly from 1951 as the decline in numbers sold will tend to be offset by higher prices. However, areas which experience cutbacks greater than the U. S. average may suffer a reduction in income. Early spring farrowings in Iowa were 25 per cent below a year ago. This is not necessarily indicative of the reduction in total spring pigs in this state, however, as farrowings through February have accounted for only about 7 to 9 per cent of the total spring crop in recent years.

Ample supplies through midyear

Effects of the cutback in hog production will not be immediately apparent at meat counters. Slaughter through July will be largely of hogs already on farms at the beginning of the year and will total slightly more than a year earlier, due primarily to the increase in pigs farrowed in the last half of 1951. Beginning in late summer, however, and extending through the first half of 1953, the volume of pork available will be determined primarily by the number of pigs farrowed this year. Very likely, hog slaughter during this period will be substantially under year-earlier levels.

Hog prices this fall to be higher than a year earlier, strong seasonal rise in prospect for summer months



Pork prices to bump ceilings

Prices farmers receive for their hogs may average moderately higher in 1952. Thus far, however, they have remained under year-ago levels and probably will continue to do so until midyear. The March price was about one-fifth lower than for the same month in 1951, continuing the decline begun last fall. This is in sharp contrast with the usual recovery from the seasonal low most often reached in December or January. In addition to the big pig crop and the proportionately greater amount of late farrowings, this unseasonal price weakness reflects the larger number of breeding animals marketed and increased accumulation of pork stocks.

By late summer, hog prices are expected to equal those of 1951 with the fall and following winter prices being several dollars above year-ago levels. The effects of reduced pork supplies will be moderated somewhat, however, by large supplies of beef and poultry.

Price ceilings on pork, if they remain at about their present levels, may assume more importance than in 1951. Pork prices are likely to be at ceilings and hog prices may be restricted at least at the time of smallest market receipts next summer. If this occurs, considerable pressure for ceilings on the live animals probably will develop.

Hog-corn ratio lowest in years

Perhaps the one best indicator of the forces working in the hog picture is the hog-corn price ratio. This is simply the number of bushels of corn equal in value to a hundred pounds of live hogs, and over a period of years has averaged about 12 bushels. Deviations from this average are usually progressively effective in reducing or increasing hog numbers and slaughter weights.

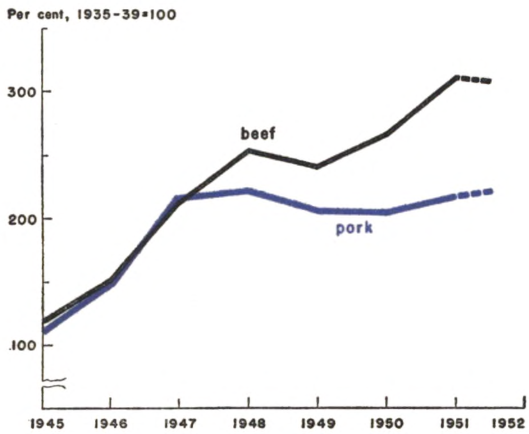
The postwar hog-corn ratio favored hog expansion. However, in the recent fall and early winter, conditions were increasingly less favorable for converting corn into pork. In the October-December period corn prices were nearly one-fifth higher than a year ago while hog prices remained about the same. As a result, the hog-corn ratio averaged 11.3 compared with 13.1 for these months in 1950.

Since the outlay for feed constitutes approximately four-fifths of total production costs, the hog producer's margin is very largely determined by feed supplies and prices. About two-thirds of the porker's ration is composed of corn and in the current feeding season hogs will consume about 40 per cent of all the corn used. With the over-all supply of this feed 6 per cent below a year ago, and the likelihood of a heavy disappearance this season, hog production cannot be expected to expand again until a large crop is harvested.

Corn to pork in ten months

Most farmers produce two pig crops a year. About four months after breeding decisions are carried through, the pigs are farrowed. Six months or so later the majority of them are ready for market. Peak marketings usually occur in December or January, these two months accounting for nearly one-fourth of the annual total. A gradual leveling has been occurring in the seasonal patterns of both farrowings and marketings. This is generally expected to continue as more farms become equipped to handle "off-season" pigs.

Pork prices to rise relative to beef in 1952 as cutback in hog production restricts supplies



Producers probably make a tentative decision for both the spring and fall farrowings when the volume and price of a new corn crop are known. The number of sows bred for farrowing in the fall, of course, is subject to modification according to the price situation in the spring and the corn crop prospects, but in 1952 is not likely to show an increase over 1951. Generally, when corn production appears to be larger than expected, more sows are bred later in the season. Conversely, if the new crop is smaller, bred sows may be marketed before farrowing. For example, in the 1951 fall farrowing season the dimming prospects for a big corn crop were reflected in a progressive reduction in farrowings.

Hogs to be good property

If the hog-corn situation evolves as described, the price ratio next fall will be more advantageous than currently for future pork expansion. But even assuming a large harvest of feed grains and a reversal of the current cutback in hog numbers, it would be late in 1953 before pork supplies would again turn upward. Meanwhile, the prospective strong demand for food products in general indicates favorable markets for hogs and pork beginning about mid-1952.

This suggests that livestock producers may do well to maintain hog numbers at as high levels as feed grain supplies will permit. Furthermore, some feeding experts have indicated that roughages can play a larger part in hog rations than previously thought possible; good pasture may be used more extensively to supplement grain supplies. In the main, however, the meat situation in the United States continues to be described importantly in terms of corn, pigs, and pork.

In Seventh District banks:
gross earnings at new peak

District banks scored their greatest postwar gain in earnings during 1951. But net profits barely topped 1950 levels.

More earning assets at higher rates—this, in a nutshell, is the story of the rise beyond the half billion dollar mark in total earnings of District member banks during the past year. In 1951, gross operating earnings totaled 518 million dollars, 13 per cent higher than the previous record in 1950. This was not a net gain. Higher costs, more charge-offs, and bigger taxes combined to hold bank profits after taxes to a 2.6 per cent increase above the previous year. Nevertheless, gross earnings are as important to banks as gross sales are to businesses, and for District banks the 1951 rise was the sharpest annual gain in total earnings in the postwar period.

The reasons: loans

The reasons for such a sharp increase are not hard to find. Basically, they lie in the continuing rise in bank loan volume. By December 1951, District loan totals were nearly 15 per cent above year-ago levels. High-yielding consumer loans did not figure in this 1951 rise, but increases of 22 per cent and 31 per cent respectively were recorded by loans to business and non-real estate loans to farmers.

Not all of the increase on loan earnings was traceable to the credit expansion which occurred in 1951, however. District banks had placed a near-record volume of loans on their books in the last six months of 1950. Many of these yielded the bulk of their income after 1950 had passed, swelling 1951 earnings accordingly.

Earnings, expenses, and profits of member banks compared

	1951	1945
	(million dollars)	
Gross earnings	518	301
From loans	253	75
From U.S. securities	156	155
All other sources	109	71
Less expenses	319	185
Salaries and wages	155	80
Interest on deposits	53	34
All other	111	71
Net current earnings	199	116
Less deductions	92	8
Losses (add recoveries)	15	+26
Net additions to reserves	20	1
Taxes on net income	57	33
Profits after taxes	107	108

The rapid rate of post-Korea loan growth also increased earnings by contributing directly and indirectly to a rise in interest rates. To curtail private credit expansion and consequent lender sales of Government securities, several restraining actions were undertaken by the monetary authorities. Federal Reserve Bank discount rates were increased in August of 1950 and subsequently System operations, first in the short-term, then in the long-term Government securities market, became much more restrictive. As one result the whole pattern of interest rates moved upward. Although this shift in interest pattern produced substantial book losses in bank investment portfolios, it also enhanced the income received on all subsequent extensions of bank credit. This, together with the other causes mentioned above, produced a 27 per cent net increase in the 1951 loan earnings of District member banks.

Other sources of income also contributed their bit to the 1951 earnings growth. The higher interest rates prevailing on additions to holdings of non-Federal securities helped to raise income from these assets by 8 per cent in 1951. In contrast, the higher interest pattern did not produce any appreciable increase in total income received on the 9 billion of Government securities held by District banks. Here, the effect of increased rates was almost fully offset by shortening maturities and moderate net liquidation of holdings in order to obtain funds to back loan expansion. In total, however, all these other sources of income accounted for only one-eighth of the total dollar rise in 1951 earnings. The remainder came from the larger payments for loan credit.

More loan earnings in Chicago

Last year's rise in earnings was not spread evenly throughout the District's banks. The most striking difference was the 40 per cent jump in loan income of Chicago banks, a rise nearly double that reported by all other District banks. As the Midwest's largest and most sensitive financial center, Chicago was the focal point of the expansion in business loans after June 1950. Its banks reaped a relatively small portion of the return on these extensions in 1950; they made up for that lag in 1951.

Because of this concentration on lending activity, however, Chicago banks did not participate in the moderate District additions to holdings of and earnings from Federal, state, municipal and corporate securities. Consequently, the over-all 1951 increase in incomes of these banks totaled only 14 per cent.

On investment portfolios, the largest reported increases in earnings were in banks in the four other District financial centers (Des Moines, Detroit, Indianapolis, and Milwaukee). These banks reported income for non-Federal securities, for example, up 24 per cent over 1950 levels. Partly as a result of such added earnings, banks in these centers reported a 16 per cent increase in total 1951 earnings.

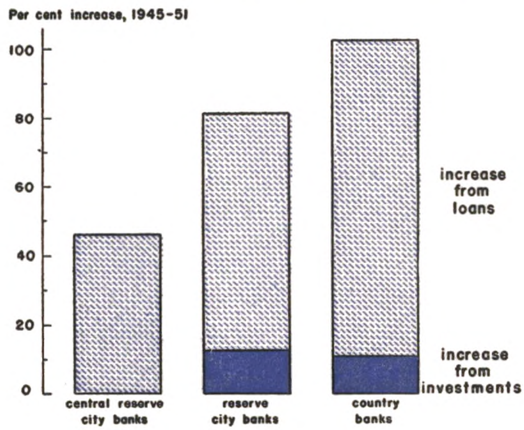
In contrast, banks outside these centers in the five midwestern states experienced more moderate increases from all income sources. Total earnings in these banks were up only 11 per cent, less than for the major cities.

Small banks postwar leaders

In a sense, the earnings records of District banks during 1951 were "abnormal." For most of the postwar period, smaller banks had reported a much more attractive earnings picture than had larger banks in the major cities. Partly this reflected the higher interest rates and heavier investment in risk assets in nonmetropolitan areas. To cite the extremes, such factors enabled Michigan banks with deposits under 2 million dollars to obtain total earnings equal to 3.26 per cent of total assets in 1951, in contrast to a comparable percentage of 2.02 per cent reported by the largest Chicago banks.

Essentially, however, the better earnings record of smaller rural banks is related to the

Smaller banks show biggest postwar gains in income from earning assets



continued growth of their loan portfolios throughout the postwar period. The difference between metropolitan and rural banks is pointedly illustrated in the accompanying chart. The 1945-1951 increase in income from earning assets is charted for three principal classes of banks—"central reserve city" banks (13 leading Chicago banks); "reserve city" banks (smaller banks in Chicago and banks in seven other leading cities); and "country" banks (all other District banks). The 103 per cent increase for country banks in this period overshadows that of larger urban institutions. Rising interest rates accounted for some of the increase, and a minor portion can be allocated simply to growth in over-all asset size. The chief factor of difference, however, is the relatively greater expansion of high-yielding loans in the smaller banks.

Steady growth, in loans as well as earnings, has been the typical characteristic of smaller banks in recent years. In 1950 and 1951, the greater sensitivity of banks in leading financial centers stood them in good stead, for they received the major portion of the sharp post-Korea increase in borrowings and returns therefrom. But such sharp rates of change in credit demands have almost always been short-lived. With the return to more gradual movements in business activity, it is likely that once again the District's smaller banks will become the leaders in the earnings picture.

operating costs on the rise

Expenses of District banks have matched the rise in gross earnings with a 70 per cent increase since 1945.

Like most businessmen, bankers have been uncomfortably aware that their operating costs have been increasing persistently in the postwar years. Until 1951, however, they could draw some small comfort from the fact that the rate of this increase had been slowing down. While expenses had spurted upward 15 per cent in 1946, by 1950 the yearly increase had dropped to 5 per cent. In 1951, however, this downward trend was sharply reversed, with costs rising almost 10 per cent over 1950 levels. All told, the six postwar years produced a net rise of more than 70 per cent in total operating expenses of Seventh District member banks.

Absolute totals, on the other hand, are not the whole story. Postwar increases in costs have been balanced by a comparable over-all rise in earnings. As a result, total expenses accounted for the same proportion of gross earnings in 1951 as they did in the year 1945.

Banking's major costs

The most important contributing factor to the 10 per cent jump in expenses in 1951 was salary costs. This could be expected, since banking, as a service industry, finds roughly half of its expense budget allotted to salary and wage payments. District member banks channeled more than 150 million dollars into payrolls in 1951—13 per cent more than in 1950. This mounting outlay for personnel resulted both from increases in average salaries and, to a lesser extent, additions of new employees.

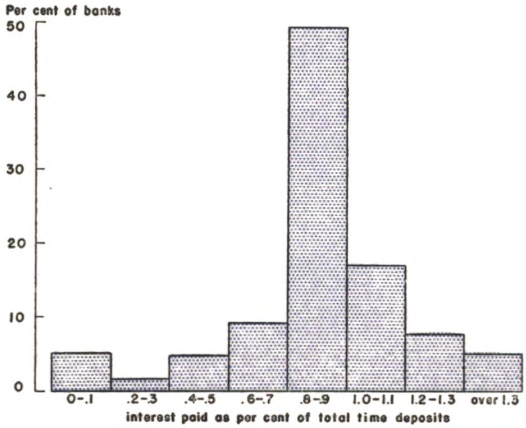
Although well below salary and wage expenditures, interest payments on time deposit accounts constitute the second largest cost item for District banks as a whole. This cost climbed about 9 per cent in 1951, in sharp contrast to the very modest relative rises of the preceding two years. The bulk of the 1951 increase centered in Chicago banks where such interest payments were boosted 15 per cent.

The total dollar cost for interest is, of course, the product of both the changing amount of time deposits and the differing interest rates applicable to various types of such deposits. A rough indication of over-all time deposit interest rate policies, however, can be obtained by comparing the total amount of interest payments with reported total time deposits. Using this method in the accompanying chart, about one-half of the District banks show interest payments between .8 and .9 per cent of their time deposits in 1951. About 45 banks, most of which were located in Illinois, paid no interest at all on deposits. Most other banks, however, appeared to have remarkably similar policies on time deposit interest.

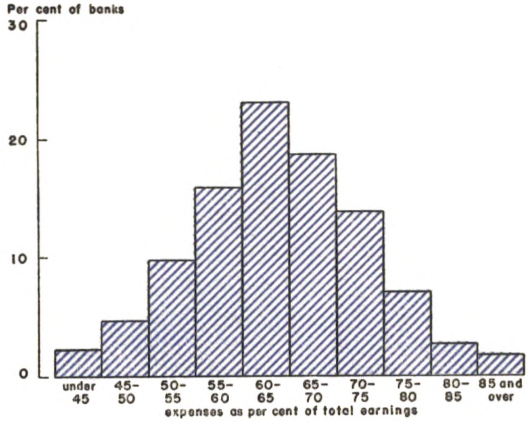
Other operating expenses, which include such items as rent, maintenance, office equipment and supplies, and FDIC insurance assessments, moved up about 5 per cent in 1951. These costs, as a group, increased much more sharply—almost 15 per cent—in smaller banks. For large banks such costs remained almost unchanged from 1950.

Although interest on borrowed money is a very minor cost in the total banking expense

Interest payments relative to time deposits about the same at most banks in 1951



Expense-to-earnings ratios showed wide divergence in 1951



picture, a significant increase in the amount spent on this item took place in 1951. Because of changing borrowing practices, dollar interest payments on funds borrowed by member banks were triple the 1950 amount. Almost the entire amount spent for borrowed funds came from banks in the five major District cities—Chicago, Detroit, Indianapolis, Milwaukee, and Des Moines. It was in those cities other than Chicago that the sharpest upturn was recorded. The increase in volume of borrowings thus reflected is a logical result of two unrelated post-Korean developments. One is the increased flexibility in the short-term securities market which sometimes makes that market a more costly source of funds than borrowing. The other is excess profits tax legislation which provides certain benefits in computing the tax liability for corporations using borrowed funds.

The expense—earnings balance

Another and more meaningful way of appraising developments in bank expenses is to relate them to bank earning changes. At the end of the war total expenses of District member banks amounted to slightly less than 62 per cent of total earnings. In the years that followed, earnings rose steadily but expenses climbed even faster, so that by 1949 the District expenses-to-earnings ratios stood at 66 per cent. Since 1949, however, earnings have been outpacing expenses. For 1951, bank expenses absorbed exactly the same proportion of earnings as in 1945.

Such an over-all ratio conceals a wide disparity in individual bank positions. Taken individually, 1951 ratios ranged from a low of 29 per cent to a high of 111 per cent. Difference in operating practices, rather than size or location of bank, was the determining factor in income-expense relationships.

On the average, however, the comparison between changes in expenses and earnings strongly tempers any evaluation of bank cost trends. Even though total operating expenses have increased substantially in the postwar years, the relatively greater rise in earnings during the last two years suggests a continued favorable outlook for bank profit margins.

retained earnings an issue

For District banks, "adjusted" retained profits have increased much less than net operating earnings. Disappearance of nonoperating recoveries is the chief cause.

Bank profits perform two functions. One is to provide stockholders a reasonable return on their investment; the other, to provide sufficient retained earnings to insure adequate capital funds. How well have profits been able to accomplish this dual purpose in the postwar period? For Seventh District member banks, annual retained earnings, plus net additions made to loss reserves, were about 10 per cent higher in 1951 than in 1945. The cumulative total of postwar retained earnings, however, together with some sales of new stock, had raised total capital accounts by 42 per cent over this period. Cash dividend payments, on the other hand, have kept up with the postwar expansion of bank capital, with an increase of 45 per cent since 1945.

Retained earnings and loss reserves

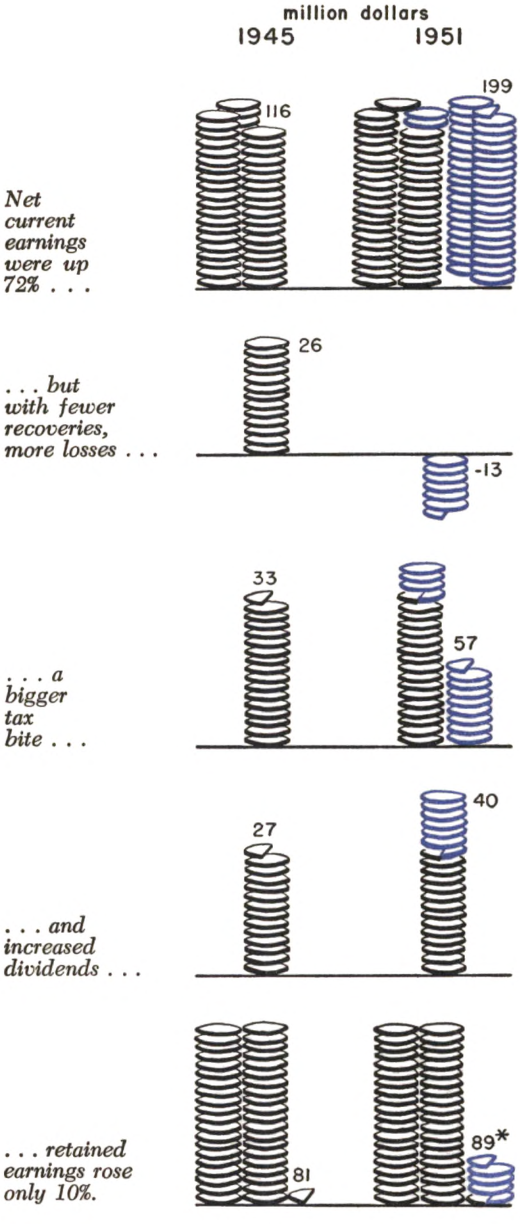
The retained earnings of Seventh District member banks have shown a declining postwar trend. The 1951 total of 68 million dollars was nearly one-sixth below the 1945 figure. Considered separately, however, such figures do not constitute a reliable index of changes in the ability of banks to withstand asset losses. To take advantage of an Internal Revenue Bureau ruling permitting the setting up of a tax-free reserve for losses on loans, member banks in each year since 1947 have made transfers from earnings to bad debt reserves greatly in excess of actual losses sustained. Thus in 1951 the net transfer of funds to all loan valuation reserves aggregated more than 20 *million* dollars, while net losses on loans totaled only 300 *thousand* dollars. In effect, therefore, this 20 million dollar addition may be considered an alternative form of retained earnings.

Including net transfers of funds to all reserves, 1951 retained earnings would total about 89.4 million dollars for the District member banks. Even this adjusted figure, however, is only about 10 per cent higher than the comparable total for 1945. During this same period, net current operating earnings rose more than 70 per cent.

Shift from recoveries to losses

What are the factors behind the lagging rise in bank retained earnings since the end of the war? The first postwar years were characterized

Earnings retained by District banks, 1951 vs. 1945



*adjusted to include net transfers to loss reserves.

by a temporarily high level of recoveries on loans and securities in relation to operating earnings. In 1945, for example, net recoveries and profits on securities and loans of Seventh District member banks boosted net current operating earnings about 25 million dollars. By 1951, however, recoveries and profits had declined, and substantial increases in losses and charge-offs on securities were a key factor in reducing earnings, second in importance only to the transfers to loss reserves.

Net losses and charge-offs on member bank securities totaled 12.2 million dollars in 1951. This reflected in large part the change in Federal Reserve open market policy in March whereby the Reserve Board withdrew most of its support of the Government bond market. Other losses and charge-offs combined with those on securities to reduce net current operating earnings 13.5 million dollars in 1951.

Taxes accounted for an additional 56.6 million dollar reduction of bank profits in 1951, as compared with 33 million dollars in 1945. The impact of increased taxes on bank profits will be discussed in a subsequent article in *Business Conditions.*

Use of reserves now widespread

The most interesting postwar development in the profits picture has been the adoption of the loss reserve procedure by an increasing number of banks. According to bank accounting practice, these reserves are built up by deductions from net current earnings in the income statement. As such they reduce profits and retained earnings figures, yet they serve one of the basic functions of retained earnings —that of providing a cushion against losses.

Prior to 1947 only 64 member banks maintained valuation reserves for loans. By the end of 1951, the number had increased to 614 of the 1,012 member banks in the District. All but a few of these six hundred banks reported the maintenance of bad debt reserves set up in accordance with the permissive provisions under the Federal income tax law.

In dollar amounts, these reserves grew from

In 1951, small banks paid out relatively more in dividends

Ratio of cash dividends to total capital* (in per cent)	Large banks (in per cent)	Small banks (in per cent)
0	5	3
1	5	5
2	34	24
3	34	39
4	22	13
5	..	12
6	..	2
7 and over	..	2
	100	100

*Within .5% of ratio listed

less than 3 million dollars in 1947 to 98 million dollars by the end of 1951. Bad debt reserves plus other loan valuation reserves have now reached a total of 102 million dollars. Reserves on securities, which for some banks constitute an important element of strength, rose but slightly during the postwar period to a total of 53 million dollars at the end of 1951. On that date, total loan and security reserve funds stood at 155 million dollars.

Tax-purpose bad debt reserve additions are not only a recent but also, under present Internal Revenue rulings, a temporary influence on bank profits. Many banks already have reached their respective reserve "ceilings," namely, three times their twenty-year average loss percentage on loans. Moreover, within the next four years the largest rates of bad debt losses for most banks, i.e. those for the years 1932 through 1935, will have been dropped from the twenty-year moving average of bad debt losses. Even if all remaining District banks begin to avail themselves of this reserve provision, therefore, the resulting total of deductions from earnings cannot approach the magnitudes reported in recent years.

Cash dividends rise

Bank profits have provided sufficient payments of cash dividends to maintain a fairly constant relationship between such dividends and capital accounts throughout the postwar period. Cash dividends on common stock paid by member banks have continued a gradual upward trend since 1945, aggregating 39.6 million dollars in 1951. This increase, however, has no more than kept pace with the rise in total capital accounts based upon reinvestment of profits. As a result, the ratio of cash dividends to total capital accounts was 2.99 per cent for 1951, almost exactly equal to the 1945 relationship.

Dividend-to-capital ratios differ considerably among the individual member banks, depending upon different policies followed in the declaration of dividends as well as the variation in their respective earnings positions during a given year. An analysis of a representative sample of 130 District member banks reveals, however, that well over half of the sample maintained dividend ratios of between 2 and 4 per cent of capital during 1951.

In dollar amounts, cash dividends on common stock constituted about 30 per cent of net profits plus reserve additions in 1951, as compared with 25 per cent in 1945. In other words, there has been a shift in the proportional uses of bank profits after taxes, with 70 per cent of profits being retained in 1951 as compared with 75 per cent in 1945. Such a trend is generally in line with the recent overall increase in the proportion of profits paid out as dividends by most other industries.

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Bank tax study

One-third to two-fifths of the District's banks with capital of more than 250,000 dollars paid excess profits tax last year and in 1950. In the current year, the proportion of banks paying tax is likely to be near the top of this range, largely because some special factors tending to reduce excess profits tax liability may not be as important as they were in 1951. Bond losses taken last year, especially by the larger banks, were the most important of these. Most larger banks used the invested capital method to compute their excess profits credits. These are the preliminary findings of the Federal Reserve System's recent study of bank capital and bank taxes.

In 1951, a significantly larger portion of District banks in the top size group—capital accounts over 4 million—paid excess profits tax than in the smaller size groups (see chart). This is in contrast to the results for the nation as a whole, which indicate that more of the banks with capital between 250,000 and 750,000 dollars paid excess profits tax than in any other size group.

Surprisingly, the banks which paid relatively substantial amounts of tax were not the larger ones, but banks of quite modest size. This is the case both nationally and for the Seventh District. For the entire country, for example, banks in the 250,000-750,000 group paid more than one-fourth of total excess profits taxes, although they held less than one-seventh of total capital of all insured commercial banks. In the District, two-thirds of the individual banks paying substantial amounts of tax had deposits of less than 20 million dollars. A large proportion of these banks were considerably more profitable, in terms of the ratio of net current earnings to total assets, than the average of similar sized banks. Moreover, most of the District's banks paying large excess profits tax bills in 1951 had markedly lower capital to risk asset ratios than similar sized banks.

In determining 1951 tax liability, the smallest banks typically used the 25,000 dollar minimum credit method of computing excess profits credit, while the larger banks generally utilized the invested capital method. The use of the three alternative methods by District banks is indicated below:

Capital (thous.)	$25,000 minimum	Average earnings	Invested capital
	(per cent of banks)		
Over $4,000	..	9	91
$750-4,000	..	24	76
$250-750	7	33	60
Less than $250	96	2	2

Further results of this survey will be released by the Board of Governors in coming weeks. Cooperating in the study were the American Bankers Association, the National Association of Bank Auditors and Comptrollers, and the various supervisory agencies. Particularly important was the excellent cooperation on the part of a large number of banks both member and nonmember. Each bank devoted considerable time and effort to developing the detailed information requested for the study.

Over one-third of all but the smallest District banks paid excess profits tax in 1950 and 1951