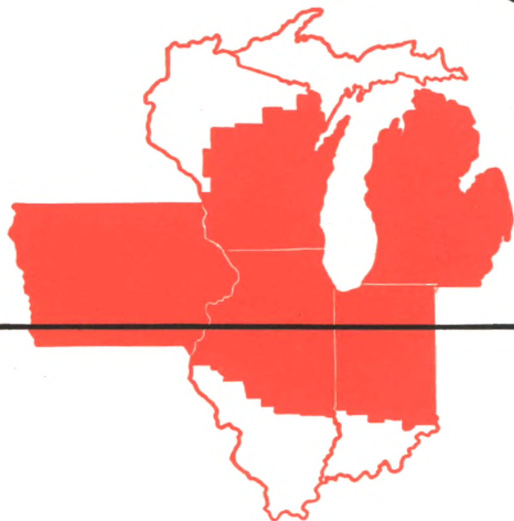
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1954 December

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THE Trend OF BUSINESS

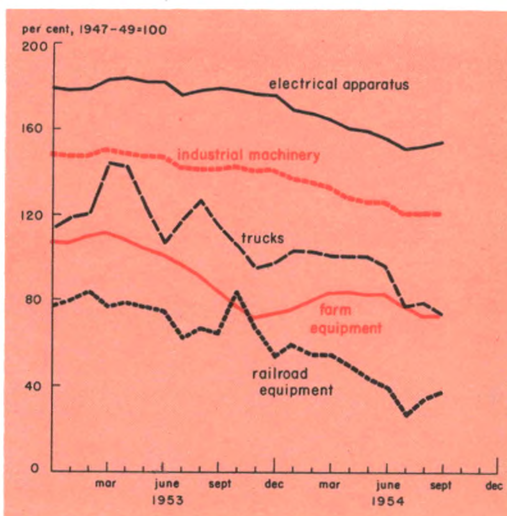
Scattered signs of more than seasonal gains this fall indicate that a modest pickup in overall business activity is now under way. Both business sales and manufacturers' new orders improved in September, while order backlogs rose for the first time in nearly two years. Wage and salary employment increased more than seasonally in September and October, and the average work week in manufacturing advanced to its highest point in ten months. Output of the nation's mines and factories increased slightly in October, and a further gain was indicated for November.

The improvement in activity so far has been considerably less vigorous than had been anticipated by many last summer. But the rise is notable in that it has begun in the face of continued inventory liquidation. Business stocks, after seasonal adjustment, dropped 430 million dollars in September—the most recent figures available. This compared with monthly declines averaging 360 million dollars since the turn of the year.

A marked slowing in the rate of inventory liquidation, however, appears close at hand and may already have commenced. Business stocks have been reduced more than 4 billion dollars in the past year, largely through a 10 per cent cut in holdings of durable goods producers and distributors. That some step-up in orders has already taken place is evidenced by the higher rate of steel operations and price firmness for many industrial raw materials.

While the inventory adjustment has been working itself out, final demand for goods and services has been well maintained through the fall. Construction expenditures have increased further since midsummer, and housing starts in recent months have been especially strong.

Output cuts in producers' durable equipment have been pronounced and widespread



A further rise of 7 per cent in construction outlays for 1955 recently was projected by the Departments of Commerce and Labor, with both private and public spending showing gains from the current year.

Retail sales have held fairly steady since spring after advancing from last winter's reduced volume and may now receive additional stimulus from early introduction of 1955 model cars (see pp. 8-11). Government outlays for national security have continued to fall off, but the rate of decline is expected to slow substantially in the months ahead. Perhaps uncertainty regarding future prospects is greatest in the producers' durable goods field, where expenditures have dropped gradually

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but steadily since the third quarter of 1953.

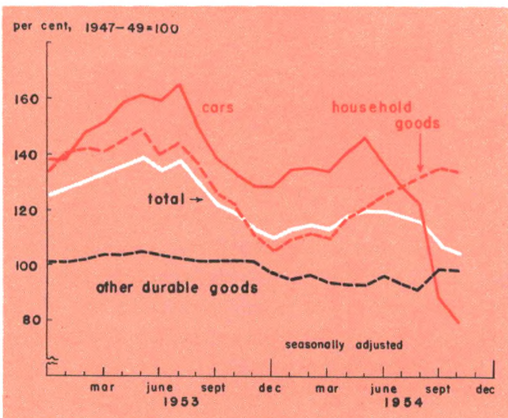
Output of producers' durable equipment has been running substantially below mid-1953 levels. During the third quarter, for example, production of both industrial machinery and electrical equipment was 15 per cent lower than in the same months of last year, while truck output was off 35 per cent. Third-quarter output of farm machinery lagged 18 per cent below the 1953 rate, while production of railroad equipment was only half the already reduced year-ago volume. Reductions in defense spending are partly responsible for the declines in some of these industries, since total business outlays for durable goods in the third quarter were a relatively smaller 11 per cent below the year-earlier rate.

Despite the lower level of output, order backlogs have dropped sharply for many producers. The number of freight cars on order at the beginning of October amounted to only 4½ months' production at current levels, 70 per cent less than a year ago. The ratio of machine tool orders to potential production capacity had fallen off to three months, as compared with seven months a year ago. The total order backlog for all durable goods manufacturers increased slightly in September, partly because of a spurt in new defense orders, but was still 30 per cent below the year-ago volume and 40 per cent below the early 1953 peak.

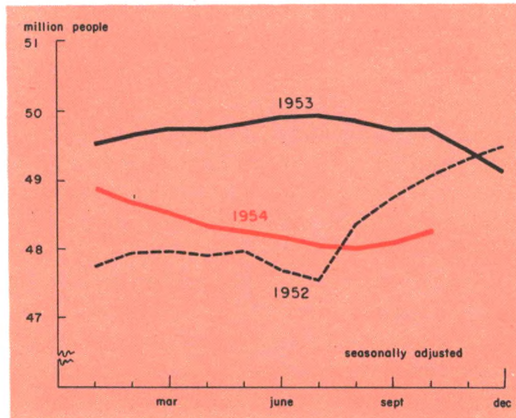
A preliminary survey of business capital spending plans, recently released by McGraw-Hill, indicates a prospective decline of only 5 per cent from 1954 to 1955. Since such spending has already dropped below the 1954 average, this would imply little or no further easing from present levels. The survey totals include both new plant and equipment, however, and thus are probably buoyed up by continued large construction outlays. However, the lower level of after tax profits for all but the largest corporations so far this year may adversely affect spending plans if continued into the coming year (see pp. 11-14).

Consumer durable goods output, depressed by extensive model change-overs in the automobile industry during September and October, should rise substantially in the closing months of the year. Through October, manufacturers of household goods had retraced about two-thirds of the output loss which occurred in the second half of 1953. Production of television sets reached a new peak for October, while output of furniture increased more than seasonally in the fall and appliance pro-

Recent weakness in consumer durables output reflects extensive model change-over period for cars



Wage and salary employment up slightly, but still is well below 1953 and late 1952



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duction held fairly steady at a rate well above last winter's low. The big increase in November and December, however, will come in automobile production. Industry estimates place output in these two months at about 1.1 million cars. If realized, this would be more than double the September-October volume and nearly half again as large as output in the last two months of 1953.

Wage and salary employment increased 240,000 in September and October, after allowing for the usual seasonal change. This rise followed a decline of nearly two million from the mid-1953 peak. About half the gain occurred in the lumber industry, as West Coast strikes came to an end. Despite the pickup, wage and salary employment is still 3 per cent below a year ago and nearly 2 per cent lower than in October 1952. Production workers in durable goods manufacturing have suffered the sharpest cutback in numbers from the mid-1953 peak—15 per cent—but employment has also dropped off 7 per cent in nondurable goods manufacturing, 14 per cent in mining and 6 per cent in the transportation and public utilities industries. Employment has held near mid-1953 levels in trade, services and construction and has risen in finance and government.

Prices received by farmers have dropped in recent months, but only slightly more than is "normal" for this heavy marketing season. As of mid-October, farm prices were 3 per cent below a year ago, continuing a downtrend of nearly three years' duration. For 1954 as a whole, the Department of Agriculture estimates that farmers' cash receipts will fall 4 per cent short of last year's total, production costs will average about 2 per cent lower, and farmers' net income will be off about 6 per cent.

At the annual Agricultural Outlook Conference recently held in Washington, Department officials expressed the judgment that farm prices would hold near their current reduced levels through 1955. This would mean that farm prices would average about 2 per cent less than this year. Cash receipts and net farm income in 1955 are also expected to fall below 1954 levels (see pp. 15-16). As in the current year, however, farm income in the Seventh District will probably hold up better than in the nation as a whole.

Easy money and security prices

Post-mortems on the 1953-54 business recession have commonly emphasized the inclusiveness of that decline. If an exception is needed to prove this rule, however, the likeliest candidate for citation is the continued rise in stock prices. In every month except one since September 1953, the stock market has been strong.

Market sages give a number of reasons for this exceptional action. An undoubted factor is the pervasive investor confidence in longer-run economic prospects. Short-run buoyant influences have been the good showing of profits after taxes and the investor-encouraging provisions of the new tax law. There may be still another factor behind the curious combination of declining business and a rising stock market, however—the policy of active monetary ease, which has provided a favorable financial climate for all sorts of investment.

The idea behind an easy money policy in a period of recession is to help stimulate business activity when there is some slack in the economy by making credit inexpensive and readily available to prospective borrowers. The objective is to avoid a condition where tight credit

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chokes off new productive investment or consumer demand, or accelerates inventory liquidation, thus worsening the recession.

The lower interest rates which accompany easy money tend to lift prices for all sorts of income-producing assets, including stocks and bonds. These resultant higher prices for securities can be positively helpful to the economy, if they encourage businesses to raise more money through the securities markets, thus tapping savings to increase investment and business activity.

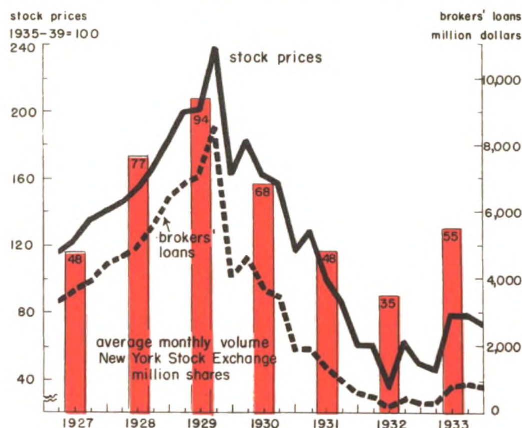
How easy money comes about

On the surface, monetary policy appears to operate only in the field of debt—and chiefly in Government obligations and bank-held indebtedness. The tools of monetary policy include some measures which affect certain types of borrowing directly, such as controls over buying stock on margin. Then there are the far more powerful indirect measures which influence the cost and availability of credit in general by expanding and contracting the banking system's capacity to lend money. This capacity is based on banks' reserve accounts with the Federal Reserve Banks.

The Federal Reserve System affects the banks' ability to lend by changing the proportion of required reserves banks must maintain against deposits; by changing interest rates at which the Federal Reserve Banks lend money to member banks to replenish their reserves; and by buying and selling Government securities in the open market, paying for purchases by expanding banks' reserves and receiving payment by reducing their reserves. This last tool of monetary policy—open market operations—is far more flexible than the others and hence is the one most relied upon on a day-to-day basis.

When the Federal Reserve Banks expand the reserves of the banking system and thereby add to the capacity of banks to lend and invest, they increase the supply of funds offered in the money markets. This increase in funds tends to appear first in bank demands for U. S. Government securities. These new demands bid up

In the 1927-33 period credit changes closely paralleled stock prices



SOURCE: Standard and Poor's composite stock average

the prices of Government securities and thus lower the effective yields—that is, the ratio of interest payments to the purchase price.

Other interest rates are closely related to the yields on Government securities, for it can be expected that investors will, within limits, shift their funds from one type of investment to another in search of the best available returns. Dropping yields on Government securities, therefore, will lead to increased buying interest in alternative types of investment. The result can be higher prices and lower yields for corporate bonds, state and local government securities, commercial paper and mortgages as well. The resultant ability to float new loans at lower yields tends to encourage businessmen, prospective homeowners and local governments to expand their purchases of the capital goods ordinarily bought with borrowed funds, which is just what is hoped for when an easy money policy is applied.

Effects percolate into equity markets

The relationship between monetary policy and the market for nondebt investment—equities and real estate—is not nearly so simple. The impact of monetary policy is fairly direct with regard to debt prices and yields for two

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chief reasons. First, the supplies of funds released by an easy money policy go originally to the banking system, which deals almost exclusively in debt rather than equity instruments. Second, debt instruments, unlike equities, involve contractually fixed interest payments. When added demands bid up the price of a debt instrument with a fixed return, therefore, the yield as a percentage of the purchase price must drop correspondingly.

There are ways, nevertheless, in which monetary policy may be reflected in equity prices. Easy credit conditions may affect the market for stocks directly to some extent by making it easier to borrow money to finance stock purchases. This direct effect can come only from lender willingness to extend more credit at the same terms, however, for the extent to which lenders can encourage more borrowing for stock purposes by easing terms is strictly controlled. The Federal Reserve's Regulations T and U set minimum margin requirements—that is, the percentage of the sales price of securities listed on the exchanges which must be paid in cash.

Regulation T affects extensions of credit by brokers and dealers to their customers, and Regulation U covers loans by banks on stocks. Since 1937, margin requirements have been set at 40 per cent or higher. Right after the War they hit 100 per cent, and since then they have been 75 per cent in periods when inflationary pressures seemed to be ascendant and 50 per cent at other times, for example, right now.

Partly because of these regulations, stock market credit is moderate at present, compared with such periods as the late 1920's. Though common stock prices are around the 1929 peaks, stock market credit is less than a third as high as it was then. It has increased substantially over the past four or five years, however, and particularly since last spring.

In the present environment, perhaps the more important influences of easy money on stock values lie outside these narrow applications. Easy money has a generally buoyant effect on the financial world and tends to create a climate in which the prospects for stocks, particularly the "blue-chip" shares of well-established companies, appear to be attractive. To the extent to which businessmen and investors believe that easy credit can foster higher levels of activity, their general outlook toward the future will be brightened. Moreover, all holders of marketable bonds and other debt instruments will be cheered by the increases in market value of such assets. The economy in general will have become more liquid, with the greater freedom of fund movement which that implies.

In a more tangible vein, when a corporation can float bond issues and borrow money from banks and insurance companies at low rates, its ratio of interest expense to income can be reduced and its profits position improved. This influence is more potent the greater the proportion of a firm's funds which it draws from debt sources. Under such circumstances, the opportunities for bolstered profits tend to raise the market price of the company's common stock.

Debt vs. equity returns

Another aspect of the indirect impact of easy money on stock prices stems from the widened disparity between returns on equities and debts from the viewpoint of investors. Since initially easy money policies produce lower yields on fixed-return debt instruments while not so directly affecting returns on equities, investors are likely to be attracted increasingly to equities rather than debts.

It is important to recognize that this widened income differential in favor of equities may be regarded as more apparent than real, if investors look forward to a period of "hard times" which will shrink profits and dividends. With less gloomy anticipations, however, the heightened opportunities for maintaining or increasing income by moving out of now high-priced debts and into equities may prove quite tempting. In such a shift in investor interest, the easily marketable nature of common stocks will attract a substantial portion of the equity demands. Stock prices will tend to be bid upward.

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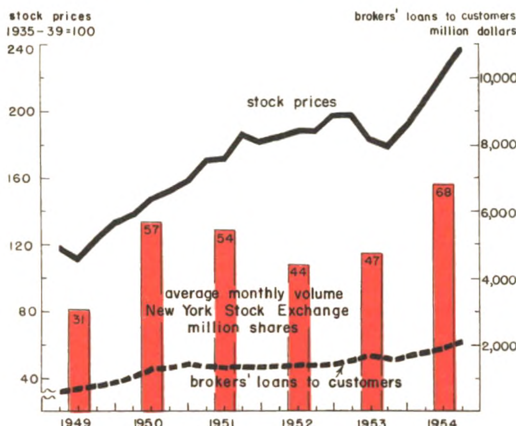
Ordinarily, this price rise will prove self-limiting, since higher stock prices do not change dividends and thus the percentage return on stocks is lower at the higher price level.

If the enhanced interest in stocks stays within a moderate range, some salutary effects may result. It is notoriously easy to float new issues of both bonds and stocks in rising markets. The favorable conditions—including rising markets—created by easy credit policies encourage borrowers to raise and invest new long-term capital. This is one of the major channels by which the effects of a policy of monetary ease helps to counteract business decline.

Abetting this encouragement of productive investment will be the general increase in liquidity which is the natural result of higher bond and stock prices. People's attitudes will be conditioned by the fact that their liquid assets are worth more in the market than before. All other income-producing assets in turn will appear relatively more valuable in investor eyes, inasmuch as the comparable rates of return on bonds and stocks have been pared by the increases in their price. As these revisions in judgment as to the worth of earning assets spread through the economy, an increasingly favorable financial climate is created. Provided the underlying bases for production and distribution have not been eroded, such a climate can contribute to continuing high-level investment and business activity.

Since 1949 the market has matched 1927-29 gains, but borrowing has played a lesser role



Some indications of the influence of climatic changes induced by monetary policy can be gleaned from the experiences of the past year or so. As far as the bond markets go, there is no question of the impact of easier credit conditions. Corporations have continued to raise large amounts from sales of bonds despite the dip in business since mid-1953. State and local government borrowing is steadily and rapidly growing. Ease in the mortgage markets has stimulated a continued high level of residential construction.

On the other hand, the sums raised from sales of stock, which have been relatively modest all through the postwar period, have not been appreciably greater in the past year. This is true despite substantial increases in stock prices.

Easy money and speculation

The recent experience of higher stock prices but few new stock issues underlines one of the difficulties which may accompany increased investor interest in stocks. If the supply of stocks remains relatively fixed and the increased demands are heavy, the initial shifts into stocks may boost prices so much that additional buyers are attracted in the hopes of speculative gains in a rising market. This, of course, can get out of hand and turn into a speculative binge complete with morning-after headache. In more prosaic words, an easy monetary policy can have the unintentioned effect of encouraging the repetitive transfer of existing assets at increasing prices.

Today's bull market is much less credit-based than at times in the past. Investors today seem primarily motivated by the higher returns yielded by stocks and by prospects for longer-term appreciation of their holdings rather than by hopes of short-term speculative gains. Scat-

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tered through the pages of history, however, are numerous cases in which the market was swept by a speculative contagion.

Unraveling the broad fabric through which easy money, security markets and the flow of investment activity are interwoven, it seems fairly certain that under certain conditions easy credit can produce sympathetic buoyancy in the equity markets. Moderate security price rises and the attendant upward recapitalization of other earning asset values, in turn, can create an encouraging financial atmosphere for the conduct of business in general and for the financing of new investment in particular. Engraved in the minds of all observers, however, are memories of the ill effects which the speculative perversion of equity interests can bring.

Ideally, the objective should be to minimize the latter possibility without losing the former advantages. If financial markets are to be reasonably free, the determining force will always be the attitudes of individual investors and seekers after funds. Most investors serve this national interest in the degree to which they look beyond short-term speculative opportunities to the longer-term prospects for income and capital appreciation. Happily, this kind of action is also encouraged by prudent investor consideration of his own best interests, as the record of past investor founderings in speculative excesses will testify.

Consumers call signals—for an unspectacular gain

High-level consumer spending along with the continuing construction boom have spelled economic stability during 1954 even in the face of powerful contractive forces. In the third quarter, consumption spending totaled 235 billion dollars—up 3½ billion from the same period last year. The sheer magnitude of these outlays—two-thirds of the gross national product in recent months—plus their effect on business inventory policy makes the consumer sector a focal point in the current business outlook.

Retail sales do not include all consumer spending nor do they represent sales to consumers exclusively; important blocks of business purchases such as cars and trucks, farm machinery and building materials are included in the totals. Nevertheless, these data provide a ready means of keeping a finger on the consumer buying pulse. The Bureau of the Census now publishes preliminary estimates for total retail sales and major categories about ten days after the end of the month. The Federal Reserve System provides figures on department store sales on both a weekly and monthly basis.

Total trade down slightly

Retail trade has not fared so well as total consumption spending in 1954. The latter has been bolstered by rising outlays for services. Total buying of goods of all types has run slightly below last year.

For the first ten months of 1954 total retail trade was less than 2 per cent below record 1953. A considerably larger deficit existed in the early months of the year, but the gap has changed little in the July-October period. This was true, despite the fact that total sales in the late summer and early fall of 1953 were mod-

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erated by hot weather and the beginning of the recession. October results just about matched the same month last year on an adjusted basis. October of 1953 was the first month of that year in which total retail trade had slipped below 1952.

Marked change in car sales

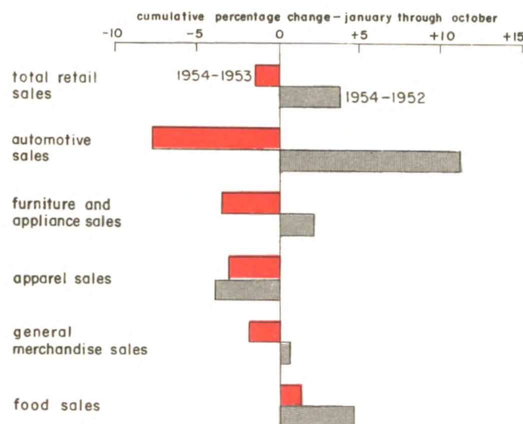
Automotive store sales comprise a large, fluctuating portion of retail trade. For ten months, sales of these dealers were down 8 per cent from 1953; the dollar volume drop was equal to the total decline for all retail stores between the two periods. During the four-month period, July-October, automotive sales were off 1.5 billion dollars, or 13 per cent, from the comparable 1953 period. Sales of all other stores showed a gain of 1 billion dollars during the same interval.

The decline in automobile sales through October was a result mainly of smaller unit sales of new cars and trucks plus a substantial decline in the average price of used cars. In September and October, sales of new cars dropped abruptly as stocks of 1954 models were worked off. This period had its counterpart in November and December of 1953. It is likely, therefore, that in the months immediately ahead, automotive sales will cease to be a drag upon year-to-year comparisons of total trade.

To the extent that new models stimulate consumer purchases of automobiles, there may be some offsetting declines in buying of other items. This effect will be moderated, however, by the extent to which buyers go into debt or dip into cash reserves for this purpose. In addition, a larger volume of auto sales will increase the income of individuals who produce and distribute cars.

There is evidence that instalment credit will be amply available. Outstandings have been stable in 1954 in contrast to sharp increases in the previous two years. Many individuals are in a position to assume additional debt. Collection difficulties have not been pressing, and finance companies have shown a willingness to stretch out maturities and reduce down payments.

Retail volume for first ten months tops 1952 but fails to match last year



Growth lines continue up

The moderate decline in business for all of 1954 and the general stability of prices permitted those types of retailing with a strong secular growth trend to show some further rise. Food and drug stores and particularly gasoline service stations increased sales in the first ten months. Apparel, on the other hand, did rather poorly with a drop of over 3 per cent. Department stores and other general merchandisers reported a 2 per cent deficit for the nation as a whole. Most types of stores in the Midwest apparently did less well than these national comparisons.

Among the housefurnishings lines results have been mixed. Furniture and floor coverings are down substantially as were certain types of appliances. Television sales at retail have been substantially higher than last year, and September established a new record with almost a million sets. Air conditioning sales also have been higher but not enough to justify manufacturers' hopes. As a result the industry has a carry-over of a half million units for next year.

The consumer is confronted with a much

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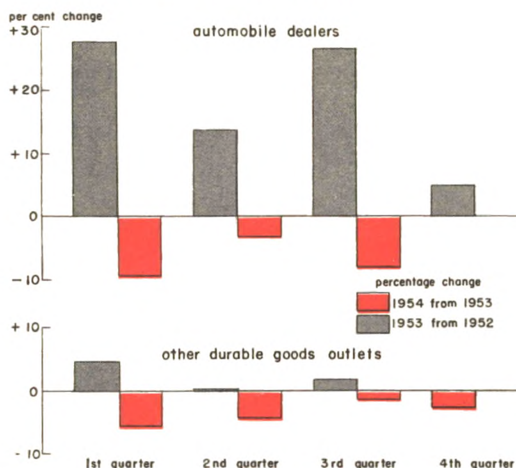
Automotive sales fluctuate more than other durables



larger array of "big ticket" items today than was the case years ago. Television is by far the most important with room air conditioners in second place. In addition, there are dishwashers, disposal units, freezers and a long list of smaller plug-in items which were not in competition for the consumers' dollar until recent years. It is apparent that the addition of these items has helped to buoy up total retail sales.

Results differ by city

The stability of total consumption expenditures in the past year reflects the general stability of spendable income, as personal income has been bolstered by unemployment compensation and tax cuts. Merchants in many cities, however, have been much less fortunate, particularly those in localities in which income has been adversely affected by employment cutbacks in the manufacturing or transportation industries.

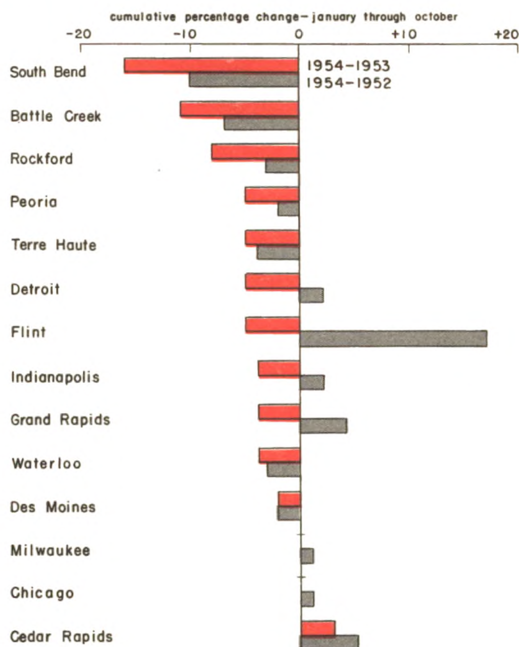
There are several examples of these depressed industries in the Midwest. Department store sales and car registrations can serve as a general gauge of performance for this purpose. South Bend, Gary, Battle Creek, Muskegon and Port Huron reported department store sales off 11 per cent or more for the first ten months of the year. The entire Seventh District showed a 3 per cent drop for this period, compared with 2 per cent for the nation. Many other cities in this area, including Detroit and Indianapolis, recorded declines of 4 per cent or more.

For the nation as a whole, automobile registrations were only 5 per cent lower than 1953 in the first nine months of 1954. In the Quad Cities, Peoria, Detroit and Jackson they were off 15 per cent or more in the same period. In most cases the difference in the year-to-year comparisons had grown wider in the third quarter.

Closing the gap

At the present time most merchants are in the midst of the all-important Christmas season. December alone accounts for about 10 per cent of annual retail sales and about 15

Department store sales have lagged both 1953 and 1952 in most District centers



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per cent of department store sales. In the case of typical gift items, such as toys, electric shavers, books or records, December sales may total 25 per cent or more of the year's totals.

Retail sales should have little difficulty meeting the year-ago figures for December and thus bring 1954's results closer to last year. December 1953 was one of the few postwar Christmas months in which sales receded from those of the previous year. In contrast to the mounting layoffs of late 1953, employment has been improving in recent months. Some of the worst hit industries such as automobiles and steel have done some rehiring, and many individual wage earners doubtless are looking toward the future with greater confidence. Moreover, new models of virtually all auto makes are scheduled to come on the market in volume in December and cause this sector to be a more vigorous component of trade.

Buyers' markets shrink profits

Lower sales and increasingly competitive markets are taking their toll in reduced corporate earnings. In the first three quarters of 1954 total corporate profits were off 18 per cent from last year. Net income after taxes—buttressed by the expiration of the excess profits tax—was down about 11 per cent.

The gap between profits for the two years will doubtless narrow substantially when the full-year comparison is available. Earnings dropped sharply in the final months of 1953, whereas this year's final quarter should compare favorably with experience of the first nine months.

Holders of common stocks, of course, are keenly interested in the trend of business profits. The effects on policies and attitudes, however, are not limited to this group. Union demands for wages and other benefits, management plans for capital expenditures and financing, Treasury attitudes on taxing, spending and debt management—all are affected by the trend of business earnings.

The buoyant behavior of the stock market during 1954 is ample evidence of investor satisfaction with recent corporate earnings reports. Many firms are enjoying a gain in net after taxes despite reduced sales. Although the experience of all corporations as a group has not been so favorable, profit behavior has been excellent, considering the fact that business activity has receded from last year's level.

A sizable decline in business profits can always be expected to accompany any recession, however mild. In fact, on the basis of past experience, a larger relative decline might have been expected. For example, gross national product was almost exactly the same in 1948 and 1949. Before tax profits, however, dropped 20 per cent between the two years.

Cost-cutting bolsters earnings

Unlike most other economic measures, business profits did not set records in 1953. Before tax earnings were higher in both 1950 and 1951, and after tax returns had been larger in 1948 as well. Rising prices had brought inventory windfalls in those years in contrast to the price stability which prevailed in 1953. The fact that prices continued stable through the 1953-54 business recession—a unique development—was an important factor in braking the decline in profits. Price trends affect profits not only through inventory gains and losses but through profit margins. Costs usually fall less than selling prices during a downturn.

Other factors tending to support profits this year were the ability to shut down older, high-

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cost facilities as surplus capacity appeared, the greater stability of work force as labor markets softened, and an easier flow of raw materials which permitted more efficient production scheduling. As a result of these developments, theoretical break-even points—the level of output required for profitable operation—have proved to be lower than might have been inferred from data for recent years. Incentives to keep costs down, moreover, have strengthened now that competition is stiffer and the excess profits tax has expired.

Large firms fare best

Profit results, of course, have varied greatly by industries and among individual firms. The more stable growth lines, such as food processing, paper manufacturing, petroleum refining and the utilities, have shown the most favorable comparisons with 1953. Iron and steel, furniture, machinery and textiles have done most poorly.

In most cases, it is apparent that profits have been maintained far better on an after tax basis. Not only EPT, but loss carry-overs have tended to sustain after tax net income. These estimates of total corporate profits by industry show generally less favorable results than those reported by the relatively large firms, which regularly issue interim financial statements.

Large firms have maintained profits in 1954 far more successfully than smaller ones. This is true for both before and after tax comparisons, but it is especially noticeable in the latter case because large firms had been paying the bulk of the excess profits taxes.

	Over 100 million dollars in assets	Under 100 million in assets
	(change first half, 1953 to 1954)	
Sales	− 5%	−11%
Profits before tax	−15	−32
Profits after tax	+ 8	−25
Dividends	+ 5	− 4

SOURCE: FTC-SEC

Dividing manufacturing concerns at the 100 million dollar asset level places 53 per cent of first-half 1954 sales in the lower bracket. These firms, however, accounted for only about 34 per cent of the after tax profits. There is no sharp break at the 100 million mark. In general, the profit decline from a year ago was greater for successively smaller size groups. Better performance on the part of large firms, moreover, was the case in virtually all categories of manufacturing.

Under the conditions prevailing since the start of the year, large, well-financed firms with products having a high degree of customer acceptance appear to have been most successful in maintaining sales and margins. In addition, diversification of product lines, which helps stabilize earnings, is most characteristic of large firms.

In a few industries the earnings picture is dominated by one or two firms. In these instances generalizations on profitability for the whole industry may be misleading.

Fast write-offs cut earnings

Reported profits of firms which have a heavy investment in fixed assets are strongly influenced by the speed with which these facilities are amortized. In the past, depreciable assets have been written off the books in equal annual amounts over the period of their "useful life."

Profit change, six months, 1953-54

	Before tax	After tax
Electric utilities	+ 5%	+ 9%
Food	− 2	+ 1
Paper	− 8	+ 3
Petroleum	− 9	+ 5
Chemicals	−15	+ 4
Motor vehicles	−24	+16
Machinery (nonelectric)	−25	−11
Electrical machinery	−29	− 7
Iron and steel	−44	−25
Railroads	−52	−46
Furniture	−53	−60
Textiles	−59	−73

SOURCE: FTC-SEC, and FRB

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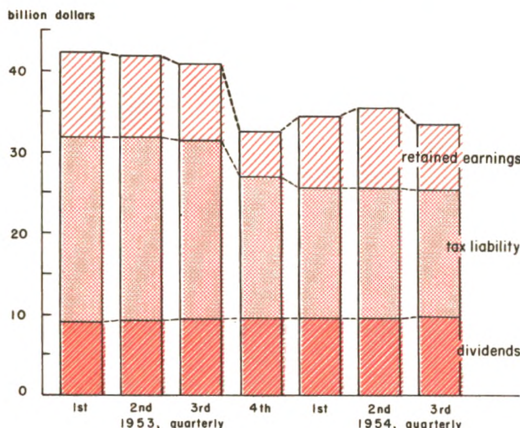
Pretax profits — lower but leveling



Beginning with the Defense Production Act of 1950, this situation has been altered.

In the past four years about 25 billion dollars of new plant and equipment put in place has been covered by Government certificates which permit all or part of the facility to be amortized in five years. This compares with about 20 years on the average under the "useful life" concept. Moreover, under the 1954 tax law depreciation allowances on *all* newly purchased facilities can be accelerated so that a larger share of the project can be charged against income in the early years of its useful life.

At the present time *additional* depreciation under these programs may be running at an annual rate of about 2 billion dollars. For the most part, accelerated depreciation is used in published statements as well as in computing taxable income. As a result, reported earnings of some firms in such industries as chemicals, iron and steel and aluminum, which have a large volume of fast write-off facilities in operation, are substantially lower than would be the case if depreciation were accrued in the normal manner.

Reflecting the more important role of depreciation in corporate accounts, investment analysts have come to regard "cash earnings" (after taxes but before depreciation) as a better clue to changes in "true" income than reported net earnings. In many cases fast write-off projects will continue to generate income long after the bulk of the capital expenditure has been run through the expense account. Stocks of many firms are selling at prices which reflect this situation.

Even without faster write-offs, heavy capital outlays would have brought a steady rise in depreciation accruals. So short a time ago as 1950, depreciation taken by all corporations amounted to 7.9 billion dollars. In 1954 it may exceed 14 billion.

Since depreciation is an expense which does not involve a cash outlay, it is apparent that except for firms which fail to make a profit these allowances are represented by a cash inflow which is available for use in the business or for disbursement to stockholders. The following table compares depreciation and after tax earnings for recent years:

	Profits after taxes	Depreciation	Combined
1950	22.1	7.9	30.0
1951	18.7	8.7	27.4
1952	17.2	10.0	27.2
1953	18.3	11.8	30.1
1954	17.5 est.	14.0 est.	31.5 est.

Apparently, cash available from net profits plus depreciation will set a new record in 1954. These funds along with the net proceeds of security issues and amounts made available by reductions in inventories and receivables have permitted business firms to pay down short-term debt owed to banks, to the Government and to other business firms and to increase aggregate dividends. Reductions in inventories, receivables and short-term debt have brought about an improvement in corporate liquidity ratios and current ratios for the first time in five years even though after tax earnings have declined.

Federal tax receipts to fall

The prospective revenue loss from corporate tax receipts is a serious matter for Treasury officials who are striving for a balanced budget. Corporate tax payments have accounted for

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Depreciation gains as profits fall

about 30 per cent of Treasury cash receipts in recent years.

Reduced corporate tax liabilities incurred during 1954 will be reflected in Treasury cash receipts in the calendar year 1955. This year's tax accruals may be down about 4 billion dollars, or 20 per cent, from last year's 21 billion. About half of this 4 billion decline will be attributable to the end of EPT—the rest, to lower pre-tax earnings.

A partial offset to this revenue loss is incorporated in the new tax bill. Under the existing program for corporate tax acceleration—the Mills plan—100 per cent of this year's corporate tax liability will be paid in the first six months of 1955 as compared with 90 per cent in the first half of the current year. Under the new program, all firms with tax liabilities over 100,000 dollars must pay 10 per cent of 1955 taxes in the second half of that year. Eventually half of each year's tax liability will be paid in the year in which it is earned. This program will offset to some extent other developments which are improving corporate liquidity.

Maintaining net in '55

Competitive pressures may be even stronger in 1955. Under these circumstances business managers will have a strong incentive to pare costs in order to maintain profit margins. And it appears unlikely that further tax reductions will cushion any drop in pre-tax earnings.

Most cost-cutting will involve attempts to lop off unprofitable operations, eliminate superfluous jobs or otherwise increase efficiency. However, the "urge to merge" induced by a desire to diversify or achieve economies connected with a larger volume of activity will also continue to make headlines.

In some lines attempts to improve profitability may be doomed to failure. In the earlier postwar years deficits or relatively low profit margins were rare in comparison with experience in previous decades. Now it appears that such industries as textiles, mining and railroading in fields characterized by stiff competition and a less than vigorous long-term demand growth will experience great difficulty in rebuilding profits from depressed levels. Some lines of business were chronically in trouble even during the generally prosperous Twenties, and it is possible that a similar situation may prevail in the years ahead.

The success achieved by most corporations in maintaining after tax net income during 1954 omens well for the future. After tax margins of recent years—about 4.5 per cent on sales for manufacturers and 2.5 per cent for retail chains—suggest the narrow band which separates most firms from unprofitable operations. However, relatively slim margins also suggest that modest improvements in production and sales techniques will suffice to keep the typical business firm from resorting to red ink.

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Agriculture—more of the same

Burdensome supplies and a relatively stable over-all demand will continue as the dominant features of the agricultural situation in the year to come. Big carry-over stocks, largely owned or under loan to the Commodity Credit Corporation, plus the large total output in 1954 and in prospect again for 1955, will assure super-adequate supplies.

Domestic demand for food and other agricultural commodities has remained strong throughout the postwar years and is expected to hold about at the current high level in 1955. Consumers probably will continue to spend about 25 per cent of their disposable income for food.

Foreign demand, on the other hand, has shown wide swings in the postwar years. Changes in exports, along with changes in production and speculative demand for stocks, have accounted for most of the fluctuations in farm commodity prices. In the year that now stretches before us, some increase is indicated in agricultural exports, but with the additional shipments being moved out of present CCC stocks. The step-up in sales abroad, therefore, would have little impact on domestic markets.

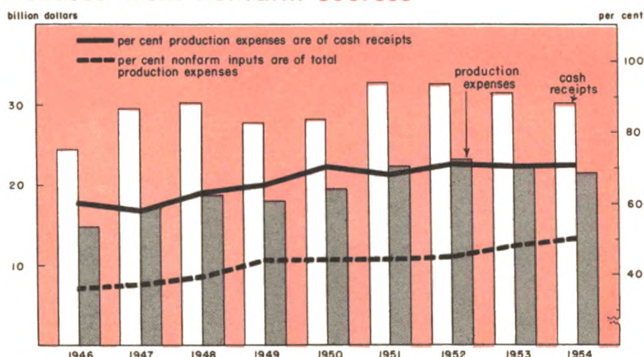
Production is expected to continue near the high level of the past year. Some increase in output of livestock products is indicated. Further cutbacks in acreages of wheat and cotton, however, may not be fully offset by expansions in substitute crops. The demand for privately held stocks may be a bit more active than in the past year and lend support to the over-all demand.

Translated into terms of prices and income, the farm outlook is for stability near the levels existing in the third quarter of 1954. Reflecting the downtrend within the current year, this would place 1955 prices and income moderately below the 1954 averages. Cash receipts from farm marketings are now indicated to total about 30.2 billion dollars this year, reflecting a decline of 5 per cent from the 1953 total. Prices received by farmers since midyear have averaged 4 per cent below the average for the first half.

A moderate decline in farm production expenditures would not fully offset the indicated decline in gross farm income, with the result that farm operators' net income from agriculture in 1955 probably will again fall below that of the previous year. The 1954 net is now indicated to total 12.5 billion dollars, about 6 per cent below that of 1953.

Production expenses higher relative to cash receipts and more stable due to larger purchases from nonfarm sources

Income per person living on farms, nevertheless, has declined less rapidly than total farm income in recent years, reflecting the 9 per cent reduction in farm population since 1951 and an increase in income of farm residents from nonfarm sources. While the average per capita income of persons engaged in agriculture remains far below that of nonfarm workers, it has shown a relatively larger gain from prewar.



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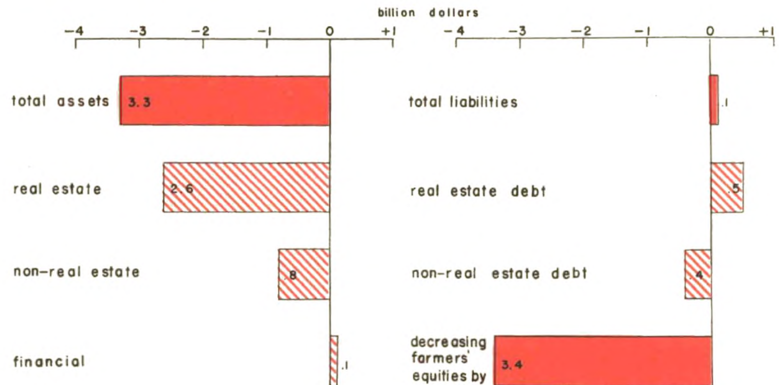
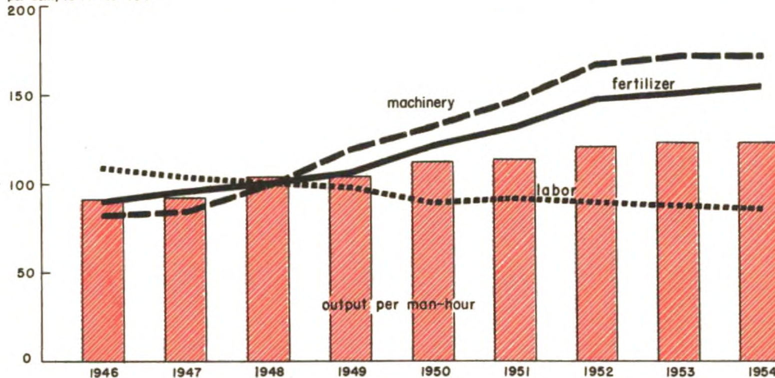
Further declines in agricultural income and prices exert downward pressure on farmers' assets and equities

Spearheading the 8 per cent decrease in total farm assets from their 1952 peak are sharply lower livestock prices and a gradual slide-off in land values. Farm debts have increased only 2.7 billion dollars but nevertheless contributed to the 10 per cent decline in farm equities. Agriculture remains in a strong financial position; debts now represent about 10 per cent of the value of farm assets.



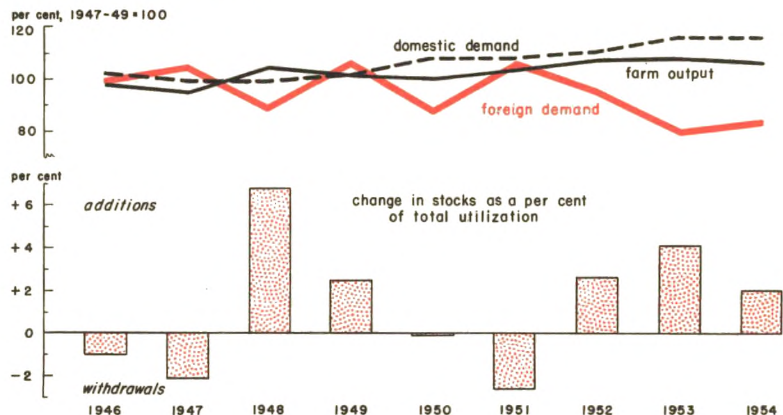
Output per man-hour has increased due to larger inputs of purchased materials, better management and fewer hours of labor



Increased use of capital in the form of machinery, equipment, fertilizer and improved seeds and livestock are largely responsible for the 27 per cent reduction in man-hours used in agriculture and the 80 per cent upsurge in output per man-hour since 1940. The rate of gain in farm mechanization has slowed in recent years under the influence of sagging farm incomes.

Fluctuations in foreign demand have been a major force in both build-ups and reductions of stocks.

Farm production has not made compensating adjustments. Agricultural output has been characterized as having largely a one-way stretch—it expands in response to increased demand but does not snap back when demand declines. In periods of reduced foreign demand, continued high production and pegged prices have brought rapid build-ups in stocks.



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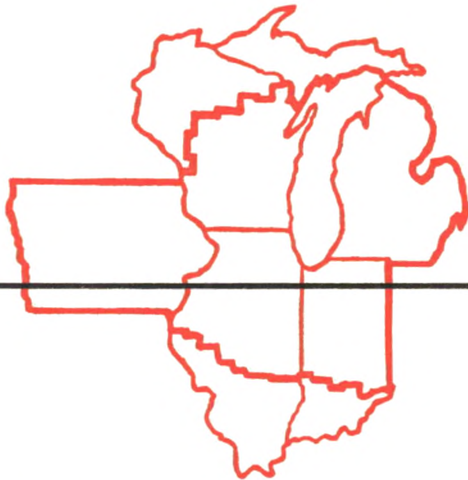

Business Conditions

a review by the Federal Reserve Bank of Chicago

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