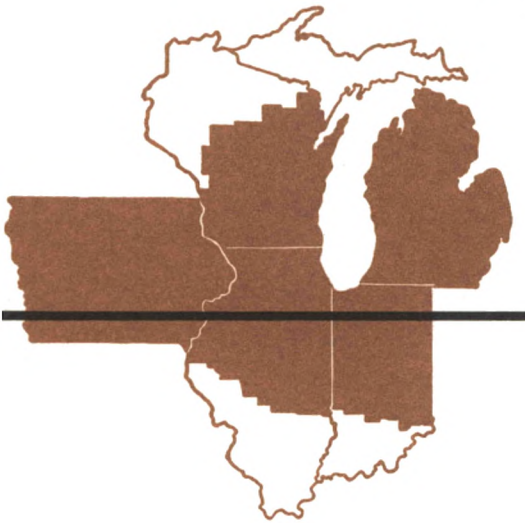
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1960 March

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THE Trend OF BUSINESS

At the turn of the year, it was quite generally asserted that a strong upsurge in business activity was a foregone conclusion for the January-June period. The need to build inventories in the durable goods lines, where they had been reduced by the steel strike, coupled with an expected further sharp rise in sales, was believed to assure a strong rise in income and employment throughout the first half of the year or longer. While most business indicators continued to rise in January and February, developments were not as vigorous as some people had expected. Hence, there was much questioning and reviewing of prospects for the first year of the new decade.

Steel supplies ease

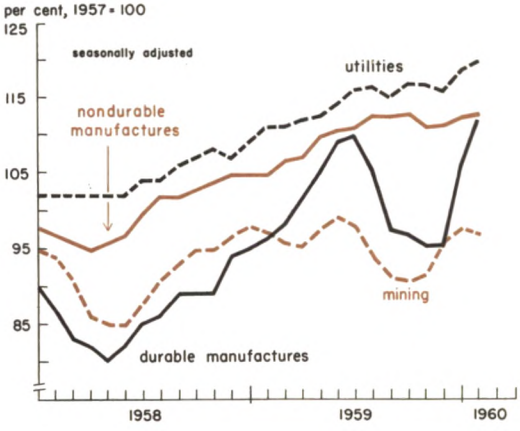
It was apparent in February that inventories were rapidly approaching levels which, with few exceptions, would be adequate to support current rates of production and sales.

In part, the rapid easing of the supply situation was the result of the quick resumption of virtual capacity operation in the steel industry. In the first two months of 1960, steel firms poured about 23 million tons of ingots—an annual rate of 140 million tons. The previous record annual total was 117 million tons in 1955. About 20 per cent of the recent output was going into inventory, according to estimates of the largest steel producer. Also, there were sizable additions to inventories of finished goods—automobiles, for example—and goods in process.

By mid-February, several types of steel were being "sold" rather than "allocated." In general, the heavier steel items were in largest supply. These included plates, some types of structurals and "oil country goods"—the materials used in crude oil exploration and production. Cold-rolled sheet, cold-finished bars and galvanized sheet were in tightest supply.

However, the supply situation for the lighter steels could ease quickly if the auto firms were to reduce production schedules appreciably. About 30 per cent of all steel and much larger shares of the cold-rolled sheet, hot-rolled sheet and strip and cold-finished bars have been flowing to the auto manufacturers. With production of autos at

Industrial production
at record level



a high level, the demand for these types of steel has been exceptionally strong, and some other users have been unable to obtain the amounts desired. Any reduction of demand from the auto sector would release current output of the lighter steel types to firms whose demands have not been met because of limited supplies.

Consumer durables

Inventories of consumer durables rose in January and February as production was increased and demand at retail did not quite equal the optimistic levels projected at the beginning of the year. In some cases, "involuntary" inventory building caused producers to reduce output schedules.

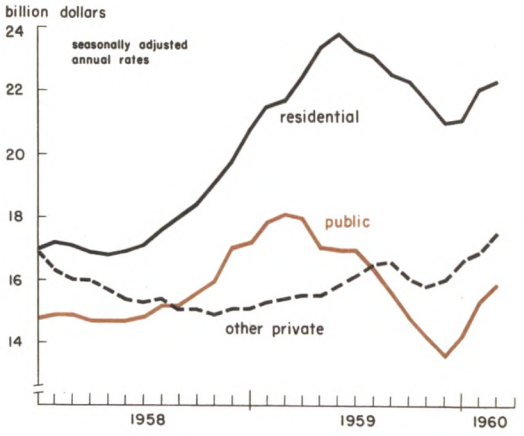
Although auto sales in January—at 18,200 per day—were 11 per cent above the year-ago rate and showed a further gain in early February, an increase on the order of 20 to 30 per cent had been anticipated by manufacturers. As a result, inventories of new cars reached 800,000 on February 1 and many suppliers of parts and materials used in auto production were directed to "set back" or "stretch out" deliveries.

The less-than-hoped-for results in auto sales were paralleled by developments in some other consumer durable goods lines, especially major household appliances and TV sets. In these, inventories rose more than had been planned in January. As in the case of autos, sales of appliances were higher than a year earlier, by about 4 per cent on the average.

The "first-quarter blues"

In several recent years, a situation described as "first-quarter blues" has been noted. Sales appeared to be sluggish during January and February following the Christmas holiday. The tendency toward succes-

Construction in renewed upswing—private outlay above year ago, public below



sively larger and larger Christmas sales may have been responsible in part. Also, with high levels of employment and rising incomes, there has been more vacationing in the early weeks of the year, and sieges of virus infections may have played a part in holding down sales in this period. Seasonal adjustments of production and sales data are supposed to allow for these factors. But if these and other factors were increasing in importance, their effects might not be adequately compensated for. In 1956, the evidence of a "first-quarter slump" was sufficiently strong to convince many observers that a recession was in progress, although prosperity, in fact, continued for a year and a half.

In the current season, it has been suggested that the lack of extra strength in demand for consumer durables must be discounted because of unbalanced inventories and a reluctance of dealers to shave prices sufficiently. Also, the long duration of the steel strike, and its secondary effects on other sectors, has severely reduced the ability

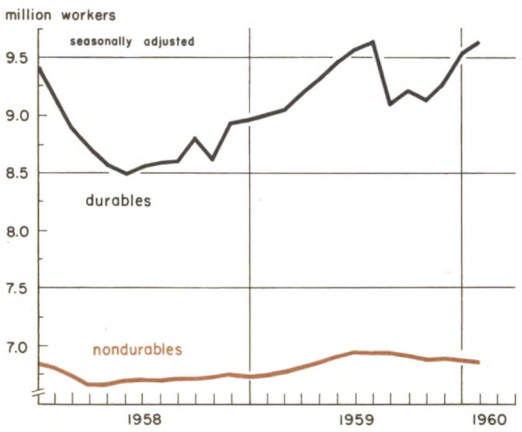
of many families to purchase durables until they have reduced their debts.

Equities and debt markets

Financial developments in the early weeks of 1960 tended to reinforce the pessimism resulting from the less-than-anticipated rise in sales of goods. The price averages of common stocks dropped 10 per cent or more in January. This occurred even in the face of expectations that corporate profits would set a record high in 1960.

At the same time, the demand for credit and capital has been smaller than had been expected. Mainly because of inventory building, it was believed that business loans outstanding at commercial banks would not register the usual seasonal decline in January. Actually, business loans fell in January by about as much as last year although part of the decline was recovered in February. Moreover, new security issues have been relatively light. Corporations apparently have maintained liquidity positions far better than had been expected with the result that many of them have added further to their holdings of securities. The Treasury's large seasonal excess of receipts over disbursements is in sharp contrast with last year, and the effects on the financial markets apparently had not been fully anticipated. These factors helped to produce a reduction in interest rates, particularly on short-term Governments. The result has been an increase in prices of outstanding bonds and lower coupon rates on new issues. The combination of falling stock prices and rising bond prices often has been associated with a deterioration in the business climate.

Employment in hard goods manufacturing regains pre-strike level



Evaluating the outlook

In any re-evaluation of recent developments, however, it must be noted that sales of consumer durables, although below expectations, have been anything but depressed. Sales of most items have been above year ago. Furthermore, farm income prospects have improved somewhat since last fall, and the anticipated decline in housing starts in 1960 from the high level in 1959 is now expected to be less drastic than had been indicated earlier. Housing starts in December and January were above the reduced rate in the late fall. The trend of housing permits granted in Midwest cities has improved along with the national picture. In the Chicago area, permits were substantially higher in January than a year earlier, largely because of new activity in apartment building. Insurance companies have been showing renewed interest in residential mortgages, and the continued strong inflow of funds to savings and loan associations indicates that a large volume of mortgage credit will be available from those institutions.

In other sectors—Government expendi-

tures, consumer purchases of soft goods and producer purchases of new equipment—the outlook has neither weakened nor strengthened since the start of the year. Government outlays are holding to budgeted levels, sales at department stores—mainly nondurables—increased by 7 per cent over the year-ago month in January (about the same increase as in most of 1959), and capital spending plans appear to have held firm in the face of the bearish sentiment.

To some, these developments have suggested that the current prosperity is near its peak and that sights should be lowered on business prospects for the remainder of 1960. To others, recent developments suggest that the duration of the upswing is more likely to be extended into 1961 since the danger of an unsustainable inventory accumulation may have been removed or mitigated.

Whatever the actual course of business through the remainder of the year, all aggregate measures of activity rose between December and January. Industrial production, employment and personal income moved to new record highs. Construction activity, which had declined between May and November of last year, rose substantially in December and January. Finally, the most inclusive measure of all—total spending on goods and services—appeared to be heading toward the 500 billion dollar rate in the first quarter, up about 15 billion dollars over the fourth quarter of 1959.

Uptrend in road building due to resume

Since the end of World War II, around 45 billion dollars has been spent to modernize the nation's highway network. Road building has accounted for close to a tenth of the total value of all kinds of construction during this period. Last year, spending for highway construction reached a record high, at 5.8 billion dollars.

This year the country is expected to experience the first decline in highway construction expenditures since 1945. The official construction outlook for 1960, released in December by the U. S. Department of Commerce, forecasts a level of highway construction spending of 5.7 billion dollars.

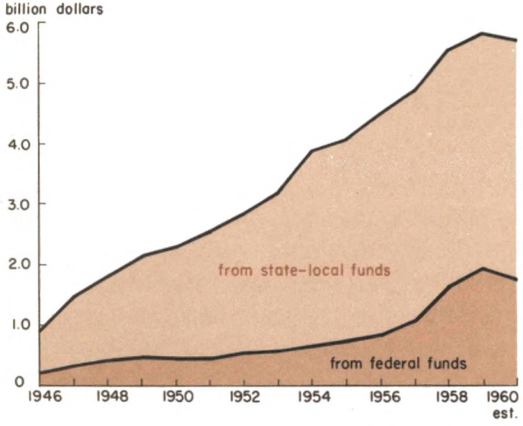
The Interstate program

The nation's highway network comprises nearly 3½ million miles of rural roads and city streets. Since 1916, the Federal Government has been making grants to the states to foster highway construction, mostly for intercity roads in the states' trunk highway systems. At present, about 250,000 miles of primary roads and 500,000 miles of secondary roads—known as the ABC system—together with their urban connections, comprise the network of conventional highways for which construction projects can be financed in equal shares by the states and the

Federal Government. In addition, there are more than 2½ million miles of city streets and rural routes financed solely by the state and local governments.

For forty years the Federal role was a marginal one, partly because so many miles of highways lay outside the Federal-aid system and partly because Federal grant appropriations were not sufficient to cover all construction work undertaken by the states on the ABC roads. Until recently, Federal aid seldom provided more than 20 per cent of highway construction funds. But in 1956, Congress assumed the lion's share of the responsibility for financing the National System of Interstate and Defense Highways. This integrated 41,000-mile system comprises the most heavily traveled routes, and interconnects substantially all communities of 50,000 population and over. While they comprise only a tiny fraction of the total mileage, the new Interstate roads undoubtedly are the most glamorous product of today's highway building effort.

Highway construction activity—first decline in postwar period expected this year



The 1956 legislation commits the Federal Government to pay 90 per cent of the estimated 40 billion dollar capital cost of the Interstate System; the states provide the remaining 10 per cent of the costs of construction and right of way and assume the total expense of maintenance, policing and administration once construction is completed. Proceeds of the Federal excise taxes on gasoline and several other highway-related products are paid into a Highway Trust Fund, which is the source of both the Interstate and the traditional Federal-aid road funds disbursed to the states. The "pay-as-you-go" or Byrd amendment to the 1956 act restricts expenditures from the Trust Fund to the amounts currently available from the earmarked revenues, plus any uncommitted balances available from previous receipts.

Spending tilted down in 1959

By 1958, the program undertaken two years earlier had set the stage for a big jump in highway spending. In addition, Congress took two steps to accelerate road building in 1958 as an interim anti-recession measure. It temporarily relaxed the pay-as-you-go requirement, and it provided for substantial additional grants under the traditional (pre-1956) Federal-aid programs, to be used within a brief period. The effects of the 1958 action had not been exhausted by the time the recession ended and continued to boost Federal highway expenditures into early 1959.

Since the Highway Trust Fund had been substantially depleted and the pay-as-you-go requirement came into effect again, after its temporary suspension during the recession, this rate of expenditure could not be maintained. Contract lettings for road building declined as 1959 wore on, and this was

followed by a dip in construction activity.

An additional 1-cent-a-gallon increase in the Federal gasoline tax, effective from October 1, 1959, to June 30, 1961, was adopted by Congress late in 1959 to bolster Trust Fund receipts and support Federal expenditure for road purposes during the next year or two at roughly the average rate in 1959. This is lower than the rate projected at the inception of the 1956 program, but appreciably above the reduced level of late 1959 and the level to which it would otherwise have been necessary to hold spending in 1960. The 5.7 billion dollar official estimate for *total* highway construction in 1960 is predicated in part on the expected upturn in the Federal Government's financial contribution.

Sources and uses of highway funds, 1958

		billion dollars	
Receipts for highway purposes			
Federal Highway Trust Fund		2.2	
motor fuel taxes	1.6		
other	.6		
State highway user charges		4.8	
motor fuel taxes	2.9		
vehicle licenses	1.2		
tolls	.3		
other	.4		
Local government highway user charges (mostly parking fees)		.8	
Other local government revenues		.8	
Borrowing by state and local governments		1.3	
Total receipts			9.9
Disbursements for highways			
Capital outlay		6.4	
Construction:			
Federal-aid programs	4.1		
Other roads and streets	1.4		
Right of way and engineering	.9		
Maintenance		2.3	
Administration, research and policing		.7	
Debt service, on state-local highway debt		.9	
Total disbursements			10.3

Note: Disbursements in excess of receipts are based on use of previously accumulated balances.

Results of a full-dress study of highway construction and finance are scheduled for presentation to Congress a year from now.

Roads for the future

By 1972, according to recent estimates, the nation will be crisscrossed by the Interstate System, a network of ultramodern roads incorporating such features as controlled and limited access, the avoidance of grade crossings, divided lanes for opposing traffic (on most of the mileage) and minimal gradients and curvatures. By far the most expensive segments of the System will be its links within the larger cities. In fact, the massive spending for urban expressways is one of the most important innovations of the 1956 program. The completed network is expected

to suit requirements of 1975. For the greater part, the Interstate roads will constitute a net addition to the existing highway plant now embracing 3½ million miles of roads and streets of all kinds, much of which will, of course, be rebuilt in the interim.

Highways of the kind scheduled for the Interstate System already are familiar in many parts of the country. Here and there, substantial mileages of modern expressways have been in service for some time. In total, however, they comprise only a minor fraction of the Interstate System mileage. Many of the existing reasonably new super-roads, moreover, already are obsolescent as compared with the advanced standards laid down for the Interstate System.

With the completion of the Interstate System, motorists will find it possible to drive long distances at sustained speeds of 60 to 70 miles an hour and more, with no interference from cross or oncoming traffic and no more than occasional need to slow or stop for traffic signals.

Quite apart from the impetus which the new plant will give to private passenger car use is the possible effect on truck and bus transportation. Recent experimentation with "truck trains" on several of the existing toll routes suggests that the new facilities may come to play a greater role in expediting the over-the-road movement of goods. Intercity express bus operations of the sort already found on some existing expressways seem destined to spread as new links in the Interstate network are completed. Such intercity passenger service could help to fill the void left by the widespread curtailment of the railroads' passenger schedules during recent years.

Some of the new Interstate facilities have been completed and placed in service. As of January, all work had been finished on nearly 3,900 miles of the network. In addition, some 9 to 10 thousand miles of existing toll and free roads, deemed acceptable under program standards, are being incorporated into the Interstate System. As of the same date, construction was actively in progress on another 4,300 miles, and contracts had been awarded on an additional 5,800 miles. A year from now, therefore, Interstate mileage in service should total from 20- to 25,000 miles, barring unforeseen interruptions.

The toll road boom

In the early postwar years, the increase in road-building expenditures was in connection with the conventional state-local highway programs, including those roads eligible for Federal aid. In the early 1950's, however, a new type of highway construction activity captured the limelight—the planning, financing and building of toll roads and connecting toll bridges and tunnels. In about a third of the states, largely in the Northeast and Midwest, the toll road device was used to make it possible to borrow very large amounts of funds during a short period for rapid construction of high-quality intercity roads along the main routes of travel.

In 1954, due largely to the huge amount of toll road financing, bond issue proceeds earmarked for highways reached 2.3 billion dollars. This was more than twice as much as yearly borrowings for all streets and highways prior to 1953; it was also twice the average annual borrowings since 1957. Recently toll road activity has declined sharply. Whether toll road construction was a short-lived interlude remains to be seen but, since the Federal highway program was enacted in 1956, the incentive to develop additional "independent" toll-financed projects inevitably has weakened. Today, only a few new toll undertakings are in the plan-

ning stage, and these are mostly minor extensions to existing systems.

The users pay

The great bulk of the funds raised for highways, whether provided by Federal, state or local public agencies, is derived from a variety of taxes and charges paid by highway users or from borrowing in anticipation of receipts based on highway use. The manner in which outlays are tied to specific revenues makes the program of Federal participation in highway construction a good illustration of user-charge financing. It is true, of course, that Federal levies on highway users likewise go back many years. The gasoline tax, for instance, was adopted in the early Thirties, and the other excises now earmarked for the Highway Trust Fund—those on tires, tubes, trucks, buses and trailers—were introduced during or shortly after World War I. But before 1956, there had been no explicit enactment on the part of Congress to link together the receipts from highway users with Federal expenditures for highway purposes.

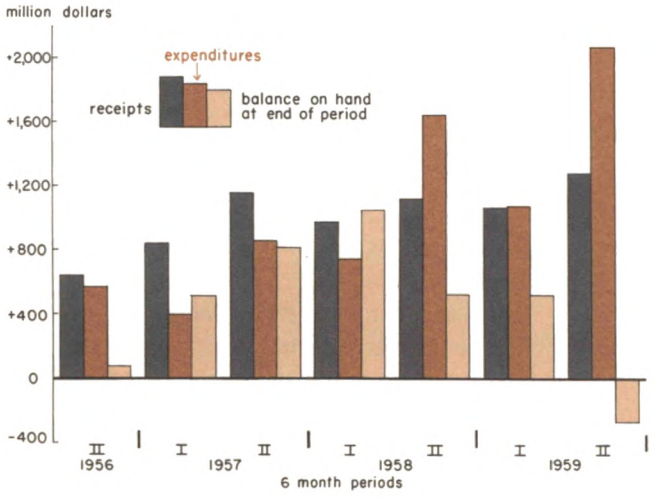
The revenue sources allocated to the Highway Trust Fund are, of course, similar to other elements of the Federal excise system. In a sense, then, when Congress in 1956 set up the Federal highway-aid program on a self-sustaining basis, it simply redefined, as user charges, certain established excise taxes.

Most observers would agree, however, that the levies now largely supporting Federal (and state-local) highway construction expenditure are of a sort suitable for the financing of expenditure conferring special and reasonably measurable benefits. While all but identical in form to other excises, the highway user charges resemble the prices charged in the market place for services received. This is a feature clearly setting the user charges apart from the other nonhighway-connected excises.

Over the years, the user-charge principle has moved into the ascendancy in the financing of highways. The fact that private motorists and commercial users of the highways are largely, if not entirely, "paying their way" has served importantly to insulate the road-building program from public discussions of the trend and level of government expenditures generally.

Although they resemble prices more closely than do other types of taxes, highway user charges, for the most part, are not precisely metered in proportion to the cost of the service used. At one extreme, the toll bridge or road

Federal Highway Trust Fund—balances built up in 1957 depleted by heavy spending in 1958 and 1959



employs toll charges which tie in closely with the costs of building and maintaining the facility. At the other extreme, the vehicle license fee and the Federal excise on new cars are unrelated to the amount of highway use or the costs of the particular roads used. In between, motor fuel taxes and mileage taxes for over-the-road common carriers provide reasonably close links between total highway use, highway costs and user-charge payments. However, great disparities arise from the fact that the governments which impose these taxes, the states and the Federal Government, have formulas for the distribution of such revenues which are at variance with the pattern of highway use.

Man-hours and electric power consumption in the Detroit area

About a year ago, two new economic series — production worker man-hours and kilowatt hours utilized by manufacturing firms — were first published for the Detroit metropolitan area (*Business Conditions*, April 1959). Analysts of economic change in Detroit have been able to observe the movements in both of these indicators as evidence of change in industrial "inputs." The more general and significant question of what they indicate with respect to industrial output has been harder to answer because there are no local output data against which to check.

When the input data were first presented, emphasis was placed on both series' potential usefulness as *short-run indicators*. A year's experience tends to reinforce the presumption that man-hours and electric power consumption do, indeed, provide valuable evidence as to the timing and even the amplitude of cyclical changes. But in the longer run the usefulness of these two input measures as indicators of output levels appears to be limited.

The national series

In December 1959, a revised index of industrial production was published which provides an improved physical volume measure for the United States. Production levels have been adjusted to new Census benchmark information and a number of new monthly series have been developed. The revised index for manufacturing and mining can be compared with electric power and production worker man-hours utilized in these industries (see top part of accompanying chart). Relationships among these national series provide further insight into the problem of measuring industrial output for key areas like Detroit which have made a significant and, in some ways, unique contribution to the postwar growth in the nation's output.

Electricity consumed for industrial use,

which includes purchases from utilities firms and self-generation in manufacturing plants, has risen at a faster rate than production during the postwar period. Between 1950 and 1959, industrial use of electricity showed an average annual increase of 6 per cent, compared with an increase of close to 4 per cent for output. The higher rate of growth in electric power consumption reflects a rise in the amount of electricity used per unit of output in individual industries as a result of increased mechanization and the shift from other types of energy to electric power. It also reflects the growing relative importance of industries which are heavy users of electricity, e.g., aluminum, cement and chemicals. Total man-hours, at least of those workers engaged directly in the production process, increased at a slower pace than output in the early '50's and since 1953 have actually been declining. This phenomenon also can be traced in part to the spread of mechanization and a shift toward a greater proportion of nonproduction workers.

As the chart indicates, there are some rather striking changes in these relationships in recent years. For example, production at the low point of the 1957-58 recession was only slightly higher than the rate reached at a comparable phase of the 1953-54 downturn. In contrast, industrial use of electricity was 15 per cent higher, while production worker man-hours were nearly 10 per cent lower.

Probably the most significant aspect of input-output relationships is that they have shifted significantly and, unfortunately for purposes of analysis, apparently *not* at a uniform rate. Cyclical swings in capital expenditures and varying ratios of man power and machine utilization at different levels of output have contributed to irregularly changing relationships among the measures. The varying mix of industrial specialization also contributes to the changes observed, which suggests that among industries and regions there will be significant differences.

An area like Detroit, with a heavy concentration of automobile manufacturing, cannot be expected to produce identical ratios of output to electric power or man-hours used or even similar changes in these ratios over time. Nor will mechanization or shifts to electricity from other types of power affect Detroit's auto industry precisely in the same way as such factors will affect the automobile industry in other sections of the country. These facts militate against the use of national averages to estimate output for local areas solely from the man power and kilowatt hour inputs.

Detroit "inputs"

As shown in the middle section of the chart, the spread between electric power consumption and man-hours employed in Detroit's manufacturing industries has been widening, particularly since 1953. Between 1950 and 1959, the industrial use of electric power has increased by 2½ per cent a year, at a compound rate. Man-hours, on the other hand, have been declining in most of these years. These conclusions are based

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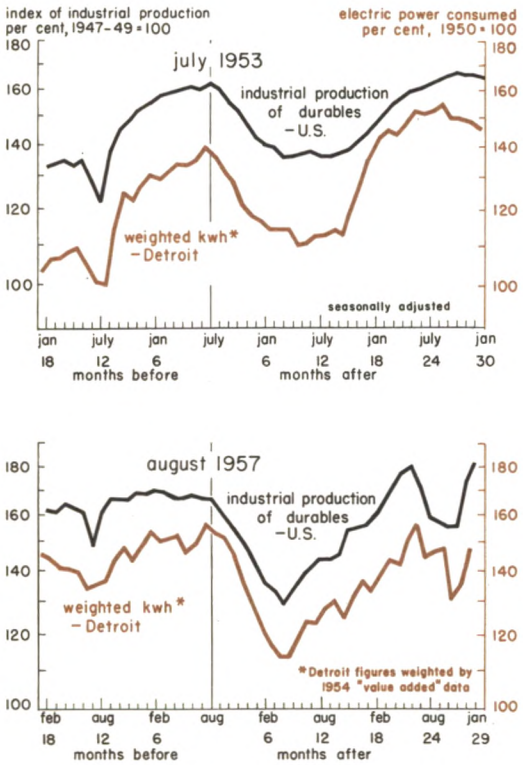
upon analysis of simple aggregates of electric power and man-hours figures. But such inputs can be reoriented or reweighted to represent output more realistically. In the simple aggregates, a kilowatt hour used in the primary metals industry, for example, has imparted to it the same effect on output as a kilowatt hour used in the metal-fabricating or machinery industry groups where the use of units of electric power is associated with considerably larger increments of value added by manufacture. Since power consumption data are available by major industry groups, it is possible to weight the power consumed by each, using as weights their percentage of total Detroit area product as measured by "value added by manufacture" from the 1954 *Census of Manufactures*. This technique prevents changes in the dominant power-consuming industries from overshadowing changes in other industries that may be much more important output-wise in the area, but are not large power users. For example, on this basis, electric power consumption rose at an average annual rate of 4 per cent from 1950 to 1959, instead of 2½ per cent. The transportation equipment industry, which accounted for only 27 per cent of electric power consumption in the area's manufacturing sector in 1954, accounted for 41 per cent of its "value added" that year. Moreover, its power consumption increased by nearly 73 per cent between 1950 and 1959, a far higher rate than that of any other industry group. This huge increase, when given the larger "value added" weight, boosts the total change in consumption significantly.

If Detroit input indexes are to be compared with national production indexes, some weighting device is indicated. There are vast differences in the amount of electricity and man power used per unit of output among various industries. Use of the "value added" weights does bring the electric power consumption series for the Detroit area into closer conformance with the U. S. index of durable manufactures (see lower part of accompanying chart). This suggests that growth in Detroit's output *associated with growth in industrial use of electricity* has about kept pace with directly measured U. S. production of durable goods. This does *not* necessarily imply that Detroit's actual production has done as well, because some

Cyclical downturns and recoveries in U.S. production of durable goods and Detroit utilization of electricity in manufacturing



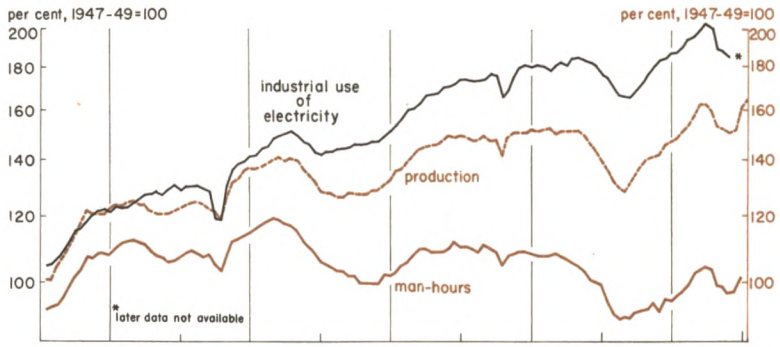
growth in electric-power-produced goods has been at the expense of other types of power. The extent to which this is the case is not known.

In terms of timing, Detroit's electric power consumption in manufacturing closely parallels that of national durable goods production. The only major difference in the direction of their movements occurred in 1951-52 when defense production rose less in Detroit than in the nation. As a result, durable goods production elsewhere continued to climb toward the end of 1951, while Detroit's industrial operations were declining.

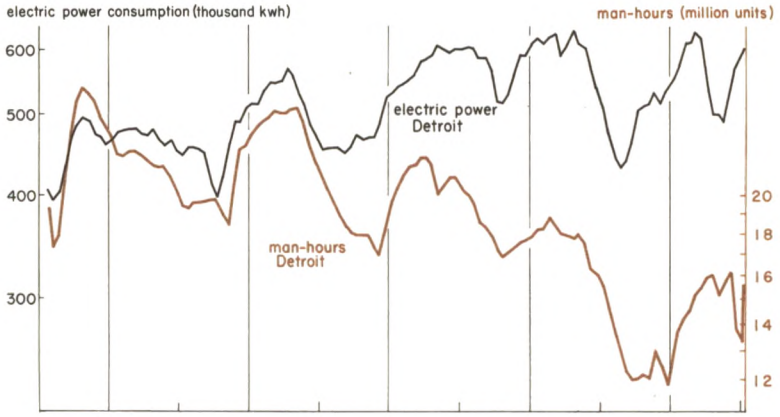
The amplitude of the cyclical swings of the Detroit series, however, has been more pronounced than that of the national production index. For example, production of durable goods in the nation declined 16 per cent from mid-1953 to mid-1954, compared with a drop of about 21 per cent for Detroit kilowatt - hour con-

Industrial production and industrial inputs of man power and electric power, 1950-60, seasonally adjusted

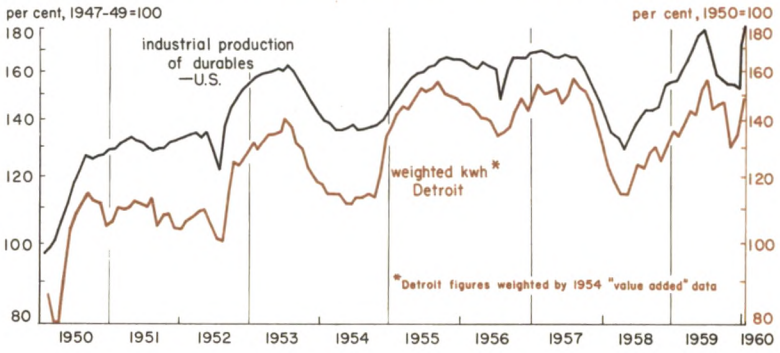
In the nation



Detroit area inputs



Contrast of U.S. durables output with Detroit KWH input



sumption by manufacturers. During the recovery period, Detroit's electric power use rose sharply to reach a level during 1955, the auto industry's banner year, nearly 40 per cent above that of mid-1954. This growth was nearly twice as rapid as that for the durable goods production index. The contrast was somewhat less marked in the 1957-58 recession.

The electric power consumption data for Detroit reflected the serious consequences of the recent 116-day steel strike on automobile manufacturers and other major steel users in the area. Steel shortages were most severe on auto makers and manufacturers of parts and components in November 1959, after the steel workers were back at their jobs.

Movements in the Detroit electric power series, when observed against a background of national industrial production trends and cyclical changes, do not appear inconsistent, erratic or improbable. Moreover, they reflect interruptions or spurts in production due to work stoppages or other local conditions about as expected. The man-hours series is less consistently reliable in timing and trend. Used together, these indexes dependably measure short-term changes in manufacturing activity in local areas.

Banking in the 1950's

The Fifties brought important shifts in the structure of bank assets as well as steady growth in total resources. Reports of condition and earnings of member banks in the Seventh Federal Reserve District reflect the vastly increased importance of lending activity that has developed over the past decade. While total assets and deposits of these banks in 1959 were roughly 50 per cent above their 1949 levels, loans had more than doubled and made up 36 per cent of the assets last year, compared with 24 per cent ten years earlier. Loans grew most rapidly, of course, in years of strong economic expansion, but the loan-asset ratio increased every year.

The gain in loans, as a percentage of total assets, was largely at the expense of the other major portfolio component—United States Government securities. Governments averaged 37 per cent of assets in 1959, down from 47 per cent in 1949. Although holdings of Governments have been reduced from the large amount at the close of World War II, most banks still hold more Treasury securities than loans. This condition, however, is less common for large banks than for small ones. The shift to loans was particularly marked at the largest banks (those with deposits of 50 million dollars or more) in 1955 to 1957 (see chart).

More income—more expense

Gross earnings rose throughout the 1950's. The gain reflected over-all growth and higher interest rates as well as the shift in asset composition in favor of loans. Despite some cyclical swings in interest rates, the rate of return on both loans and securities followed an upward trend during the decade. The rise

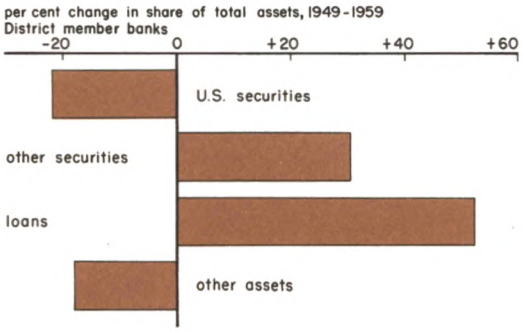
in yields on Governments was relatively sharper than on loans, but the return on loans, of course, remained at a much higher level. In 1959, loans accounted for 55 per cent of gross earnings, compared with 46 per cent ten years earlier.

As operating income rose, expenses climbed. Interest paid on time deposits was the fastest growing expense by far, and quadrupled over the ten-year period. The increase reflected both higher rates paid and the larger amount of time deposits. The average ratio of time deposits to total deposits rose from 35 per cent in 1949 to 39 per cent in 1959. Since 1956, almost 90 per cent of total deposit growth has been in the time category.

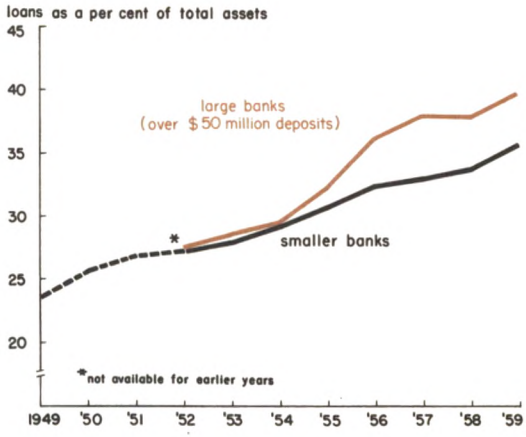
The profits enigma

During most of the decade, additions to gross operating earnings more than offset higher expenses. Net current earnings rose in every year except 1958. For 1959, the gain was more than 15 per cent. Profits, however, fluctuated widely in the Fifties. Despite record operating earnings in 1959, net profits after taxes declined sharply and were equal to 7.1 per cent of capital—

Loans increased in importance in bank assets in the 1950's



Loans have risen more at the large banks



lower than in any other postwar year. By way of contrast, in 1958—the only year in the last decade when net current earnings declined—net profits were equal to 10.2 per cent of capital, second only to the 11.6 per cent in 1954—another recession year.

This seeming paradox results from adjustments in "nonoperating" accounts and, of course, taxes on income. Adjustments include recoveries of losses previously charged to bad debts, profits and losses on sales of securities and transfers to reserves. The net effect of these adjustments has been to add to taxable income in years of relatively low earnings and to reduce taxable income when current earnings are high. This result stems principally from the pattern of gains and losses on security transactions. Banks normally liquidate securities in years of business expansion and strong credit demand, when security prices decline and interest rates rise. At such times, moreover, reserves for loan losses are increased as loan volume expands. In recession years, on the other hand, banks tend to realize capital gains on

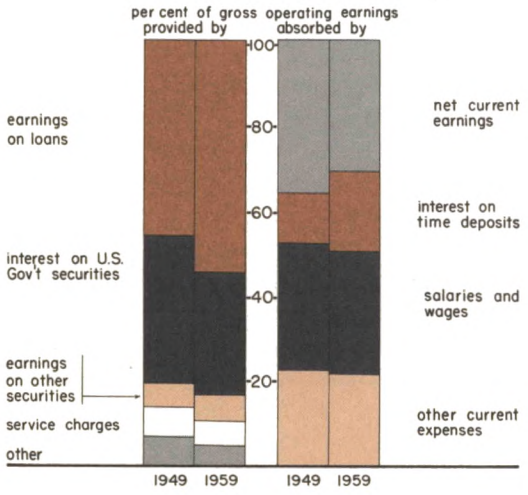
security transactions. Capital gains, of course, are taxed at a lower rate than taxable income derived from current operating earnings.

These adjustments are large enough to dominate year-to-year profits movements. This is illustrated in a comparison of the relevant operating accounts for 1958 and 1959.

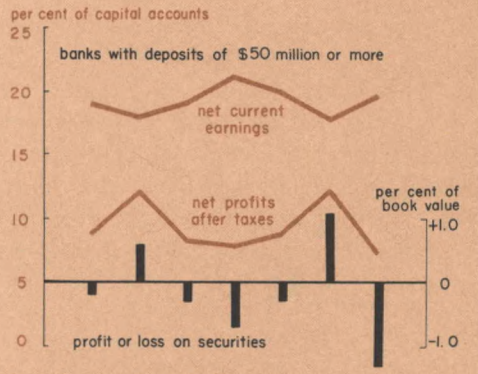
	1958	1959
	(million	dollars)
Net current earnings	356	412
Net gains and recoveries (+) or losses and charge-offs(−)	+32	−151
Profits before taxes	388	261
Taxes on income	163	95
Net profits	225	166

Gains or losses on securities are much more important for large banks than for small ones. In relation to capital accounts, net profits and net current earnings moved in opposite directions in each of the past six years for banks with deposits of 50 million dollars or more (see chart). This was largely due to the pattern of gains and losses on securities. For banks with 2.5 to 5 million of deposits and with similar experience as to net current earnings, this inverse relation does not hold true. Profits of banks in this group increased sharply in 1959. Losses on securities in 1959 varied directly with bank size, from 0.2 per cent of book value of securities for banks under 2.5 million dollars of deposits to 1.26 per cent for those over 50 million.

Shifts occurred in sources and uses of earnings



Security transactions dominate profit trends at large banks . . .



but have less influence at small banks