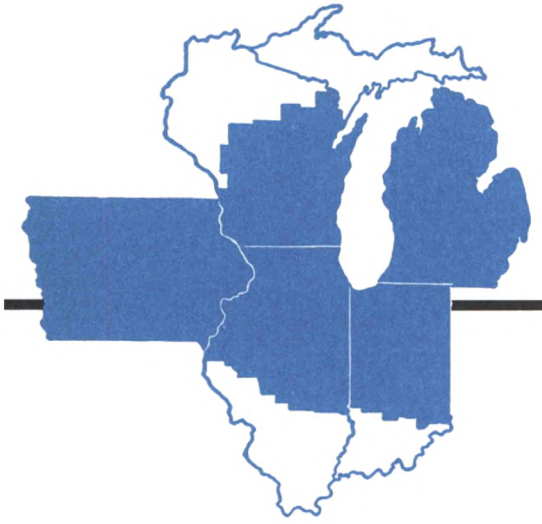
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



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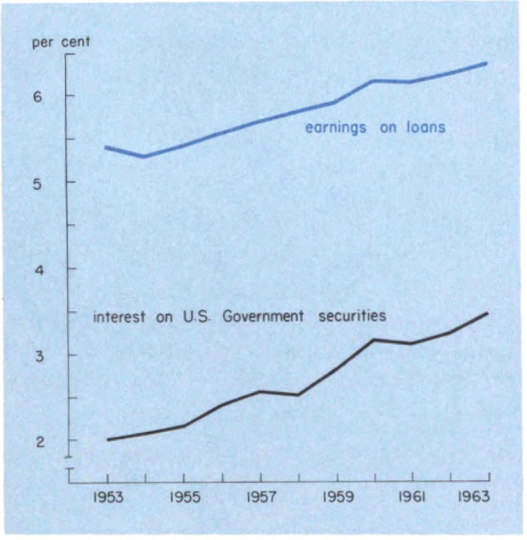
Trends in banking and finance

District operating ratios in 1963

Another favorable year was recorded by Seventh District member banks in 1963. Total deposits rose 7 per cent, slightly less than in 1962 but more than in any other postwar year. Time deposits continued to account for most of the increase in total deposits, expanding 15 per cent.

The rising level of business activity during the year was reflected in the large increase in loans extended by District banks. Loans rose 13 per cent, the largest postwar increase since 1955. Investments in "other" securities, largely obligations of state and local governments, also increased substantially but somewhat less than in either 1961 or 1962. To help finance the rapid expansion in loans and other securities, District member banks reduced their holdings of Treasury securities more than 6 per cent. Nevertheless, total loans and investments rose more than in any other postwar year except 1962.

Earnings on loans and Treasury securities at District member banks rose further in 1963



While earnings on loans and investments rose further in 1963, bank expenses, particularly interest expense on time deposits, also climbed rapidly. Consequently, net current earnings before income taxes for the "average" District member bank changed only slightly from 1962 as a percentage of either capital or total assets.[1]

Earnings on loans by the average bank during the year were 6.37 per cent compared with 6.23 per cent in 1962 and 5.38 per cent 10 years earlier. Interest earnings on investments in Treasury securities climbed from 3.22 per cent in 1962 to 3.47 per cent last year. Treasury securities yielded only 2 per cent in 1953.

Higher return on loans combined with an increase in the proportion of loans to total assets raised the percentage of total operating

[1]Operating ratios are computed as averages of individual bank ratios. Thus each bank receives equal weight regardless of size, and the resulting ratio measures the performance of the "average" bank. Ratios for individual banks may deviate greatly from the average.

revenues obtained from this source to a new postwar high of 58 per cent. The increase in yield on Treasury securities, however, was not enough to offset the effects on total revenue of the decline in the proportion of total assets held in this form.

Interest expense rises

During 1963 the interest rate paid on time and savings deposits increased sharply and exceeded 3 per cent for the first time in the postwar period. The rate paid by the average District bank has risen every year since 1950 and in 1963 was almost three times the rate paid 10 years earlier.

The combined effect of the higher rates and the greater percentage of total deposits in the form of time deposits is evident in the increased proportion of total operating expenses attributed to interest expense. Interest paid on time deposits in 1963 accounted for 37 per cent of the total expenses of the average Seventh District member bank. This was more than three percentage points higher than in 1962 and twice as great as in 1953.

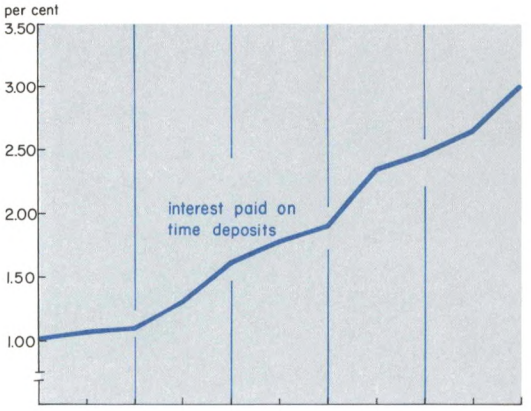
Reflecting the continued trend toward automation, the proportion of total expenses attributed to wages and salaries declined to 34 per cent. This compares with 49 per cent 10 years earlier and marks the first year that wages and salaries accounted for a smaller percentage of total operating expenses than interest on time deposits.

The increases in revenues and expenses offset each other to a considerable degree. Net current earnings before income taxes remained unchanged from a year earlier as a percentage of capital and declined slightly as a percentage of total assets. Nevertheless, because banks had greater losses on the sales of Treasury securities, in large measure attributable to the rise of interest rates in 1963, net profits after payment of Federal income tax declined to the lowest level since 1959, in relation to both capital and total assets.

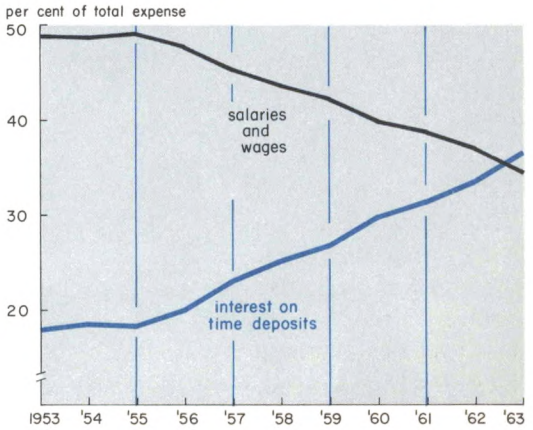
Area and size differences

Operating experience differed substantially among banks of different size and location.

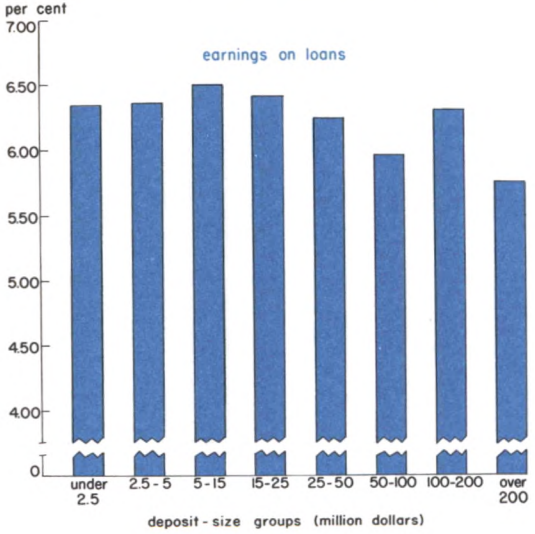
Interest rate paid
by District banks on time and savings deposits climbs to new high



and interest expense surpasses wages and salaries as single largest item in total operating expense



Gross return on loans tended to be greater for small than for large banks in 1963



Gross earnings per $100 of loans tended to vary inversely with bank size, being higher for smaller banks and lower for larger banks. This pattern indicates both differing mixes of loans and possible economies of scale in the processing and servicing of loans. Large banks tended to hold a greater proportion of large business loans (which typically carry a lower interest rate) in their portfolios than do small banks. Among large banks in major District cities, earnings on loans in 1963 were highest in Detroit and lowest in Milwaukee.

Differences among banks in earnings on Treasury securities were somewhat smaller than the differences on loans and reflect primarily variations in the maturity mix of the securities portfolio. Smaller banks generally held a higher proportion of longer-term higher yielding Treasury securities than larger banks and, as a consequence, earned somewhat higher returns on their portfolios. Smaller banks also earned a higher gross return on other securities. In large part, this reflects the greater proportion of nontax-exempt (and thus higher yielding) Federal Reserve stock and obligations of Federal agencies held by these banks and included along with tax-exempt securities in the other securities category.

Larger banks tended to pay higher interest rates on time and savings deposits than did smaller banks. The smaller banks, however, experienced the greater increase in rates between 1962 and 1963.

Interest paid on time deposits

Deposit-size groups (million dollars)	1962	1963
	(per cent)	
Under 2.5	2.36	2.87
2.5 - 5	2.45	2.93
5 - 15	2.63	2.97
15 - 50	2.94	3.13
50 - 100	3.12	3.26
100 - 200	3.20	3.28
Over 200	3.30	3.47

The sharper rise by the smaller banks may in part be attributed to differences in accounting practices for passbook savings deposits. Under Regulation Q, member banks are permitted to pay up to 4 per cent interest on funds left on deposit for one year or more but only 3.5 per cent on savings deposits of less than one year. Funds on deposit since January 1, 1962, the effective date of the change in regulations, first became eligible for the ½ per cent "bonus" on January 1, 1963, and many banks credited their customers' accounts by this amount. Banks differed, however, in the way they recorded this expense on their books. Those using an accrual accounting system charged the expense to 1962 while the others charged it to 1963. As a greater proportion of large banks are believed to use the accrual basis, the impact of the bonus payment for these banks ap-

peared largely in 1962 while it appeared mainly in 1963 for the smaller banks.

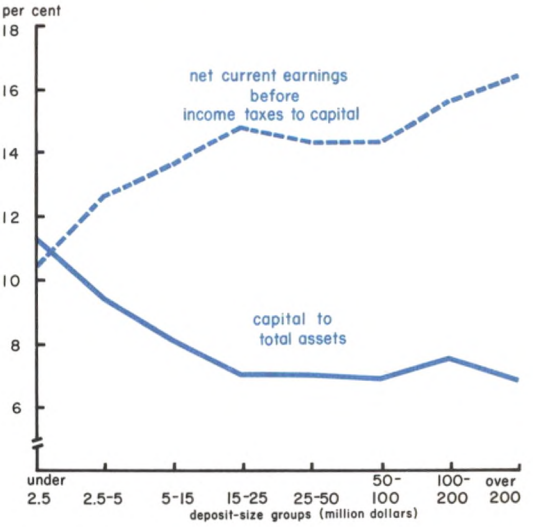
Among large banks in the five major District cities, those in Chicago and Detroit paid the highest rates on time deposits while banks in Indianapolis paid the lowest. The lower rates at Indianapolis banks as well as at banks in the remainder of Indiana are explained by the fact that these banks were prohibited by state law from paying rates higher than 3 per cent until January 1, 1964. Since then, many Indiana banks have raised their rates to levels comparable to those paid by banks of similar size in other District areas.

Banks in all deposit-size groups except the 100 to 200 million dollar size group and in all District areas experienced increases in the ratio of time to total deposits. The greatest increases were experienced by the largest banks, reflecting the sharp rise in negotiable time certificates of deposit which are issued primarily by these banks. Differences in the ratio of time to total deposits were substantially greater among banks in different areas than among those of different size. In general the ratio of time to total deposits varied with the level of interest rates paid. For large banks in the major District cities the relation was as follows:

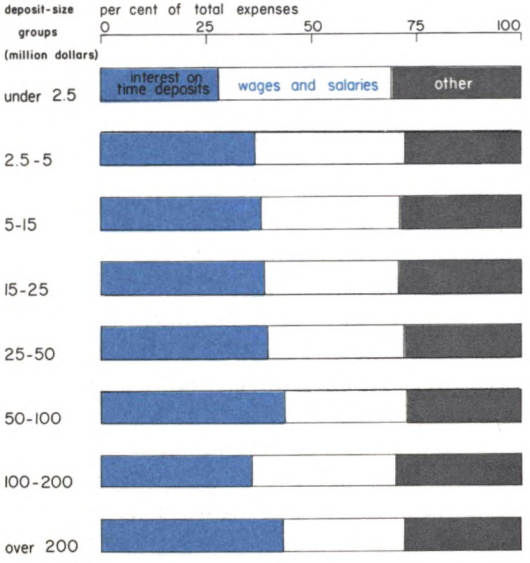
	Time to total deposits	Interest rate paid
	(per cent)	
Detroit	59	3.59
Chicago	46	3.65
Milwaukee	35	3.08
Indianapolis	25	2.63
Des Moines	17	2.92

The ratio of time to total deposits among banks of different size ranged only from 50 per cent for the average bank with deposits of 50 to 100 million dollars down to 36 per cent for the average bank with under 2.5 mil-

Large banks had highest current earnings on capital



Interest expense is relatively greater for large than for small banks



lion dollars. The larger ratios were again associated with the higher interest rates paid. As a consequence, interest expense accounted for a greater proportion of total expenses for larger banks than for smaller banks. The proportion of total expenses attributable to wages and salaries, on the other hand, varied inversely with bank size, being greatest for small banks and smallest for large banks.

Net current earnings before income taxes as a percentage of total capital accounts varied directly with bank size in 1963, averaging 16.4 per cent for the largest banks and only 10.4 per cent for the smallest. These differences, however, are attributed more to differences in capital ratios than in current earnings. Capital at banks with less than 2.5 million dollars in deposits was equal to 11.3 per cent of total assets compared with 6.8 per cent for banks with over 200 million.

Net current earnings as a percentage of total assets did not vary consistently with size of bank, being smallest for banks with 50 to 100 million dollars in deposits and largest for banks with 100 to 200 million dollars.

Profits after Federal income taxes show a pattern similar to current earnings before taxes, varying directly with size of bank as a percentage of capital and being unrelated to bank size as a percentage of total assets. Interarea differences in income before and after payment of Federal income taxes tended to exceed intersize differences. In 1963 the average large bank in Milwaukee experienced the highest after tax income among large banks, with respect to both capital and assets, while the average large bank in Des Moines reported the lowest income.

$50 billion on the instalment plan

The instalment debt of consumers has climbed 10 billion dollars, or almost one-fourth, during the business expansion of the past three years. Outstandings rose a record 5.7 billion dollars in 1963 alone; the total pushed over the 50 billion dollar mark by midyear and at the end of the year had reached 53.7 billion. All told, the volume of this form of indebtedness has doubled in the eight years since 1955 and quadrupled since 1950.

Recent growth has been accompanied by a rise in the ratio of debt repayments to consumer income. In the third and fourth quarters of 1963, payments on instalment debt were equal to about 13.8 per cent of total personal income after taxes—a record high proportion.

Repayment rate through the ceiling

From time to time it is suggested that the ratio of repayments to income has reached a "ceiling" and cannot rise further, at least for any extended time. Presumably, when the ratio approaches this level, a slowdown must occur in the rate of new consumer borrowing and in types of spending that borrowing aids in financing.

In the past three or four years, 13 per cent has been suggested frequently as the apparent limit. Accordingly, the view has been expressed lately that curtailment in instalment

borrowing is at hand—on the ground that the "repayment burden" consumers find tolerable has been exceeded.

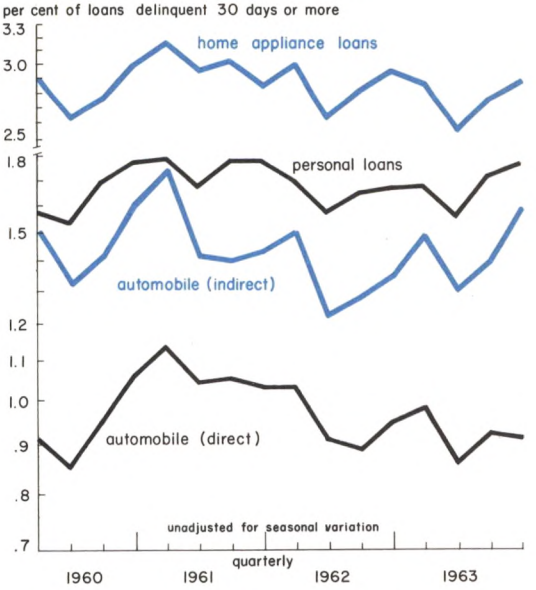
Other observers are inclined to question this interpretation. They grant that a rise in the proportion of income needed to service debt contracted earlier will tend to restrain current spending to some extent. But they doubt that any hard-and-fast ceiling exists.

These observers point out that a greater proportion of families recently have been using instalment credit than had been true earlier: 50 per cent in January and February 1963 compared with 46 to 48 per cent in the three preceding years, according to findings of the Survey Research Center at the University of Michigan. Although the overall repayment-to-income ratio has climbed, it is not necessarily true that individual instalment borrowers have become increasingly burdened and therefore that the willingness of consumers generally to assume additional debt and sustain debt-financed expenditures has lessened.

The greater the proportion of all families with instalment obligations, the greater the ratio of aggregate repayments to total consumer income tends to be. But a rise in instalment indebtedness—and the volume of repayments—that reflects an increase in the average indebtedness of families having such debt is a different matter than an increase related to spreading use of instalment borrowing. A rise in the proportion of families using instalment credit would call for an upward revision of the repayment ratio ceiling, if one exists.

Willingness of consumers to take on instalment obligations depends largely upon their attitudes toward future income and employment. When expectations are buoyant, expansion in borrowing is likely, paralleling and to a degree underpinning rising expenditures. Although the repayment ratio was 13.2 per cent in the first quarter of 1961 when the current business expansion started, new instalment borrowing has displayed an uninterrupted series of quarterly gains since that time and the repayment ratio has been edging upward since the third quarter of 1961.

Instalment loan delinquency in downtrend during recent business expansion



SOURCE: American Bankers Association.

The two unusually good back-to-back automobile years, 1962 and 1963, played a big part in this debt expansion. Although automobile credit amounted to 39 per cent of all outstanding instalment debt when 1961 began, it accounted for 45 per cent of the total growth in instalment obligations from then to the end of 1963. If 1964 also proves to be a big year for automobile sales—as is widely anticipated—a further climb in auto instalment credit is all but assured. Whether

this will bring about a still higher repayment-income ratio will depend, of course, on the direction of movement in the other categories of instalment debt as well as the disposable income of consumers.

More credit with easing of terms

Historically, there has been considerable slack in the relationship between the amount of instalment debt outstanding and the associated rate of repayment. The main reason for this has been variation over the years in the length of loan terms—mostly in the direction of lengthening.

In 1950, for example, the total volume of instalment credit repayments exceeded by more than half the amount of instalment debt outstanding at the beginning of the year. By 1963, however, the paydown of debt was only about 15 per cent more than outstandings at the start of the year. This reflects the shift to longer loan maturities—conspicuously in auto credit contracts—that occurred during the period.

The turnover of instalment credit thus has slowed; a given dollar volume of loan repayments today supports a considerably larger total of instalment credit outstanding than it did earlier. In the fourth quarter of 1950 repayments were roughly one-third as great as toward the end of 1963 but debt outstanding was only a little over one-fifth as great: 14.6 billion dollars when the 1950 quarter began and 67.1 billion at the start of the fourth quarter of last year.

Lengthening of terms, of course, tends to increase loan carrying costs, and thus the total dollar volume of repayments, as more of the monthly instalment is allocated to finance charges and less to principal. The presumption is that borrowers consider the longer terms worth this added cost, or the lengthening would not take place.

The liberalization of standards in automobile financing was in general a once-and-for-all matter. During the big 1955 model year, maturity limits stretched out abruptly, moving from 24 months to 30 and, in some areas, to 36 months for loans on new cars and from 18 and occasionally 21 months to 24 and sometimes 30 months for those on used models. Since that time, maximum terms appear to have changed little, although recently reports have been received of moves still further outward—to 42 and sometimes 48 months on new car loans.

In general, however, 36 months has remained substantially the standard maximum for the past eight years, but with a growing proportion of loans running this term to maturity. One reason often credited for the persistence of the 36-month limit is the lessening advantage of further lengthening the longer are terms to start with, as measured by the impact on the monthly payment.

A glimpse ahead

It is evident that the potential for further expansion of consumer instalment indebtedness is substantial. A major reason for this is that the nation is now at the threshold of a period of rapid expansion in the number of families that characteristically are among the most active users of instalment credit.

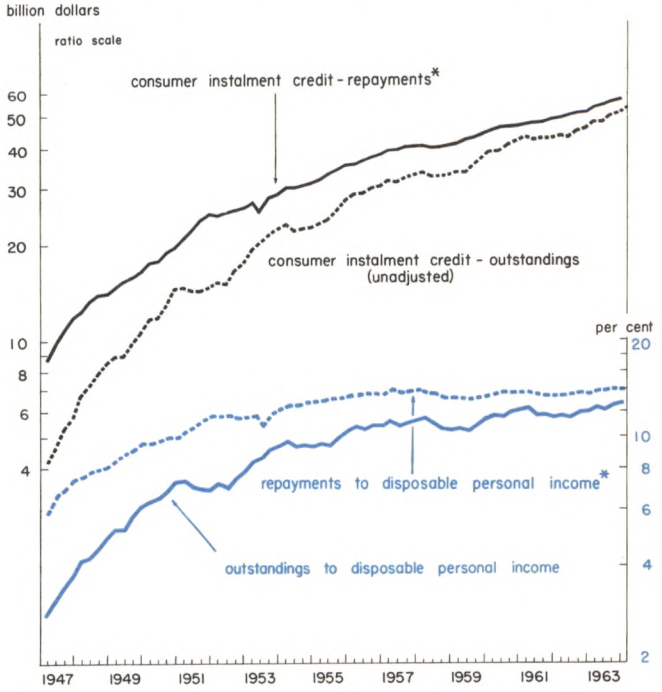
The Bureau of the Census estimates that by 1970 households headed by persons under 25 years of age will number 72 to 88 per cent (depending on the trend of marriage rates) more than in 1962. The rapid increase, moreover, is expected to continue on into the decade of the Seventies and by 1980 the number of households with youthful heads will be more than double the total of two years ago.

Following form, the new households, of course, will be outfitted with furniture, home

appliances, radio and TV sets and automobiles. These are items that frequently entail instalment borrowing because they are needed at a stage in the "life cycle" when income generally is low; the expectation that it will rise lessens the prospective burdensomeness of repayment commitments.

Newly married couples typically are occupants of rental housing. To the extent that certain of the durables they need in order to set up housekeeping are provided by landlords, rental payments rather than instalment debt repayments will be the means of financing. Rental payments are fixed charges similar to obligations under instalment debt contracts. Therefore, the level of debt service as such—whether in its absolute volume or relative to disposable income—tells only part of the story of the impact of prior commitments upon current decisions to spend and to assume new obligations.

Sharp climb in instalment loans causes only slow rise in debt-to-income ratios, reflecting strong rise of personal income



*Annual rate.

Apartment dwellers in the larger urban communities, moreover, often are able to use public transportation—perhaps supplemented from time to time by auto rentals—rather than private automobiles. To these persons, transit or commuter fares are counterparts of the automobile loan repayments budgeted by others. Although not classed as fixed contractual obligations, such charges are in fact of the same nature.

Apartment dwellers and public transit riders to some extent avoid the use of instalment credit by making other arrangements that come to nearly the same thing. The difference is that the credit to finance the household durables they use and the transportation plant and facilities that serve them is found under the headings of mortgage and business indebtedness.

The question of quality

During the rapid expansion of consumer instalment debt in the postwar period as a whole, concern frequently has been expressed about signs of deteriorating credit quality. Given the large amount of this credit outstanding and its relative importance among the assets of commercial banks and other financial institutions, it is evident that any marked slowing in repayments would impair

the liquidity and might also adversely affect earnings of lenders.

Liberalization of loan contract terms, as by reducing required downpayments and lengthening loan maturities—perhaps most obvious in automobile instalment financing—has been taken by many observers to indicate a decline in loan quality, inasmuch as it has tended to increase the risk exposure of lenders. Still, it is difficult to read the record of the period as showing any clear connection between the easing of terms and difficulty on the collection front.

Along with the exercise of businesslike prudence on the part of lenders in the screening of credit applications, prosperous economic conditions clearly offer the best assurance that consumer loan commitments will be fulfilled. By the same token, the most "conservative" loans may run delinquent during business recessions even if they do not become a source of outright loss.

Banks step up consumer lending

In the business expansion of the past three years, commercial banks and credit unions have appreciably widened their shares of total instalment credit outstanding. The proportions held by sales finance and consumer finance companies and by retail merchants have declined slightly, although their dollar holdings have increased along with growth in the total.

By the end of 1963, instalment loans accounted for about 8.5 per cent of the total loans and investments held by the nation's commercial banks or 14 per cent of their loans. Three years earlier, though, the ratios were roughly the same, indicating that growth since then in holdings of instalment paper has been no more than in proportion to total bank growth.

The past three years have seen an especially vigorous increase in commercial bank time deposits, a development accelerated by deposit interest rate advances that occurred mostly in 1962. The growth in bank holdings of instalment credit is an indication that liquid savings have been utilized in good part to finance consumer durables along with investment in such conventional forms as business capital and housing.

The resurgence of corporate profits

Corporate profits after payment of Federal income taxes rose 10 per cent in 1963 to a record 27 billion dollars—25 per cent above the somewhat depressed level of 1961. A further substantial gain is widely anticipated in the current year, partly because of the cut in corporate tax rates from 52 to 50 per cent but primarily because output and sales are expected to continue to expand.

If profits do increase in 1964, it will mark the first time in the postwar period that this has occurred three years in a row. In the five-year period 1957-61, profits rose only in 1959.

Profits rising three years after the low point in the 1960-61 business recession present a striking contrast with the earlier postwar pattern. In previous business expansions, profits reached peaks and then turned downward six or seven quarters after the beginning

of each upswing even though activity continued to rise for a much longer period.

Higher profits were widespread in 1963. Two-thirds of the firms and virtually all of the industry groups for which statements have been tabulated by the First National City Bank of New York reported increases. Relatively large gains were shown by the steel, automotive, furniture and transportation groups while, among major industries, substantial reductions were confined mainly to the motion picture and shoe and leather categories.

Favorable earnings reports in recent months have been a major factor behind the rise of common stock prices to record highs. Moreover, improved earnings are credited with helping to stimulate the 10 per cent expansion in business expenditures on new plant and equipment now projected for 1964.

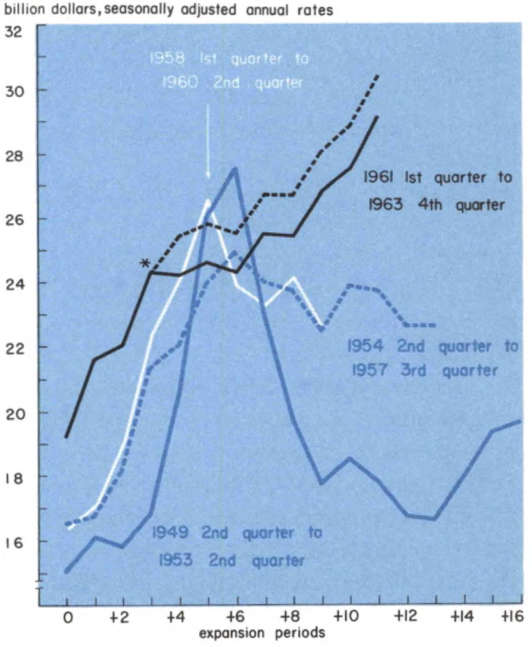
Corporate profit "squeeze"?

In recent years a good deal of publicity has been given to the fact that since the early postwar period corporate profits have not advanced proportionately with the rise of the nation's output. Usually such conclusions are based upon an examination of trends in corporate profits after taxes as a percentage of corporate net worth, of sales or of the total spending on goods and services.

Perhaps it is more logical to relate corporate profits to *corporate gross product,* that is, the portion of the nation's total production originating in the corporate sector. This relationship shows the same general tendency for profits to be lower in recent years as do comparisons with net worth, sales or overall production. After-tax profits in 1947 were 14.8 per cent of corporate gross product and were almost as high in 1948 and 1950. The ratio dropped sharply in the Fifties, reaching a low of 7.6 per cent in 1961. The 1961-63 profit revival carried it only to 8.3 per cent.

Rising wages commonly are assigned responsibility for the squeeze on after-tax profit margins. But the ratio of corporate wages and salaries to corporate product has been remarkably stable throughout the postwar period. Wages and salaries amounted to 64.4 per cent of corporate product in 1963, slightly below the average of the past five years (64.6 per cent) or the average for the entire postwar span, 1946-63 (64.7 per cent). The main component of corporate product that has risen while corporate profit margins have declined has been depreciation, although higher interest charges also have played a role. For the corporate sector as a whole

Corporate profits after taxes have continued to rise throughout the current business expansion



*Profits adjusted for effect of new depreciation guidelines.

rising interest rates have been relatively unimportant.

Corporate capital consumption allowances (mainly depreciation but also including accidental damage and capital items charged to current account) were 32.4 billion dollars in 1963, six times as great as in 1946 and double the level of 1953. Allowances for corporate capital consumption have risen substantially in every year since 1946.

In the early postwar years, corporate capital consumption allowances were only 5 per cent of corporate product. Last year this proportion reached 10 per cent. Corporate profits after taxes plus capital consumption, often referred to as *cash flow,* were 18.3 per cent of corporate product in 1963—the highest since 1956 and only moderately below the peak years of the early postwar period.

Corporate cash flow should not be thought of as an alternate measure of profits. Depreciation of capital goods, representing the rate at which they wear out or become obsolete, is a real expense and must be allowed for in determining profits. But at best, current estimates of depreciation are rough approximations based upon expected useful life of capital equipment or, frequently, current tax regulations.

Cash flow has a useful application in financial and economic analysis. It indicates the funds available from operations during a given time period that may be applied to dividends, debt retirement or investment in capital goods or other assets without resorting to outside sources of funds.

Corporate outlays on new plant and equipment often are related directly to corporate cash flow, but this relationship has not been stable. Last year corporate cash flow less the portion paid out in dividends was 42 billion dollars compared with plant and equipment expenditures of 33.5 billion. As recently as 1957 corporate cash flow after dividends was substantially *less* than corporate capital expenditures. Needless to say, many individual firms are less well supplied with internal funds than the corporate sector as a whole. Nevertheless, many are in a position to finance substantial increases in capital outlays without resort to borrowing or stock issues. This situation is especially striking today in the case of certain public utilities which traditionally rely heavily on outside financing for new capital programs.

Tax credits and depreciation

Various programs for accelerating depreciation account for part of the decline of profit margins in the past 10 or 15 years. The Revenue Act of 1954 permitted business firms to use the "double-declining balance" and "sum-of-the-years'-digits" methods of calculating depreciation. These allow larger write-offs in the early years of an asset's life than do "straight-line" schedules. In the years that followed many firms chose to use these methods.

Two developments in 1962 helped boost corporate cash flow. The first was promulgation of the new depreciation guidelines by the Internal Revenue Service, which permitted many types of businesses to write off existing and newly acquired capital assets at a faster rate for purposes of calculating Federal income taxes. The second was the "investment tax credit" allowing many business firms to reduce their tax liabilities by an amount ranging up to 7 per cent of the purchase price of new equipment. The Revenue Act of 1964 enhances the effectiveness of the investment credit by allowing firms to base depreciation on the full purchase price of new equipment without deducting the amount of the credit as required by the original legislation.

The Department of Commerce estimated

in July 1963 that the depreciation guidelines and the investment tax credit together increased corporate cash flow 2.3 billion dollars in 1962 and a similar amount in 1963. Of this amount 1.2 billion was attributable to reduced taxes resulting from increased depreciation and the rest to the tax credit.

To aid firms in determining depreciation schedules, the Treasury in 1942 issued Bulletin F which listed useful lives for particular types of assets. At the time the new guidelines were published in mid-1962, it was commonly stated that these schedules "replaced" Bulletin F in which the specified useful lives generally were said to be unrealistically long. It appears, however, that Bulletin F long since had fallen into disuse. Established firms had been allowed to use depreciation schedules based upon their actual experience. Small and new firms typically adopted "expected lives" suggested by their accounting firms.

Use of guidelines

Business firms that accounted for about 55 per cent of total corporate depreciation in 1962 increased their write-offs by employing the new guidelines on that year's profits, according to a Department of Commerce survey. For these firms depreciation was increased 20 per cent above what it otherwise would have been. Among the principal beneficiaries of the changes were the chemical, iron and steel and automotive industries and the railroads and airlines. In many cases this higher depreciation was used in earnings statements included in annual reports, resulting in substantially lower after-tax profits than would have been reported had existing depreciation schedules been followed.

Business firms accounting for about one-fifth of all corporate depreciation did not use the new guidelines because their depreciation rates already were as rapid as or more rapid than those permitted by the regulation. Utilities and transportation firms, which accrue about 8 per cent of total corporate depreciation, did not follow the guidelines because of conflicts with procedures authorized by regulatory commissions. Some firms did not use them because they had no tax liability for 1962. Perhaps no more than 10 to 15 per cent of corporate depreciation in 1962 was accounted for by firms which could have reduced their tax liabilities by using the guidelines but which did not do so.

In the long run a firm's income tax liability is reduced if depreciation is taken as rapidly as permissible for tax purposes—unless it is assumed that tax rates will be raised substantially in the future. This practice tends to raise future taxes when particular assets have been fully depreciated. Any postponement of taxes is, in effect, a reduction of taxes because present income is worth more than future income, especially if future results are uncertain.

But changes in depreciation schedules are not the major reason for the decline in reported profit margins. In the early postwar years, business firms were selling their products at current price levels while, in the main, they used buildings and equipment purchased at lower prewar prices. Moreover, in years when prices rose appreciably between the time goods were purchased from suppliers and sold to customers, there were widespread windfall profits. As a result, profits were almost certain to decline relative to corporate sales or corporate gross product as the portion of equipment and real estate acquired at higher price levels rose and commodity prices stabilized.

Current profit trends

Toward the end of the decade of the

Fifties there were widespread complaints of "profitless prosperity." This phrase, of course, overstated the case because after-tax profits were substantial, amounting to 22 billion dollars in 1960. Nevertheless, total profits in that year were below the level of 1955 while corporate gross product had risen 26 per cent during the five-year period. From 1960 to 1963, profits rose almost 25 per cent while corporate product advanced 16 per cent. Yet, in 1963 the ratio of profits to corporate product was less than that of any year in the 1946-59 period with the exception of the "recession year" 1958. Many business leaders are convinced that current and prospective profits are inadequate to stimulate the capital investment needed for long-term growth.

The pattern of the earlier postwar period of a profit sag after the upswing had been under way approximately a year and one-half has been broken in the current expansion. Moreover, it is commonly thought that total spending on goods and services will rise 5 to 6 per cent in the current year, with profits increasing at least proportionately.

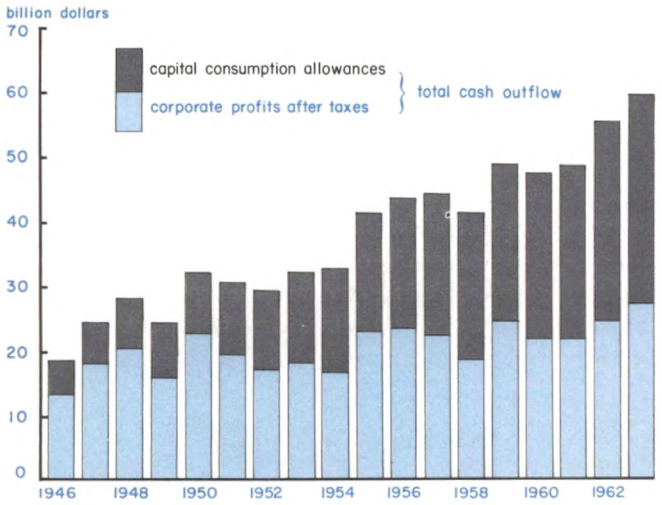
Since World War II there have been four years—1947, 1950, 1955 and 1959—with an after-tax corporate profits rise of 30 per cent or more. But each of these years followed a recession year, and the first three were associated with a pronounced upswing in prices. Under conditions of relatively stable prices and starting from a high level of activity, such as at present, a rise in profits approaching this magnitude is highly improbable.

One reason for optimism about the trend of profits is that output per man-hour has continued to rise in the current expansion in contrast to the tendency for such gains to diminish once an upswing was well under way as evident earlier in the postwar period. This, together with more moderate increases in worker compensation than in past periods of rising activity, has helped hold down producers' costs. In part the continuance of productivity gains reflects the fact that major strikes have been avoided since 1959.

Second, corporate profits have been boosted by the gradual rise in the proportion of industrial facilities in use in the past three years. As a result, overhead costs have been spread over a larger volume of output. Some further gains in utilization of the nation's industrial facilities is expected in 1964.

Third, rising demand has enabled many business firms to increase prices and thus improve profit margins. Average wholesale

Corporate profits
and total cash flow advanced sharply in 1962 and 1963



prices of all nonfarm industrial goods were about ½ of 1 per cent above the year-earlier level in February. This rise is small but it contrasts with a stable or declining trend in wholesale prices from 1959 to 1962. Moreover, relatively modest increases in prices may have a significant effect on the profits of particular firms because profits are the residual claimant upon corporate receipts. Announcements of price increases in a number of commodities in recent weeks suggest that average prices are continuing to edge up slightly at the present time.

Inflation and profits

Sharp price inflation always aids profits substantially in the short run because owners of goods and of facilities that produce goods automatically benefit from higher prices for their products. Sellers of goods are also buyers, however, so that one firm's price is another firm's cost. It is only when higher prices move through to final consumers and costs rise less than prices that the corporate sector can benefit from price inflation in the long run. Such a development is unlikely because price inflation tends to encourage upward pressures on wages and salaries, the principal business expense. Finally, general price inflation in the United States usually has been followed by a reaction in the form of a recession resulting in losses for many firms.

Is a sharp but short-lived rise in corporate profits in prospect? Is the nation's economy "overheating" and entering a period of excessive demands upon resources? Available evidence points to a contrary conclusion.

Business sales and orders have increased in recent months but inventories were lower relative to sales in January than in any similar month since 1956, when the present series begins. Moreover, manufacturers have maintained their ability to ship goods promptly to satisfy customers' demands, and backlogs of unfilled orders remain low relative to shipments. Capital expenditure plans indicate a substantial gain in 1964 but well below the increases of 1947 or 1956, which were accompanied by sharp price inflation. Stable growth in output and a steady rise in corporate profits require that excesses of optimism and pessimism be avoided on the part of business and consumers. At present this condition appears to hold.

Corporate cash flow remains near early postwar relationship to corporate gross product