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# BUSINESS REVIEW

The Great Corporate Profits Mystery

Recovery, Market Interest Rates,  
and Monetary Policy

Business and Banking in 1961



FEDERAL RESERVE BANK OF PHILADELPHIA

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## BUSINESS REVIEW

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# THE GREAT CORPORATE PROFITS

## *A Study in Stability*

In recent years businessmen have worried and economists have wondered about the strange behavior of corporate profits. The economy has climbed to new heights over the last decade, and corporate profits have shown an uncomfortable tendency to sit still.

Since our economy is moved primarily by the profit motive, profit stability appears incongruous with economic expansion. Will profits continue to be depressed in the 1960's—and, if so, can we really expect our economy in general and corporate investment in particular to grow rapidly?

The answers to these questions depend in part, at least, on what lies behind the relative stability of corporate profits.

### JUST THE FACTS

In the 1950's, the gross national product of the United States increased about 77 per cent; this economic expansion provided a substantial increase in the material well-being of most Americans. On the other hand, corporate profits after taxes were about the same in 1960 as they had been in 1950.<sup>1</sup>

<sup>1</sup> In the national income accounts, corporate profits are adjusted to eliminate "book" profits or losses on inventory that arise from changes in prices. The corporate profit figures discussed above are not so adjusted. When profits after taxes are adjusted for inventory price changes, an increase of \$5 billion for the decade of the 1950's is revealed. This is due to the fact that profits in 1950 were overestimated because the cost of replacing inventory, in that year of rising prices, was underestimated.



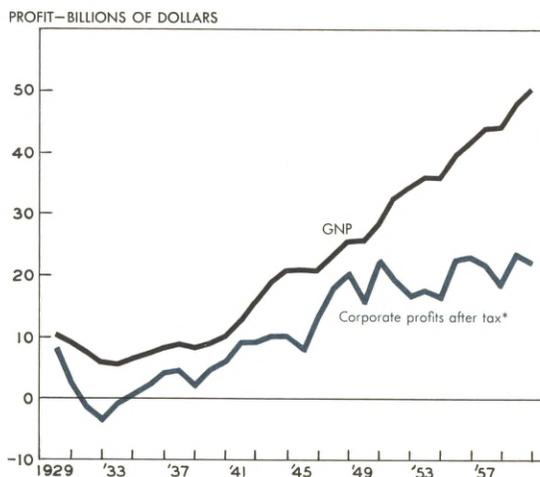
## MYSTERY

This failure of corporate profits to respond to economic expansion seems to represent a break with past experience. From 1929 to 1950, both gross national product and profits increased substantially. Only four times in the 21-year period did GNP and profits move in opposite directions. On the other hand,

### CHART I

#### PROFITS AND PRODUCTION

*Between 1929 and 1950, gross national product and corporate profits pretty much kept pace. Over the last decade, however, production continued to increase while profits seemed to reach a plateau. GNP grew 77 per cent over the fifties; profits were about the same in 1960 as they had been in 1950.*



\* Without inventory valuation adjustment.

over the last ten years they have moved in opposite directions five times; and each time, profits fell while GNP was rising.<sup>2</sup>

Had profits kept pace with economic growth over the last decade, they would have been about \$18 billion higher in 1960 than they actually were—about \$41 billion instead of \$23 billion. But profits did not keep pace with economic growth and the \$18 billion or so dollar gap was opened up. So the question remains: who or what killed corporate profits?

### ON THE TRACK OF THE GAP

We can view our economic growth over the last decade—the upsurge in gross national product—as an increase in the total value of goods and services produced by our economy. We can also view it as an increase in the income of our families and institutions. For the goods and services produced are, for the most part, distributed among the producers—the workers, businessmen, landowners, and lenders—who devote their services to production.

There are two major items, however, which are included as part of gross production but can't be counted as part of income received—depreciation and so-called “indirect business taxes.” Depreciation allowances, more or less, reflect the production needed to replace worn-out capital equipment. If depreciation charges were not made, we would, as a society, be living off our capital and counting it as income. Indirect taxes—sales and excise—are included in the price of goods and services sold. These “hidden taxes” inflate the value of gross production; but they cannot be counted as earned income.

<sup>2</sup> Using the sign test, the hypothesis that the directions of change were not related in the earlier period can be rejected with a confidence of greater than 99.5 per cent. It seems reasonable that the experience since 1950 represents a break with the earlier period but due primarily to the briefness of the later period, this hypothesis cannot be statistically supported with a comparable degree of confidence.

There follows a line-up of the major components of our economy's performance—the major components of gross national product.

#### *Non-Income Components*

- Depreciation
- Indirect business taxes

#### *Income Components*

- Corporate profits after taxes
- Corporate profits taxes
- Wages and salaries
- Supplements to wages and salaries
- Proprietors' income
- Rent
- Interest

With corporate profits after taxes about stable over the last decade, a “profit gap” was opened up by the growth of the other incomes and also the non-income items mentioned. A quick examination will help determine where the payments that might have gone to profits actually did go.

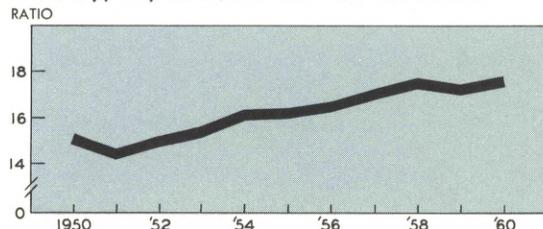
### Depreciation and indirect business taxes

Depreciation charges grew very rapidly over the decade; they more than doubled. The growth of depreciation accounted for almost 11 per cent

### CHART II

#### A LARGER SHARE FOR DEPRECIATION AND TAXES

*During the 1950's, a growing share of gross national product was composed of depreciation allowances and payments to Government in the form of “hidden” taxes—excise and sales taxes included in prices. Depreciation and the so-called “indirect business taxes” accounted for over one-fifth of the total in GNP over the decade.*



of the total increase in gross national product. We shall have more to say about this very important cost later.

Excise and sales taxes also increased rapidly; these taxes almost doubled. They accounted for a little less than 10 per cent of the total increase in gross national product.

Non-income components of gross national product, then, accounted for something in excess of 20 per cent of the total economic expansion over the decade. As Chart II shows, the ratio of these components to gross national product increased in a fairly consistent fashion.

### The corporate profits tax

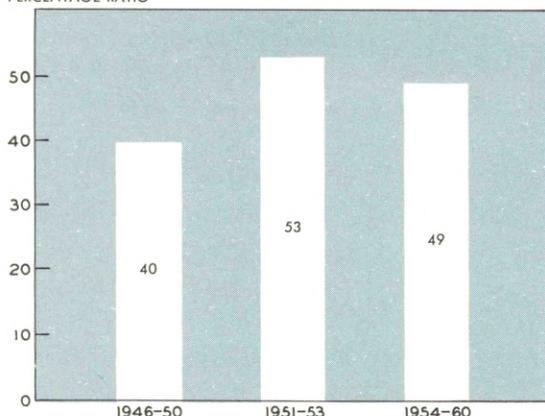
The share of corporate profits taken by federal, state, and local governments—particularly during the Korean War—was unusually high. As Chart III shows, the governments' share was considerably higher than in the early postwar years.

CHART III

#### THE GOVERNMENT SHARE

During the Korean War, federal, state, and local governments took, in income taxes, about 53 per cent of total corporate profits. In more recent years, government has taken a somewhat lower proportion of profits. But the government's share has not fallen back to the levels of the early postwar years.

PERCENTAGE RATIO



While corporate profits after taxes were stable over the 1950's, profits before taxes did increase

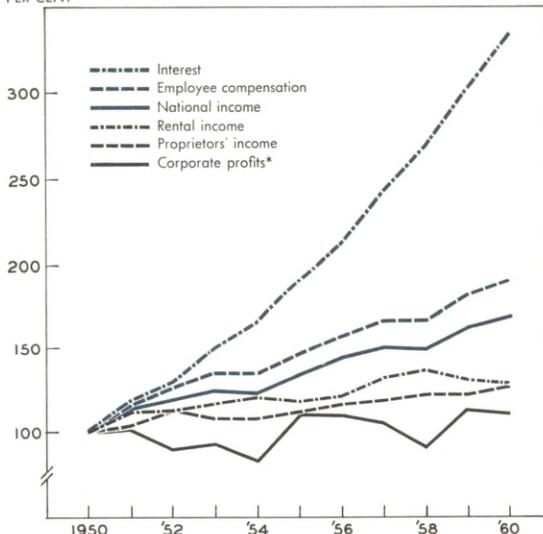
CHART IV

#### SLOW GOING FOR PROFITS

Profits, prior to corporate profits taxes, did increase somewhat over the 1950's; but they increased at a slower rate than any other type of income and, as a result, at a slower rate than total or national income. The ratio of corporate profits to national income, as shown in the bottom panel, decreased significantly over the decade.

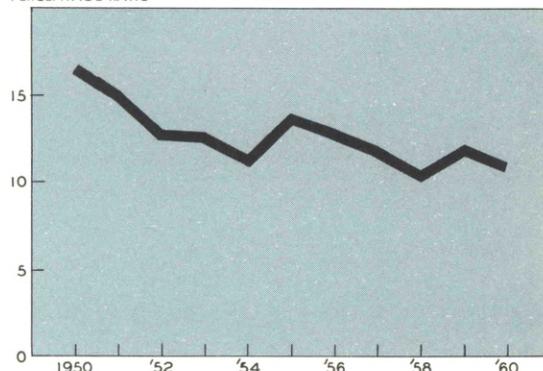
Interest accounts for a relatively small proportion of total income; but it increased more than 325 per cent over the decade. Employee compensation, accounting for well over half of total income, increased about 90 per cent over the decade.

PER CENT



\* Before taxes.

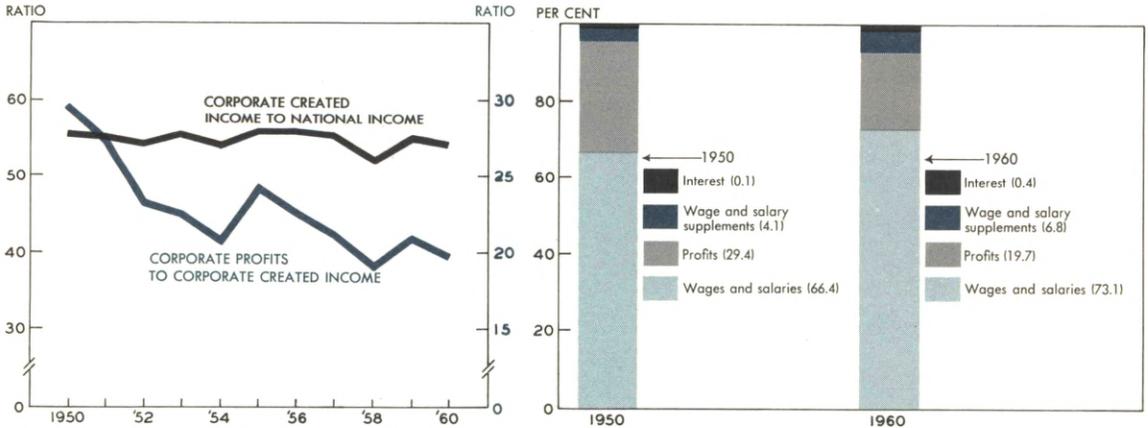
PERCENTAGE RATIO



## CHART V

### THE CORPORATE CONTRIBUTION

*The proportion of total national income created by corporations did not change much over the 1950's. In other words, corporations were about as important as income creators in 1960 as they had been in 1950. But the share of the income corporations created that went to profits declined considerably. All other forms of corporate income payments—as the bar charts show—grew relatively more important.*



about 11 per cent. The increase in the receipts of governments from corporate profits accounted for about 2 per cent of the total increase in gross national product.

#### Other incomes

Corporate profits, even before taxes, registered the slowest rate of growth of all types of income. As Chart IV indicates, interest income increased most rapidly, followed by employee compensation.

Compensated employees—recipients of wages, salaries, and related payments—were, by far, the most important beneficiaries of advancing output. Employee compensation is the largest single component of gross national product; it absorbs well over half of total output, and it almost doubled over the 1950's.

The increase in total output over the last decade, then, was distributed among a number of payments. In order of importance: employee compensation, depreciation, indirect business

taxes, and interest income. These accounted for about 86 per cent of the over-all increase.

#### FITTING THE PIECES TOGETHER

Although the above items accounted for the lion's share of economic growth in the 1950's, they cannot be accused, out of hand, as being responsible for the relative stability of profits. Simply because they increased is not a reason, in and of itself, for profits not to increase.

One possible reason for the poor showing of corporate profits compared to other kinds of income is that the corporate sector of our economy—as an income creator—might have been growing less important.

This is a possibility, but on investigation it is not borne out. As Chart V shows, the importance of the corporate sector did not change much over the period. It was just that larger proportions of the income that corporations were creating during the decade went to wages, salaries, interest, and taxes, and a smaller pro-

portion went to profits.

The types of incomes and payments that increased rapidly do, inevitably, direct our attention. They can all be found on the corporate income statement—as costs of doing business.

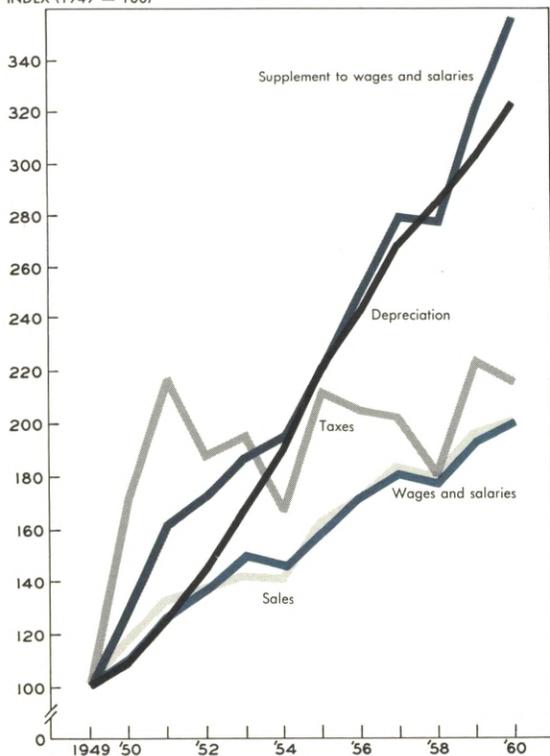
Since profits did not increase over the decade, corporate costs must have increased much faster than corporate sales. Had costs risen no faster than sales, profits would have about doubled. Sales actually increased by over 70 per cent

### CHART VI

#### THE COST-PUSH ON PROFITS

*Since 1949, corporate sales have about doubled. They have increased at a rate comparable to gross national product. But some costs increased much faster than sales. Supplements to wages and salaries—including most fringe benefits—increased much more rapidly; and so did depreciation allowances. Tax payments, too, increased more rapidly than sales. On the other hand, wages and salaries—without the fringe benefits—increased at approximately the same rate as sales.*

INDEX (1949 = 100)



during the 1950's—at a rate comparable to gross national product.

The data available in the national income accounts are meager; yet they provide a clue as to what kinds of costs were most important in depressing profits. As Chart VI shows, corporate payments of wage and salary supplements, and depreciation allowances, increased much faster than sales in the 1950's. Tax payments increased somewhat faster than sales. Wage and salary payments proper—without the supplements—increased at about the same rate as sales; an increasing proportion of sales receipts *was not* earmarked for wages and salaries proper.

For a more conclusive determination, we have to go to the greater detail provided by the income tax returns; and, also, to the critical industries that largely shaped the total corporate profit experience.

### SOME ADDITIONAL EVIDENCE

The corporate profit figure conceals a diversity of experience in many different parts of the economy. Corporations, as a whole, did not seem to prosper in the 1950's; but some kinds of corporations did much better than others. Corporations in the communications industry, for example, did very well. Others, in agriculture, did very poorly. In evaluating the profit performance of the major industrial sectors over the past decade, two critical industries stand out—transportation and manufacturing.<sup>3</sup> They seemed to have had common and representative, as well as strategic, experiences.

Over the decade, profits of corporations in transportation declined a good deal. Profits in

<sup>3</sup> Profits for each of the ten corporate sectors listed below were cumulated from 1951 to 1960. The impact of each sector's profit experience on total corporate profit was determined. The sectors were as follows: agriculture, manufacturing, mining, construction, communications and utilities, transportation, wholesale and retail trade, services, finance, all other.

manufacturing—accounting for about half of total corporate profits—increased but the increase was relatively small.

Detailed data on costs and receipts for these industries are available only to mid-1958.<sup>4</sup> But a comparison of cost experience in the early postwar years when profits were relatively good (1946 to 1950) and in the more recent period (1950 to 1958) is revealing.

In order to make this cost comparison, two major types of costs must be broken out—(1) those we might call the direct costs of operations and sales; and (2) the other, less direct costs of doing business. In 1950, the direct costs, including costs of materials and wages, accounted for about 80 per cent of total costs; the multitude of other costs we have labeled “indirect,” including depreciation, depletion, amortization, advertising expenses, pensions, and other wage supplements, and interest payments, accounted for the rest.

In the case of both manufacturing and transportation, as can be seen in the accompanying table, total receipts in the 1946 to 1950 period increased more rapidly than total costs; neither type of cost increased so rapidly as receipts; both industries experienced substantial increases in profits.

In the 1950 to 1958 period, however, total costs in both industries increased more rapidly than receipts. But, as the table indicates, the indirect costs went through the roof, while *the direct costs of operations and sales*, in both manufacturing and transportation, increased only at about the same rate as receipts. In particular, depreciation, amortization and depletion, pensions and other wage benefits, and interest payments increased at very rapid rates.

<sup>4</sup> The data from income tax returns are for fiscal or tax years.

#### PERCENTAGE CHANGE\*

	TOTAL	DEDUCTIONS		
	RECEIPTS	TOTAL	DIRECT	INDIRECT
All industry				
1946-1950	59	58	59	56
1950-1958	63	70	59	106
Manufacturing				
1946-1950	59	55	56	52
1950-1958	50	59	49	99
Transportation				
1946-1950	36	27	24	34
1950-1958	39	50	40	79

\* Years are tax or fiscal rather than calendar years.

Many other industries had similar experiences during the 1950's. For industry as a whole, direct costs did not rise any faster than receipts. However, the indirect costs rose much more rapidly. It appears, therefore, that these indirect costs were chiefly responsible for the relative stability of profits.

Of the indirect costs that can be broken out, depreciation, depletion, and amortization charges were the most important contributors to the rapid increase in the total. They rose at over twice the rate of total sales.

Some of the rapid increase in depreciation allowances in the 1950's may reflect the elimination, more or less, of the unrealistically low allowances in the late 1940's. In the early postwar years, depreciation charges were largely based on depression prices and seriously underestimated current replacement costs. As a result, profits were, in all probability, seriously overestimated at that time. And the “true” growth of profits over the decade was, therefore, hidden.<sup>5</sup>

Interest charges, taxes, and wage supplements

<sup>5</sup> The replacement and expansion of prewar plant and equipment at postwar prices, and the 1954 liberalization of methods for calculating depreciation, have tended to increase depreciation allowances rapidly. The overestimation of profits because of unrealistic depreciation allowances in, say, 1950 should be added to the overestimation stemming from inventory profits discussed in footnote 2. These two sources of overestimation could explain a significant proportion of the profit gap described above.

such as pensions also contributed importantly to the rapid rise of indirect costs. There is no reason to believe that these costs were underestimated at the beginning of the decade. Rapid increases represent a substantial pressure on profits.

There were other cost items as well which made contributions worthy of mention. However, they cannot be mentioned individually because they are lumped together in the income tax returns in a category called "other deductions."

### CONCLUSIONS AND CONJECTURES

It turns out, then, that there were many reasons why profits didn't increase in the 1950's. Just about all of them can be found on the cost side of the income statement. The costs that appear to have exercised the largest restraining influence on profits were those *indirectly* related to operations and sales—depreciation, interest, pensions and other wage supplements, and taxes, among others.

But all these costs did not affect profits in the same way; and all of them do not have the same implications for capital spending. Gertrude Stein, notwithstanding, a cost is not a cost is not a cost.

It appears that profits were depressed in the 1950's, partly because of a rapid rise in depreciation allowances; these allowances were probably too low in 1950 and have risen rapidly since. But the increase in many other indirect costs—fringe benefits, taxes, and interest, for example—more clearly reflect what has commonly been called the "profit squeeze."

Moreover, to the extent profits are restrained by growing depreciation charges, our concern about corporate investment has to be qualified. Depreciation allowances, unlike other costs of production, presumably represent funds that will find their way into gross investment.

While depreciation allowances are different from other costs, they are, nevertheless, not the same as profit. There is need for new, net investment as well as replacement if the economy is to grow and prosper.

Some of the factors that seriously restrained profits during the 1950's may well continue to operate in the 1960's. There is considerable attention being given to more liberal depreciation allowances. If they are permitted, they will tend to increase costs. Government pressure for increasing tax revenue seems still to be growing; corporate profits represent a very important source. In addition, the demands of employees for supplemental and fringe benefits may increase in the years to come.

A rapid growth of demand for goods and services represents, perhaps, one way of offsetting the persistent growth of costs—and particularly indirect costs that are frequently determined by social and political considerations. A more rapid growth of productivity is a way of meeting increases in demand while restraining costs of operations and sales. The dilemma that confronts us is simply this: in order to get increases in demand and improvements in efficiency, more new investment is necessary; and to get this new investment, profits, themselves, may first have to improve.

# RECOVERY, MARKET INTEREST RATES, AND MONETARY POLICY

Business activity turned upward early in 1961, and before the end of the year total output had surpassed its pre-recession peak. For the most part, the pattern has been similar to the recoveries of 1954–1955 and 1958–1959. But there have been significant differences, two of the important ones being the behavior of interest rates and monetary policy.

Market rates have responded less promptly, and an easy money policy has been pursued longer than in the other two upswings. Federal Reserve authorities have been confronted with a twofold problem—promoting recovery and sustained growth without aggravating the balance-of-payments situation. They have pursued a policy of maintaining ample reserves and ready availability of credit in order to foster recovery, and to facilitate absorption of the unemployed and unused productive capacity. At the same time, the Federal Reserve has attempted to supply reserves in ways that would minimize downward pressure on short-term rates and thus avoid intensifying the outflow of gold and short-term funds.

The lag in interest rates has stimulated considerable discussion. Why the sluggish response of rates? What are the differences, if any, in the factors influencing rates in this recovery as compared with other postwar recovery periods? Does the rate lag reflect monetary policy, debt management, a weak demand for credit, or a large flow of savings? Factors influencing interest rates are too diverse, too intangible, to be able to pin down *the* causes of

recent rate behavior. Recognizing the difficulties involved, this article attempts to analyze demand and supply forces in order to throw light on the question of why the rate lag in the 1961 recovery. Our primary concern is market rates rather than customer loan rates charged by lending institutions.

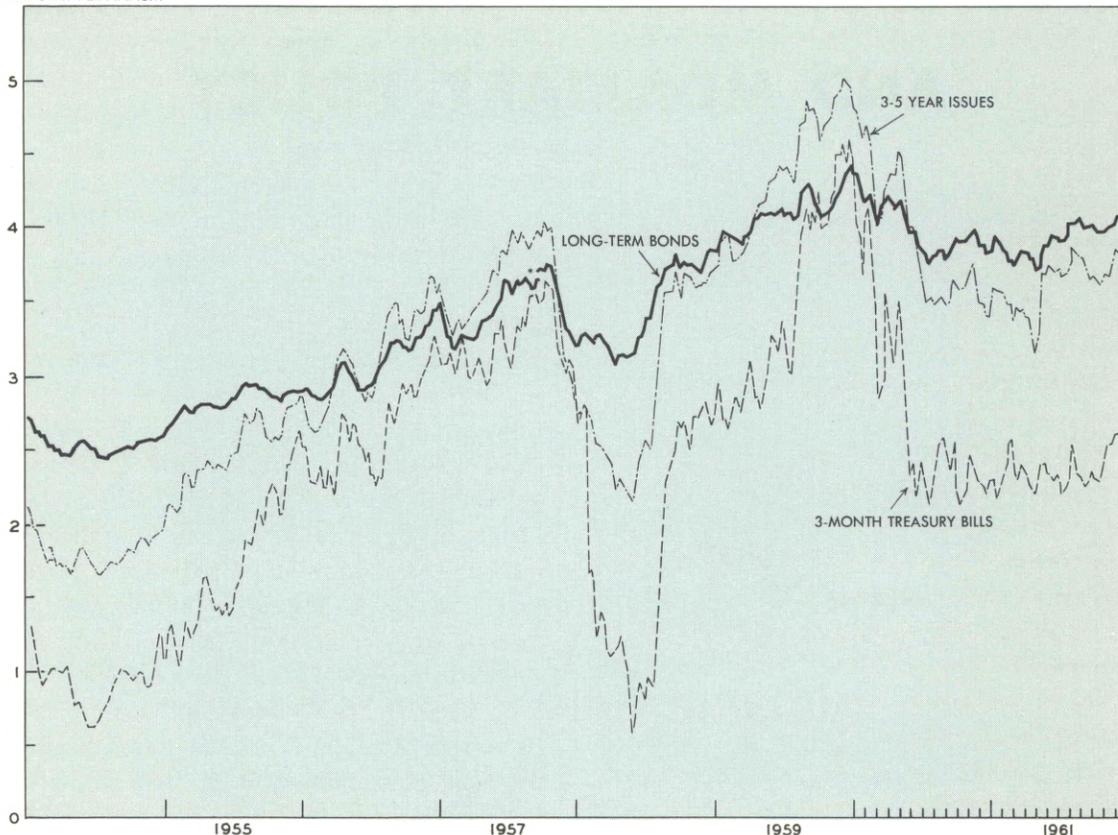
## UPWARD AND DOWNWARD SWINGS IN BUSINESS AND RATES

Rates, just as other prices, respond to shifts in demand and supply. An expansion in business activity usually generates increases in demands for credit. Businessmen borrow to help finance growing inventory and working capital needs, and larger expenditures for plant and equipment. Consumers want more credit to buy automobiles, other durables, and homes. Recession and declining output result in reduced private demands for credit.

Government demand for credit is not so closely associated with changes in the volume of business activity. State and local borrowing has risen steadily during the postwar period. Cyclical swings in business activity tend to have inverse effects on Treasury borrowing.

The supply of credit is not geared so closely as demand to cyclical swings in business activity. Saving, the principal source of funds for meeting credit demand, is fairly stable. Commercial bank credit, the other source of funds, tends to vary inversely with business activity. With cyclical swings in credit demand impinging on a more stable supply, tighter credit and rising rates

## YIELDS ON UNITED STATES GOVERNMENT SECURITIES PER CENT PER ANNUM



\* Change in series.

usually accompany business expansion; greater credit availability and falling rates are characteristic of recession.

### THE RATE LAG

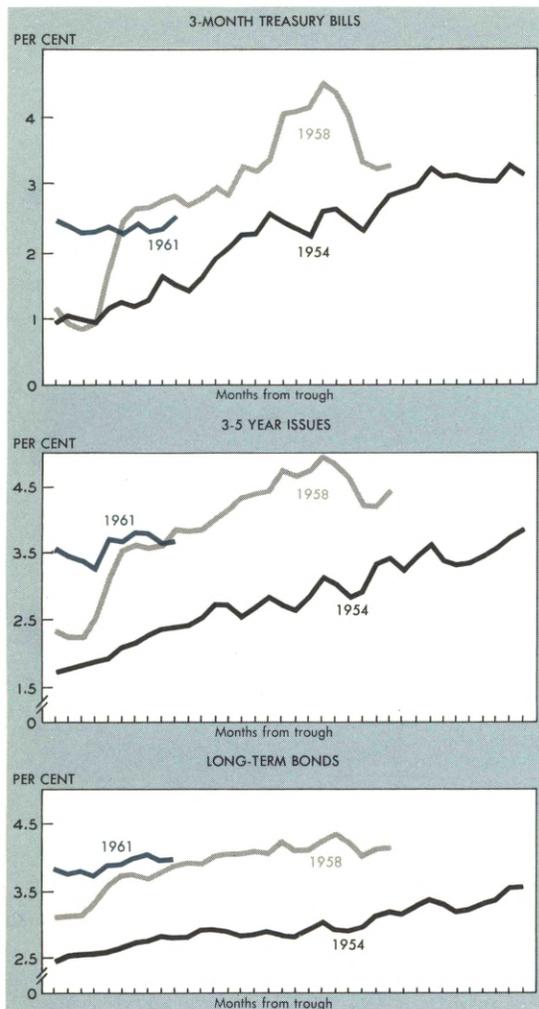
It is clear from the charts that market interest rates have responded more slowly to business expansion than in the recovery periods of 1958–1959 and 1954–1955.\* The three-month Treasury bill rate has moved within a narrow range, with no observable upward trend, in contrast to substantial increases in the two

earlier periods. (It is too soon to tell whether the rise in the bill rate in the latter part of last year marks the beginning of a general upward trend.) By the same length of time after the 1958 upturn began, the bill rate was two and a half times its level at the recession trough, and had risen about 60 per cent in 1954–1955.

Rates on intermediate- and long-term Governments have moved upward, but the rise has been considerably less than in the corresponding phases of the 1954–1955 and 1958–1959 upswings. The average yield on intermediate-term Governments is only slightly higher than when the recovery began, as compared with increases

\* Statistical comparisons, unless otherwise noted, are for the same length of time from recession trough for the three latest recovery periods: 1961, 1958–1959, and 1954–1955. Data, except personal saving and corporate retained earnings, are not seasonally adjusted.

## YIELDS ON GOVERNMENT SECURITIES



of 65 per cent in 1958–1959 and nearly 40 per cent in 1954–1955. The rise in yield on long-term Governments has also been more moderate. Corporate AAA bond yields have risen somewhat, but the increase has been substantially less than in 1958–1959.

Another feature which should be recognized is that interest rates were at a considerably higher level when the latest recovery began than in the earlier periods. The bill rate, for example,

never dropped as low as 2 per cent in the latest recession, but dipped below 1 per cent in each of the other two. The fact that recovery began with rates at a higher level might tend to retard or moderate the rise; however, it seems unlikely that the higher level would long delay an increase in rates if business expansion resulted in credit demands pressing strongly against a limited supply.

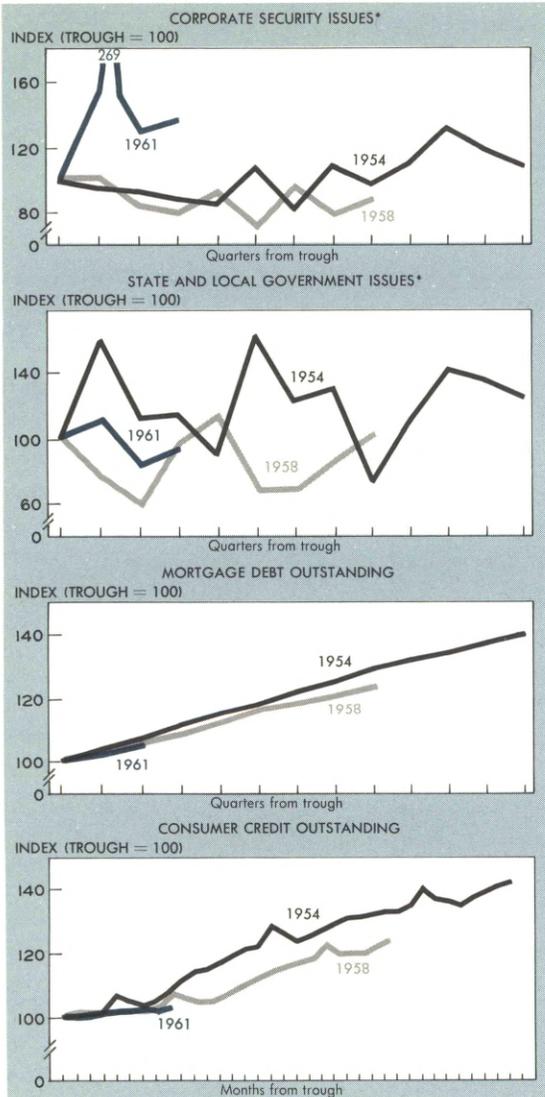
### Demand factors

There is no statistical measure of credit demand in the sense of amounts borrowers would be willing to take at various interest rates; however, changes in credit outstanding are a fairly good indicator of the strength of demand, especially in the early part of an upswing when there is not much of a problem of rationing a limited supply of credit. Measured in this way, the increase in over-all credit demand has been similar to the two previous recoveries.

Commercial bank loans outstanding have risen 4 per cent from the recession trough, about the same as in 1958–1959, but well below the 11 per cent rise in 1954–1955. Response of consumer demand for credit to the forces of recovery has been about the same as in 1958, but much less than in 1954–1955 when a surge in automobile sales generated a sharp rise in consumer installment credit.

Demand for long-term credit has been substantial in the current business expansion. Total mortgage debt outstanding has moved up at about the same rate as in 1954–1955 and 1958–1959. Corporate demand, as reflected by new securities offerings, was especially large in the early months of the 1961 recovery; new issues have been well above the other two upswings. State and local government offerings are also running above 1958–1959.

## DEMAND FACTORS



The Treasury has been a net borrower. Marketable Government securities outstanding have increased about \$5 billion since the beginning of the recovery period. The net increase in 1958–1959 was \$10 billion, and it was \$3 billion in 1954–1955.

Fluctuations in demand, especially for short-

term credit, make it difficult to compare strengths of total credit demand in the three recovery periods. Analysis of demand factors, however, fails to reveal differences that account for the markedly slower response of market rates to forces of the current recovery.

### Factors influencing supply

Saving and bank credit are the two sources of funds to meet credit demands. Personal saving, which accounts for the largest part of total saving, has increased at about the same rate as in 1958, but considerably more than in 1954. The net increase in assets of savings institutions, a good indicator of the flow of personal saving into credit instruments, has been about the same as in the two earlier recoveries. Retained earnings of corporations show the usual sharp rise for periods of recovery. The increase has been somewhat less than in 1958, but more than in 1954–1955.

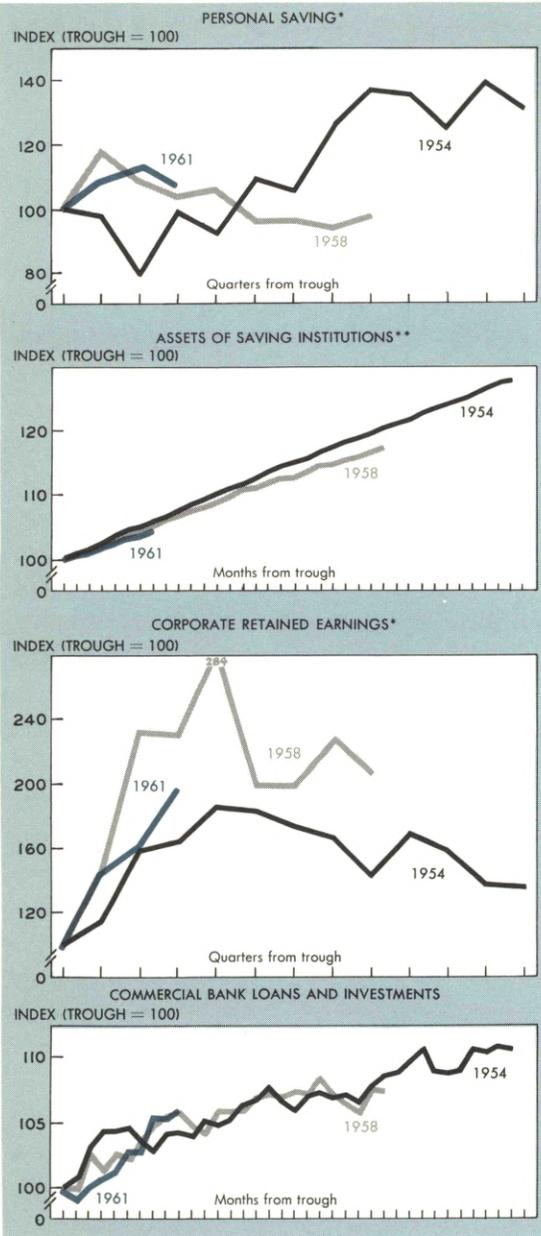
The principal difference on the supply side has been the position of commercial banks. Their total loans and investments have increased somewhat more than in the two previous recoveries. A more significant difference, however, has been their capacity to extend credit—their ability to meet loan demand and to continue to increase their investments. For an explanation, let's take a look at reserve positions and monetary policy.

### Monetary policy

Federal Reserve actions impinge directly on bank reserves, which in turn determine the capacity of commercial banks to make loans and purchase securities. More reserves mean more capacity to extend credit; less reserves mean less capacity.

The Federal Reserve has pursued an easy

## SOURCES OF SUPPLY



\* Fourth quarter estimated; seasonally adjusted.

\*\* Saving and loan associations, life insurance companies, and mutual savings banks.

money policy longer than in the two earlier recovery periods. Average free reserves, one

indicator of the degree of ease in bank reserve positions, has remained at about the recession level, except for short-term fluctuations. In 1958–1959, however, the reserve position had shifted from net free to a small volume of net borrowed reserves; and in 1954–1955, free reserves had been reduced to about \$100 million. Member bank borrowing from the Reserve Banks tells the same story. Daily average borrowing is still at about the recession level, in contrast to substantial increases in the two previous recoveries.

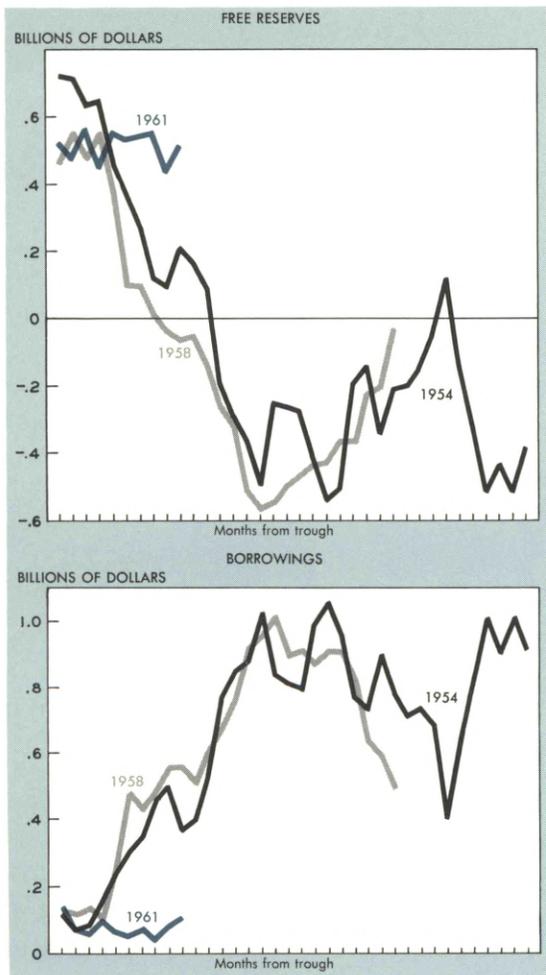
### Expectations

Interest rates are sometimes influenced by what people think is going to happen as well as by actual events. Expectations may have a significant influence on market rates temporarily, especially near cyclical turning points, but the effects are short-run unless confirmed by the expected events.

The quick turnaround in the Government securities market in mid-1958 affords a good illustration of the impact of expectations. Until about midyear, many expected the recession to be the longest and most severe of the postwar period and, as a result, anticipated continued strength in the Government securities market and a further decline in interest rates.

A conjuncture of events, however, led to a sharp turnaround in expectations. The flow of data began to indicate emerging business recovery. A large deficit in prospect for fiscal 1959 meant the Treasury would be a substantial borrower. Improved business prospects and a large Treasury deficit pointed to a substantial increase in credit demand and higher, not lower, rates. Also, the quick shift from pessimism to optimism came at a time when large speculative holdings of Governments, especially the recently

## FREE RESERVES AND BORROWINGS OF MEMBER BANKS



offered  $2\frac{5}{8}$ 's, had been built up in anticipation of lower, not higher, rates. The shift in expectations touched off a rise in market rates—a rise which was accelerated by heavy liquidation of speculative holdings of Governments.

Expectations of business recovery emerged more gradually in 1961 and in 1954–1955 than in mid-1958. Thus far there has also been less fear of inflation than in the 1958–1959 expansion. Continuation of an easy money policy in

the current recovery has probably discouraged actions in anticipation of higher rates and, more important, has prevented the tightening of credit required to reinforce and sustain increases that might have been induced by such actions.

### MATURITY STRUCTURE OF RATES

Borrowers want credit for different lengths of time, and lenders and investors have different preferences as to maturity. For this reason, market rates vary for different maturities of securities of the same quality and credit risk. At any one time, therefore, instead of a single rate on Government securities there is a whole range or pattern of rates. The accompanying charts show “yield curves”—that is, yields on the various maturities of Government securities outstanding at about the end of the recession and at later dates during the ensuing recovery.

Borrower preference as to maturity is determined primarily by the length of time credit is needed. Lender and investor preferences vary mainly according to liquidity needs. Commercial banks, with the bulk of their liabilities payable on demand or short notice, have a strong preference for shorter maturities, whereas savings institutions, with less need for liquidity, prefer longer maturities.

Changes in economic conditions are unlikely to affect supply-demand relationships equally in all maturity sectors of the market. Both demand and supply tend to be more volatile in the short- than in the longer-term sector of the market. As a result, short-term rates fluctuate more widely during the cyclical upward and downward swings in business than long-term rates. There is a certain amount of mobility of funds among maturity sectors but it is not sufficient to prevent shifts in the maturity structure of interest rates.

One of the more distinctive features of the current recovery has been the stability of short-term rates. This stability reflects several diverse influences.

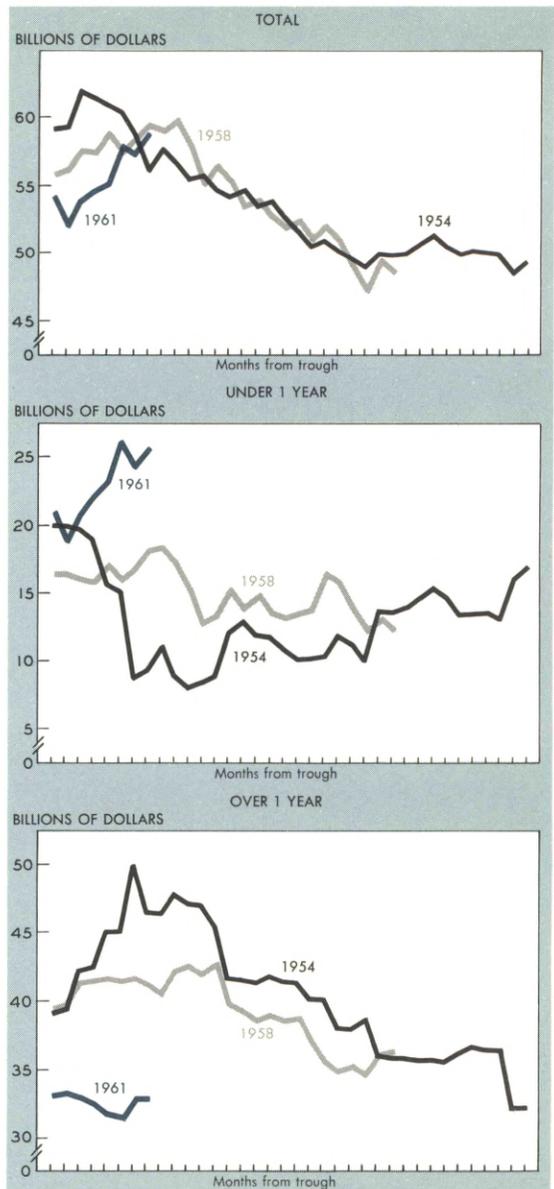
The principal factor tending to raise rates has been the growing volume of business activity accompanied by increased credit demands. Treasury cash borrowing has put considerable upward pressure on short-term rates. Treasury bills outstanding increased over \$6 billion during the last three quarters of 1961. Nonfinancial corporations, usually large purchasers of short-term Governments as the net cash inflow rises during recovery, have not added to their Government portfolios thus far in the current expansion.

An easy money policy has been the major force exerting downward pressure on short-term rates. Banks have been supplied with sufficient reserves not only to meet loan demand but, in addition, to increase their holdings of Government securities. Bank purchases of Governments—both in the recession and thus far in the recovery—have been concentrated in short maturities, mostly issues maturing within one year. Holdings of short-term Governments relative to deposits are larger than at this stage of the 1958–1959 recovery; however, the ratio of loans to deposits is also higher.

Another difference is that banks began liquidating Governments sooner, especially in the 1954–1955 recovery in order to get funds to meet expanding loan demands. The fact that banks have been able to continue buying Governments, instead of having to sell in order to get funds for loans, has been a strong force tending to offset the upward pressure on short- and intermediate-term rates generated by business expansion.

Techniques employed by the Federal Reserve

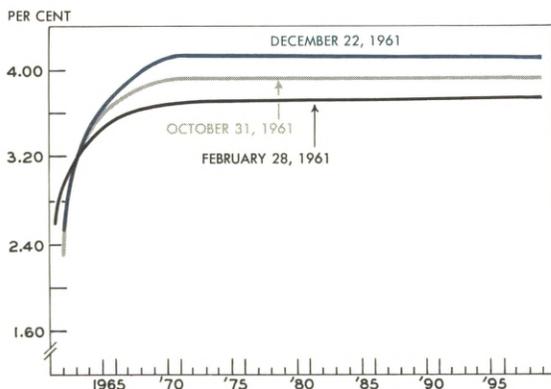
## COMMERCIAL BANK HOLDINGS OF GOVERNMENTS BY MATURITY



in supplying reserves have tended to minimize the downward pressure on short-term rates. Under authority granted prior to the recession, the Board of Governors permitted banks to

count vault cash as reserve. Country banks hold a large part of cash in vault; hence, reserves supplied in this way were not likely to flow to the money market as quickly as if the reserves had been supplied by purchasing securities. The policy of conducting open market operations in all maturities instead of short-term issues only, also relieved the downward pressure on short-term rates. A substantial part of System purchases in supplying reserves was in intermediate and longer maturities, thus diverting the direct impact from short- to intermediate- and longer-term rates.

#### YIELD CURVES ON GOVERNMENT SECURITIES



Diverse influences also help to explain the sluggish response of intermediate- and long-term rates to the expanding volume of business activity. Here, too, private demand appears to have been about as strong as in the other two recovery periods. Treasury debt management operations have tended to absorb some long-term funds. Marketable Government securities of over five years' maturity have increased considerably more than in 1958–1959, and about the same as in 1954–1955.

Techniques in implementing open market policy have cushioned upward pressures on intermediate- and long-term rates. System net

purchases outside the short-term area in the last ten months of 1961 exceeded \$2.5 billion. The major part of these purchases was in the three- to ten-year maturity range. Although it is impossible to measure their impact, it does seem certain that purchases of this magnitude either exerted considerable downward pressure on intermediate- and longer-term rates or the market for these maturities is very broad. The latter appears not to be the case.

#### SUMMARY AND CONCLUSIONS

Causes of the tardy response of market rates to the 1961 recovery cannot be quantified and measured; however, analysis of demand and supply factors does reveal differences that apparently account for much of the sluggishness of rates as compared with the 1954–1955 and 1958–1959 recoveries.

The explanation does not appear to be on the demand side. Total private demand for credit has shown about the usual response to business recovery. Consumer demand for credit, especially for the purchase of automobiles, has been weaker but corporate, and state and local government demands have been somewhat larger than in the other two upswings.

A principal reason for the lag in market rates appears to be on the supply side—a greater availability of credit made possible by easier bank reserve positions. The flow of saving has not been out of line with other recovery periods. Easy reserve positions, however, have afforded commercial banks the capacity to expand both loans and investments. The fact that banks have been able to continue as net buyers of securities, instead of having to sell securities to get funds for loans, has been a major force cushioning upward pressures on rates, especially short- and intermediate-term rates.

Techniques in implementing monetary and debt management policies have exerted some influence on the structure of market rates. The Federal Reserve has tried to supply reserves in ways that would minimize direct downward pressure on short-term rates. Substantial open market purchases outside of intermediate and longer maturities diverted direct downward pressure from short- to intermediate- and long-term rates. Treasury debt operations have also

been designed to help meet the needs of the balance-of-payments situation and domestic economic recovery.

Expectations apparently have exerted less upward pressure on interest rates than in 1958. The absence of widespread expectation of an inflationary boom, and presumably of large speculative holdings of Government securities, has tended to hold down transactions made in anticipation of higher rates.

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## BUSINESS AND BANKING IN 1961

The year 1961 opened on a bleak, dreary note. Snow and ice covered much of the nation; clouds of recession hung low over business. Both the climate and the economy remained chilled through February.

Spring finally came and it was especially welcome. It ended the Eskimo weather and it brought recovery in business.

The recovery was rapid at first. Industrial production rose eight points from March to June. The inventory sector provided much of the initial impetus.

By late summer the economy had begun to sputter a bit. There was widespread concern lest the recovery end prematurely. As things turned out, however, it was only a pause to shift gears. The expansion resumed in the fall with consumers leading the way. In the fourth quarter, automobile sales picked up sharply and Christmas buying hit record highs.

Although the over-all economy expanded from March, stability characterized three key areas—

prices, interest rates, and unemployment. All three moved sideways during most of the year. Usually, the three series are more sensitive to changes in business conditions.

### **Third district business**

Local business followed roughly the same trend as the national economy during 1961—a slow start and then considerable improvement.

The longstanding gaps between the district and the nation were narrowed in a number of statistical series. Unemployment was of particular note. Chronic unemployment continued to be a problem but, with very few exceptions, the rates here improved relative to the United States total. For example, the Philadelphia Metropolitan Area matched the national rate for the first time in a decade.

The following table compares the first 10 or 11 months of 1961 to similar periods of 1960 for a selection of district business indicators. The large number of minuses tends to obscure

the momentum behind the local economy as 1961 ends. The explanation is that 1961 was a year of recession and recovery, and only in the latter part did it begin to compare favorably with the previous year.

### LOCAL BUSINESS INDICATORS

*Third Federal Reserve District—  
Percent change 1960 to 1961*

Employment (15 areas)*	— 1%
Factory payrolls*	— 3
Factory working time*	— 5
Electric power consumed by manufacturers*	+ 2
Anthracite coal output*	— 4
Construction contracts:	
Residential**	+13
Nonresidential**	+ 7
Public works and utilities**	+36
Car loadings (Philadelphia region—51 weeks)	—13
Retail sales, total (excluding national chains)**	— 4
Department store sales*	+ 1
Automobile registrations (48 counties, eastern Pennsylvania)**	—11
Bank debits (20 cities)**	+11

\* First eleven months.

\*\* First ten months.

Construction was a strong feature in the Third District during 1961. Contracts rose more rapidly here than in the nation as a whole. The district enjoyed particular strength in public works and in the residential sector—a type of spending that has widespread effects on the local economy.

### Commercial banking

The past year was a disappointing one for

Philadelphia banks. They hoped the business recovery would bring a substantial increase in loan demand. But new demand was slow to materialize. Loans of Philadelphia (reserve city) banks were stable until the waning weeks of 1961 when they finally rose above year-earlier levels. Loans in Third District country banks, on the other hand, increased pretty much throughout 1961.

In order to stimulate economic recovery and growth, the Federal Reserve System pursued a policy of monetary ease during 1961. This policy, and the relatively listless loan demand, meant that district banks—particularly the Philadelphia banks—remained liquid and had little need to borrow at the discount window.

Net profits of district member banks were almost 15 per cent higher in the first half of 1961 (the latest available data) than in the similar 1960 period. Profits on sales of securities were one of the principal reasons for the increase.

### Reserve Bank operations

Automation took several giant steps here at 925 Chestnut Street during 1961. In January our Check Department installed an electronic check-handling system. It was a pilot installation used to test the reading, sorting, and listing of checks

### THIRD DISTRICT BANKING

(Millions \$)

	Dec. 31, 1959	Dec. 31, 1960	Change in 1960	Dec. 27, 1961	Change in 1961
Reserve City Banks					
Loans	2,128	2,292	+164	2,430	+138
Investments	945	929	— 16	1,085	+156
Deposits	3,793	4,007	+214	4,139	+132
Country Banks					
Loans	2,737	3,032	+295	3,260	+228
Investments	2,392	2,432	+ 40	2,531	+ 99
Deposits	5,519	5,791	+272	6,085	+294

imprinted with magnetic ink. The test proved effective and, as planned, the equipment took its place on the check collection production line. In October we added a second system and the department now processes 170,000 checks a day on its electronic equipment.

The success of our electronic check handling installation is due, in large measure, to the cooperation of district banks, most of which now are preprinting checks in magnetic ink. About 60 per cent of all the checks we receive are now preprinted and the percentage is rising all the time.

The Data Processing Department installed its own electronic computer in May, 1961. At present it is doing over 60 different jobs for the various departments of the Bank. The Research Department, for example, uses

up to two hours a day of computer time and has written a number of its own programs.

The Bank and Public Relations Department took on several new activities in 1961. They were: a series of pamphlets explaining our economy for the "mass" reader; participation in a series of public service television programs; preparation to make a movie about the Federal Reserve System.

In other departments, discounts and advances to member banks fell to \$564 million from \$2,712 million in 1960. Issues of saving bonds exceeded redemptions for the first time in several years. Fewer pieces of currency but more coins were counted in 1961.

Additional statistics on Reserve Bank operations are shown on page 26.

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## NEW RELEASE

*Forecasts for 1962.* The Department of Research has compiled and analyzed a number of predictions made by businessmen, economists and Government officials. This compilation includes a summary of forecasts for the economy as a whole and particular sectors of the economy. The more important indicators are presented in chart form.

Copies of this release are available on request from the Bank and Public Relations Department, Federal Reserve Bank of Philadelphia.

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## DIRECTORS AND OFFICERS

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At the election held in the fall of 1961, Frank R. Palmer was re-elected as a Class B director by the banks in Group 1 for a term of three years from January 1, 1962. Eugene T. Gramley, President of the Milton Bank and Safe Deposit Company, Milton, Pennsylvania, was elected for a like term by banks in Group 3 to serve as a Class A director. He succeeds O. Albert Johnson.

The term of Henderson Supplee, Jr. as a Class C director and his service as Chairman of the Board of Directors expired at the end of 1961. The Board of Governors of the Federal Reserve System appointed Willis J. Winn to succeed him as a Class C director for a three-year term. Mr. Winn is Dean of the Wharton School of Finance and Commerce, University of Pennsylvania. During 1962, Walter E. Hoadley, previously Deputy Chairman, will serve as Chairman and David C. Bevan as Deputy Chairman of the Board of this Bank.

By appointment of the Board of Directors, Howard C. Petersen, President of the Fidelity-Philadelphia Trust Company, Philadelphia, Pennsylvania, will continue to represent the District on the Federal Advisory Council during 1962.

With the approval of the Board of Governors of the Federal Reserve System, the Board of Directors reappointed Karl R. Bopp as President and Robert N. Hilbert as First Vice President for terms of five years beginning March 1, 1961. Roy Hetherington, an Assistant Cashier, retired on May 31, 1961 and Philip M. Poorman, Vice President in charge of fiscal agency operations, on June 30. Norman G. Dash, previously an Assistant Vice President, was made a Vice President, effective July 1. He succeeds Mr. Poorman as senior officer of the fiscal agency function.

## DIRECTORS AS OF JANUARY 1962

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Group		Term expires December 31
	<b>CLASS A</b>	
1	<b>FREDERIC A. POTTS</b> President, The Philadelphia National Bank, Philadelphia, Pennsylvania	1962
2	<b>J. MILTON FEATHERER</b> Executive Vice President and Trust Officer, The Penn's Grove National Bank and Trust Company, Penns Grove, New Jersey	1963
3	<b>EUGENE T. GRAMLEY</b> President, Milton Bank and Safe Deposit Company, Milton, Pennsylvania	1964
	<b>CLASS B</b>	
1	<b>FRANK R. PALMER</b> Chairman, The Carpenter Steel Company, Reading, Pennsylvania	1964
2	<b>R. RUSSELL PIPPIN</b> Treasurer, E. I. du Pont de Nemours & Company, Wilmington, Delaware	1962
3	<b>LEONARD P. POOL</b> President, Air Products and Chemicals, Inc., Allentown, Pennsylvania	1963
	<b>CLASS C</b>	
	<b>WALTER E. HOADLEY, Chairman</b> Vice President and Treasurer, Armstrong Cork Company, Lancaster, Pennsylvania	1963
	<b>DAVID C. BEVAN, Deputy Chairman</b> Vice President, Finance, Pennsylvania Railroad Company, Philadelphia, Pennsylvania	1962
	<b>WILLIS J. WINN</b> Dean, Wharton School of Finance and Commerce, Philadelphia, Pennsylvania	1964

## OFFICERS AS OF JANUARY 1962

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KARL R. BOPP

President

ROBERT N. HILKERT

First Vice President

JOSEPH R. CAMPBELL

Vice President

WALLACE M. CATANACH

Vice President

NORMAN G. DASH

Vice President

DAVID P. EASTBURN

Vice President

MURDOCH K. GOODWIN

Vice President, General Counsel  
and Assistant Secretary

JAMES V. VERGARI

Vice President and Cashier

RICHARD G. WILGUS

Vice President and Secretary

EVAN B. ALDERFER

Economic Adviser

CLAY J. ANDERSON

Economic Adviser

JOHN R. BUNTING, JR.

Business Economist

EDWARD A. AFF

Assistant Vice President

HUGH BARRIE

Assistant Vice President

ZELL G. FENNER

Assistant Vice President

RALPH E. HAAS

Assistant Vice President

GEORGE J. LAVIN

Assistant Vice President  
and Assistant Secretary

HENRY J. NELSON

Assistant Vice President

HARRY W. ROEDER

Assistant Vice President

JOSEPH M. CASE

Chief Examining Officer

HAROLD M. GRIEST

Examining Officer

JACK H. JAMES

Examining Officer

LEONARD MARKFORD

Examining Officer

G. WILLIAM METZ

Examining Officer

JACK P. BESSE

Assistant Cashier

WILLIAM A. JAMES

Personnel Officer

WARREN R. MOLL

Assistant Cashier

FRED A. MURRAY

Director of Plant

RUSSELL P. SUDDERS

Assistant Cashier

HERMAN B. HAFFNER

General Auditor

# STATEMENT OF CONDITION

## FEDERAL RESERVE BANK OF PHILADELPHIA

(000's omitted in dollar figures)	End of year	
	1961	1960
<b>ASSETS</b>		
Gold certificate reserves:		
Gold certificate account .....	\$ 906,959	\$1,055,712
Redemption fund—Federal Reserve notes .....	71,517	66,251
Total gold certificate reserves .....	\$ 978,476	\$1,121,963
Federal Reserve notes of other Federal Reserve Banks .....	43,635	42,519
Other cash .....	12,852	10,793
Loans and securities:		
Discounts and advances .....	2,185	4,192
United States Government securities .....	1,658,963	1,545,012
Total loans and securities .....	\$1,661,148	\$1,549,204
Uncollected cash items .....	439,443	412,324
Bank premises .....	3,521	3,791
All other assets .....	13,590	12,044
Total assets .....	\$3,152,665	\$3,152,638
<b>LIABILITIES</b>		
Federal Reserve notes .....	\$1,890,074	\$1,867,323
Deposits:		
Member bank reserve accounts .....	829,237	831,788
United States Government .....	10,696	27,038
Foreign .....	15,370	12,626
Other deposits .....	3,211	5,700
Total deposits .....	\$ 858,514	\$ 877,152
Deferred availability cash items .....	323,808	334,971
All other liabilities .....	3,347	1,697
Total liabilities .....	\$3,075,743	\$3,081,143
<b>CAPITAL ACCOUNTS</b>		
Capital paid in .....	\$ 25,641	\$ 23,832
Surplus .....	51,281	47,663
Total liabilities and capital accounts .....	\$3,152,665	\$3,152,638
Ratio of gold certificate reserves to deposit and Federal Reserve note liabilities combined .....		
	35.6%	40.9%

# EARNINGS AND EXPENSES

## FEDERAL RESERVE BANK OF PHILADELPHIA

(000's omitted)	1961	1960
<b>Earnings from:</b>		
United States Government securities .....	\$ 53,954	\$ 61,843
Other sources .....	180	879
<b>Total current earnings .....</b>	<b>\$ 54,134</b>	<b>\$ 62,722</b>
<b>Net expenses:</b>		
Operating expenses* .....	\$ 8,119	\$ 7,594
Cost of Federal Reserve currency .....	624	691
Assessment for expenses of Board of Governors .....	364	384
<b>Total net expenses .....</b>	<b>\$ 9,107</b>	<b>\$ 8,669</b>
<b>Current net earnings .....</b>	<b>\$ 45,027</b>	<b>\$ 54,053</b>
<b>Additions to current net earnings:</b>		
Profit on sales of U.S. Government securities (net) .....	\$ 200	\$ 140
Transferred from reserves for contingencies (net) .....	—	824
All other .....	1	—
<b>Total additions .....</b>	<b>\$ 201</b>	<b>\$ 964</b>
<b>Deductions from current net earnings:</b>		
Miscellaneous non-operating expenses .....	1	7
<b>Total deductions .....</b>	<b>\$ 1</b>	<b>\$ 7</b>
<b>Net additions .....</b>	<b>\$ 200</b>	<b>\$ 957</b>
<b>Net earnings before payments to U.S. Treasury .....</b>	<b>\$ 45,227</b>	<b>\$ 55,010</b>
Dividends paid .....	1,472	1,399
Paid to U.S. Treasury (interest on Federal Reserve notes) .....	40,136	51,585
<b>Transferred to or deducted from (—) Surplus .....</b>	<b>\$ 3,618</b>	<b>\$ 2,025</b>

\* After deducting reimbursable or recoverable expenses.

# VOLUME OF OPERATIONS

## FEDERAL RESERVE BANK OF PHILADELPHIA

	1961	1960	1959
Number of pieces (000's omitted)			
<b>Collections:</b>			
Ordinary checks* . . . . .	181,100	176,700	173,600
Government checks (paper and card) . . . . .	26,300	25,000	24,200
Postal money orders (card) . . . . .	16,200	17,200	17,900
Non-cash items . . . . .	732	707	718
Clearing operations in connection with direct send- ings and wire and group clearing plans** . . . . .	677	698	742
Transfers of funds . . . . .	149	145	133
Currency counted . . . . .	260,300	295,000	299,200
Coins counted . . . . .	476,200	451,200	491,100
Discounts and advances to member banks . . . . .	1	2	2
Depository receipts for withheld taxes . . . . .	544	529	505
Postal receipts (remittances) . . . . .	317	326	328
<b>Fiscal agency activities:</b>			
Marketable securities delivered or redeemed . . . . .	406	419	353
Savings bond transactions— (Federal Reserve Bank and agents)			
Issues (including re-issues) . . . . .	8,650	7,872	7,536
Redemptions . . . . .	6,756	6,657	6,766
Coupons redeemed (Government and agencies) . . . . .	1,119	1,043	953
Dollar amounts (000,000's omitted)			
<b>Collections:</b>			
Ordinary checks* . . . . .	\$64,600	\$64,500	\$64,300
Government checks (paper and card) . . . . .	5,866	5,131	4,974
Postal money orders (card) . . . . .	274	283	287
Non-cash items . . . . .	166	150	157
Clearing operations in connection with direct send- ings and wire and group clearing plans** . . . . .	36,395	34,707	33,267
Transfers of funds . . . . .	90,676	87,251	69,826
Currency counted . . . . .	1,783	2,072	2,074
Coins counted . . . . .	55	54	52
Discounts and advances to member banks . . . . .	564	2,712	6,262
Depository receipts for withheld taxes . . . . .	2,240	2,182	1,981
Postal receipts (remittances) . . . . .	851	861	842
<b>Fiscal agency activities:</b>			
Marketable securities delivered or redeemed . . . . .	10,998	10,557	12,771
Savings bond transactions— (Federal Reserve Bank and agents)			
Issues (including re-issues) . . . . .	405	386	382
Redemptions . . . . .	377	405	531
Coupons redeemed (Government and agencies) . . . . .	156	142	128

\* Checks handled in sealed packages counted as units.

\*\* Debit and credit items.