Business Review

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The Shrinking Trade Surplus

The Changing Profitability Gap

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Federal Reserve Bank of Philadelphia

The Responsibility of Business and Industry for Social Welfare in Today's World:

. . . Social responsibility is inherent in both theory and practice of modern business, a change some have failed to note. Voluntary efforts, related to corporate objectives, serve the community as well as the company.

The Shrinking Trade Surplus:

. . . Booming U.S. economy helps boost imports faster than exports. Implications for balance of payments told by charts.

The Changing Profitability Gap:

. . . Since 1961, higher interest expense of Philadelphia member banks has caused their earnings to lag behind those of Third District "country" member banks. City banks still have a higher rate of return on total assets and owners' equity, but the gap is narrowing.

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THE RESPONSIBILITY OF BUSINESS AND INDUSTRY FOR SOCIAL WELFARE IN TODAY'S WORLD

by Robert N. Hilkert*

During recent times we have heard and learned much about the bottom twenty per cent of the American people who comprise "the Other America." Regrettably, an unconscionable state of affairs has been too much hidden from too many of us for too long. We should be thankful that it has been brought out of the darkness into the light by all those concerned people who have given contemporary meaning to a question asked long ago, "And just who is my neighbor?"

A social and economic order which permits to exist the present condition of the lower-fifth of the population obviously needs to be improved. To the extent that it is within our power and competence to effect improvement, not to do so is immoral. The problems are not insoluble, over time, but this is not to say that they will be solved by soft hearts unaccompanied by hard heads.

In the interest of perspective, we should not lose sight of another point. There *is* an upper eighty per cent. While the American system needs improvement, needs it urgently, perhaps a system that has succeeded in raising the living standards of eighty per cent of the people to present levels deserves some sort of medal of merit. There is no country which, in terms of material living standards, has achieved so much for so many. That there is much left to be done should not blind us to what has already been done. Attainments up to now should give us hope of attainments to come.

It may well be true that our economic growth has not been all that it might be. Conclusions along this line involve many value-judgments, and with these one may always quarrel. We must admit, however, that very large numbers of people are today living very well. To say this is not to be callous toward those who are not.

It simply serves to emphasize the moral problem. We cannot feel comfortable about an America which is accurately described both at home and throughout the world as a land in which dire poverty exists in the midst of unmatched affluence. No one can read Michael Harrington, or Edgar May's *The Wasted Americans*, or Leon Keyserling's study on *Poverty and Deprivation in America* and not immediately feel the need to fight what really is a *just* war—a war on poverty. However we may differ in our thoughts as to means, I fail to see how we can quarrel about ends.

Business and social well-being

We cannot say that our material attainments have stemmed solely from the accomplishments of

**Mr. Hilkert, First Vice President of the Federal Reserve Bank of Philadelphia, gave this talk at the Annual Forum of the National Conference on Social Welfare, Chicago, June 1, 1966. The views expressed in this paper do not necessarily reflect the views of the Federal Reserve System.*

business and industry. There have, of course, been many factors and forces (including government, labor, education, geography, natural resources, etc.) which have contributed greatly to our nation's state of material well-being. However, anyone who looks at the facts must affirm the tremendous part played by business and industry. We have been called, and I believe rightly, a business society. Without business and industry there can be no "Great Society."

Looked upon historically, business has not always shown a righteous concern for people. Much of the story, going back, say, to the Industrial Revolution, has not been a pretty one. After all, children did work in the mines. There have been "robber barons." The public-be-damned attitude is not just a myth. Our industrial history contains many incidents of violence associated with the pursuit of human justice. Progressive legislation has more often than not had to travel rough roads. Yes indeed, from the annals of business and industry we learn that the welfare of people has not always been of over-riding concern.

This is history. While it should not be forgotten, it should be looked upon as a part of the past and not the present. Changes *have* occurred in business and industry. I don't know why people who recognize revolutionary changes that have been taking place in nearly every other aspect of our society find it so hard to believe that changes have also taken place in the organization, philosophy and conduct of American business. And yet, I believe I can see two reasons for skepticism.

The first and obvious one is that there are some black sheep in the family. There are some who violate the standards which society has a right to expect of us, and these receive the glaring light of intense publicity. While I offer it as no excuse, I have to remind myself that man is, indeed, somewhat lower than the angels.

But there is another reason, one which arises from the traditional statements about the nature and function of business. It has often been said, verbally and in the literature, that social welfare, as commonly construed, is not the primary, direct concern of business. Under the American system, so the story goes, it can hardly be the primary concern; and there is increasing evidence that it cannot be under any other system.

It is not, however, quite this simple and bald. It is difficult to clear up the semantic difficulties involved in the thought, and it all gets mixed up in the formulation of short-run vs. long-run business goals. Above all, it is hard to categorize situations in which self-interest and the public interest coincide, as they do in so many ways.

It is my view that if social welfare is not the primary interest, it is a strong secondary one; and to indicate how significant a secondary concern can be, let me cite the world's best illustration. It is the Christian admonition or commandment which says, ". . . and the *second* is like unto it, thou shalt love thy neighbor as thyself." It may well be that the primary and secondary concerns of business are not quite this close, but I know of many instances in which they are almost as hard to separate.

Business goals

Essentially, the job of business is to produce goods and services which society wants, at prices which people are willing and able to pay. Moreover, the business must survive. If the business fails, then all talk about its responsibility for social welfare is purely academic, and we can forget it. But to survive it must be profitable, and to survive in today's dynamic world it must grow. So the logic of the case, certainly as seen by the typical businessman in performing his duties, sets the main concern—*to produce efficiently for society's needs and wants, to be* *profitable, to survive, and to grow.*

Profits must be high enough to permit the risks of innovation, growth and expansion, because business enterprise must not only adapt to changing times, it must be a producer of change. Almost everything that modern business does involves change, and hence, risks. Risks entail genuine costs even though they can't always be measured before the future becomes past. Obviously, there must be some basic level of profitability adequate to the assumed risks, not only for the survival and growth of the business but in the interest of society itself. This principle is different from that of profit maximization.

I dwell on the subject of profits for a special reason. I spend a lot of time working in social welfare circles, and in ecumenical church circles where one encounters deep social concern. As one might expect, I often hear remarks to the effect that business is "more concerned about profits than about people." There is an implication that we must hasten the day when this will no longer be true. In the context in which the statement is made, I believe it is, more often than not, quite irresponsible though righteous.

In response, however, let me point to the following quotation from a work by Peter Drucker, one of the foremost management philosophers of our day:

"*The need for profitability is objective. It is of the nature of business enterprise and as such is independent of the motives of the businessman or the structure of the 'system.' If we had archangels running businesses (who, by definition, are deeply disinterested in the profit motive), they would have to make a profit and would have to watch profitability just as eagerly, just as assiduously, just as faithfully, just as responsibly, as the most greedy wheeler-dealer or as the most convinced Marxist commissar in Russia.*"

It is not my plan to make a personal defense of a highly restricted view of social responsibility which a pure theory of business enterprise might logically permit, a view defended by many who are as deeply interested in attaining a good society as are the rest of us. I feel it important, however, to point out that their view is not as narrow as many would like to believe. Their main thought is that business is business, that it should tend to its own knitting, that it should do—in honesty and in good faith—that which it is best qualified to do: to produce goods and services efficiently, to provide jobs for as many as can be economically justified, to make reasonable returns to shareholders, to provide appropriate wages and working conditions for all employes, to operate with a view toward economic stability, to abide by the rules set by society as legally expressed through government, to survive, and to grow. The theory holds that if business does only what it is supposed to do, and does it honestly and effectively, then the *social welfare of the people will be served as well as society has a right to expect of business.* Business is not government, it is not the church, it is not the educational system, and it is not a federation of voluntary agencies. It is business enterprise—which through being itself will best serve the national interest and the needs of people.

While all this may not be as inclusive as some such as I might like, it certainly is not a narrow view, and its comprehensive nature should be carefully studied by the more pious among us who may be seeking a scapegoat to blame for various kinds of social injustices which prevail in our nation. Business, of course, is a perennial target, and this includes my own occupation of banking.

Social responsibilities of businessmen

Now anyone who thinks that business in our day is not concerned with social responsibilities has not seen much of the recent literature of business, hasn't kept up with the teaching in our modern schools of business administration, hasn't attended the innumerable meetings, conferences, and conventions held by businessmen. (Yes, we have them too!) Certainly our critics have not sat around many Board tables.

In the vernacular, social responsibility is "in" and the business "in-groups" are composed of men who are deeply concerned about social responsibility. I don't for a moment believe that the motivation is totally altruistic, and I don't believe that matters. Modern business knows that society *expects* business to be socially responsible and business today recognizes the importance, yes, the necessity, of being responsive to society's expectations. Business knows that society can legislate it out of business. Since some of society's expectations of business may be quite unrealistic, it considers part of its job to be that of influencing the populace so that its expectations are pertinent and reasonable and not irrelevant and blue-sky.

But we encounter a basic problem. Business doesn't really know in specific terms, beyond that which is expressed in law, just what comprises its social responsibility. It is not altogether sure of its appropriate roles. I don't believe anybody else knows either, and one reason is that the concepts change so rapidly. All of us must progress farther in our thinking along this line.

Business behavior and social welfare

It is enlightening to see a leading column in the *Wall Street Journal* (April 7, 1966) for which the headline reads, "Business Undertakes Broad Social Programs, Reaps Gains Themselves." The text contains items such as:

1. A recently held four-day symposium in Philadelphia which brought together leading thinkers, including Edward Teller, to discuss arms control. A principal sponsor was Bendix Corporation.
2. Coming up this summer—a business-government conference at Ohio University which will try to coordinate fragmented Federal programs for aiding Appalachia. Initiated by Nationwide Insurance Company.
3. IBM—bankrolling a $5 million, ten-year Harvard study of the Social Impact of Automation.
4. 78 U.S. companies helping to finance a world population study by the International Planned Parenthood Federation.
5. Some Bell Telephone Companies—developing programs of recruiting and training volunteer workers, including many present Bell employes, to counsel and tutor potential high school dropouts. (The long-run gain here is stated as "aiding Bell to compete in the labor market for high school graduates.")

The main thing, as the article states, is that many companies are "moving far beyond traditional concepts of what concerns business to a *new theory that business will prosper from economic, social and cultural advancement of the people who work in its plants and buy its products.*"

Some of the activities listed above may not be earth-shaking, but great oaks from little acorns grow, and *under this new theory business could find its way in to almost any area of social responsibility*. I doubt very much that it will lead to a welfare state "under new management."

Let me, however, cite two illustrations to point up ways in which business decisions have great effects on social welfare. The first was used by Abram Chayes in his Reynolds lecture at Amherst in 1958:

"In 1954, the announcement by General Motors of a $1 billion expansion program was largely credited with heading off the then threatening recession. GM's management might as easily, and perhaps with equal justification, have put the

$1 billion in dividends, or wage increases, or price cuts."

I pass up the temptation to ask which decision we here might have made, and make only the following points: that corporate decisions of this kind have profound public effects; that business has an obligation to make such decisions in terms of the public interest; and that we must recognize that judgments may differ as to what decision is most in the public interest at a given time under the current circumstances.

A second example relates to the public stake in a wage settlement by a large corporation such as United States Steel. Invariably, the settlement sets a pattern and a target, not only for other steel producers but for other major manufacturing industries. It spreads directly and indirectly to influence wage rates and other terms of employment, and hence costs, in companies throughout the land. It may lead to increases not only in the prices of steel, but in a host of commodities. *There really are no private interests here that are wholly separable from the public interest.* Both the corporation and the union have great power and it must be exercised with great care. The settlement must be neither too fat nor too lean. And when big government steps in, as it occasionally does, it too must act responsibly. It must not be hostile either to labor or management and the motives must be primarily economic and not political. (I realize this is a counsel of perfection.)

I do think it important to say, however, that when it is reported that management is resisting particular demands of labor it is not necessarily behaving in an antisocial manner. Indeed, it may well be that *it is in fact fulfilling a critically important social responsibility.*

I must call attention to the fact that in this paper I am saying little about two important areas of business responsibility, except for these few remarks in passing. The first is the concern for *good industrial relations and sound personnel administration.* The fulfillment of the responsibilities of business and industry toward *its own employes*, as human beings, entitled to justice and dignity, is too broad a subject for this paper. I make just one moot point.

Over the years employers have taken on responsibilities for many facets of employe welfare. But just how does one judge objectively—let us say when the next fringe benefit proposal comes along—whether it is one for which the *employer* is socially or morally responsible? When is it the responsibility of society or government, or the community, and when is it the responsibility of the individual himself? Are there only pragmatic approaches? Are answers to be obtained only through power-struggles?

A second major area which can rate only a once-over-lightly, despite its importance, is that of "corporate giving"—referring to contributions made to philanthropic, educational, scientific, cultural, and civic organizations. (I don't mean to imply that by making gifts a company fulfills its responsibilities to society.) These contributions run into hundreds of millions of dollars annually. I make here only the point that to make these contributions on the basis of some theory of corporate *philanthropy* is probably unwise. A purely charitable role can become too vague, ambiguous, and indefinable. (I leave out legal problems.) My belief, however, is that a purely charitable role is, yes, too *restrictive.* I subscribe, at least philosophically, to the idea set forth by Richard Eells:

"The only safe course is to relate the policy to the specific business objectives *of the company, and to specify in some detail the ways in which corporate support payments (a term he prefers for giving or contributing) can be used as prudent investment of corporate funds for the*

purpose of reaching those stated objectives. There are the long-term objectives of the corporation in relation to the industry, to the economy as a whole, and to the larger community it serves."

In my judgment, corporate support payments should be justified in terms of company long-range (as well as short-range) goals, which, however, must be broadly and comprehensively stated. They must permit the inclusion of various kinds of *public* responsibilities because *business simply doesn't live, move, and have its being in a private world or community.* Business both influences and is influenced by community conditions, problems and issues, and it must be concerned with them, financially and otherwise.

To illustrate more specifically, the *quality* of a community is important to business and industry. We see this most clearly when a new business is seeking a location. It seeks not only a ready source of labor and materials, but it looks for a community in which citizens have a concern for, and give support to, health, education, recreation, and so on. It does not pick for its new site a place in which the citizens are indifferent to "quality of community."

It follows that businesses and industries cannot be beneficiaries only. They must be *contributors to community improvement.* Just as the individual is taxed, so the business is taxed to support the community. But just as the citizen is also a *voluntary* contributor, so must business be a voluntary contributor. I insist, however, that this is not playing a charitable role. It is a socially responsible *business role* which redounds to the long-run interest of the business itself. It is making an investment just as the individual who contributes to the United Fund Appeal is making an investment. The new breed of men in the managerial class is increasingly looking at things in this way, and one even finds that striking Pauline conversions are taking place in many of the old familiar, but "hard-sell," places.

There are so many items entailing social responsibility that must be passed over because their complexities require elaboration. Some which come immediately to mind are: health and safety (covering the entire front from food and drugs to automobiles and planes); air and water pollution; careful administration of all natural resources; truth in advertising, labeling, and packaging; compliance with the spirit as well as the letter of law in relationships with all others; the entire field of decision-making within the framework of not-always-clear business ethics; moral vs. amoral approaches to business problems; participation in political activity, including lobbying. The list could be quite extensive. Few of the answers are as simple as they seem to people who are not in business.

Business and poverty

Now let's turn to the issue with which we started, the poor who comprise the other America. Whose responsibility are they?

This situation is the responsibility of our entire society, and I don't say this with any thought that what is everybody's business is nobody's business. Rather, what has appeared to have been nobody's business is indeed the responsibility of all of us. Since business and industry is a highly important institution in our society, it must bear its full share of that responsibility. So must all other institutions: government, labor, the church, the schools and colleges, the voluntary agencies, hospitals, prisons—just name them all. There are no exemptions.

One thing that seems clear is that government has *ultimate* responsibility. If the job isn't done by others, it must necessarily pass into the hands of government because government has final responsibility for the welfare of the people. It comes with ill grace, not to mention lack of reason, for any of us, including businessmen, to be blatantly critical of government for endeavoring to meet its responsibility when it is not being met by anybody else. I feel strongly about this even though I am often tempted to marvel at the government's voracious appetite for such responsibility. As a crusader for voluntarism I am not anxious to feed that appetite unnecessarily. This means that I must, and I do, advocate citizen responsibility across-the-board; and this, of course, includes corporate citizens. Along with Richard Cornuelle, I deplore the fact that so many seem to believe that the "test of a good citizen is not that he takes responsibility, but that he successfully sends it to Washington."

In allocating our obligations we must, of course, consider appropriateness of role. Each institution should do what it is best qualified or equipped to do. Everybody shouldn't get into every act.

So, where does business belong? I think it belongs in a variety of places, but it is uniquely concerned with employment and unemployment. Poverty results from lack of income and, in our current structure, incomes are associated with jobs. We look rightly to business and industry for job opportunities. (I must forego any discussion of guaranteed family incomes, negative income taxes, "demogrants," etc., but I believe the writings of Robert Theobald and other avant-garde thinkers must be taken seriously.)

The question is, "Job opportunities for whom—everybody?" The answer must be no; but this doesn't let business off the hook. Society, however, must understand that there are rational and irrational approaches to problems of employment. We don't have to worry about business employing all the people it can effectively use—that's not the problem under discussion. We are talking about those it cannot now effectively use.

It is irrational for business to place on its regular payrolls people who can't do the work, or whose work contribution is worth substantially less than the pay exchanged for services rendered. (I suspect you wouldn't want to justify running a social agency on that basis.)

Poverty and education

We must recognize that many failures to employ are caused by problems of basic educational deficiencies, and deficiencies in fundamental or basic skills, the kind of deficiencies that do not come within the scope of any reasonable training program for *new* employes. This educational and training job belongs to the educational system, the *costs to be borne by the entire society through the taxing process*. Whatever the tax needs may be to do this basic job, business must and will pay its appropriate share.

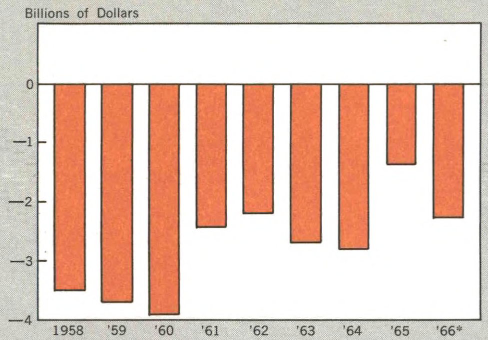
It may well be that there is some of this basic skill training that, under special circumstances, can be done better by business and industry than by the school system, for both technological and psychological reasons. There are, as you know, experimental programs currently going on, and I believe that this practice should be continuously and comprehensively explored. However, and this is important, the *cost* is still a proper charge upon education and not upon business. It should continue to be supported by tax dollars. If business takes on in any extensive way the work of the educational system, then it should be reimbursed or compensated through some form of *tax incentive or allowance*. It is even a rational use of anti-poverty funds. We have not begun to explore all the ways in which business and industry might contribute to training and to making use of services of many types of individuals who are unable to meet market tests of employment. Nevertheless, and this is a proper caveat, these costs must not be saddled upon business.

(Continued on Page 12)

THE SHRINKING TRADE SURPLUS

by Kathryn Kalmbach

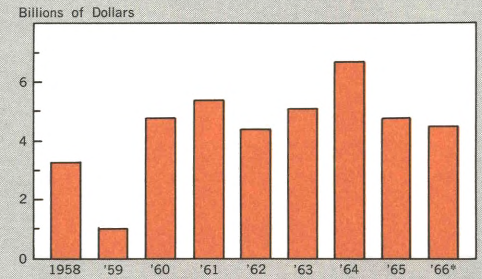
BALANCE OF PAYMENTS — LIQUIDITY BASIS



*1st. qtr.; s.a.: a.r.

1. The United States has run a deficit in its balance of payments for many years.

MERCHANDISE BALANCE



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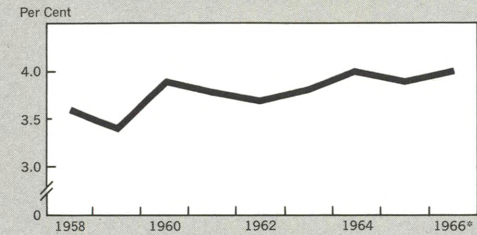
2. These deficits have been held down by big surpluses in the trade balance.

EXPORTS AS A PERCENT OF GNP



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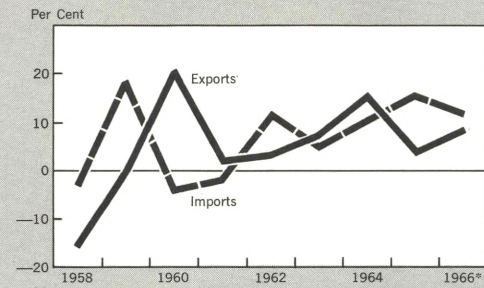
3. And that is one reason why exports, which account for only a small percentage of Gross National Product, are so important in our economy.

PERCENT ANNUAL CHANGE IN EXPORTS AND IMPORTS



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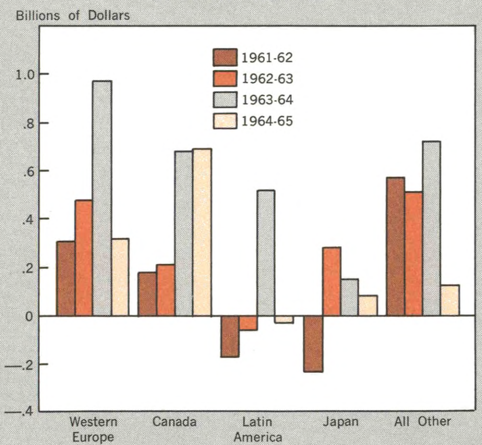
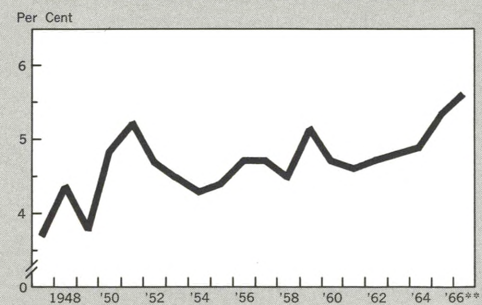
4. Recently, however, the trade surplus has been getting smaller as the rate of increase for exports has fallen short of that for imports.

ANNUAL CHANGE IN UNITED STATES EXPORTS BY AREA, 1962-1965



5. This reflects, on the one hand, a general slackening in the expansion of demand for United States products as well as world demand,

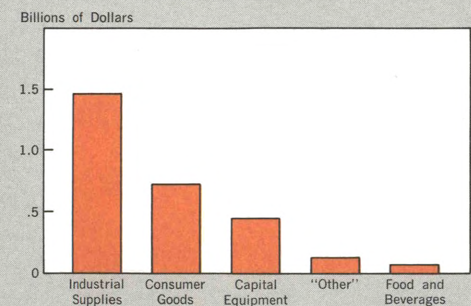
IMPORTS AS A PERCENT OF FINAL DEMAND*



*Excluding services.
**1st. qtr.; s.a.: a.r.

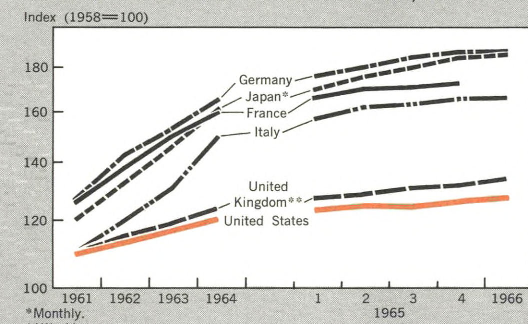
6. and, on the other hand, increased demands of our presently booming economy as well as long-term growth in the importance of imports in our economic life.

UNITED STATES MERCHANDISE IMPORTS — CHANGE — 1964-1965



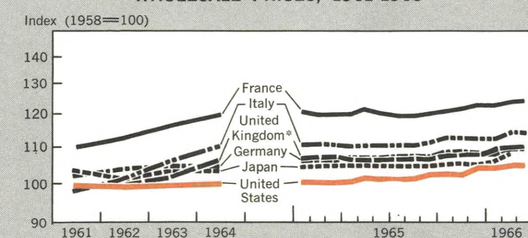
7. Most of the recent gain in imports was accounted for by increases in industrial supplies and consumer goods.

HOURLY EARNINGS IN MANUFACTURING, 1961-1966



*Monthly.
**Weekly.
Source: I.M.F.

WHOLESALE PRICES, 1961-1966



*Basic Materials.
Source: U.N.

8. The slowdown in exports occurred although the United States' competitive position in world markets showed little change. Wages in this country have risen less than those in the major trading countries. However, recent price increases have been somewhat greater in some instances.

(Continued from Page 9)

Of course, society could say that business should do all these things anyway, and consider their costs as the costs of doing business. But it should think twice about this because society will not be relieved of the costs in any case. It will merely be faced with a choice, and the decision will be an unfortunate one if it should require business to dilute its operational results through the adoption of outright uneconomic policies, however deeply they might be rooted in social motivation. There are no rabbits in this hat.

In order to make clear the preceding point, I have painted it in terms that are actually too black and white, too much either-or. There is increasing evidence that business wishes to play a more constructive training role than it has in the past, and at its own operative expense. I illustrate this by taking relevant sentences from an interview with NAM's President Gullander by the business editor of the *Christian Science Monitor:*

"What happens when a company plays such a community role (hiring high school dropouts, retaining displaced workers)? Three things: a grateful person finds a job again—and also becomes a spending consumer. The company gets a needed employe. And a social problem is solved locally, without expanding the role of government."

The interview continues:

"What about a company that doesn't need any new employes? Would the NAM urge it, too, to retrain workers for other jobs in the community? Yes, replied Mr. Gullander. In the long run it would help both the community and the company."

There are important and difficult business decisions to be made in such areas of activity. Some businesses can do more than others and each business must think in both long-run and short-run terms. Each must be sure that in its vision for the long run it doesn't become a business casualty in the short run, thereby having no long run.

Business-government cooperation

I have spoken many times publicly on the need for business and government to work together more closely on social welfare problems, for each desperately needs the help of the other. My record of not looking upon government as either evil or incompetent, or lacking in dedication, is also quite clear. However, I think I am seeing an increasing need for business and businessmen to work more closely with government, or vice versa, in the field of *anti-poverty programs.* I don't mean to detract from the good that has already been done, but I believe that there are signs pointing to the fact that we are in trouble, or at least that there are real trouble spots.

Anti-poverty business is big business. In this highly complex field, the insights, abilities, and skills required are many and varied. Among these are executive and administrative abilities, business judgment and foresight, analytical talents, fiscal competence, economic realism as well as social perspective, and a knowledge of history. These essentials, and many others, are not necessarily associated with low incomes. The qualifications for handling huge, complex, and costly programs go beyond sincerity, dedication, grass-roots sociological insight, empathy, and personal income. I think we need a serious review of ideas as to who should be involved "to the maximum extent feasible."

I have been telling businessmen that these programs are going to go on whether they are in or out, and that I believe that it will be better for everybody if they are in. Criticism from the sidelines isn't enough.

Whether by design or not—and I believe not—

an attitude has swept the country that to attain success we must move away as far as possible from the "old establishments"—and these include business, the existing political structures, the old-line voluntary organizations, and even the social work professions. This is utterly ridiculous and, of course, tragic. What *is* all this talk about wasting human resources?

I have also spoken publicly of the need to involve, *at all levels of responsibility*, those who will be "the beneficiaries" of anti-poverty programs. Their contributions and insights, and direct involvement, are indispensable. But they can't do the job alone, and I don't believe that government ever intended that they could or should. Yet, something has happened to create a pervasive belief that others are, as the Pennsylvania Dutch might say, "not wanted in." This belief must change, and change fast.

Responsible citizen action rests upon our ability to achieve unity of forces of *all* pertinent talents—to the maximum extent feasible. My hope is that business talents will be among those used more extensively in this exercise of responsibility for social welfare.

We live in an era of tension and discontent. This should result in hope, not despair. In line with this thought I close with a quotation from Macaulay's *History of England*, published in that politically turbulent year of 1848 which also saw the publication of the *Communist Manifesto*. Here are the relevant sentences:

"It is in some sense unreasonable and ungrateful in us to be constantly discontented with a situation that is constantly improving. But, in truth, there is constant improvement precisely because there is constant discontent. If we were perfectly satisfied with the present, we would cease to contrive, to labor, and to save with a view to the future."

Third District banks had lagged behind all member banks in terms of profitability; and within the district, profitability of country banks had lagged behind that of Philadelphia banks. However, recent patterns of bank earnings have caused . . .

THE CHANGING PROFITABILITY GAP

by William F. Staats

An analysis of bank earnings posted during the five-year period, 1961-1965, revealed these developments:

1. Earnings of country banks in the district rose much faster than those of reserve city banks.
2. Bank earnings increased at a slightly faster rate in the Third District than in the nation.

Here we take a look at bank earnings and profitability and highlight the major factors responsible for the performance during the past half-decade.

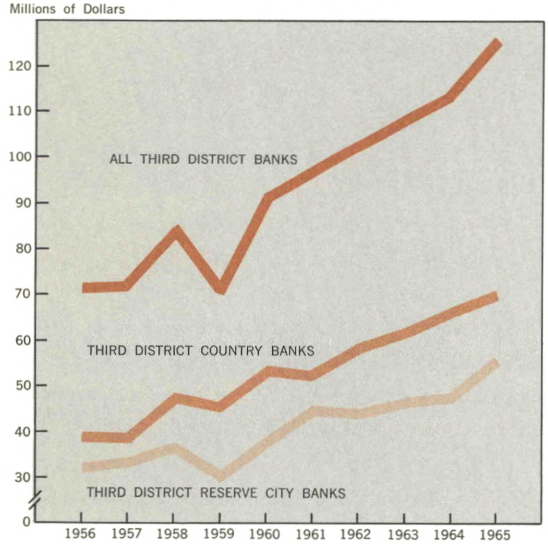
Country banks vs. Philadelphia banks

While earnings of Third District banks advanced markedly during the five-year period, as shown in Chart 1, earnings of country banks increased especially rapidly. Net income (plus change in loan-loss reserves) of country banks rose by 34

CHART 1

NET INCOME PLUS CHANGE IN LOAN-LOSS RESERVES

Third District Banks (1956-1965)



per cent, compared with 24 per cent for Philadelphia banks. The difference was even more pronounced in terms of current earnings, as shown in Table 1. For country banks and Philadelphia banks, current earnings rose 34 per cent and 13 per cent respectively.

Table 1

CHANGE IN EARNINGS OF THIRD DISTRICT BANKS

	Percentage Change	
	1956-1960	1961-1965
Country Banks:		
Net Income Plus Change in Loan-Loss Reserves	37	34
Net Income	53	37
Current Earnings Before Income Tax	17	34
Philadelphia Banks:		
Net Income Plus Change in Loan-Loss Reserves	17	24
Net Income	29	24
Current Earnings Before Income Tax	36	13

Table 2

SOURCES AND USES OF FUNDS THIRD DISTRICT MEMBER BANKS (1961-1965)

	Philadelphia Banks	Country Banks
Sources		
Increase in:		
Demand deposits	14.3%	19.7%
Time deposits	64.8	62.0
Other liabilities	7.5	2.3
Capital accounts	7.7	8.1
Decrease in:		
U.S. Government obligations	5.7	7.9
Total	100.0%	100.0%
Uses		
Increase in:		
Loans	74.7%	70.2%
Other securities	11.9	25.8
Cash assets	8.6	1.6
Other assets	4.8	2.4
Total	100.0%	100.0%

Source: Computed from Member Bank Call Reports, *Board of Governors of the Federal Reserve System, 1960-1965.*

The principal reason for these disparities seems to be interest paid on time and savings deposits. Interest expense on time deposits paid by Philadelphia banks jumped 185 per cent during the period, compared with 58 per cent for country banks.

Two factors, in turn, caused the rise in interest expense—an increased volume of time deposits and higher rates of interest paid on them. Large banks—those with deposits of $100 million or more—raised their average rate from 2.48 per cent of average time deposits in 1961 to 3.36 per cent in 1965. Smaller banks raised their rates only slightly. Meanwhile, the amount of time deposits nearly tripled at Philadelphia banks but increased only 45 per cent at country banks.

Growth of interest expense far outpaced that of current revenue from loans and securities,

Table 3

EARNINGS RATIOS
THIRD DISTRICT MEMBER BANKS
(1961-1965)

	Net Income Plus Change in Loan-Loss Reserves as Percentage of Total Capital Accounts			Net Income Plus Change in Loan-Loss Reserves as Percentage of Total Assets		
Year	Philadelphia	Country	Difference	Philadelphia	Country	Difference
1961	9.45	7.79	1.66	.96	.78	.18
1962	8.84	8.25	.59	.90	.82	.08
1963	9.10	8.26	.84	.94	.82	.12
1964	8.68	8.44	.24	.88	.83	.05
1965	9.49	8.68	.81	.92	.85	.07

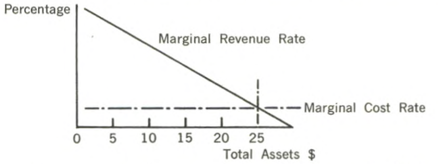
especially at Philadelphia banks. As a result, the proportion of current revenue available to cover expenses other than interest on time deposits declined during the period. In 1961 Philadelphia banks' current revenue from securities and loans amounted to 7.8 times interest expenses on time deposits, but by 1965 the ratio had dropped by one-half to 3.9. The ratio declined by a much smaller amount for country banks.

In an attempt to counter the adverse effects of higher interest expenses, Philadelphia bankers were more aggressive than country bankers in expanding loans to secure greater yields. As shown in Table 2, Philadelphia bankers placed nearly 75 cents of every dollar received during the period into loans while country bankers channeled just over 70 cents per dollar into loans. However, country bankers led in acquiring "other securities" (primarily tax-exempt municipal securities), using nearly 26 cents of each dollar for that purpose, compared with 12 cents per dollar by Philadelphia bankers.

While the net effect of these factors was that country banks increased their earnings faster than Philadelphia banks, they did not close the earnings gap completely. Philadelphia banks continued to enjoy a higher return on total assets,[1] as shown in Table 3.

Similarly, while reserve city banks had a higher rate of return on owners' equity than country

[1] *A high ratio of net income to total assets does not necessarily mean that a bank is being successful in its attempts to maximize profits (if indeed profit maximization is a goal of bank management). Actually, an increasing ratio of earnings to total assets would mean that a bank was heading toward a maximum volume of profits only if the amount of total assets was held constant. Given the realistic case of asset variability, profit maximization occurs when the return of additions to assets equals the cost of the additional assets. The diagram shows an arbitrary marginal rate of return*



curve and a marginal rate of cost curve (which was held constant for simplicity) which may exist for a bank at a given time. If, (assuming a constant rate of costs) a bank has total assets equal to $5, a high rate of return is possible. But because the highest yielding investment opportunities are used, the second $5 of assets will yield a somewhat lower rate of return. Any assets in excess of $25 cannot yield a return sufficient to cover the costs (the 26th dollar may yield 3 cents but may cost the bank 3.5 cents) so the bank has attained the maximum amount of profit when assets total $25 in this example. But the ratio of earnings to total assets declines as the bank moves toward profit maximization because the rate of return on each additional dollar is less than that of the preceding.

Table 4

CHANGE IN EARNINGS OF MEMBER BANKS

	Percentage Change	
	1956-1960	1961-1965
All Member Banks:		
Net Income Plus Change in Loan-Loss Reserves	42	30
Net Income	65	23
Current Earnings Before Income Tax	36	16
Third District Member Banks:		
Net Income Plus Change in Loan-Loss Reserves	28	30
Net Income	42	31
Current Earnings Before Income Tax	26	24

banks, the gap was closing.

Third district vs. the nation

During the period, 1961-1965, the performance of banks in the district relative to that of all member banks improved sharply from the preceding five-year period when earnings growth in the Third District had lagged far behind, as shown in Table 4.

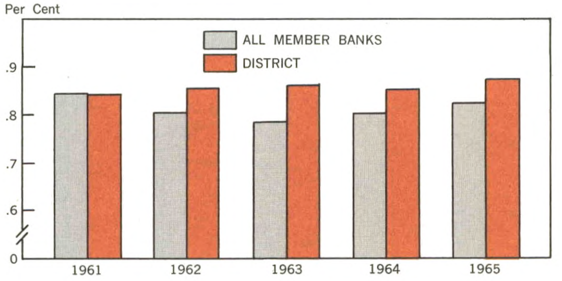
One reason for the improved performance is that Third District bankers have been among the leaders in shifting funds out of lower-yielding assets and into loans and other securities with higher after-tax income. As shown in Tables 5 and 6, liquidation of Government securities provided 6.9 per cent of the total volume of funds of district banks compared with just 4 per cent for all member banks. District banks used a larger proportion of their funds—72 per cent—for loans.

However, the average rate of return on loans and on securities in the district was among the lowest of all Federal Reserve Districts. The unfavorable effect of relatively low loan and investment yields on earnings was offset by the

CHART 2

RATE OF RETURN ON TOTAL ASSETS

All Member Banks and Third District Member Banks



ability of Third District bankers to employ their assets. For example, the ratio of earning assets to total assets of banks in the district was higher than that of banks in all other districts except one.

In 1961, profitability (net income plus change in loan-loss reserves as a percentage of total assets) was lower for banks in the Third District than for banks in any other district; but in 1965, the district ranked fifth among the 12 regions in profitability. The improved standing of Third District banks was more the result of poor performances in some of the other districts than the result of an outstanding improvement in the district. Profitability in many districts actually declined during the period; while for banks in the Third District, the ratio increased slightly from .84 per cent to .88 per cent as shown in Chart 2.

As indicated in Chart 3, the rate of return on capital in the Third District lagged behind that of all member banks in the nation partly because, in the aggregate, district banks had more capital for each dollar of assets. For example, at mid-1965, all member banks had $9.18 of capital for each $100 of total assets, but banks in the district had $9.83 of capital per $100 of assets. Capital-asset ratio values were nearly equal for reserve city and country banks in the district.

Table 5

SOURCES AND USES OF FUNDS ALL MEMBER BANKS IN UNITED STATES (1961-1965)

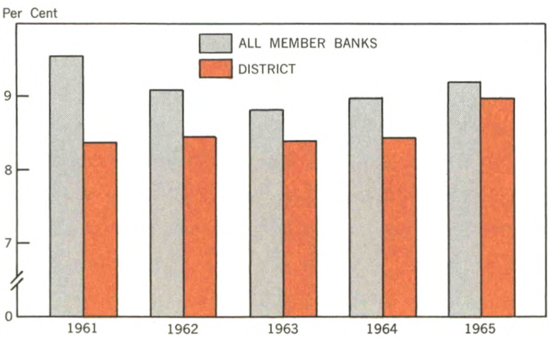
	Year 1961	Year 1962	Year 1963	Year 1964	Year 1965	Period 1961-1965
Sources						
Increase in:						
Demand deposits	42.9%			45.5%	10.9%	19.9%
Time deposits	45.6	61.6%	55.6%	44.5	58.9	60.7
Other liabilities	3.7	16.2	4.3		8.5	6.6
Capital accounts	7.8	6.3	7.2	7.9	8.6	8.8
Decrease in:						
U.S. Government obligations		5.3	17.9	2.1	13.1	4.0
Cash assets		10.6	15.0			
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Uses						
Increase in:						
Loans	34.8%	61.0%	65.9%	56.2%	79.3%	69.7%
U.S. Government obligations	26.4					
Other securities	14.5	23.3	24.6	10.3	16.6	19.7
Cash assets	20.4			28.5	0.3	6.9
Other assets	3.9	2.1	2.9	3.3	3.8	3.7
Decrease in:						
Demand deposits		13.6	6.6			
Other liabilities				1.7		
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Computed from Member Bank Call Reports, *Board of Governors of the Federal Reserve System, 1960-1965.*

CHART 3

RATE OF RETURN ON CAPITAL

All Member Banks and Third District Member Banks



The outlook

Bank earnings are of critical importance. First, earnings are the prime source of protection against insolvency of banks. In "normal" times current earnings are expected to absorb losses on loans or investments. In "abnormal" times when a heavy volume of losses occurs, earnings of previous years (in the form of reserves, surplus, undivided profits or even capital) provide the bulwark of defense against insolvency. Second, earnings represent a return on capital investment. If growth capital is to continue to flow

Table 6

SOURCES AND USES OF FUNDS THIRD DISTRICT MEMBER BANKS (1961-1965)

	Year 1961	Year 1962	Year 1963	Year 1964	Year 1965	Period 1961-1965
Sources						
Increase in:						
Demand deposits	39.0%			44.1%	9.3%	17.1%
Time deposits	50.4	58.0%	51.8%	45.0	56.6	63.3
Other liabilities		10.6	10.6		7.1	4.8
Capital accounts	10.6	5.8	9.1	3.9	5.1	7.9
Decrease in:						
U.S. Government obligations			17.6	7.0	21.9	6.9
Cash assets		25.2	10.9			
Other assets		0.4				
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Uses						
Increase in:						
Loans	42.6%	64.3%	58.3%	50.8%	77.5%	72.4%
U.S. Government obligations	32.1	0.3				
Other securities	5.4	17.1	26.7	14.4	12.4	19.0
Cash assets	15.7			28.4	2.3	5.0
Other assets	2.2		2.1	1.8	7.8	3.6
Decrease in:						
Demand deposits		18.3	12.9			
Other liabilities	2.0			4.6		
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Computed from Member Bank Call Reports, *Board of Governors of the Federal Reserve System, 1960-1965.*

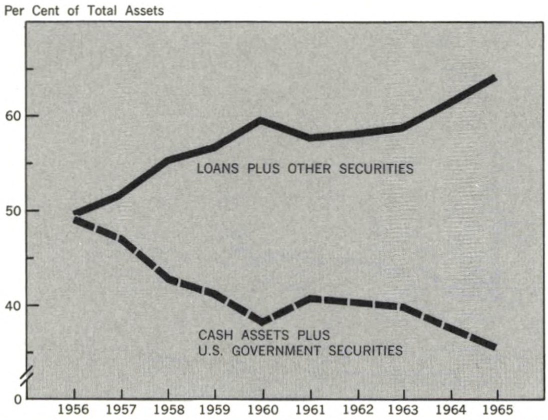
into the banking system, an adequate rate of return has to be realized on stockholders' equity. If earnings are insufficient to provide an acceptable return, the privately owned banking system is in jeopardy. Therefore, the earnings performance of banks is of wide concern.

During the last five years of widely heralded prosperity, bank earnings generally failed to grow as vigorously as in the last half of the 1950's. Will still slower growth prevail in the future? One cannot forecast future bank earnings precisely because they are affected by a myriad of factors, many of which are unpredictable. But it does appear that bank management is now in a less flexible position to counter future unfavorable influences within the traditional context of commercial banking. There is, for example, a practical limit to redistributing assets in search of higher yields to cover increased costs. In the last ten years, Philadelphia banks have reduced the proportion of U.S. Government securities from about 17 per cent of total assets to just under 9 per cent, while increasing loans from 48 per cent of total assets to 59 per cent.

CHART 4

ASSET DISTRIBUTION

Third District Member Banks



How much longer can the trends depicted in Chart 4 continue?

In search of greater profit opportunities for the future, some banks have already launched into enterprises such as direct leasing, credit card operations and computer services which are outside the traditional sphere of banking. These and other new activities may provide a hedge against any future decline in the growth of earnings from loans and investments.

THE CONCEPT OF BANK EARNINGS

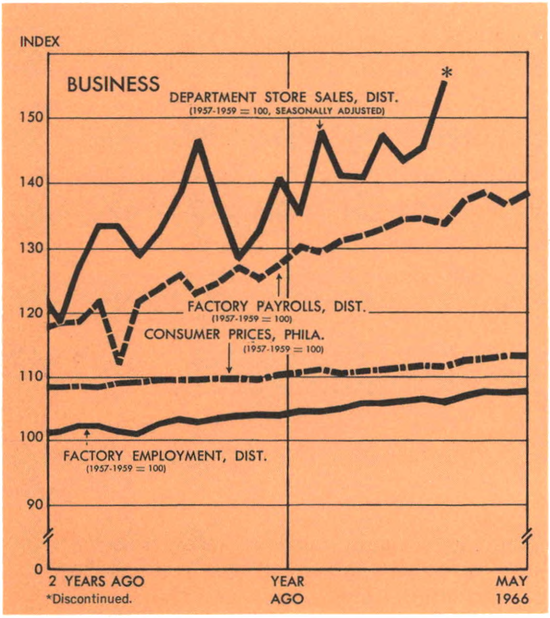
Bank earnings obviously represent the excess of revenues over expenses. But there are three concepts of bank earnings which may be useful in an analysis of bank profitability. One is called "current earnings" and is used to describe the difference between so-called current revenues (such as interest on loans and investments, service charges and various other fees) and certain expenses which include wages and salaries, interest on borrowed money and time deposits and occupancy expenses. This concept of earnings concerns revenues and expenses which result from a bank's regular operating activities. However, it ignores such items as gain or loss from sale of securities, losses on loans, recoveries of previously charged-off loans and income taxes.

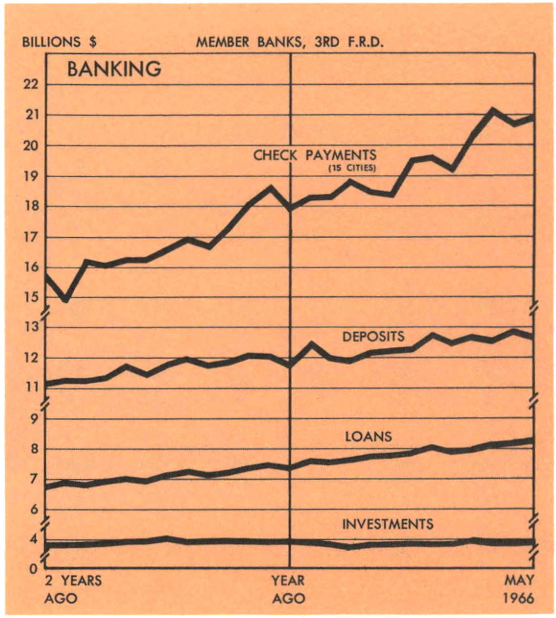
A more inclusive concept of earnings called net income includes the effects of such nonrecurring items as profits and losses on securities along with recoveries and charge-offs of assets. Net income gives a better indication of the financial results of a bank's total operations during a given period of time than does current earnings. However, net income is not a precise measure of bank earnings because of the effect of changes in valuation reserves. Most banks maintain an account (called "reserve for loss on loans," or something similar) to which transfers are made from current revenue.* Since 1947 under regulations prescribed by the Internal Revenue Service, banks have been permitted to transfer annually to loan-loss reserves a tax-deductible amount which has exceeded actual losses on loans at most banks. Consequently, on a current basis, these transfers have resulted in understating profit and reducing income taxes. Therefore, reported net income of banks after loan-loss reserves has been unrealistically low.

In order to secure a more complete measure of bank earnings, it is necessary to add net changes occurring in loan-loss reserves during a given year to net income reported for that year. All three concepts of earnings—current earnings, net income and net income plus changes in loan-loss reserves—are used in this analysis.

**Some banks do not use a reserve for loss on loans, preferring instead to charge off losses against revenue in the year in which losses occur. In the Third District, 74 per cent of the member banks used loan-loss reserves in 1965 compared to 69 per cent in 1960. However, data indicate that the loan-loss reserve method is used by about 60 per cent of banks having deposits of less than $10 million and by almost 100 per cent of banks with deposits of $20 million or more.*

FOR THE RECORD . . .





SUMMARY	Third Federal Reserve District, Per cent change, May 1966 from mo. ago	year ago	5 mos. 1966 from year ago	United States, Per cent change, May 1966 from mo. ago	year ago	5 mos. 1966 from year ago
MANUFACTURING						
Production	....	....	....	+ 1	+10	+10
Electric power consumed	+ 4	+12	+10	....	....	....
Man-hours, total*	+ 1	+ 5	+ 6	....	....	....
Employment, total	0	+ 4	+ 3	....	....	....
Wage income*	+ 1	+ 9	+ 9	....	....	....
CONSTRUCTION**	−10	+ 1	− 4	+ 1	+ 5	+ 9
COAL PRODUCTION	+51	+ 2	− 3	+37	+ 3	+ 2
BANKING						
(All member banks)						
Deposits	− 1	+ 8	+ 6	− 1	+ 8	+ 8
Loans	+ 1	+12	+10	+ 1	+13	+13
Investments	0	− 1	− 1	− 2	+ 1	+ 1
U.S. Govt. securities	− 1	−10	− 9	− 4	− 9	− 8
Other	+ 3	+11	+11	+ 1	+13	+12
Check payments***	− 2†	+14†	+15†	− 2	+20	+16
PRICES						
Wholesale	....	....	....	0	+ 3	+ 4
Consumer	0‡	+ 3‡	+ 2‡	0	+ 3	+ 3

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

LOCAL CHANGES — Standard Metropolitan Statistical Areas*	Manufacturing: Employment, Per cent change May 1966 from mo. ago	year ago	Manufacturing: Payrolls, Per cent change May 1966 from mo. ago	year ago	Banking: Check Payments**, Per cent change May 1966 from mo. ago	year ago	Banking: Total Deposits***, Per cent change May 1966 from mo. ago	year ago
Wilmington	+ 1	+ 4	− 1	+ 4	+ 6	+30	−13	− 6
Atlantic City	....	....	....	....	− 7	+11	0	+11
Trenton	0	− 1	+ 1	+ 3	− 4	+ 2	+ 1	+15
Altoona	+ 1	+13	− 4	+11	− 8	+ 7	− 1	+ 8
Harrisburg	+ 1	+ 6	+ 3	+10	− 4	+12	− 2	+10
Johnstown	+ 1	+ 2	− 2	+ 2	− 2	+10	+ 1	+ 4
Lancaster	0	+ 9	+ 1	+18	+ 2	+15	0	+11
Lehigh Valley	0	+ 2	+ 1	+ 5	− 3	+16	0	+ 6
Philadelphia	0	+ 4	+ 1	+11	− 4	+10	− 2	+ 8
Reading	0	+ 3	− 1	+ 8	− 6	+11	− 1	+12
Scranton	+ 2	+ 6	+ 5	+14	− 1	+16	− 1	+ 9
Wilkes-Barre	+ 1	+ 6	+ 5	+15	− 2	+11	− 1	+ 5
York	+ 2	+ 5	+ 4	+13	− 2	+12	0	+ 6

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.