BUSINESS REVIEW

April 1969

FEDERAL RESERVE BANK OF PHILADELPHIA

1966-67: Will History Repeat?

U. S. Trade position Deteriorated As
Balance of Payments Improved in 1968

Booming Bank Earnings

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1966-67: Will History Repeat?

. . . Conditions in 1966-67 may offer some lessons for monetary and fiscal policy in 1969.

Booming Bank Earnings

. . . Third District member banks scored impressive earnings last year in spite of rising costs. Also, in 1968 District banks showed greater profitability than the average for all member banks.

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1966-67: Will History Repeat?

by Warren J. Gustus and Sheldon W. Stahl

Recent actions by the Federal Reserve System to raise both the discount rate and reserve requirements draw anew the public's attention to the battle being waged against inflation. On the fiscal side, the new Administration has urged stringent economies in federal spending, has detailed proposed cuts of about $4 billion for the fiscal year 1970 budget, and has advocated extension of the income surtax for an additional year beyond the current June 30th expiration date, although at a reduced rate beginning January, 1970. This reduction depends upon acceptance of another proposal–rescinding the 7 per cent investment tax credit. These moves are designed to achieve a sizeable surplus in the federal budget for fiscal year 1970.

Fiscal policy must, of course, address itself to the difficult problem of inflation. With the enactment of the surtax last year, along with efforts to trim Federal expenditures in fiscal 1969, the budgetary position did, in fact, show a large shift from a sizeable first-half 1968 deficit to a small surplus at year-end. A larger surplus is in prospect for the first-half of calendar 1969. And, as noted above, President Nixon is determined to press for an even larger surplus for fiscal year 1970. Despite, however, this determination to trim spending, the nation's pressing domestic needs and the requirements of national defense will make any sizeable economies in spending difficult to achieve. If such economies are realized, some impact may likely be felt late in 1969. Their major impact, however, probably will not be felt until the first half of calendar 1970. On balance, then, for the remainder of 1969, fiscal policy appears to offer only modest promise of heightened restraint beyond that associated with rising tax receipts generated by growth in the economy.[1]

[1] Although difficult to quantify, mention should be made of the expectational effects which the Administration's tight budget posture might have in postponing or restricting non-federal spending.

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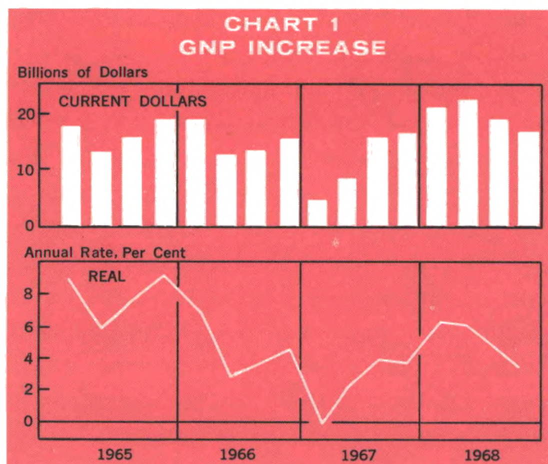

This overall fiscal outlook and the persistence of inflation still mean that heavy reliance will be placed on monetary policy as a near-term weapon to restrain an overheated economy. Monetary authorities have been charged with this role on a number of earlier occasions. Particularly, in late 1965 and through much of 1966 the Federal Reserve System aggressively pursued a policy of monetary restraint. This experience, therefore, is of particular interest today. But to understand 1966, it is necessary to backtrack to mid-1965.

BACKGROUND TO RESTRAINT

By mid-1965, the economy had moved a considerable distance from the trough of the 1960-1961 recession toward full employment. Growth had been essentially balanced among the major sectors of the economy and was accomplished with relative stability in prices. However, the prospects for further orderly progress to full employment were abruptly changed on July 28, 1965 with the announcement of a greatly expanded military commitment to Vietnam.

Increased defense spending was superimposed on already strong private demands, especially for business investment. From mid-1965 through the first quarter of 1966, real gross national product (GNP), shown in Chart 1, grew at an annual rate of more than 7 per cent. This surge in activity came when much of the slack in resources, both from earlier slow economic growth of the 1950's and from the short 1960-1961 recession, had been absorbed. Earlier price stability gave way to more rapidly rising prices both at wholesale and for consumers. From the middle of 1965 onward, then, the need for fiscal and monetary restraint became increasingly obvious.

DIMENSIONS OF RESTRAINT

Beginning in late 1965, exclusive of open market operations, the Federal Reserve took a series of major steps to slow down the overheated economy. Among these were a half percentage point hike in the discount rate, two increases in reserve requirements against time deposits, and issuance of the September 1st letter. Except for the last step, these actions were general in nature, aimed at decreasing reserve availability or raising the cost of securing additional reserves. The September 1st letter called for ". . . a slower rate of expansion of bank loans to business within the context of moderate over-all money and credit growth."[2]

From January to June of 1966, seasonally adjusted bank reserves grew at an annual rate of $1.5 billion—more than the $1.1 billion gain in all of 1965. However, in the third quarter, a sharp turn-around occurred. Reserves actually declined by $620 million.

In spite of attempts to coordinate the use of various policy tools, at times during July and August, 1966, a liquidity crisis seemed

[2] The letter noted that the ". . . exceedingly rapid business loan expansion is being financed in part by liquidation of other banking assets and by curtailment of other lending in ways that could contribute to disorderly conditions in other credit markets."

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imminent. Securities markets approached the disorderly—a situation characterized by exceedingly thin markets and rapidly declining securities prices. In early September of 1966 a credit crunch finally developed.

For the first time since the expansion had begun, fiscal policy, too, moved in the direction of restraint. The Government raised Social Security taxes, instituted graduated withholding, accelerated payments of corporate income taxes, and partially rescinded excise tax cuts made in 1965. Finally, late in the year, it suspended the 7 per cent investment tax credit as an interim measure to restrain plant and equipment spending. Nevertheless, the overall budgetary position moved from a small surplus to a small deficit at year-end. And, early in 1967, the budget deficit rose sharply. So, the dominant weapon against inflation in 1966 was monetary policy.

A number of postmortems have been held since then. In spite of disagreements about the costs and benefits of restraint, it is clear that even with escalation of the war in Vietnam, inadequate fiscal restraint, and the continuing capital boom, monetary policy from May to November of 1966 did succeed in moderating the expansion.

THE ECONOMY'S RESPONSE

Following the rapid GNP gains from mid-1965 through the first quarter of 1966, the rate of increase dropped off by about one-fourth during the remainder of the year, and was about in line with the economy's real potential. The cooling-off was reflected in the performance of a number of key economic indicators, including a slower increase in consumer prices and a leveling of industrial commodities prices at wholesale.

The burden of restraint fell most heavily on the homebuilding industry. And, the impetus from heavy defense spending and from capital outlays contributed substantially to a high level of inventory investment. As consumer expenditures softened in the last quarter of 1966, an involuntary element was added and inventories grew at the fastest pace since the Korean War. It was this tremendous overhang of inventories which played such a key role in both the first and second quarters of 1967, when the lagged impact of monetary policy hit the economy with its full force. In anticipation of this emerging danger of weakness, late in 1966 the monetary authorities again shifted their stance—this time toward ease.

POLICY, 1967-1969

A turn-around in growth of bank reserves, bank credit, and the money supply took place. These variables grew substantially through early 1968. This occurred, despite an increase in reserve requirements and in the discount rate during the fourth quarter of 1967.[3] Both these actions were taken to counter the persistent inflation, and because expected fiscal relief had failed to materialize. In early 1968, the discount rate was raised twice. But this time, it was followed by a virtual cessation of growth in bank reserves, and a sharp drop in the rate of growth of bank credit during the April-June period.

This was short-lived, however, as monetary policy moved to an accommodative posture following the imposition of the surtax in June, 1968. In anticipation of moderation in the rate of economic activity, the Federal Reserve permitted bank reserves to grow at close to a 9 per cent annual rate during the second half of 1968. In spite of high and rising interest rates, banks clearly were being pinched not by lack of reserves, but rather by growing demands for funds. Some of this demand was perhaps in anticipation of still higher interest

[3] The increase in reserve requirements announced on December 27, 1967, was effective in January, 1968.

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rates, and in recognition of the implications for real borrowing costs of price increases at more than a 4 per cent annual rate.

In retrospect, the economy turned out to be stronger than expected, and monetary ease in the latter half of 1968 proved to be inappropriate. The effects of this ease are still being felt in 1969, as evidenced by the $16.0 billion gain in GNP during the first quarter of this year.

Some would read the behavior of interest rates throughout 1968 and into 1969 as suggesting similar underlying conditions in both periods. However, circumstances have changed drastically on the supply side. During the first quarter of 1969, growth in bank reserves was at a rate of less than 1 per cent a year. Current estimates for April indicate that reserves declined. In addition, the recent hike in the discount rate and the increase in reserve requirements will further increase pressures on the banking and financial community. The stringency now being observed in almost all credit and capital markets is no longer so much the result of demand factors—although they are still important—but of increasing pressures on the supplies of funds.

Judged by such things as bank reserves, bank credit, and money supply, Federal Reserve policy has moved about as sharply in 1969 as during the second half of 1966. As the table indicates, growth in bank reserves, bank credit, and the money supply decelerated between the second and fourth quarters of 1966. The speed of the turn-around is part of the explanation for the credit crunch that occurred, since financial institutions and markets were unable to effect a smooth adjustment. In 1969 the turn-around has been equally fast, but significant differences do exist. In particular, banks and thrift institutions, although under pressure, have been able to adjust more smoothly.

Thrift institutions. Thrift institutions were under extreme pressure in 1966 when they lost funds both to commercial banks and to the money and securities market. Since then, because of administration of ceiling rates on savings, thrift institutions have been at less of a disadvantage relative to commercial banks. Although banks and thrift institutions still face competition from market-type investment alternatives, even in this respect they have fared somewhat better than in 1966.

One reason may be that most of the highly interest-sensitive money is no longer on deposit in the thrift institutions. A second reason is that the institutions themselves have taken steps to increase liquidity. Despite relatively large outstanding commitments compared with cash flows, increased holdings of marketable instruments and expanded borrowing capacity have thus far given them a measure of protection not available in 1966. A third reason is the higher volume of personal savings. Although thrift institutions acquired a decreased share of these savings during 1967 and 1968, the relative decline was less disruptive than it otherwise might have been because of the unusually large flows of household savings in these years.

Selected Financial Variables
Annual Rates of Change (s.a.)

		Member Bank Reserves	Member Bank Credit*	Money Supply
1966	1	4.4%	5.4%	5.8%
	2	4.5	7.3	3.1
	3	– 1.4	2.1	0
	4	– 2.9	– 1.5	– 0.2
1967	1	16.9	15.4	6.6
	2	4.0	8.7	6.5
	3	11.3	13.7	7.0
	4	5.8	7.2	4.9
1968	1	10.5	7.0	4.6
	2	0.2	1.2	8.7
	3	9.0	13.1	4.5
	4	8.8	12.2	7.6
1969	1	0.9	– 5.7	2.3

(s.a.)—Seasonally adjusted

*Because of data availability considerations, estimates of member bank credit are based on changes in member bank deposits.

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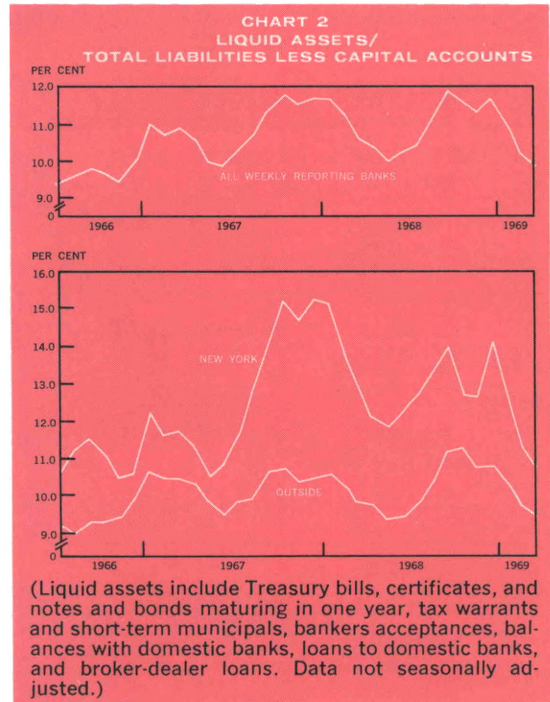
With these institutions in a better position than they were in 1966, the dangers of a liquidity crisis are diminished. Even so, mortgage markets are under pressure now as they were then, and housing may again be one of the areas hardest hit by restraint, despite liberalization of usury ceilings. Part of the reason for this is that current usury ceilings and other controls designed to provide funds to homeowners at "reasonable" rates again have been outpaced by market developments.

Commercial banks. Another development in the recent period has been the increased resourcefulness of large money market banks in finding ways to obtain additional reserves or economizing in the use of existing reserves. For example, the run-off of negotiable C.D.'s in the last half of 1966 was 15 per cent. In the first quarter of 1969, however, an even larger run-off—20 per cent—has, in part, been compensated for by various devices. Banks have borrowed Euro-dollars in increased amounts, sold participations in loan portfolios, endorsed customer paper to create money market acceptability and relieved themselves of the need to make a loan to the customer.

But contrary to a fairly widespread impression, access of large banks to these sources of funds has not meant that the policy of restraint has been vitiated. While some of these devices enable individual banks to obtain reserves, they do not enlarge the total pool of reserves available to the banking system. Although the impact of tightening may be protracted somewhat for some banks, the practical effect is that the transition for the banking system from easier monetary conditions to tighter conditions may be effected more smoothly. Clearly, while banks have been able to adjust to a sudden and sharp turn-around in policy, they have not been able to escape its impact.

Signs of that impact are now unmistakable. During the first quarter of 1969, bank credit declined at an annual rate of about 6 per cent. Growth in the money supply, although positive, was only at about a 2 per cent annual rate. And as Chart 2 indicates, bank liquidity, both in the New York money market banks and outside, has declined to levels approaching the 1966 lows.

CHART 2
LIQUID ASSETS/
TOTAL LIABILITIES LESS CAPITAL ACCOUNTS



(Liquid assets include Treasury bills, certificates, and notes and bonds maturing in one year, tax warrants and short-term municipals, bankers acceptances, balances with domestic banks, loans to domestic banks, and broker-dealer loans. Data not seasonally adjusted.)

DIFFERENCES IN THE REAL ECONOMY

A complete explanation of both these periods —1966-67 and 1968-69—is obviously more complicated than this review indicates. It would most certainly have to include such factors as mistaken forecasts, especially early estimates of the anticipated costs of the war in Vietnam. Gross mis-estimation of those costs and subsequent mistaken economic projections provided the rationale for the policies which followed.

To be sure, in some ways 1969 is like 1966. Labor markets were tight then and are tight now. Cost pressures on prices characterize both

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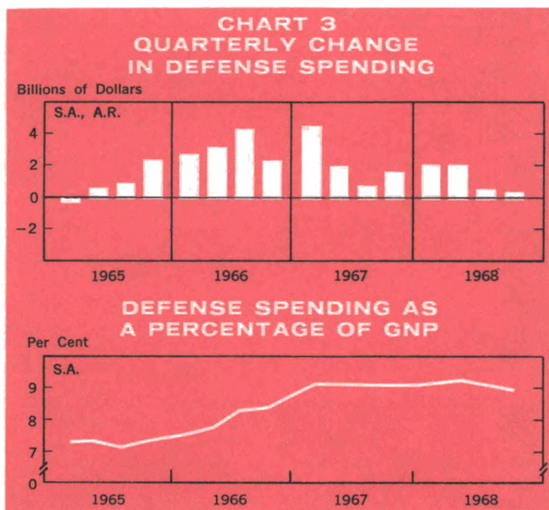
periods. Aggregate demand was strong in 1966 and appears to be strong in 1969. Beyond the aggregate, however, differences do exist.

In 1966, defense spending (shown in Chart 3) was, with the exception of the fourth quarter, tracing a sharply rising curve. It was, in fact, a major propelling force in the economy. Since then, despite further increases in defense outlays, their rate of growth has moderated sharply. With the exception of the military pay hike in the second half of 1969, defense outlays are expected to change little or possibly decline. Thus, a major inflationary element present in 1966 is not likely to be present in 1969.



This has further implications for another important sector of the real economy—capital spending. This year, outlays for plant and equipment are projected to rise nearly 14 per cent, little below the rate of increase posted in 1966. In this respect, capital outlays would appear to have a major stimulative role this year, as in 1966. However, there are some fundamental differences. In 1966, manufacturers were straining capacity to keep up with aggregate demand. They clearly needed additional investment for purposes of adding to capacity and to meet defense orders. In 1969, they face excess capacity, rather than inadequate capacity. If moderation in aggregate demand can be achieved and if the inflationary psychology can be changed, two key incentives to capital investment will have been removed.[4]

CONCLUSIONS

The current situation is enough like that of 1966 to be of some concern; it is enough unlike it to be of considerable puzzlement.

In the real sector of the economy, unlike 1966, defense spending will not be rising and manufacturers will have substantial excess capacity. This offers hope that excessive demand may be more tractable to restraint. More than offsetting these advantages is that inflation is now in its fifth year. In 1966, it was a relatively new phenomenon. Strong monetary medicine to halt the newly arrived inflation of 1966 gave way in the face of the threat of recession. With inflation now so deeply embedded in the economy, it is even more unlikely that it could be halted quickly.

Without question, expectations about the inevitability of inflation must be changed. Cost increases already built into the economy have to be worked out. Final demand has to be moderated. But all of these take time, as evidenced by the vigor of the economy so far in 1969.

Granting all this, how gradual has been the restraint? Judged by real economic indicators, restraint since the end of 1968 has been gradual indeed. Another way of judging gradualism is in terms of the smoothness of adjustments of the financial system to policy changes. By this standard, too, this has been a period of gradualism. But judged by the standards of growth in money, credit and bank reserves, standards more relevant for forecasting activity in the months ahead, a different conclusion must be drawn.

[4] Rescinding the investment tax credit would have only minimal impact on 1969 outlays.

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In the financial sector of the economy, there are indications that institutions and markets are better protected against a crunch than they were in 1966. But the slowdown from fourth-quarter 1968 to the present in growth of bank reserves, bank credit, and the money supply bears considerable resemblance to 1966.

One observation, based on the real economy, is that, although we have had monetary restraint, it has not been enough. We need to step harder on the brakes. Another—and what seems a more plausible one—is that much of the current economic strength is a result of the expansive monetary policy of 1968.

It will still be some months before the full impact of last year's fiscal restraint, and the restrictive policies—monetary and fiscal—of 1969 are fully felt. As noted earlier, fiscal restraint may well be biting more heavily late this year and early next year. An important lesson that 1966 demonstrates, and one which the real economy in early 1969 corroborates, is the lagged response to stabilization policy. Given the prospect of heightened fiscal restraint some months down the line, the lesson of 1966-67 for gradualism in monetary policy is all the more relevant.

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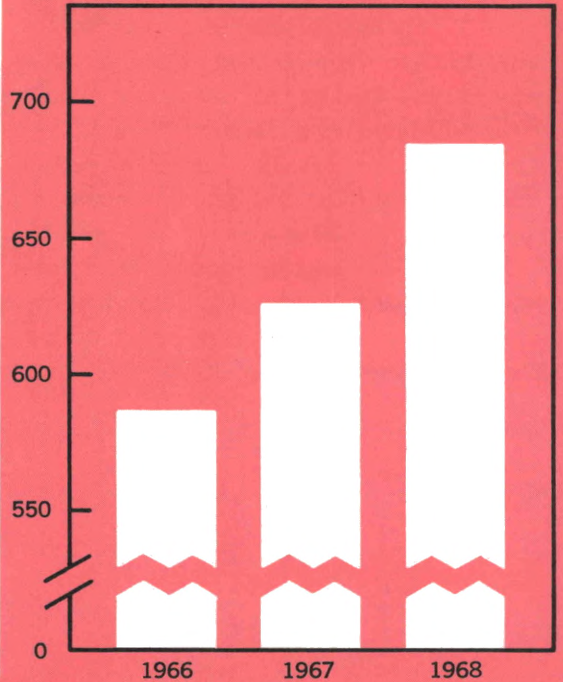
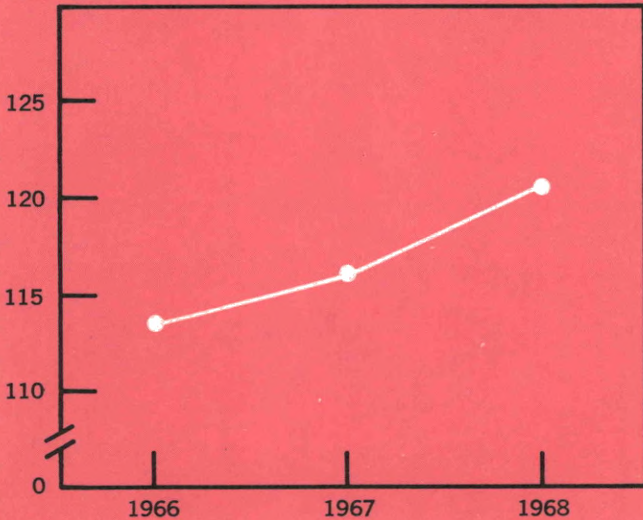
U.S. TRADE POSITION DETERIORATED AS BALANCE OF PAYMENTS IMPROVED IN 1968

by MARLENE G. DOAK



Record incomes . . .



and rising prices . . .

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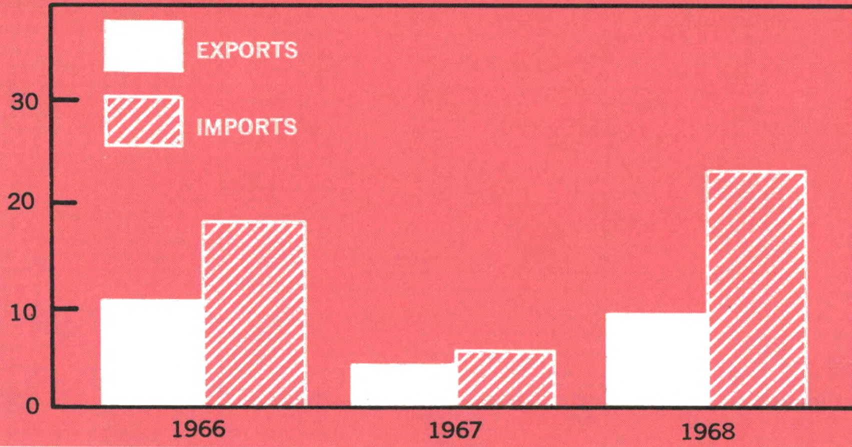
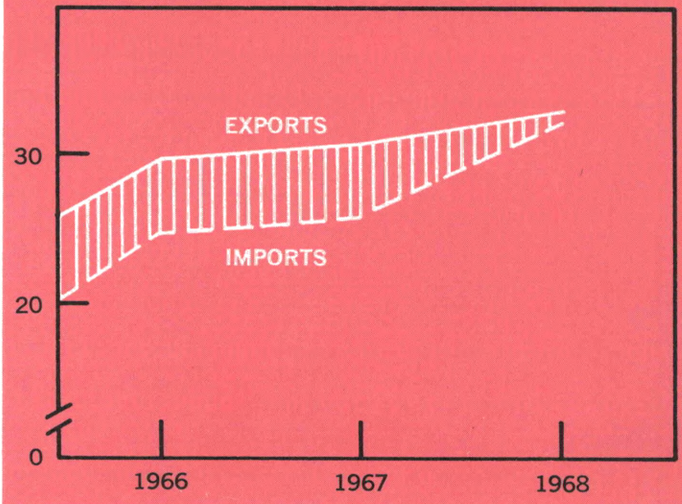
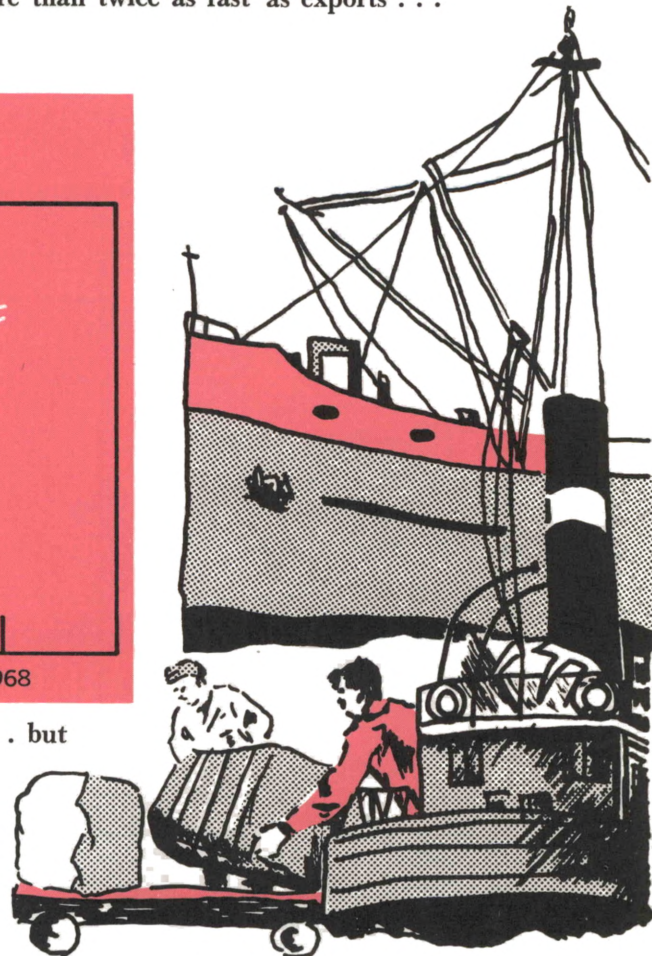


caused imports to rise more than twice as fast as exports . . .



thus nearly erasing the trade surplus . . . but



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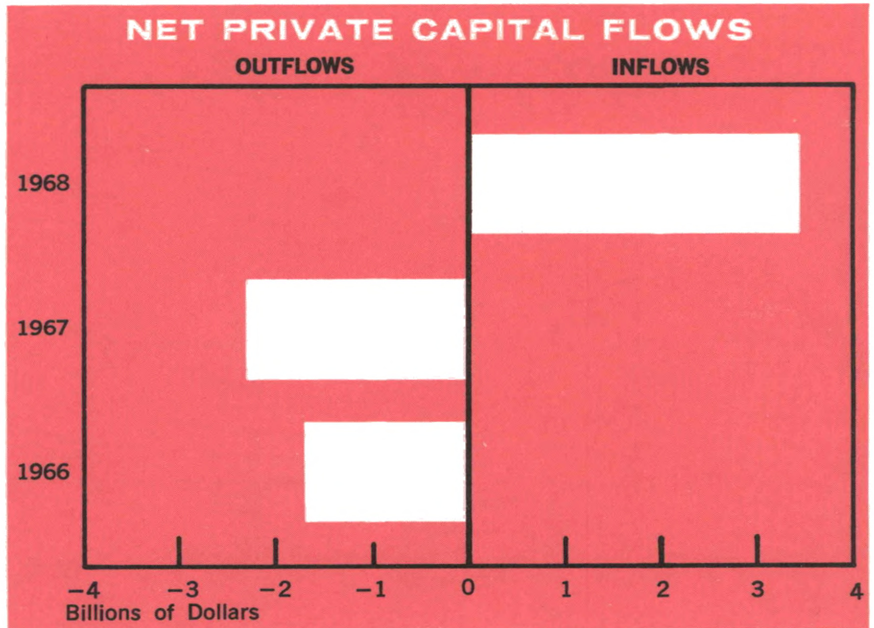
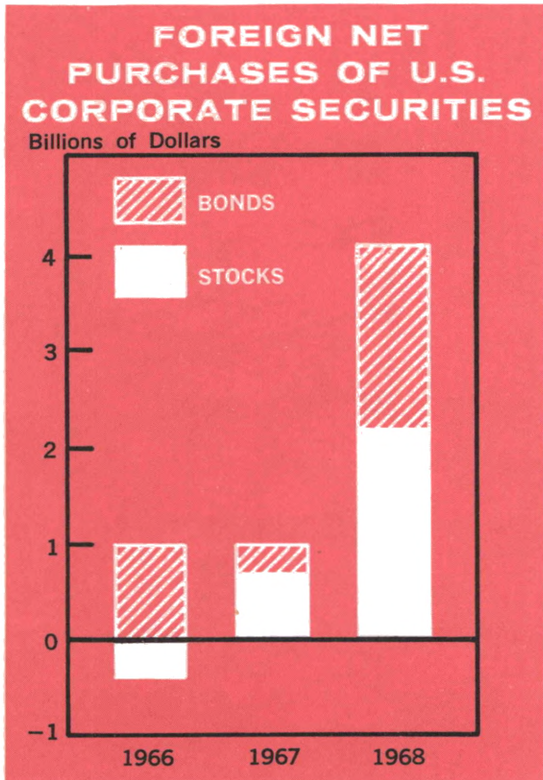


the reversing of net capital outflows . . .



in large measure because of stepped-up foreign purchases of U.S. securities . . .

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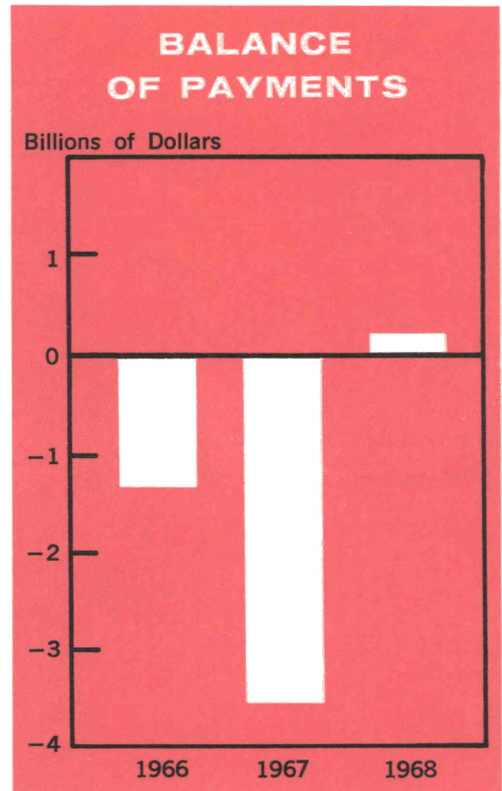

wiped out the balance of payments deficit in 1968.

But last year's overall improvement in the balance of payments was precarious. The net capital inflow was the first in nearly a quarter of a century, and it easily could be reversed in succeeding years. Hence, a more enduring foundation for international equilibrium is a favorable balance of trade. Excessive economic growth with accompanying inflation in 1968, however, generated rapid increases in imports and discouraged exports—causing a further deterioration in the U.S. trade balance. Some moderation in the rate of economic advance to restore a measure of price stability is, therefore, as essential for international balance as it is for domestic well-being.

Source: U.S. Department of Commerce

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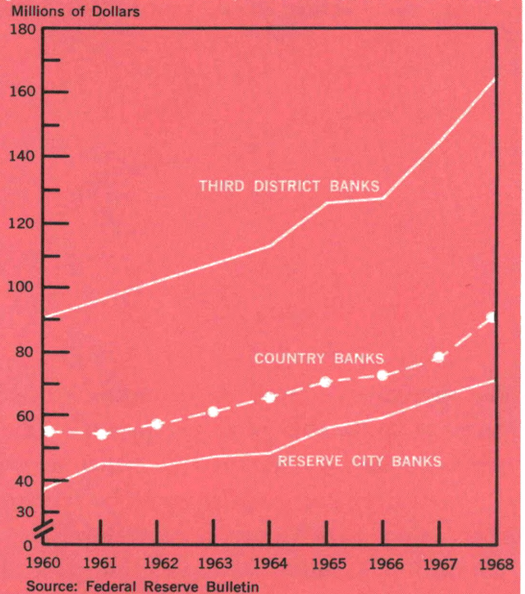
Booming Bank Earnings

by Susan R. Robinson

Net income of Third District banks soared 12 per cent during 1968, continuing a growth trend which has existed throughout the 1960's, as shown in Chart 1. Country banks, which had trailed Philadelphia banks in return on both assets and capital in the past, scored greater gains in profitability than their larger colleagues did last year. Banks in the Third District outperformed all Federal Reserve member banks as a group in terms of profitability.



Since the end of 1965, banks have been operating in an inflationary environment. Heavy demands for credit and high interest rates have boosted bank revenues. During the past three years, however, banks also have faced increasing costs, particularly interest paid on time deposits. Nevertheless, revenues have outstripped expenses, causing impressive gains in bank earnings during this inflationary period.

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SOURCE OF REVENUE GAINS

In 1968, as in previous years, growth in revenues of Third District banks was sparked by a shift from non-earning and low-yielding assets into higher-yielding ones. At the end of last year, cash and U.S. Government securities at Philadelphia banks accounted for 22 per cent of assets—down from more than 40 per cent seven years ago. Meanwhile, loans and other securities (primarily tax-exempt debt of state and local governments) rose to over 68 per cent of total assets from about 55 per cent in 1961. Country banks have experienced a similar but slightly less pronounced shift in assets.

Rapidly climbing interest rates also have helped boost revenue of banks in recent years. Average rates on 3-month Treasury bills hit record highs in 1968 and yields on municipal bonds, as measured by the Dow Jones Yield Index, set a 35-year record at the end of 1968. As a consequence of high interest rates, District banks received more revenue from each dollar of loans and investments than in the previous years.

EXPANDING COSTS

Impressive as it was, earnings performance of District banks would have been even better in 1968 had costs not risen so sharply. For example, wages, salaries, and fringe benefits at District banks jumped 11.6 per cent last year —more than three times the annual rate of growth recorded over the previous 6 years.

But the biggest cost item for banks in the District in 1968, as in prior years, was interest paid on time and savings deposits. Over the past decade, time deposits have had a two-pronged impact on costs as both the volume of these deposits and the interest rates paid on them have increased. During the period 1966-1968, time deposits grew at an annual rate of 12 per cent at country banks and almost 18 per cent at Philadelphia banks. The interest paid for each dollar of time deposits jumped, too. Philadelphia banks paid 4.68 cents for each dollar of time deposits in 1968, against only 2.62 cents in 1961. For the first time during the 1960's, the rate paid by country banks on time deposits grew even more rapidly than that paid by reserve city banks. For all Third District banks, interest on time deposits averaged 32.5 per cent of expenses during the first half of the decade. But as anti-inflationary actions of monetary authorities and heavier demand for credit began to be felt in 1966, interest on time deposits rose faster than other expenses. It has averaged 42.6 per cent of expenses over the last three years.

COUNTRY BANKS VS PHILADELPHIA BANKS

Over the years, profitability of country banks has lagged that of Philadelphia banks.[1] But during the past three years the profitability gap was closed as country bankers outscored their city counterparts. As shown in Chart 2, return on capital has grown at an annual rate of 6 per cent for country banks and 4.8 per cent for reserve city banks since the Federal Reserve began to attack inflation at the end of 1965. Return on assets of country banks jumped 3.5 per cent a year from 1966 to 1968, while profitability of city banks inched up only 1.8 per cent a year, as shown in Chart 3.[2]

Country banks were able to boost return on capital faster than Philadelphia banks because they had a higher return on assets and because they increased the amount of assets supported by each dollar of capital more than did city banks. Net income grew faster relative to total assets for country banks than for city banks, resulting in a higher return on assets.

[1] For a look at bank earnings during the first half of the 1960's, see William F. Staats, "The Changing Profitability Gap," *Business Review*, Federal Reserve Bank of Philadelphia, July, 1966.

[2] Return on capital is the ratio of net income (adjusted for changes in loan-loss reserves) to average capital accounts, and return on assets is net income relative to average total assets.

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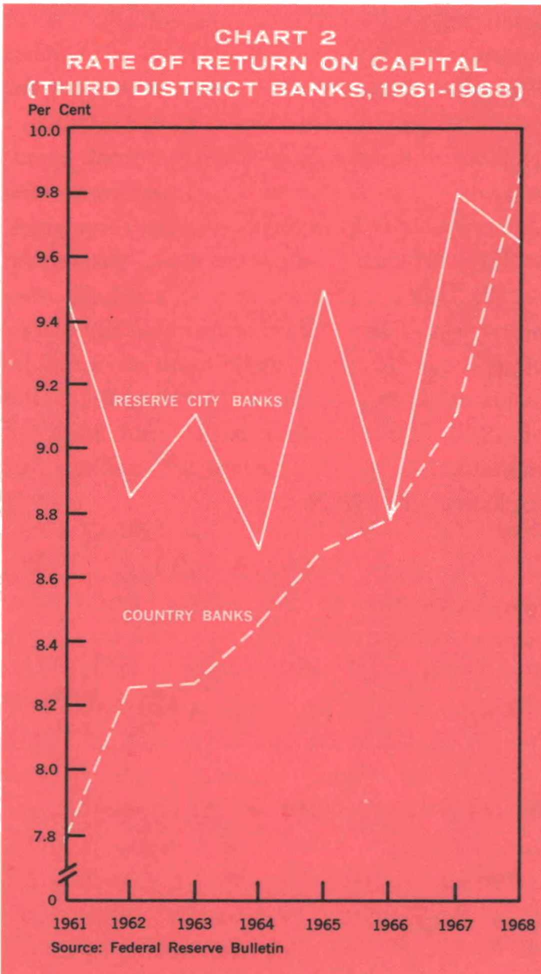
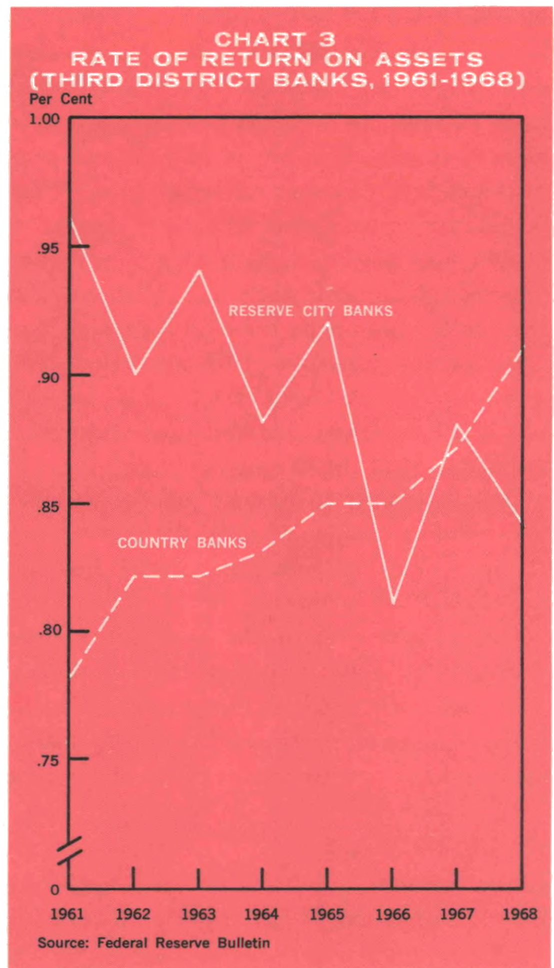
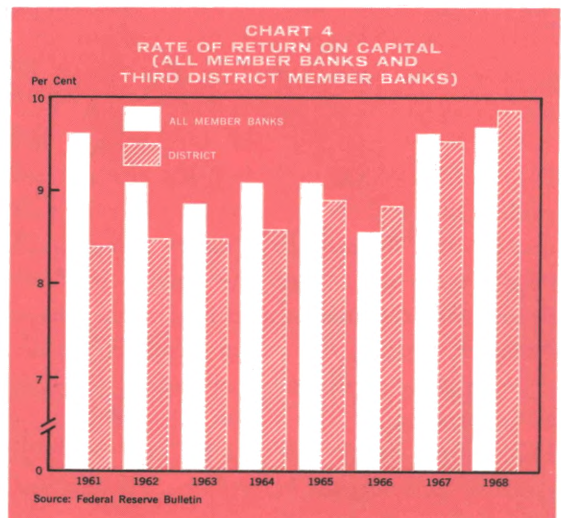




THIRD DISTRICT VS. THE NATION

In 1966, for the first time in the decade, Third District banks chalked up a higher rate of return on capital than did all member banks in the Federal Reserve System, as shown in Chart 4. The Third District banks also led all member banks in return on assets, largely because banks in the District had a higher proportion of earning assets to total assets.

District banks also had a larger percentage of higher-yielding assets than did all member banks and were more aggressive in moving funds into these assets. In the past three years, loans plus other securities increased from 68.8 per cent



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of total assets of District banks to 71 per cent, while for all member banks the proportion increased only from 66.8 to 67.6 per cent. Moreover, the proportion of U.S. Government securities plus cash assets in balance sheets shrank more for Third District banks than for all member banks.

As shown in the sources and uses tables, Third District banks put over half of their net new funds into loans during the 1966-1968 period, while all member banks channeled about 44 per cent into loans. Also, District banks used a smaller proportion of net new funds to build up cash assets than did all member banks.

Although local banks had a more profitable asset mix, they did not achieve as high a rate of return on each type of asset as did all member banks. For example, average return on securities was 4.02 per cent for District banks in 1968—18 basis points less than the return for all banks. Also return on loans was lower and grew more slowly in the District during the last three years.

The high rate of return on assets chalked up by Third District banks would have been even more impressive from the bank shareholders' viewpoint if their aggregate ratio of capital to assets had been lower. For example, at the end of 1968, Third District banks held $8.82 of capital for each $100 of assets, while all member banks had only $8.26.

SOURCES AND USES OF FUNDS
Third District Member Banks

	Year 1961	Year 1962	Year 1963	Year 1964	Year 1965	Year 1966	Year 1967	Year 1968	Period 1961-1965	Period 1966-1968
Sources										
Increase in:										
Demand deposits	39.0%			44.1%	9.3%	11.8%	34.8%	34.5%	17.1%	35.3%
Time deposits	50.4	58.0%	51.8%	45.0	56.6	60.0	53.8	44.6	63.3	50.0
Other liabilities		10.6	10.6		7.1	7.5	4.5	11.4	4.8	8.2
Capital accounts	10.6	5.8	9.1	3.9	5.1	4.8	6.9	5.9	7.9	6.5
Decrease in:										
U.S. Government obligations			17.6	7.0	21.9	15.9		3.6	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%	100.0%	100.0%	100.0%	100.0%
Uses										
Increase in:										
Loans	42.6%	64.3%	58.3%	50.8%	77.5%	63.2%	45.6%	60.8%	72.4%	54.6%
U.S. Government obligations	32.1	0.3					16.2			5.9
Other securities	5.4	17.1	26.7	14.4	12.4	14.6	30.4	19.7	19.0	25.3
Cash assets	15.7			28.4	2.3	19.4	7.6	15.8	5.0	12.1
Other assets	2.2		2.1	1.8	7.8	2.8	.2	3.7	3.6	2.1
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%	100.0%	100.0%	100.0%	100.0%

Source: Computed from Member Bank Report of Condition, Board of Governors of the Federal Reserve System, 1960-1968.

The tables were constructed by computing the absolute change during a year in each category of assets and liabilities. Net total changes in sources and in uses are equal for each year. Figures shown for each category are percentages of these total changes in sources and uses of funds. Totals for the periods 1961-1965 and 1966-1968 are also shown.

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SOURCES AND USES OF FUNDS
All Member Banks

	Year 1961	Year 1962	Year 1963	Year 1964	Year 1965	Year 1966	Year 1967	Year 1968	Period 1961-1965	Period 1966-1968
Sources										
Increase in:										
Demand deposits	42.9%			45.5%	10.9%	27.4%	40.6%	36.4%	19.9%	38.5%
Time deposits	45.6	61.6%	55.6%	44.5	58.9	37.4	48.3	38.2	60.7	43.2
Other liabilities	3.7	16.2	4.3		8.5	16.7	5.6	19.4	6.6	12.6
Capital accounts	7.8	6.3	7.2	7.9	8.6	6.4	5.5	6.0	8.8	5.7
Decrease in:										
U.S. Government obligations		5.3	17.9	2.1	13.1	12.1			4.0	
Cash assets		10.6	15.0							
Total	100.0%	100.0%	100.0%	100.0%	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%	55.8%	36.6%	60.5%	69.7%	48.5%
U.S. Government obligations	26.4						12.8	2.4		7.5
Other securities	14.5	23.3	24.6	10.3	16.6	8.5	26.3	19.3	19.7	22.8
Cash assets	20.4			28.5	0.3	31.1	20.8	12.2	6.9	16.5
Other assets	3.9	2.1	2.9	3.3	3.8	4.6	3.5	5.6	3.7	4.7
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%	100.0%	100.0%	100.0%	100.0%

Source: Computed from Member Bank Report of Condition, Board of Governors of the Federal Reserve System, 1960-1968.
See footnote to Table 1.

FUTURE OF BANK EARNINGS

Bank earnings are important because they help induce the necessary flow of new capital into the banking system. A viable banking system requires healthy growth of earnings. Income growth in past years has been achieved largely by shifts into less liquid, higher-yielding assets. But this shift cannot continue unabated if banks are to retain an adequate margin of liquidity. In recent years, high rates of interest have boosted income from investments, but this trend toward higher and higher rates will not continue forever. And when interest rates fall, income from loans and securities falls faster than interest expense.

In seeking higher profits, bankers have sought to make their operations more efficient. But more noteworthy, they have also begun to supplement loan and investment revenue with proceeds from new activities such as equipment leasing, computer services, management-consulting services and travel bureaus. Explicit fees for more traditional banking services are another new source of revenue. The movement toward one-bank holding companies is also an attempt to broaden the base of bank activities and to insure against the possibility of lagging loan and investment revenue in the future.

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WHAT ARE BANK EARNINGS?

Not everyone agrees on what the best measure of bank earnings is. Earnings data used throughout this analysis are net income adjusted for changes in loan-loss reserves. Net income includes operating revenues and expenses, capital gains and losses on securities transactions, losses on loans, transfers to reserves held to cover bad loans and income taxes. This figure is then adjusted to account for transfers to and from loan-loss reserves. Since banks are allowed, for tax purposes, to deduct from revenues an amount that may be in excess of actual losses on loans, these transfers understate income. For example, in 1968 net income of Philadelphia banks was $65.0 million. But if only actual losses on loans were charged off, net income would have been $71.5 million. Country banks reported net income of $82.8 million, which when adjusted equalled $91.3 million. The difference between the two measures is slightly less marked for country banks because some smaller banks do not use the Internal Revenue Service formula for computing deductible charges to loan-loss reserves, and consequently, do not charge off more than their actual losses on loans.

The measure of earnings most often emphasized by commercial banks is net current operating earnings. They represent the difference between operating revenue, which includes income such as interest earned on securities and loans, and operating expenses. Salaries and wages, interest on time deposits, interest on borrowed money and other current expenses comprise operating expenses. For years such as 1966 and 1968 when demand for loans is heavy and interest rates are high, net income is less than net operating earnings for many banks. During years such as these, banks sell securities, even at a loss, for one or more of the following reasons: to provide funds for loans, to shift into higher-yielding securities, to achieve a basis for future capital gains, and to realize capital loss which may be charged off against gains in other years for tax purposes. Furthermore, the transfers to and from loan-loss reserves mentioned earlier understate net income in every year. Many bankers do not consider these transactions "ordinary" in the sense that payment of wages or receiving interest on securities, for example, are normal operations, and they have been reluctant to include loan losses, transfers to reserves and securities transactions in current operating earnings. The Federal Reserve also requires banks to report capital gains and losses separately. However, the American Institute of Certified Public Accountants has recently issued a ruling which states that banks must now incorporate certain aspects of the net income figures into operating earnings in order to receive a certification without "exceptions" from an accounting firm. The exact nature of the change has not been spelled out as yet, but it has already stirred a controversy between bankers and accountants.

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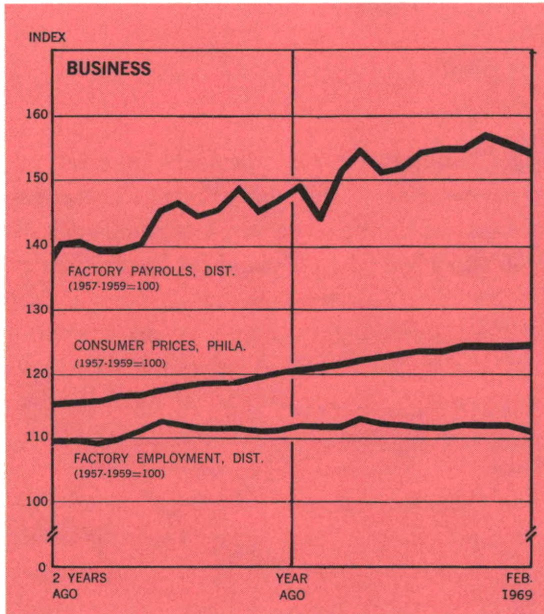
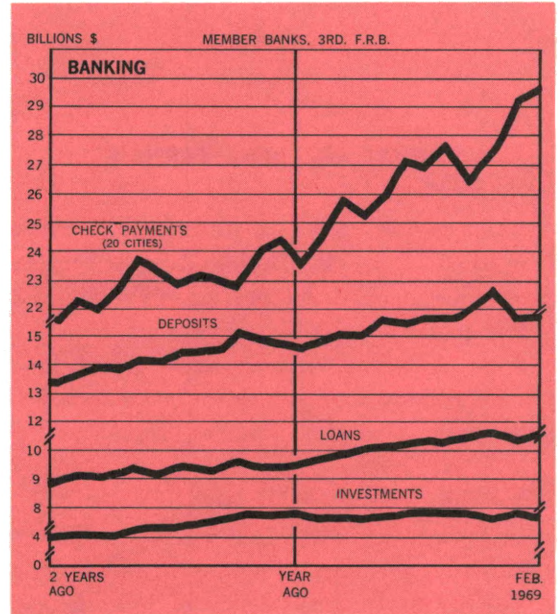
FOR THE RECORD . . .





SUMMARY

	Third Federal Reserve District			United States		
	Per cent change			Per cent change		
	Feb. 1969 from		2 mos. 1969 from year ago	Feb. 1969 from		2 mos. 1969 from year ago
	mo. ago	year ago		mo. ago	year ago	
MANUFACTURING						
Production	....	....	....	+ 2	+ 4	+ 4
Electric power consumed	....	....	....	....	....	....
Man-hours, total*	− 1	− 1	0	....	....	....
Employment, total	− 1	0	0	....	....	....
Wage income*	− 1	+ 6	+ 7	....	....	....
CONSTRUCTION**	+ 9	+40	+36	+ 1	+30	+29
COAL PRODUCTION	+15	+ 7	+ 5	+ 1	− 2	+ 1
BANKING						
(All member banks)						
Deposits	− 1	+ 7	+ 7	− 1	+ 7	+ 7
Loans	+ 1	+13	+12	+ 1	+13	+12
Investments	− 1	+ 5	+ 6	− 3	+ 2	+ 4
U.S. Govt. securities	− 4	− 6	− 5	− 7	− 8	− 4
Other	+ 1	+16	+15	0	+12	+13
Check payments***	+ 2†	+22†	+22†	+ 1	+22	+20
PRICES						
Wholesale	....	....	....	0	+ 3	+ 3
Consumer	+ 1‡	+ 5‡	+ 5‡	0	+ 5	+ 5

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

†15 SMSA's
‡Philadelphia

LOCAL CHANGES

Standard Metropolitan Statistical Areas*	Manufacturing				Banking			
	Employ-ment		Payrolls		Check Payments**		Total Deposits***	
	Per cent change Feb. 1969 from		Per cent change Feb. 1969 from		Per cent change Feb. 1969 from		Per cent change Feb. 1969 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Wilmington	− 6	− 5	− 9	+ 2	+ 9	+24	0	+12
Atlantic City	....	....	....	....	− 7	+ 7	0	+10
Trenton	0	+ 4	− 2	+13	+32	+12	+ 1	+12
Altoona	+ 1	+ 1	0	+10	− 5	+ 8	+ 1	+11
Harrisburg	0	− 2	+ 2	+ 2	+ 2	+ 9	+ 2	+14
Johnstown	+ 1	− 3	+ 2	+ 1	− 5	+14	0	+10
Lancaster	+ 1	+ 1	+ 4	+10	+ 4	+14	0	+10
Lehigh Valley	− 1	0	− 2	+ 5	− 3	+17	+ 1	+11
Philadelphia	0	− 2	0	+ 4	0	+25	− 1	+ 5
Reading	0	+ 3	− 2	+14	− 5	+38	− 1	−11
Scranton	0	+ 1	− 2	− 1	− 2	+ 8	0	+ 7
Wilkes-Barre	0	+ 3	+ 2	+ 9	− 1	+19	0	+ 8
York	0	+ 5	− 3	+ 9	+ 2	+ 5	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.

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