

Federal Reserve Bank of San Francisco

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The Bottom Line

All the talk about a devaluation, decelerating economy and the loosening of controls has led corporate treasurers to ask the basic question—what will it do to the bottom line? Corporate profits before taxes jumped about 13 percent last year, to roughly \$94 billion, on top of a similar gain in the previous year, but gains of that magnitude may be harder to come by as the expansion matures in the later stages of 1973 or 1974. But that, of course, is just another way of saying that profits are intensely sensitive to the stages of the business cycle.

The controls mechanism should not limit the profit expansion unduly. Phase III rules for calculating allowable profit margins permit the inclusion in the base period of the prosperous fiscal years following August 1971, in addition to the several sluggish years preceding that date. On the cost side, the mechanism is still in place—"the club in the closet"—although that system (and profit margins) could come under strong pressure if major labor-contract negotiations take place in a tightening labor market this year.

Rising margins

Being a residual, profits reflect the changing relationship between the prices received by corporations and the costs they incur for labor and other factors of production. In 1972, the price trend decelerated, but profit margins nonetheless improved because of the easing of

the perennial cost squeeze.

The rise in unit labor costs slowed down for the second straight year, with an increase of less than 1 percent recorded between the third quarter of 1971 and the third quarter of 1972. This development reflected both the accelerating rise of labor productivity to 5 percent a year and the decelerating rise of hourly worker compensation to less than 6 percent a year—in each case, the best performance of the last half-decade.

Other unit costs remained essentially unchanged in the same period, albeit with a different movement of components. Interest costs and indirect business taxes declined on a per unit basis, but these declines were offset by an increase in per unit depreciation costs. In this connection, if liberalized depreciation allowances had not been in effect last year, capital consumption costs would not have risen as they did, and profits before taxes would have been correspondingly higher. Profits per unit of output rose more than 6 percent over the past year, on the heels of an increase of almost like magnitude during 1971. Those gains, however, followed a net decrease of nearly 30 percent over the two preceding years; indeed, even today, profits per unit remain about 25 percent below the peak reached in late 1965.

Declining trend

Rising profit margins and increasing physical volume together raised

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total pretax profits of nonfinancial corporations about 14 percent between 1971 and 1972. Even so, the increase in this recent expansion has not been large in comparison with the experience of previous recoveries. The cyclical rise in profits relative to the rise in output of nonfinancial corporations has been one of the smallest in recent history, and the recovery measures even smaller when allowance is made for the fact that the late-1970 trough was further depressed by a major auto strike.

More importantly, the profit trend has been declining for the last several decades, when measured as a percentage of gross corporate product—essentially as a return on capital. (If anything, the situation has deteriorated even more rapidly since 1965.) This trend is still evident even after an upward adjustment is made for the changes in depreciation laws and practices that have occurred over the years. By this adjusted measure, corporate profits amounted to 11 percent of gross corporate product in 1972—up from 1970's postwar low (10 percent) but far below the 15½ percent average of the 1960's and even farther behind the 17½ percent average of the 1950's.

Again, the declining trend is evident, although to a lesser degree, if interest also is taken into account in measuring the return on capital. Interest has increased in importance over time as corporations have placed more reliance on debt than on equity financing, and as interest rates have outpaced the rise in prices of corporate output.

Productivity crucial

To turn the situation around, cost control becomes essential. In terms of unit labor costs, this means either (or both) holding down the rise in labor compensation or speeding up the rise in productivity. Some observers claim that a permanent shift has occurred in the allocation of the corporate sales dollar, with the labor share rising because of a high and rigid floor beneath wages.

If this is true, the crucial factor in the profits equation becomes productivity growth. Basically, then, will output per manhour increase rapidly enough to offset the rising trend of compensation per manhour—it almost did in 1972—and thereby limit the advance of unit labor costs over time?

John Kendrick, in his ongoing study of productivity at the National Bureau of Economic Research, has noted a significant slowdown of labor productivity growth over the past half-decade, in relation to the trend growth of 2.9 percent a year. Part of the explanation lies with the slowdown of economic growth and

the declining rate of utilization of capacity which occurred during the recent recession, but several other factors account for an even larger part of the answer. These include the recent reduction of research-and-development expenditures (in real terms), the shift in the labor-force mix towards youth and women, the diversion of resources from civilian investment to military security, the economic distortions created by the Vietnam inflation, and the increase in business expenditures designed to retard the deterioration of the environment.

Relevant factors

In considering long-range productivity growth, it should be noted that some of these negative factors no longer are relevant. Military outlays have been declining relative to GNP for the last several years, and the Vietnam-inspired price inflation generally has been abating. The growth-inhibiting impact of the bulge in new entrants into the labor force now is largely behind us. Besides, an improvement in rates of capacity utilization can be expected over time with the nation's commitment to full employment. In addition, we can assume the continuation of substantial intangible investments underlying productivity growth—education and training, health and safety, and labor mobility.

Yet with the slowdown of R&D investment, the growth of the real

stock of knowledge available for embodiment in new production techniques will grow less rapidly than it did a decade or so ago. At the same time, business will continue to spend at an accelerated pace for anti-pollution equipment; from \$9 billion in 1970, such spending could double in each half of this decade. Each of these factors in its own way could reduce the trend rate of growth of real product and productivity.

Because of the sluggishness of R&D spending and the rapidly rising rate of anti-pollution expenditures, Kendrick believes that the long-term growth of labor productivity could fall about one-tenth below the trend rate (2.9 percent) established over the past several decades. Of course, all of these are long-run speculations which have little to do with the bottom line in 1973 income statements. This year as last, profits figures should make happy reading for most corporate treasurers, simply because of the continuing strength of the current business expansion. Still, a spotlight on longer-run trends should serve to make everyone realize that the cost squeeze will remain a fact of business life.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/7/73	Change from 1/31/73	Change from year ago	
			Dollar	Percent
Loans adjusted and investments*	69,298	+200	+8,274	+13.56
Loans adjusted—total*	51,282	+700	+8,214	+19.07
Commercial and industrial	18,017	+153	+2,280	+14.49
Real estate	15,202	+ 8	+2,444	+19.16
Consumer instalment	7,874	+ 29	+1,374	+21.14
U.S. Government securities	6,812	—515	+ 57	+ 0.84
Other securities	11,204	+ 15	+ 3	+ 0.03
Deposits (less cash items)—total*	66,620	—309	+2,658	+ 4.16
Demand deposits adjusted	20,278	— 36	+1,317	+ 6.95
U.S. Government deposits	925	—299	— 3	— 0.32
Time deposits—total*	44,185	+ 86	+4,685	+11.86
Savings	18,072	— 29	+ 263	+ 1.48
Other time I.P.C.	17,457	+134	+3,080	+21.42
State and political subdivisions	6,312	— 61	+ 797	+14.45
(Large negotiable CD's)	7,043	+106	+1,991	+39.41

Member Bank Reserve Position	Weekly Averages of Daily Figures		
	Week ended 2/7/73	Week ended 1/31/73	Comparable year-ago period
Excess reserves	39	— 1	14
Borrowings	101	248	1
Net free (+) / Net borrowed (—)	— 62	—249	+ 13
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (—)	+507	+230	+201
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (—)	+315	— 4	+151

*Includes items not shown separately.

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