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## BANKERS' ACCEPTANCES

The use and outstanding volume of dollar bankers' acceptances increased sharply in the past decade. This growth reflects the expansion in world trade and international credit flows during this time, since bankers' acceptances are primarily used to finance international transactions. The outstanding volume of this money market instrument rose from \$1.2 billion at yearend 1959 to \$5.5 billion at the close of 1969. Most of the growth occurred in two distinct subperiods, 1960-1961 and 1967-1969, with the determining factors differing for each period.

The nearly fivefold increase in the volume of outstanding acceptances in the past decade seems very impressive until it is compared with the growth in the volume of other money market instruments. After comparison, it is evident that the use of dollar acceptances has not kept pace with other forms of short-term financing in the United States. For example, from yearend 1959 to yearend 1969, the volume of commercial and finance company paper rose nearly tenfold; outstanding time certificates of deposit climbed, on balance, from less than \$1 billion to \$11 billion; Eurodollar volume rose from an estimated \$2 billion (at the end of 1960) to \$40 billion; and the size of the markets for Federal funds and Federal agency issues increased more than fivefold. Moreover, the outstanding volume of bankers' acceptances in 1969 was substantially smaller than the dollar amounts of all other types of money market instruments with the exception of repurchase agreements. Although the growth in dollar acceptances was less vigorous partly because of the specialized nature of this instrument, other factors were at work. This article describes dollar acceptances and recent developments in the market for this instrument.

## FUNCTION OF ACCEPTANCES

A bankers' acceptance arises from a short-term credit arrangement designed to enable businesses to obtain funds to finance commercial transactions. In recent years, an overwhelming proportion of acceptances has reflected the financing of foreign trade, as opposed to the shipment or storage of goods within the United States. Acceptances are well-suited for transactions involving businesses in different countries and with less well-known credit standings; however, they are somewhat cumbersome in domestic commerce because of the documentation that is required. Generally, a dollar acceptance is a time draft drawn on a bank by an exporter or an importer to obtain a stated amount of funds to pay for specific merchandise or, less frequently, foreign exchange. The draft is then "accepted" by the bank (the drawee) that, in effect, unconditionally guarantees to pay the face value of the instrument on its maturity date. The face of the instrument specifies the dollar amount involved, the maturity date, and the nature of the underlying transaction. Upon acceptance, the United States bank stamps "accepted" and signs the face of the instrument. Most acceptances are short term in nature; that is, they have maturities of six months or less. The short-term nature of the instrument reflects the time required to ship the financed merchandise and sell it into trade channels.

In a typical transaction, a foreign manufacturer might wish to sell a shipment of radios to a United States importer. The importer could ask his domestic bank to send the foreign exporter a letter of credit authorizing the exporter to draw a time draft on the bank with a maturity of, say, three months. After gathering supporting documents, such as bills of sale, bills of lading, and insurance papers, the exporter might sell or discount the

time draft with his local bank, thus obtaining cash before the buyer (the United States importer) has paid for the radios.<sup>1</sup> The foreign bank would then remit the discounted draft to the importer's bank in the United States for acceptance and discount. The accepting bank forwards the accompanying documents to the importer so that he may obtain possession of the goods when they arrive. The acceptance may then be held by the accepting bank as an earning asset—or it may be sold in the secondary market at the going rate of discount for the specific maturity. The importer must pay the bank before the acceptance matures, whereupon the bank liquidates the obligation.

Several advantages of a dollar acceptance are apparent from this simplified example. The exporter receives his funds promptly and thereby avoids any delays that could result from extended shipping time. The exporter does not have to be overly concerned with the credit standing of the United States importer, because a bank has guaranteed to pay for the merchandise. Similarly, the exporter does not have to be concerned about foreign exchange costs and risks because his local bank pays him in domestic funds. In view of these advantages, it is not surprising that dollar acceptances are chiefly used for overseas financing and that they are frequently instituted by foreigners.

Because of the highly specialized nature of this financing, the creation of dollar acceptances has tended to be concentrated among the largest and best known banks in the United States (and their Edge Act corporations), foreign banks, and United States agencies of foreign banks. About 170 institutions, mainly in New York City and San Francisco, currently report their activity to the

<sup>1</sup>The exporter will receive fewer funds than the face value of the draft, reflecting the bank's rate of discount and any fees and costs not absorbed by the bank.

Federal Reserve System. When created by this select group of banks, dollar acceptances are considered to be prime quality money market instruments; for example, they are eligible to be used as collateral by banks when borrowing from Federal Reserve banks<sup>2</sup> and may be purchased by the Federal Reserve in the secondary market.

The illustration given above can be modified to demonstrate the great flexibility of these financing arrangements.<sup>3</sup> The importer could have drawn the time draft on his United States bank, promising to repay the bank in three months. Upon acceptance and receipt of the funds (less the discount), the importer would remit the funds to the exporter. In effect, the importer would have delayed his final payment for three months, which would have provided time to sell the imported merchandise. Or the foreign exporter could have used acceptance financing to buy merchandise (in this case, radios) prior to exporting. From the bank's standpoint, acceptances can be used to accommodate a large credit demand: several drafts may be drawn and individually distributed among a group of participating banks.

Almost half of the dollar acceptances created are used to finance transactions that do not involve United States exporters and importers. These acceptances fall into two general groups:

those used to finance merchandise stored in or shipped between foreign countries, and those used to create dollar exchange. The latter acceptances are not associated with the shipment of specific merchandise "but are designed to alleviate seasonal shortages of dollar exchange for certain countries,"<sup>4</sup> especially Latin American countries. Dollar exchange acceptances no longer serve their original purpose, however, and their use has been severely limited in comparison with other acceptance financing in recent years.

## RECENT GROWTH PATTERNS

The outstanding amounts of various types of dollar acceptances in the past decade are shown in Chart 1. It is apparent that acceptances to obtain dollar exchange and to finance the shipment or storage of merchandise *within* the United States no longer play a significant role in this sector of the money market. From 1960 through 1969, dollar exchange acceptances represented an average of only about 3 percent of outstandings, while acceptances for domestic financing accounted for a slightly larger average share—4 percent. Both types of acceptances became progressively less important in the 1960's, particularly when measured in terms of relative shares of total dollar acceptances.

Acceptances to finance third country trade showed the largest growth during the period under review. The outstanding volume of these instruments rose from nearly \$250 million at yearend 1959 to almost \$2.3 billion at yearend 1969. Such acceptances represented two-fifths of acceptance financing in 1969. Third country financing expanded very sharply (by more than 20 percent) in 1960-1961, 1963, and 1967. It might be

<sup>2</sup>Federal Reserve Regulations A and B govern the use of acceptances as collateral. The Federal Reserve System requires that only endorsed acceptances be used as eligible paper; banks endorse acceptances to pass legal title.

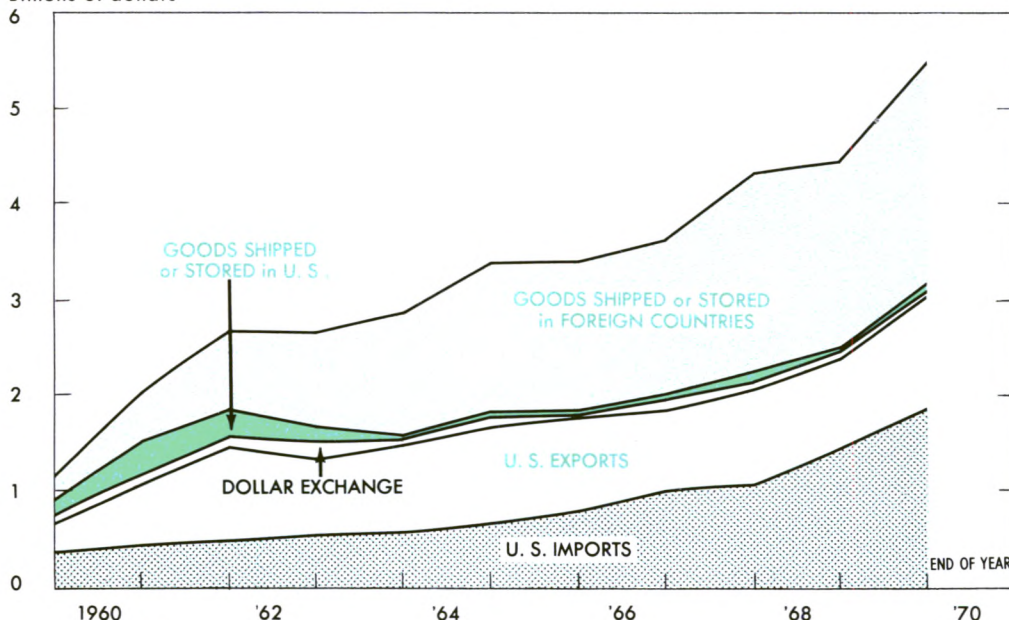
<sup>3</sup>Only a few modifications are described here. For a more complete discussion, see Robert L. Cooper, "Bankers' Acceptances," *Essays in Domestic and International Finance*, Federal Reserve Bank of New York, August 1969. This article also describes the types of trade financed and discusses the role of acceptance dealers at length.

<sup>4</sup>*Ibid.*, p. 67.

Chart 1.

BANKERS' ACCEPTANCES OUTSTANDING  
By Type of Transaction Financed

Billions of dollars



Last entry: Dec. '69

Source of data: Federal Reserve Bank of New York

presumed that the sharp gains coincided with an increase in world merchandise trade, but a comparison of indexes for both quantum and value of trade, as published by the United Nations, shows no significant correlation with rates of growth in third country acceptance financing. This suggests that the relative availability of other types of trade financing, the comparative costs of financing, and the preferences of foreign borrowers have an important influence on the use of dollar acceptances. It is known, for example, that the surge in third country acceptances in the past decade was due primarily to Japanese borrowing to finance a major increase in exports and imports. During part of this period, the United States balance of

payments program constrained long-term borrowing by Japan, and short-term financing was used instead. Japanese traders used dollar acceptances to obtain funds at a cost that was lower than the cost of domestic sources of funds.

The volume of acceptances to finance United States imports and exports also increased sharply from 1959 to 1969, but not as rapidly as the volume of third country acceptances. Moreover, the pattern of increase in import-based acceptances was quite different from that for acceptances used to finance United States exports. For example, export acceptance growth was largely confined to 1960-1961 and 1969. (Interestingly, the volume of United States exports did not

expand at an unusual rate in 1960-1961, again suggesting that the economic relationship between merchandise trade and the use of acceptance financing is complex and determined by a number of factors.) In contrast, the volume of dollar acceptances based on United States imports showed fairly steady growth during the 1959-1969 period (see Chart 1). In only two years, 1963 and 1967, was the year-over-year increase less than 10 percent; both years coincided with a leveling in merchandise imports to the United States. In general, the diverse patterns in import *versus* export acceptances bear out the conclusion that such financing is arranged more frequently by foreigners than by United States traders. This preference no doubt is due to the relatively limited sources (and higher costs) of financing available to the foreigners as compared with their counterparts in this country.

In the United States, for example, exporters and importers can seek funds in the form of business loans from their commercial banks, export credits from governmental agencies, and accounts receivable financing. Large traders can also borrow in the commercial paper and Euro-dollar markets. Foreign exporters and importers rarely have as many credit alternatives. Moreover, the cost of dollar acceptance financing tends to be lower than the cost of domestic credit in most foreign countries.

### COST OF FINANCING

The costs of borrowing funds through dollar acceptances are determined by the accepting bank's fees and handling charges plus a rate of discount. Prime borrowers (a wider group than borrowers paying the prime business loan rate) pay a commission of 1 1/2 percent, although customers with lesser credit standings may be charged more and sometimes there are other fees and

charges. In turn, the rate of discount represents the current bid rate for acceptances of similar maturity as traded in the secondary market. Because of the complicated financial relationships involved in acceptance financing, it is sometimes difficult to determine who bears the cost of the financing; generally, the party arranging for the credit pays.

Similarly, the *relative* cost of acceptance financing is complicated. A United States borrower, for example, would want to compare alternative costs on bank loans (including the costs of compensating balances, which are usually not involved in acceptance financing), accounts receivable, and commercial paper. In recent years, rates on commercial paper have, on average, been slightly higher than market rates on dollar acceptances, but this margin would be more than offset by the additional fees and charges that accompany acceptances (see table). Moreover, relatively few borrowers can obtain funds in the commercial paper market.<sup>5</sup> Sophisticated foreign borrowers seeking funds through dollar acceptances might also be interested in comparing the cost of a Eurodollar loan or a sterling acceptance with the cost of a dollar acceptance. At one time, the foreign borrower might have "shopped around" in the foreign exchange markets for funds denominated in other major foreign currencies, but the rise of the Eurodollar market—with its lower transactions costs, reduced exchange risks, and freer movement of funds—has probably curtailed such borrowing. A major cost disadvantage of a foreign currency loan is the need to "hedge" the loan to offset the risk of a change in the value of the foreign currency. Hedging frequently increases the cost of borrowing a foreign currency.

<sup>5</sup>See "Commercial Paper, 1960-1969," *Economic Review*, Federal Reserve Bank of Cleveland, May 1970.

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### Comparative Costs of Bankers' Acceptances and Commercial Paper 1959–1969

| Average<br>for<br>Year | Averages of Daily Rates in<br>Secondary Markets |                         | Adjusted<br>Acceptance<br>Costs* | Adjusted<br>Spread<br>(basis points) |
|------------------------|-------------------------------------------------|-------------------------|----------------------------------|--------------------------------------|
|                        | Commercial<br>Paper                             | Bankers'<br>Acceptances |                                  |                                      |
| 1960                   | 3.85%                                           | 3.51%                   | 5.01%                            | +116                                 |
| 1961                   | 2.97                                            | 2.81                    | 4.31                             | +134                                 |
| 1962                   | 3.26                                            | 3.01                    | 4.51                             | +125                                 |
| 1963                   | 3.55                                            | 3.36                    | 4.86                             | +131                                 |
| 1964                   | 3.97                                            | 3.77                    | 5.27                             | +130                                 |
| 1965                   | 4.38                                            | 4.22                    | 5.72                             | +134                                 |
| 1966                   | 5.55                                            | 5.36                    | 6.86                             | +131                                 |
| 1967                   | 5.10                                            | 4.75                    | 6.25                             | +115                                 |
| 1968                   | 5.90                                            | 5.75                    | 7.25                             | +135                                 |
| 1969                   | 7.83                                            | 7.61                    | 9.11                             | +128                                 |

\* Includes addition of 1 1/2 percent for commissions and charges.

Sources: *Federal Reserve Bulletin* and Federal Reserve Bank of Cleveland

**Secondary Market.** Upon acceptance by a United States bank, a dollar acceptance becomes a high-grade negotiable instrument that can be sold in a secondary market if funds are needed before the maturity of the bill. The accepting bank can add the instrument to its own investment portfolio; however, some banks trade in the market at the prevailing rate. The secondary market is "made" or maintained by a small group of dealers in New York City that stand ready to trade for their own accounts. Investors in bankers' acceptances also include United States corporations and financial institutions, foreign banks (including central banks) and businesses, and the Federal Reserve System.

Historically, dealers operating in the market have posted rates on bankers' acceptances in the secondary market at fixed levels. Both bid and offered rates are posted for various maturities, with the spread (from 1/8 to 1/4 percent) between the two quotes representing the dealer's profit margin. This margin is somewhat higher than those

on other money market instruments because of the higher costs of handling acceptances.

Posted interest rates tend to lag market developments, rather than to respond quickly to changes in supply and demand. Late in 1969, however, two dealers in bankers' acceptances announced that their market quotes would be subject to negotiation. The move was considered necessary because of increased trading activity in acceptances and more volatile interest rate movements in the money market. One dealer also cited the practice of negotiating rates on some transactions even with the existence of posted rates, as well as the tendency for all dealers to have to conform to a change in rates posted by any one dealer. Initial market response to the new rate procedure was mixed. Some market observers believed that it would make it difficult for commercial banks to determine the discount rates on new dollar acceptances. At present, five out of the seven major dealers continue to post rates daily.

**Investment Returns.** In general, secondary yields on bankers' acceptances closely followed the pattern of other interest rates in the 1960-1969 period. Yields on acceptances declined sharply in 1960-1961 and then rose gradually during the 1962-1965 period. In 1966, in response to a general tightening in credit conditions, money market rates rose sharply (but temporarily) to the highest levels since the early 1930's. Yields on acceptances averaged 5.36 percent in 1966. After declining briefly in 1967, interest rates climbed to record levels in 1968-1969. The average yield on prime bankers' acceptances (90-day maturities) reached 8.58 percent in December 1969.

## BANK HOLDINGS OF ACCEPTANCES

At yearend 1969, \$1.6 billion of dollar acceptances were held by accepting banks. The bulk (84 percent) of the dollar volume represented bills retained by the accepting bank, while only 16 percent consisted of bills originally accepted and subsequently sold by other United States banks. Bank holdings changed noticeably during the period under review, apparently in response to changes in bank reserve pressures. In 1959-1960, accepting banks retained less than \$300 million of their own bills, with their holdings increasing irregularly after August 1959. August 1959 also represented a peak in bank reserve pressures, as measured by member bank borrowings from the Federal Reserve System (see Chart 2).

When reserve pressures diminished in the 1959-1961 period (which included a period of business recession), bank portfolios of dollar acceptances rose sharply, reaching a peak of nearly \$1.3 billion at the end of 1961. (During this time, market yields on acceptances declined.) Holdings of retained acceptances continued to rise more rapidly through 1964 than holdings of bills

accepted by other banks (see Chart 2). From 1961 through 1964, holdings of acceptances of other banks showed virtually no net change, while reporting banks' holdings of their own acceptances rose by about \$400 million (or by 45 percent). During this period, bank reserve pressures increased only moderately.

In 1965-1966, however, member bank borrowings rose sharply as money and credit conditions moved toward restraint. At the same time, bank holdings of dollar acceptances declined. When credit conditions eased in 1967, banks again added acceptances to their portfolios, and by December 1967, bank holdings reached \$1.9 billion—a record level.

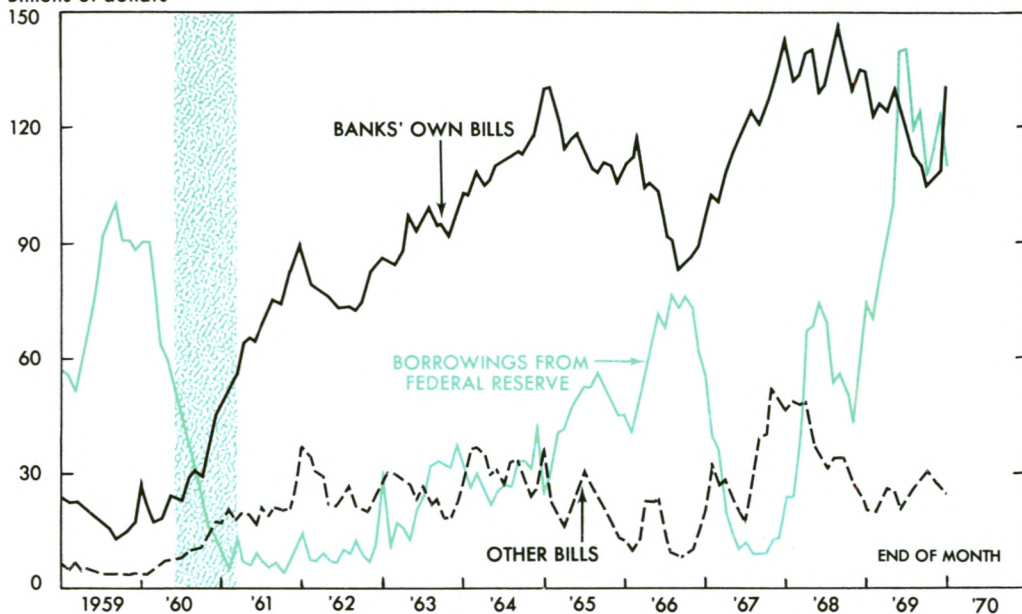
Since then, the pattern of bank investment in acceptances has changed significantly. Credit restraint became increasingly severe in 1969, as reflected in the sharp climb in bank borrowings from the Federal Reserve since November 1968. From the end of that month through the end of December 1969, however, bank holdings of the acceptances of other banks showed little net change, averaging somewhat more than \$200 million (see Chart 2). Holdings of banks' own acceptances also declined less than might have been expected based on their behavior during preceding periods of reserve pressure.

Some generalizations about bank investment in dollar acceptances might be made on the basis of the 1959-1969 experience. First, bank activity in buying the acceptances of other banks did not expand as fast as did the overall market. At the end of 1969, bank holdings of the acceptances of other banks were no larger than the average level of holdings in 1962. In the past, these bills were not necessarily bought to be held as investments, but rather to add a second bank's name, or endorsement, to the acceptance. Some foreign

Chart 2.

## BANK HOLDINGS of DOLLAR ACCEPTANCES

Billions of dollars



Last entry: Dec. '69

Sources of data: Board of Governors of the Federal Reserve System and Federal Reserve Bank of New York

investors required such an endorsement. This practice declined in the past four or five years, as United States banks sold more of their own acceptances to their customers.

Second, there is a fairly close inverse relationship between bank holdings of acceptances and banks' reserve positions. As supplementary evidence, in 1961-1964 and 1967, when member bank borrowings were relatively low, total bank holdings accounted for about 45 percent of all reported acceptances outstanding; in other recent years, the banks' proportion was below 35 percent. Finally, the experience in 1968-1969 suggests that acceptance holdings may have become less sensitive to credit restraint. This

development may reflect increased effort by banks to retain foreign trade customers or the judgment that acceptances are preferred assets because of their short-term nature and attractive rates. In addition, credit restraint encourages banks to lend through acceptance financing (rather than direct loans) because the acceptances can then be shifted to other lenders, such as corporations and foreign investors.

## FEDERAL RESERVE OPERATIONS

As mentioned earlier, prime bankers' acceptances are considered eligible collateral for member banks borrowing from the Federal Reserve banks; they can also be used to secure Treasury tax and loan accounts. In addition, the Federal

Reserve System is actively involved in the secondary market for dollar acceptances. In the 1920's, the System used acceptances as the principal instrument in its open market operations. In addition, the System bought and sold acceptances for the accounts of foreign correspondents, mostly other central banks. At that time, the market for acceptances (centered in London) was active and growing, reflecting a boom in world trade after World War I. This boom was cut short in the 1930's by worldwide depression, rising economic nationalism, and repression of trade in Europe. Foreign central banks continued to maintain modest holdings of dollar acceptances, but the acceptance market did not really regain its importance until after World War II, when international trade recovered and the United States dollar became the world's vehicle currency.

On March 29, 1955, the System Open Market Account was authorized to undertake operations for its own account in the bankers' acceptance market. (In this function, the Federal Reserve Bank of New York acts as agent for the entire Federal Reserve System to implement actual transactions, just as it carries out open market operations in U. S. Government securities.) Such operations in acceptances were used to encourage the development of the acceptance as an important instrument to finance international trade. The System's holdings are deliberately kept relatively small. For example, in December 1969, outright holdings averaged less than \$60 million in comparison with a total of nearly \$5 1/2 billion in outstanding dollar acceptances. The Federal Reserve Bank of New York also buys bankers' acceptances under repurchase agreement to provide temporary reserves to the banking system when needed. In these cases, the Federal Reserve buys acceptances with the agreement that the

seller will repurchase the instruments after a stated period of time at a predetermined yield.<sup>6</sup> Here, too, the dollar volume of transactions is still moderate, although it is much larger than the volume of outright transactions. Repurchase agreements are made only with nonbank acceptance dealers.

System transactions in acceptances are confined to bills endorsed either by the dealer involved or by a member bank other than the acceptor. Because of this, the Open Market Account buys at a discount of 1/16 percent below the dealers' selling rates for unendorsed acceptances. Although the System usually purchases maturities of 90 days or less for its own account, its foreign correspondents will generally take bills with maturities out to six months. In its operations as agent for foreign correspondents, the System guarantees payment and charges an additional 1/8 percent.

### CONCLUDING COMMENTS

Although the outstanding volume of bankers' acceptances has not grown as rapidly as that of other money market instruments, the acceptance has some unique advantages. It is well-suited to finance international merchandise trade and probably contributed significantly in the 1960's to the freer movement of goods and capital throughout the world. Its relative lack of growth can be attributed to the legal constraints associated with documentation and Federal Reserve use, as well as to the fact that the underlying funds are specifically tied to certain merchandise. In that sense, a dollar acceptance is less speculative than, say, a Eurodollar loan. Given a continuation of the recent growth in world trade and the need for funds to finance trade, the future of the bankers' acceptance looks favorable.

<sup>6</sup>For a description of repurchase agreements in general, see *Economic Review*, Federal Reserve Bank of Cleveland, November-December 1969.

# A NOTE ON THE CURRENT DECLINE IN CORPORATE PROFITS

The current decline in corporate earnings ranks among the longest and the largest of the profit declines in the post-World War II period. This decline reflects primarily the slowdown in overall economic activity and some imbalances among prices, costs, and productivity. In view of the length of the time period and the magnitudes involved, the current decline would seem to have important implications for capital spending plans, corporate financing activities and, as a result, for the general course of economic activity in the months ahead. This article compares the scope and magnitude of the current decline in corporate earnings with those of the declines that have occurred since 1956. The article also considers some of the apparent implications of the recent behavior of corporate profits, particularly for capital spending in the months ahead.

## THE MAGNITUDE OF THE DECLINE

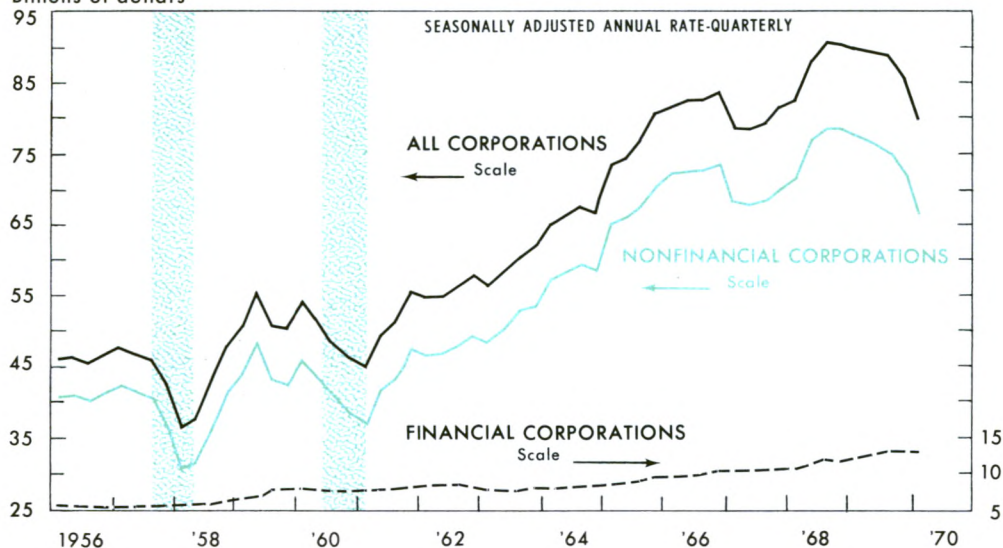
Since 1956, there have been four periods in which corporate profits (before taxes) declined

significantly for extended periods of time.<sup>1</sup> These periods generally coincided with economic recessions and slowdowns in overall economic activity (see Chart 1). The first two declines were associated with the 1957-1958 and 1960-1961 recessions and extended over four and seven quarters, respectively. The third decline occurred during the economic slowdown in 1966-1967 and lasted only two quarters. The current decline in corporate profits began in the fourth quarter of 1968 and continued through the first quarter of 1970—the latest quarter for which data are available. Thus, the current decline in corporate profits was

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<sup>1</sup> Measures of corporate profits discussed in this article refer to corporate profits, before taxes as reported in the national income and product accounts. Data reported in these accounts are based on profits as reported by the recipient for tax purposes and may differ in several respects from profits as reported to shareholders. For a further discussion of alternative measures of profits, see Edmund A. Mennis, "Different Measures of Corporate Profits," *Financial Analysts Journal*, September-October 1962.

Chart 1.

**CORPORATE PROFITS\***All Corporations  
Billions of dollars

Last entry: 1Q '70

\*Before taxes.

Source of data: U. S. Department of Commerce

exceeded in duration only by the decline associated with the 1960-1961 recession.

The current profit decline also ranks among the largest in dollar terms, although it has been less severe in relative terms. At the end of the first quarter of 1970, the decline in corporate profits amounted to \$10.9 billion, compared with \$11.3 billion during the 1957-1958 recession, \$10.2 billion during the 1960-1961 recession, and \$5.4 billion during the 1966-1967 slowdown. In relative terms, corporate profits have declined by 12 percent through the end of the first quarter of 1970, compared with 23.7 percent during the 1957-1958 recession, and 18.5 percent during the 1960-1961 recession. During the 1966-1967 slowdown in economic activity, corporate profits declined by 6.5 percent. Thus, the current relative

decline in corporate profits ranks somewhere between the 1966-1967 slowdown and the 1960-1961 recession, which seems to be about where the current slowdown in overall economic activity would rank thus far.<sup>2</sup>

**THE SCOPE OF THE DECLINE**

As in previous periods of declining corporate profits, the current downturn has been centered in the profits of nonfinancial corporations (see Chart 2). During the recent period, the profits of nonfinancial corporations declined by \$12.0 billion. This decline was partially offset by a \$1.1

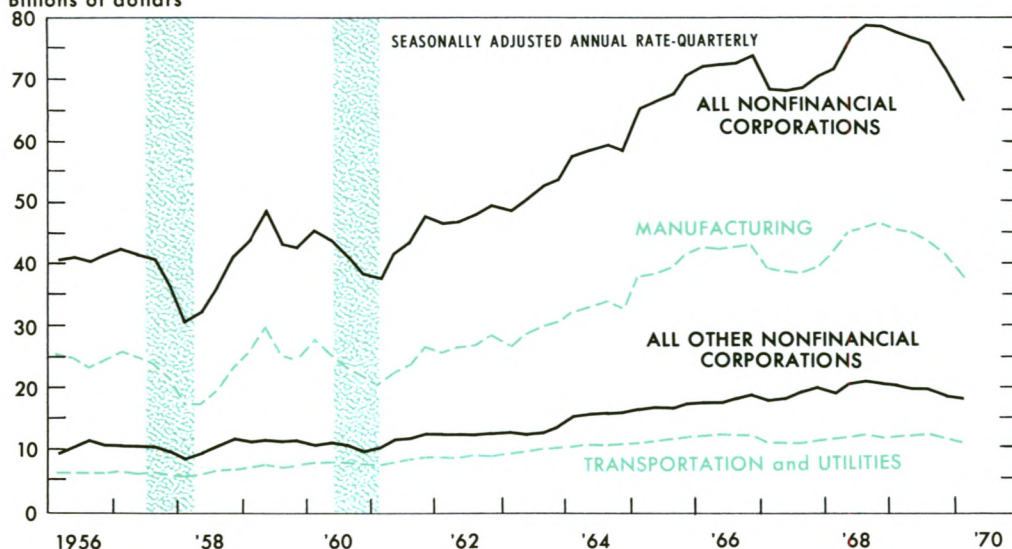
<sup>2</sup>For a discussion of the scope and magnitude of the current slowdown in overall economic activity, see "Dimensions of Recent Economic Activity," *Economic Commentary*, Federal Reserve Bank of Cleveland, June 8, 1970.

Chart 2.

### CORPORATE PROFITS\*

All Nonfinancial Corporations

Billions of dollars



Last entry: 1Q '70

\* Before taxes.

Source of data: U. S. Department of Commerce

billion increase in the profits of financial corporations.

Two-thirds of the current decline in the profits of nonfinancial corporations is the result of lower earnings of manufacturing corporations. Profits in manufacturing have declined by 17.6 percent, while there has been a 10.8 percent decline in the profits of transportation and utilities companies and a decline of 12.4 percent in the profits of all other nonfinancial corporations. Although the current relative decline in manufacturers' profits exceeds the decline experienced during the 1966-1967 slowdown, it falls far short of the declines during 1957-1958 and 1960-1961. On the other hand, the most recent decline in the profits of other nonfinancial corporations has been more

severe thus far than during the recessions of 1957-1958 and 1960-1961.

Within manufacturing, the durable goods industries experienced the largest decline in corporate profits—at least through the fourth quarter of 1969 (see Table I). The declines were most pronounced in the following industry groups: lumber and wood products, 49 percent; motor vehicles and parts, 38 percent; and aircraft and parts, 36 percent. However, primary iron and steel and nonferrous metal products had steady increases in profits during this period.

It was impossible to compute accurately the decline in profits that occurred in the nondurable goods industries during the recent period because of changes in certain industrial classifications. Within the nondurable goods category, however,

TABLE I

## Corporate Profits in Selected Industries During Recessions and Slowdowns\*

| Industry                          | Percent Change From Peak to Trough |           |           |           |
|-----------------------------------|------------------------------------|-----------|-----------|-----------|
|                                   | 1957-1958                          | 1960-1961 | 1966-1967 | 1968-1969 |
| Durable goods                     | -49%                               | -44%      | -18%      | -11%      |
| Lumber and wood products          | -52                                | -86       | -40       | -49       |
| Furniture and fixtures            | -61                                | -69       | -12       | -8        |
| Stone, clay, and glass            | -53                                | -42       | -39       | -20       |
| Primary iron and steel            | -75                                | -78       | -44       | †         |
| Nonferrous metals                 | -62                                | -32       | -40       | †         |
| Fabricated metal products         | -46                                | -37       | -18       | -7        |
| Machinery, except electrical      | -50                                | -36       | -11       | -5        |
| Electrical machinery              | -30                                | -32       | -11       | -19       |
| Motor vehicles and parts          | -97                                | -55       | -51       | -38       |
| Aircraft and parts                | -38                                | -65       | -15       | -36       |
| Instruments                       | -28                                | -29       | -6        | -5        |
| Miscellaneous and ordnance        | -44                                | -9        | -7        | -9        |
| Nondurable goods                  | -30                                | -9        | -7        | n.a.      |
| Food products                     | -7                                 | -3        | -4        | †         |
| Tobacco manufactures              | -17                                | -1        | -2        | †         |
| Textile mill products             | -59                                | -48       | -37       | -9        |
| Apparel and products              | -47                                | -49       | -24       | -29       |
| Paper and products                | -19                                | -16       | -21       | -10       |
| Printing and publishing           | -38                                | -30       | -11       | n.a.      |
| Basic chemicals                   | -42                                | -23       | -27       | -15       |
| Drugs                             | -15                                | -13       | -5        | -7        |
| Petroleum and products            | -47                                | -5        | †         | -8        |
| Rubber and miscellaneous plastics | n.a.                               | -29       | -29       | -23       |
| Leather and products              | -39                                | -59       | -24       | -18       |
| All manufacturing                 | -41                                | -28       | -12       | n.a.      |

\* Before taxes.

† Denotes increases during the period.

Sources: Federal Trade Commission and Securities and Exchange Commission. Seasonally adjusted by Data Resources, Inc. Reprinted with the permission of The First National City Bank of New York.

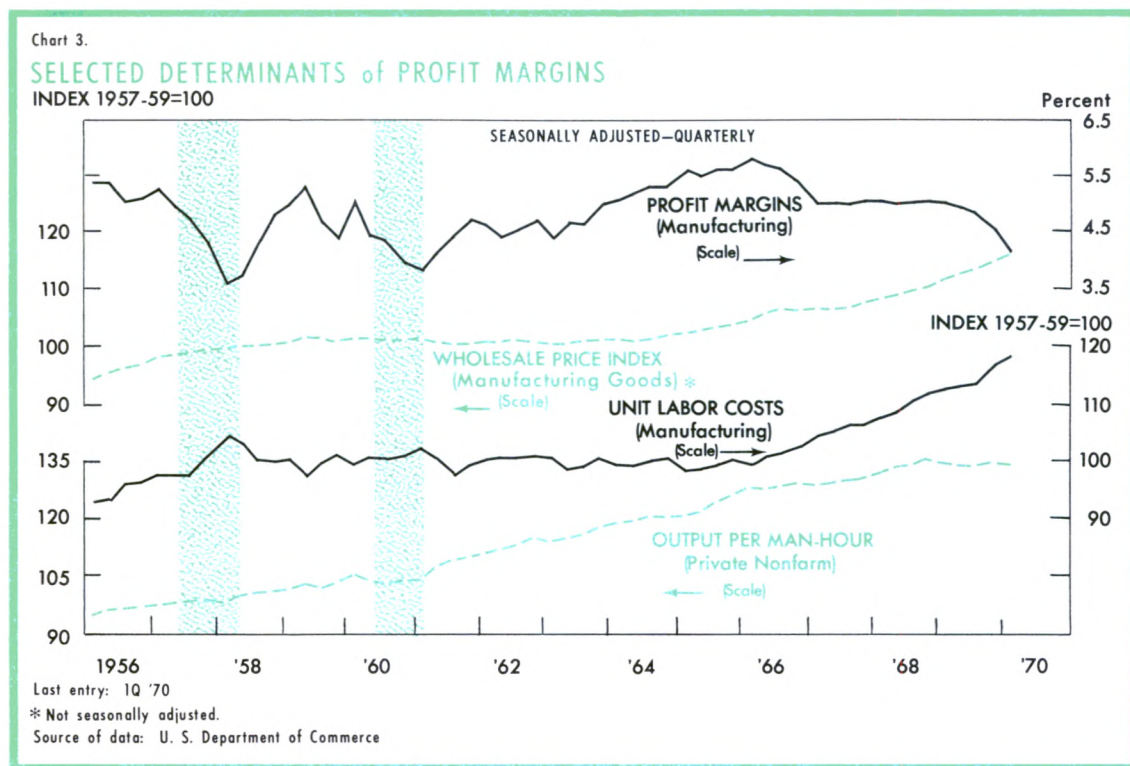
large declines occurred in apparel (29 percent) and in rubber and miscellaneous plastics (23 percent). Profits increased in the food products and tobacco manufacturing industries during the recent period.

Although seasonally adjusted data are not available for the first quarter of 1970, as of the end of the fourth quarter of 1969, three out of 26 durable and nondurable goods industries reported pre-tax profit declines of more than 30 percent. In

contrast, during the 1966-1967 period, earnings declines of 30 percent or more on this basis were reported by six industries, 13 industries in 1960-1961, and 16 in 1957-1958.

## IMBALANCES

The recent decline in corporate profits reflects, in part, the general slowdown of economic activity. Beyond this, however, there are some fundamental imbalances that have been eroding profit



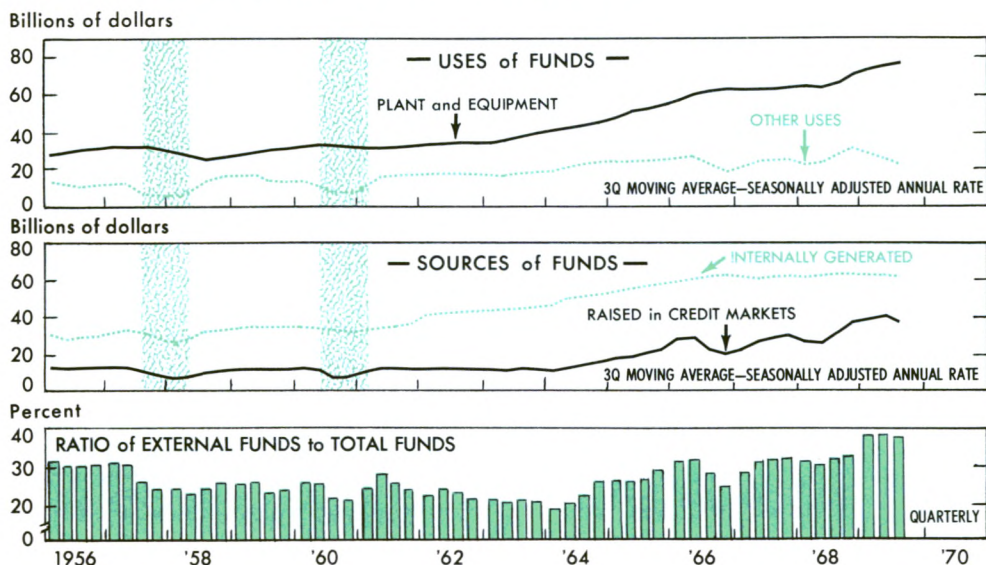
margins since 1966 (see Chart 3). Profit margins in manufacturing have fallen 1.7 percentage points, or by 1.7 cents per dollar of sales, from the first quarter of 1966 through the first quarter of 1970. This decline is largely the result of rapid increases in labor compensation that were combined with only moderate rates of growth in productivity. Between the first quarter of 1966 and the first quarter of 1970, labor compensation in manufacturing rose by more than 30 percent, while output per manhour increased by only about 11 percent. As a result, unit labor costs rose by more than 18 percent during this period. In addition to increased unit labor costs, net interest costs in manufacturing more than quadrupled, capital consumption allowance rose by more than 25 percent, and indirect business taxes increased by almost 10

percent during this period. These increases were partially offset by an increase of approximately 12 percent in prices. Thus, profit margins generally absorbed the difference between rising prices and more rapidly rising costs.

The data on profit margins shown in Chart 3 are, however, averages that apply only to manufacturing corporations and are based only on sales. Even on this basis, the spread of profit margins ranged from nearly 10 percent to a mere 1 percent. In nonmanufacturing industries, profit margins on sales in 1969 were as high as 17 percent. Furthermore, more than three-fourths of all reporting manufacturing industries had a rate of return on net worth of more than 10 percent in 1969. Nevertheless, the conclusion still holds that profit margins in manufacturing, on average and in

Chart 4.

## SOURCES and USES of FUNDS: Nonfinancial Corporations



Last entry: 3Q '69

Source of data: Board of Governors of the Federal Reserve System

terms of sales, have been "squeezed" between rapidly rising costs of all types and less rapid increases in prices and productivity.

## IMPLICATIONS

The recent decline in corporate profits seems to have some implications for future capital outlays and the methods of financing these outlays. During 1967 and the early part of 1968, firms relied mainly on internal sources of funds (retained earnings and depreciation allowances) to finance the surge in plant and equipment expenditures that followed the slowdown in economic activity in 1966-1967 (see Chart 4). By the fourth quarter of 1968, however, internal sources of funds began to decline, reflecting the general downward trend in corporate profits. Thus, since

late 1968 firms have been forced to rely more heavily on external sources of funds to finance capital spending.

According to the most recent survey of capital spending plans conducted by the U. S. Department of Commerce and the Securities and Exchange Commission, business firms plan to spend approximately 8 percent more on plant and equipment in 1970 than in 1969.<sup>3</sup> If realized, this amount of spending would seem to be in excess of the currently anticipated rate of growth of internal sources of funds. Thus, firms will have to continue to rely heavily on external sources of funds to

<sup>3</sup>The results of the most recent survey appear in the June 1970 issue of the *Survey of Current Business*, U. S. Department of Commerce.

## ECONOMIC REVIEW

TABLE II

Percent Changes in Corporate Profits and Revisions  
Of Capital Spending Plans

|                                                         | Corporate Profits | Revisions in Planned<br>Capital Expenditures |           |
|---------------------------------------------------------|-------------------|----------------------------------------------|-----------|
|                                                         | III Q 68 - IQ 70  | 1968-1969                                    | 1969-1970 |
| All Industries                                          | -12.0%            | -3.3%                                        | -2.8%     |
| Manufacturing                                           | -17.6             | -4.7                                         | -6.1      |
| Durable goods                                           | -28.2             | -0.4                                         | -7.3      |
| Nondurable goods                                        | - 3.4             | -1.5                                         | -4.8      |
| Transportation, communications,<br>and public utilities | -10.8             | -3.0                                         | -0.3      |

Sources: U. S. Department of Commerce and Securities and Exchange  
Commission

finance capital outlays during 1970, particularly in the second and third quarters, when expenditures are expected to rise by approximately 3 percent in each quarter.

There is some limited evidence, however, that suggests that actual capital spending may fall short of current expectations. During 1969, businessmen reduced their planned amount of expenditures by more than 3 percent (see Table II). In the most recent survey (conducted in late April and May), firms reported that they had reduced their planned spending for 1970 by nearly 3 percent from what they had originally reported in the survey conducted in the fall of 1969. The largest reductions appear to have occurred in those industries that experienced the largest declines in corporate profits. For example, profits in the durable goods industries declined nearly 30 percent between the third quarter of 1968 and the first quarter of 1970, and firms in those industries trimmed their spending plans for 1970 by more than 7 percent. Conversely, profits in nondurable goods industries

have declined by only 3.4 percent, and spending plans have been reduced less than in durable goods industries.

## CONCLUDING COMMENTS

The current decline in corporate profits has been centered in nonfinancial corporations, primarily in manufacturing. Although the decline through the first quarter of 1970 was not as large as the declines associated with the 1957-1958 and 1960-1961 recessions, it nevertheless has important implications.

The most obvious effects of the current decline in profits and internal cash flow would seem to be on capital spending plans and external financing requirements. Further increases in capital spending will apparently have to be financed largely by external sources of funds. Thus, the amount of spending that takes place in the months ahead will depend to a considerable extent on the availability and the cost of credit.