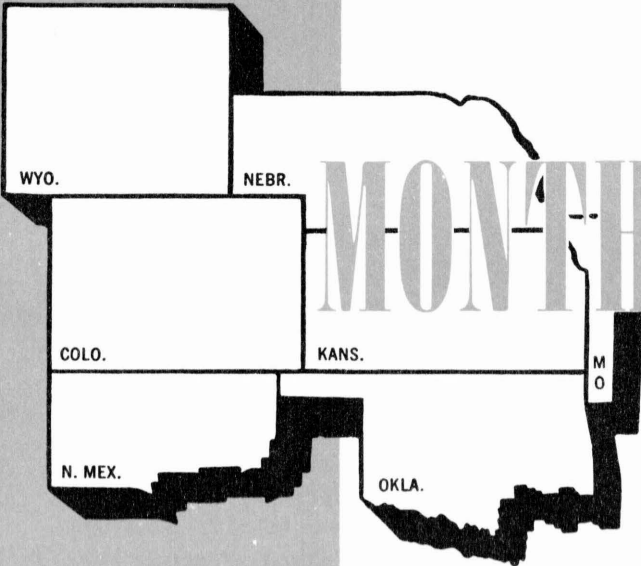


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MONTHLY REVIEW

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Our Unemployment Yardsticks:

Concepts and Measurement

HOW TO achieve a full utilization of resources leading to rapid economic growth without inflation is generally acknowledged to be the major domestic economic problem facing this Nation. To those who follow closely the economy's performance, the underutilization of available manpower resources has been of particular concern. Interest, however, has been by no means confined to professional analysts. With major policy decisions framed in the context of statistics on employment and unemployment, general public interest has mounted to a point exceeded only by that in the great depression of the thirties.

Current public attention and interest in general labor force developments were aroused by the high level of unemployment during 1960 and 1961. After mounting steadily during most of 1960, the unemployment rate failed for nearly a year to respond to the general recovery in the economy. This provoked a host of editorial comments and articles on the problem. More recently, the unemployment situation has recorded some improvement, but change for the better has been slow and faltering. The improvement has been obscured, moreover, by a pronounced slowdown of labor force growth during the past year.

Two avenues of discussion, in general, have arisen from the current interest in unemployment. One is concerned with the appropriate policies, both public and private, designed to return to an environment of more rapidly expanding demands for manpower and of reduced rates of unemployment. The second area of discussion is aimed directly at the adequacy of the statistics describing employ-

ment and unemployment conditions. While the matter of measurement has been constantly subject to technical examination, it is probably safe to say that never before has the public been so involved in the problem. Unfortunately, the discussions have not resulted in clear-cut gains in understanding. Evidence of gross misunderstandings concerning unemployment data are evident in various widely circulated publications. In addition, it has been common to confuse the evaluation of unemployment concepts and measurements with attitudes toward policy decisions utilizing the statistics.

Because unemployment figures are so important in general public discussion of economic developments, it is essential that the concepts and methods of measurement, as well as the purposes of the information, be widely understood. This article, by directing attention to what is being measured and why, has been designed to extend public understanding of unemployment statistics.

WHY MEASURE UNEMPLOYMENT?

From the standpoint of total national output, statistics measuring unemployment provide a measure of unused potential. When manpower resources are idle, the goods and services they could have produced are lost forever. Excessive unemployment thus constitutes a waste of productive services. By reducing unemployment to a minimal level, a larger total of output and real income can be produced, assuming other resources also are available.

Shortly after World War II, certain broad economic goals of the American people were reaffirmed in the Employment Act of 1946.

The Act delegates a responsibility to the Federal Government "to promote maximum employment, production, and purchasing power." It also gives the Federal Government a responsibility for creating an environment in which "there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work."

Thus, as a tradition of a free society and as subsequently embodied in national legislation, emphasis in the American economy has been given to work and the avoidance of involuntary unemployment, as well as to high and rising levels of income and output. It is readily apparent that adequate employment and unemployment statistics are a necessary requisite for the type of analysis which will measure the progress toward such goals and provide the basis for policy decisions to help insure their attainment. Recalling the period of the thirties, it will be remembered that valid labor force statistics were lacking altogether and various unemployment estimates differed by millions. This deficiency was a serious handicap at that time. Fortunately, a major advance has been made since then and direct statistical measurements of unemployment are available on a current basis.

In addition to the objective of knowing the extent to which manpower resources are being utilized, labor force data are of interest as an economic indicator. Unemployment figures are a significant key in the analysis and discussion of the economic situation. Together with other labor force measures, they provide a record of the operation of the economy over time. Thus, the data are used extensively in the study of cyclical movements in economic activity.

In describing these two reasons for measuring unemployment, it may be noted that need of the individual or family has not been mentioned. While need may induce an individual to seek employment, knowledge of the motivation prompting the action is not relevant to the unemployment count desired for the uses

identified. The need may be great; or, the desire for greater wealth may govern the action. Indeed, the range of motives for seeking employment is undoubtedly extensive. The point being made, however, is that the loss of national output and income arising from unemployment is not dependent upon the circumstances of the individual.

It is true that unemployment is frequently thought of in terms of the need or hardship caused the individual. While this may be done, it is well to point out that economic hardship is influenced by many factors other than unemployment. Savings, other sources of income, secondary worker contribution to family income, number of dependents, duration of unemployment, and other considerations are necessary to form judgments on need or hardship. To illustrate the significance of this requirement for additional information, it may be observed that the needs of some employed individuals and their families may be greater than the needs of some unemployed persons.

THE SYSTEM OF CONCEPTS

Truly, then, there are legitimate differences as to who should be counted as unemployed. Consequently, the way in which unemployment is defined and measured affects the statistics themselves. Much of the misunderstanding concerning the data undoubtedly grows out of the failure to distinguish the purposes and the concepts governing the enumeration of unemployment in the United States.

The major purposes designed to be served by current labor force concepts are those relating to the performance of the economy. They provide a measure of resource availability and utilization and serve as an economic indicator. While they do reveal some information for making judgments on need and hardship, they are not intended to be a complete measure of need.

Unemployment is not measured by itself. Rather, it is part of a system of concepts on

the labor force. The system is related, in turn, to the population in a definite way. Measurement of labor force participation is based on that part of the population 14 years of age and over and not in institutions. While it is recognized that youngsters of 14 and 15 are not likely to be working or looking for work in substantial numbers, there is interest in learning of their number and occupations.

This part of the population is classified into four groups: (1) in the armed forces, (2) employed, (3) unemployed, and (4) not in the labor force. The first three categories constitute the total labor force, while the second and third groups comprise the civilian labor force.

Information on the labor force status of civilians is provided by the Current Population Survey and is reported in the U. S. Department of Labor publication, the *Monthly Report on the Labor Force*. The survey is taken for one week each month (the calendar week ending nearest the 15th of the month) by asking questions about the activities of each member of a sample of households. The total labor force is obtained by the addition of the armed forces to the civilian labor force count.

The concept of the civilian labor force is designed to include those persons who are economically active in the labor market. They are either participating or actively seeking to participate in the production of goods and services for pay or profit. Housewives and students, it may be noted, are not engaged in economic activities and therefore are not counted in the labor force.

The civilian labor force numbered about 73.5 million persons at midyear. Of these the majority, about 69.5 million, were employed. The concept of employment is based primarily upon the activity of working for gain during the survey week. It includes, however, persons who have jobs but were absent from work due to illness, vacation, inclement weather, labor disputes, etc. In addition, the concept includes among the employed those unpaid fam-

ily workers who worked 15 hours or more a week on a family farm or in a family business.

Under this concept, for reasons which will be clarified at a later point, persons need not work full time in order to be listed as employed. Working as little as one hour for pay or profit during the survey week qualifies a person to be listed as employed. Because part-time employment may be related to part-time unemployment, information is collected as to the reason for part-time work. Some persons may desire, or be able to accept, employment only on a reduced basis from the usual length of the workweek. Others, on the other hand, may desire full-time employment but work less than that because of economic factors resulting in a lack of demand for labor.

An activity test also governs the determination of persons counted as unemployed. Those who did not work during the survey week and were actively looking for work are unemployed. The status of unemployment is more difficult to identify than this definition may suggest, however, and certainly it is more difficult to measure than is employment.

A person may be out of work, but is he unemployed? While the answer depends primarily upon the activity of seeking work, it is recognized that the attitudes and motives of the person himself influence the answer. Suppose that a construction worker on a highway project is laid off when the work is completed in the early winter. If, in response to the question as to whether he is looking for work, he says "yes," he is unemployed. If "no," he indicates that he has withdrawn from active participation in the labor force.

The case assumes more controversial aspects, however, if the reply is that he has decided not to look for work because he doesn't think there are any jobs in his line of work in the community. In this instance, he is counted as unemployed. It is important to understand that such a person is placed in the unemployed category *only* when this information

is volunteered. Persons who reported they did not seek work in the survey week are not explicitly asked whether they would if they had believed work was available. In addition, when a person volunteers that his job-seeking efforts were temporarily interrupted by illness or that he was awaiting the results of a job inquiry made within the previous 60 days, he is listed as unemployed.

Another exception to the "looking for work" concept concerns those who are on temporary layoff or waiting to start new jobs. Take the case of a man who has been laid off temporarily with notification that he will be called back to work within 30 days. It is relatively easy to determine he is not working, but is he unemployed or has he temporarily left the labor force? In this instance, an exception is made to the "seeking work" concept and the man is counted as unemployed whether he is actively looking for other work or not. In similar fashion, persons waiting to start a new job within 30 days are listed as unemployed until they actually begin to work. A student waiting to take a new job, however, continues to be classified as not in the labor force.

Largely because of the measurement difficulty, but also because they are smaller than employment totals, unemployment figures are less accurate. When unemployment was reported recently at 4 million persons, the true figure as revealed by a complete census might have varied from that sample result. It may be stated, however, that true unemployment lay between 3.8 million and 4.2 million, with 95 per cent certainty of being correct. While this lack of preciseness might be disappointing to some, the measure is highly useful.

As noted above, the civilian labor force is defined as the total of the employed and the unemployed. The unemployment rate is formed by dividing unemployment by the civilian labor force.

Persons listed as not in the labor force include all civilians 14 years and over who are

not classified as employed or unemployed. For the most part, housewives and students constitute the great majority of the persons not in the labor force. In addition, persons may be retired, disabled, or have other personal reasons for not being in the labor force.

The household survey is our sole source of nationwide totals on the labor force, employment, and unemployment, as well as on major demographic features of the totals. This information may be supplemented with nonfarm establishment payroll records and claims for unemployment insurance. Indeed, an assessment of labor market conditions would rely upon all three sources. It should be noted, however, that the household survey data are derived independently of the two other sources and are designed to serve specific analytical purposes.

THE INTERVIEW

The questions used in the monthly survey are designed to elicit information in accordance with the underlying conceptual system. Trained enumerators conduct the survey among a small list of scientifically selected households scattered throughout the United States.

Each month, 42,000 households in 333 areas in 641 counties and cities are selected for survey by the U. S. Bureau of the Census. This number is reduced by about 7,000 units due to vacancies and other reasons which make an interview with permanent residents impossible. The resulting sample of about 35,000 households is assumed to be representative of the population of the country as a whole. Part of the sample is rotated each month, primarily to avoid the problem of lack of cooperation. Under the procedure used, 75 per cent of the sample segments are common from month to month and 50 per cent from year to year.

Classification of the sample into the three basic groups—employed, unemployed, and not in the labor force—is determined by the re-

sponses of the person being interviewed to a standard set of questions. The enumeration procedure is designed to yield a maximum degree of conformity between a similar set of circumstances and questionnaire answers, regardless of who asks or answers the questions.

In order to contribute to a better understanding of the enumeration procedure, the portion of the Current Population Survey relating to employment status is reproduced on an accompanying page.¹ Any responsible person, usually the housewife, may answer questions relating to the activities of other members of the household who are not present at the time of the interview.

Focusing on unemployment for the moment, the questionnaire provides two opportunities whereby a person may disclose his work-seeking status. The first question dealing with labor force activities (question 19 in the survey) asks what the person was "doing most of last week" (i.e., the week ending nearest the 15th of the month). If the reply is "looking for work," a second question (number 20) is asked in order to establish whether any work at all was done during the survey week. If he worked only an hour and spent the rest of the week looking for a job, he would be counted as employed. This is because of the system of priorities which has been established. The system puts at work first, looking for work second, with a job but not working third, and not in the labor force fourth. Thus, the labor force categories are exclusive as well as exhaustive.

If the answer to the first question is neither working nor looking for work and working is denied in the second question, a third and more direct question is asked—"Was this person looking for work?" If the answer is affirmative, he is considered unemployed. The question is *not* asked, as is sometimes assumed, "How

many people here want a job?" Such a question would definitely lead to an overcount of the unemployed. As noted earlier, volunteering certain information about why he was not seeking work may cause a person to be classified as unemployed.

A large number of details, as may be inferred from the questionnaire, are provided about the employed and the unemployed each month in addition to the total numbers. For the employed, several characteristics are determined, including industry, occupation, age, sex, and marital status. In addition, the survey obtains information concerning the number of persons working less than 35 hours a week and whether this was due to personal preference or because of economic reasons. For the unemployed, as well, several demographic characteristics are obtained. It may be learned also whether they are looking for their first job or are experienced members of the labor force with occupational skills and industrial attachment. Information on the duration of unemployment is also provided by the questionnaire.

The amount of detail available each month on characteristics of the employed and the unemployed permits those wishing to use somewhat different concepts to do so. Within the limits of the basic conceptual framework and the amount of detail provided, it is possible to tailor specific definitions of employment and unemployment for particular purposes. Such rearrangements may be helpful in understanding a given economic situation or conditions of employment.

In the final analysis, complete and accurate survey information depends upon the skills of the enumerator. Accordingly, the Bureau of the Census devotes a great deal of time and effort to a program of quality control. New interviewers are given special training—classroom lectures, discussion, and review materials—during the first 3 months. Experienced personnel are given several hours of home study prior to each monthly survey, and day-long

¹In order to permit reproduction on a page of this *Review*, one slight change in arrangement and the elimination of the alternative categories in items 27 through 32 have been necessary.

LABOR FORCE STATUS QUESTIONNAIRE

Fill for civilian household members 14 years of age and over.

18. LINE NO. THIS PERSON	20. Did ... do any work at all LAST WEEK not counting work around the house? Yes <input type="radio"/> No (Skip to 22) <input type="radio"/>	22. Was ... looking for work? (Include special cases) If LK in 19, skip to 23 Yes <input type="radio"/> No (Ask 24) <input type="radio"/>	24. Even though ... did not work LAST WEEK, does he have a job or business? If I in 19, omit 24 and go to 25. Yes <input type="radio"/> No <input type="radio"/> (Omit 25-26)
19. What was ... doing most of LAST WEEK — Working Keeping house <input checked="" type="checkbox"/> Going to school <input checked="" type="checkbox"/> Or something else? Working (Skip to 21) WK <input type="checkbox"/> Looking for work ... LK <input type="checkbox"/> With a job but not at work ... J <input type="checkbox"/> Keeping house ... H <input type="checkbox"/> Going to school ... S <input type="checkbox"/> Unable to work ... U <input type="checkbox"/> (Omit 20-26) Other (Specify) ... OT <input type="checkbox"/>	21. How many hours did ... work last week (at all jobs)? 0 <input type="radio"/> <input type="radio"/> <input type="radio"/> 1 <input type="radio"/> <input type="radio"/> <input type="radio"/> 2 <input type="radio"/> <input type="radio"/> <input type="radio"/> 3 <input type="radio"/> <input type="radio"/> <input type="radio"/> 4 <input type="radio"/> <input type="radio"/> <input type="radio"/> 5 <input type="radio"/> <input type="radio"/> <input type="radio"/> 6 <input type="radio"/> <input type="radio"/> <input type="radio"/> 7 <input type="radio"/> <input type="radio"/> <input type="radio"/> 8 <input type="radio"/> <input type="radio"/> <input type="radio"/> 9 <input type="radio"/> <input type="radio"/> <input type="radio"/> If 1-34 hours in 21, fill 21A-B-C. If 35 or more hours in 21, skip to 26 and enter job worked at last week.	23. How many weeks has ... been looking for work? 0 <input type="radio"/> <input type="radio"/> <input type="radio"/> 1 <input type="radio"/> <input type="radio"/> <input type="radio"/> 2 <input type="radio"/> <input type="radio"/> <input type="radio"/> 3 <input type="radio"/> <input type="radio"/> <input type="radio"/> 4 <input type="radio"/> <input type="radio"/> <input type="radio"/> If weeks marked, skip to 26 and enter last full-time civilian job. 5 <input type="radio"/> <input type="radio"/> <input type="radio"/> 6 <input type="radio"/> <input type="radio"/> <input type="radio"/> 7 <input type="radio"/> <input type="radio"/> <input type="radio"/> 8 <input type="radio"/> <input type="radio"/> <input type="radio"/> 9 <input type="radio"/> <input type="radio"/> <input type="radio"/>	25. Why was ... absent from work last week? Own illness <input type="checkbox"/> On vacation <input type="checkbox"/> Bad weather <input type="checkbox"/> Labor dispute <input type="checkbox"/> Temporary layoff (Less than 30 days) ... <input type="checkbox"/> New job to begin within 30 days <input type="checkbox"/> Other (Specify) ... <input type="checkbox"/> How many weeks ago was ... laid off? Record answer in Item 23 and go to 25A. How many weeks ago did ... start looking for a job? Record answer in Item 23 and go to 25A. If entry in 25, always fill 25A.

IF WORKED LESS THAN 35 HOURS LAST WEEK (1-34 in Item 21)		26. DESCRIPTION OF JOB OR BUSINESS A. For whom did ... work? EMPLOYER (Name of company, business, organization, or other employer) B. What kind of business or industry was this? INDUSTRY For example: TV and radio mfg., retail shoe store, State Labor Dept., farm C. What kind of work was ... doing? OCCUPATION (For example: civil engineer, stock clerk, typist, farmer, etc.) D. CLASS OF WORKER Was this person — An employee of PRIVATE company, business, or individual for wages, salary, or commission P <input type="radio"/> A GOVERNMENT employee (Federal, State, county, or local).... G <input type="radio"/> Self-employed in OWN business, professional practice, or farm... O <input type="radio"/> Working WITHOUT PAY in family business or farm WP <input type="radio"/> NEVER WORKED..... NEV <input type="radio"/>	If entry in Item 25 25A. Is ... getting wages or salary for any of the time off last week? Yes <input type="checkbox"/> No <input type="checkbox"/> Self-employed <input type="checkbox"/> Go to Item 26 and enter job held last week.
21A. Does ... usually work 35 hours or more a week at this job? Yes <input type="radio"/> No <input type="radio"/>	21B. What is the reason ... worked less than 35 hours LAST WEEK? Mark one circle below <input checked="" type="checkbox"/> Slack work <input type="radio"/> Material shortages <input type="radio"/> Plant or machine repairs <input type="radio"/> New job started during week <input type="radio"/> Job terminated during week <input type="radio"/> Could find only part-time work <input type="radio"/>	21C. What is the reason ... USUALLY works less than 35 hours a week? Holiday (legal or religious).... <input type="radio"/> Labor dispute <input type="radio"/> Bad weather <input type="radio"/> Own illness <input type="radio"/> On vacation <input type="radio"/> Too busy with house-work, school, etc. <input type="radio"/> Did not want full-time work <input type="radio"/> Full-time work week under 35 hours <input type="radio"/> Other reason (Specify) <input type="radio"/>	27. LINE NO. 28. RELATIONSHIP TO HOUSEHOLD HEAD <input checked="" type="checkbox"/> 29. AGE LAST BIRTH-DAY 30. MARITAL STATUS 31. RACE <input checked="" type="checkbox"/> 32. SEX AND WORLD WAR II VETERAN STATUS

27. LINE NO.	28. RELATIONSHIP TO HOUSEHOLD HEAD <input checked="" type="checkbox"/>	29. AGE LAST BIRTH-DAY	30. MARITAL STATUS	31. RACE <input checked="" type="checkbox"/>	32. SEX AND WORLD WAR II VETERAN STATUS
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group training is conducted at least four times a year. About twice each year, the interviewer is accompanied by a supervisor who observes his application of the current concepts and procedures of enumeration. The reinterview of a sample household by a supervisor provides an even broader quality check. In this manner, the general accuracy of the survey may be evaluated in addition to the performance of the specific interviewer. Also, the completed questionnaires are inspected each month so that appropriate training materials may be sent to the enumerator. Ultimately, if an interviewer cannot meet the prescribed standards of quality, he is replaced.

THE CONTINUING QUEST

With improved understanding of the basic concepts of employment and unemployment and of the procedures used in their measurement, public concern about the statistics seems destined to subside. The statistics are basically sound and the concepts are suitable for the

major purpose for which they are wanted. This does not mean that there is no room for improvement. On the contrary, many major changes have been made in recent years and others undoubtedly will be coming. Also, there continues to be a relatively large number of unsatisfied needs among users for additional information.

Several years ago, the Review of Concepts Subcommittee, established by the U. S. Bureau of the Budget, undertook a fundamental review of concepts and measurements. Its recommendations provided the direction for subsequent changes and improvements in labor force statistics. More recently, the President appointed a Committee to Appraise Employment and Unemployment Statistics. This committee is composed of men from outside of Government who are university economists or users of statistical data. Their report is to be published shortly and it is certain to bring forth new ideas for improving and extending the usefulness of the basic labor force statistics.

Postwar Trends in District Bank Earnings

RATES OF RETURN on commercial bank assets have risen substantially since the end of World War II, reflecting both the upward drift of interest rates on bank loans and investments and the marked shift of bank assets from liquid instruments of low earning power to loans and investments with higher yields. Member banks in the Tenth Federal Reserve District have participated fully in these developments. During each of the past 3 years, the aggregate ratio of net current earnings to assets at all District members was more than twice as high as in 1946.

This article reviews in broad outline the trend of District member bank earnings over the postwar years. Such a review appears timely in light of the possibility that forces shaping the trend of bank net income may currently be undergoing a rather significant alteration. Interest rates on newly acquired bank earning assets have failed to advance significantly during the current economic upswing, contrary to earlier cyclical experience, and are presently

well below peak levels attained in 1959. Cost pressures, meanwhile, have intensified in the banking system, partly as a result of increases in rates paid on time deposits. Taken together, these two factors generate a question as to whether net earnings rates of banks are likely to continue to advance in the immediate years ahead.

A discussion of past experience cannot, of course, disclose whether these recent developments herald a fundamental change in the trend of bank earnings rates. It may, however, help to place these developments in a more appropriate perspective.

RATIOS OF CURRENT EARNINGS AND COSTS TO ASSETS

District member banks, like banks elsewhere in the Nation, entered the postwar period with an asset structure heavily weighted with liquid assets of low earning power—especially U. S. Government securities. In the intervening years, the composition of their assets has been shifting almost continuously toward loans bearing higher yields. The dimensions of that shift may be seen in Table 1, which lists major classes of assets held by all District members at year-end 1946 and 1961. Total loans in the 15-year period increased from 17 to 43 per cent of total assets, while Treasury security

Table 1.

STRUCTURE OF ASSETS

All Tenth District Member Banks

Type of Asset	Dec. 31, 1946 Millions of Dollars	Per Cent of Total	Dec. 30, 1961 Millions of Dollars	Per Cent of Total
Total Loans, Gross	1,003	17.09	4,569	42.79
<i>Business Loans</i>	455	7.75	1,734*	16.24
<i>Loans to Individuals</i>	123	2.10	943	8.83
<i>Farm Loans</i>	172	2.93	876	8.21
<i>Real-Estate Loans</i>	168	2.86	673	6.30
<i>All Other Loans</i>	85	1.45	343	3.21
U. S. Government Securities	2,754	46.92	2,627	24.61
Other Securities	314	5.35	805	7.54
Cash and Miscellaneous Assets	1,799	30.64	2,675	25.06
Total Assets	5,870	100.00	10,676	100.00

*Includes loans to nonbank financial institutions.

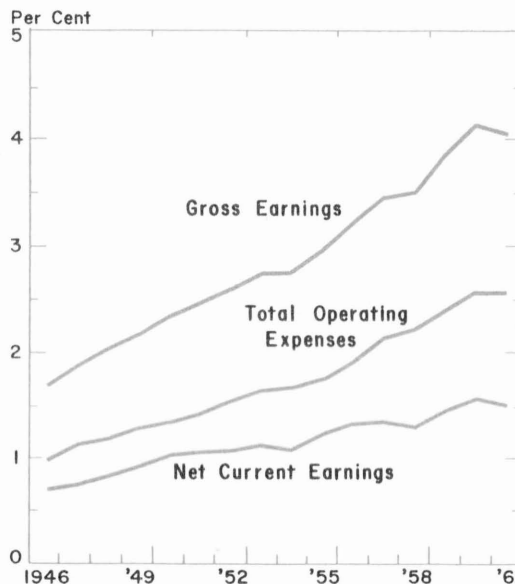
ownership was reduced from 47 to 25 per cent and cash and other miscellaneous assets fell from 31 to 25 per cent.

This phenomenal restructuring of asset portfolios would itself have produced a substantial rise in gross rates of return on bank assets, but another powerful factor working in the same direction was the increase in gross yields on bank loans and investments that accompanied the advance of market rates of interest on virtually all categories of debt instruments. Unfortunately, data relating to rates of interest charged on each individual class of bank loans and investments are not available. The information submitted by banks in their earnings and condition reports can, however, be used to compute gross yields on the three major classes of earning assets — loans, U. S. Government securities, and other securities. Table 2 shows figures for 1946 and 1961 which indicate that gross yields at all District member banks advanced 1.75 percentage points on Treasury securities, 1.61 percentage points on loans, and .96 percentage points on securities other than Treasury issues.

The result of these twin forces—the restructuring of asset portfolios and the rise in rates of interest—was an increase in gross earnings on total assets of District member banks from less than 2 per cent in 1946 and 1947 to over 4 per cent in 1960 and 1961. As the chart indicates, 1961 was the only year during this interval in which the aggregate ratio of gross earnings to assets at District member banks declined. A reduction in the growth rate of this

RATIOS OF EARNINGS AND COSTS TO ASSETS

All Tenth District Member Banks



ratio, induced by recessionary declines in interest rates and sharp increases in bank holdings of lower yielding earning assets, can be noted in 1954 and again in 1958, however.

The chart also indicates that while ratios of net current earnings to assets rose—the level in each of the 3 years 1959-61 was more than twice as high as in 1946, as noted earlier—the growth in net earnings rates was less, absolutely, than the increase in gross earnings. This reflects, of course, the increase in operating expenses relative to total bank assets. The pace of advance in net current earnings rates also was more irregular. The decline in 1961 was not the first but the third since 1946. Net current earnings rates fell both in 1954 and in 1958, when the growth rate of gross earnings slowed down.

Factors Underlying the Growth of Bank Costs

Since an important part of the rise in gross earnings rates shown in the chart resulted from a shift in the composition of assets from liquid instruments to loans, it is not surprising that

Table 2.
GROSS YIELDS ON MAJOR CLASSES OF EARNING ASSETS

All Tenth District Member Banks
In Per Cent Per Annum

	1946	1961
Loans	4.29	5.90
U. S. Government Securities	1.36	3.11
Other Securities	1.94	2.90

NOTE: These gross rates of return are computed from aggregate banking figures by dividing the appropriate category of earnings for the full year by an average asset figure based on three condition reports for the year.

the increase in gross rates of return on bank assets did not carry through fully to net current rates of return. Administrative costs of granting loans generally are higher than those of acquiring investments, and therefore the change in the structure of bank assets would be expected to increase bank costs as a per cent of assets. The increase in the ratio of total operating expenses to assets shown in the chart, however, was affected by other forces as well. It is desirable to identify the various factors responsible for increasing costs and to obtain some idea of their relative importance.

A breakdown of total operating expenses into its major components is displayed in Table 3 for 1946, 1961, and 2 intermediate years. All major categories of expenses increased as a per cent of assets between 1946 and 1961, but by far the largest relative increase was in interest on deposits. The marked rise in this expense item began about 1951, when Federal Reserve policy switched from "pegging" interest rates on Treasury securities to operating as a stabilizing force on economic activity. Interest rates on nearly all classes of financial assets trended upward in subsequent years, and rates on time deposits, though less flexible than market rates of interest in the short-run, have followed a broadly parallel course of movement over the past decade. With the ratio of time to total deposits also increasing, interest payments on time accounts nearly doubled from 1951 to 1956, and more than doubled between 1956 and 1961.

Table 3.
RATIOS OF OPERATING EXPENSES
TO ASSETS

Ratio:	All Tenth District Member Banks In Per Cent			
	1946	1951	1956	1961
Total Costs to Assets	.98	1.41	1.90	2.55
Wages and Salaries to Assets	.49	.75	.97	1.12*
Interest on Deposits to Assets	.08	.12	.23	.55
Other Expenses to Assets	.41	.54	.70	.88*

*Ratios for 1961 not entirely comparable with those for previous years due to changes in the report of income and dividends.

The rise in wage and salary payments shown in the table was the product of two dominant influences. Average wage and salary payments per employee advanced, and the number of employees per dollar of bank deposits increased. Data for 1946 and 1960 suggest that average wage and salary payments per employee (including officers as well as nonofficial employees) at District banks have approximately doubled since the end of the war, while the number of bank employees per \$1 million in aggregate deposits has risen about 14 per cent—from 2.2 to 2.5.¹ This latter change reflects, in the main, the altered character of banking activities implied by the sharp increase in the relative magnitude of loans in bank earning asset portfolios. On the basis of these data, it appears that about four fifths of the increase in the ratio of total wage and salary payments to total assets resulted from increasing rates of remuneration to bank personnel; the remainder is accounted for by the rise in numbers of employees per dollar of bank deposits.

Sources of the rise in "other expenses" per dollar of assets are not easily determined with any precision. Included under this broad category are a host of items such as supplies, advertising expenses, postage and freight, outlays for insurance, purchases of furniture and equipment, fees paid for legal and accounting services, and so on. Prices of nearly all of these items must have risen along with the general price level of commodities and services during the postwar years, however, and this presumably accounts for the bulk of the increase.

¹These figures are based on wage and salary outlays and number of banks at year end for all banks with over \$2 million in deposits. Smaller banks were eliminated from the calculation because information on numbers of employees at these banks was inadequate. The terminal year used for the calculation was 1960 because, as indicated in the note to Table 3, changes in the income and dividends report for 1961 make the wage and salary data not strictly comparable with those for past years.

Table 4.
RATIOS OF EARNINGS TO CAPITAL
AND CAPITAL TO ASSETS

Ratio of:	All Tenth District Member Banks In Per Cent		
	1946-47	1960-61	Change
Net Current Earnings to Capital	14.98	18.11	+3.13
Profits Before Taxes to Capital	15.23	17.16	+1.93
Profits After Taxes to Capital	11.19	10.02	-1.17
Capital to Total Assets	4.89	8.51	+3.62

PROFITS ON INVESTED CAPITAL

It may come as something of a surprise, in view of the marked increase in net earnings as a per cent of bank assets, to learn that the rate of aftertax profits on invested capital at District member banks has not risen at all during the postwar period. As a matter of fact, post-tax profits of all District members averaged somewhat lower, as a per cent of capital accounts, in the 2 years 1960-61 than in the 2 years 1946-47. The tale of "where the profits went" is told in Table 4.

A major factor in the failure of aftertax profits to increase relative to bank capital was the decision of District banks to build up their capital accounts. The capital-asset ratio for all District members rose from 4.89 per cent in 1946-47 to 8.51 per cent in 1960-61. Had the ratio of capital to assets remained constant over this period, aftertax profits would have amounted to 17.44 per cent of capital in the years 1960-61—more than 50 per cent larger than in 1946-47. Ratios of net current earnings to capital, and profits before taxes to capital, also would have risen much more had bank capitalization ratios remained stable.

There is no doubt that the expansion of net income in relation to bank assets since the end of the war presented the banks with an excellent opportunity to enlarge their capital positions from internally generated sources. The only question is why the banks chose this disposition of earnings rather than distributing the enlarged income stream to bank stockholders.

The motives of bankers cannot be deduced from these statistics, but a view prevails that

bankers have pursued this course of action for three principal reasons. In the first place, bank capitalization ratios were widely regarded as unusually low at the end of World War II as a consequence of the squeeze on bank current income throughout the 1930's and during the war years. Thus, banks welcomed the opportunity to restore capitalization ratios to what they considered more nearly normal levels. A second reason is that bank ownership of risk assets—assets other than cash and Government securities—has been on the upswing since the end of the war and conservative banking practices, along with the encouragement of the supervisory authorities, would dictate adding to capitalization ratios in these circumstances. Still a third motive underlying the substantial rise in capital accounts was the desire of banks to enlarge their legal lending limits to individual borrowers. The growth of business, farm, and individual credit requirements during the postwar years, together with the expansion in size of businesses and farms, has exerted strong pressures on banks to increase the amounts they can lend to individual borrowers by adding to their capital accounts.

Table 4 also indicates that two other considerations, in addition to the rise in capitalization ratios, prevented the increase in net current earnings as a per cent of assets from being reflected in ratios of aftertax profits to capital. A minor factor was the failure of profits before taxes to advance in step with net current earnings. Detailed data on additions to and deductions from net current earnings indicate that the smaller increment to profits before taxes was due mainly to rather large recoveries on loans and securities in the early postwar years. Such recoveries are added to net current earnings in the computation of net profits before taxes, and raised the magnitude of pretax profits to unusually high levels in relation to net current income during 1946-47.

The more important factor holding down the expansion of posttax profits at District

banks between 1946-47 and 1960-61 was the larger share of pretax profits taken by income taxes. These tax outlays comprised less than 30 per cent of pretax profits in 1946-47, but over 40 per cent in 1960-61. The Federal tax rate on corporate income was higher in the later period, of course, and in addition a larger share of bank income was subject to the 22 per cent surtax on corporate income, since total bank income was greater and taxable income of many smaller banks had risen above the \$25,000 level.

SOME COMPARISONS

A comparison of District bank earnings performance during the postwar years with that of member banks throughout the United States indicates that profitability of banking in this region has grown about as much as in other sections of the country. Table 5 shows comparative rates of return at member banks in the Tenth District and in the United States, and also in the various District states for the years 1946-47 and 1960-61. Net current earnings rates are used as the basis for comparison because, as noted above, the increase in profits figures before and after taxes over this period is subject to special influences which make difficult a meaningful evaluation of relative performance.

As a per cent of total assets, net current earnings of District members exceeded the national average ratio in 1946-47 and again in 1960-61, both ratios displaying about the same amount of gain over the 15-year interval. Among the seven District states, the largest increases in the ratio of net current earnings to assets were recorded in Missouri and Nebraska—states in which the ratio was well below the District average in 1946-47. The smallest increase was in New Mexico, which enjoyed unusually high net current rates of return on assets at the beginning of the postwar period. This small gain in New Mexico is due in part to an unusually sharp decline in net current rates of return on assets in 1961. In 1960, member banks in New Mexico achieved a ratio of net current earnings to assets surpassed only by banks in Wyoming. Nevertheless, it is clear that the past 15 years have witnessed an appreciable narrowing of the wide dispersion in ratios of net current earnings to assets that existed in 1946-47.

As the third column of the table indicates, capitalization ratios at District members since 1946-47 have risen much more sharply than at all member banks in the United States, with the result that net current earnings in relation to capital accounts increased less. Total capital accounts at all District members rose 175 per

Table 5.
COMPARATIVE EARNINGS RATES
United States and Tenth District Member Banks
In Per Cent

	Ratio of Net Current Earnings to Total Assets		Ratio of Net Current Earnings to Total Capital Accounts		Ratio of Total Capital Accounts to Total Assets	
	1946-47	1960-61	1946-47	1960-61	1946-47	1960-61
All Member Banks, U. S.	.72	1.52	11.53	18.48	6.22	8.22
Tenth Dist. Member Banks	.73	1.54	14.98	18.11	4.89	8.51
Colorado	.74	1.54	15.61	20.41	4.75	7.55
Kansas	.70	1.49	15.08	17.00	4.65	8.74
Missouri*	.58	1.55	12.52	17.64	4.60	8.76
Nebraska	.67	1.52	14.65	17.59	4.58	8.67
New Mexico*	1.02	1.48	25.00	23.20	4.07	6.38
Oklahoma*	.90	1.59	15.77	17.06	5.73	9.29
Wyoming	.81	1.60	15.30	20.54	5.27	7.79

*Tenth District portion only.

cent between 1946-47 and 1960-61, or about three times the relative gain in total assets. At all member banks in the United States, the relative growth of capital accounts was somewhat less than twice the percentage rise in total assets. It was in Nebraska and Western Missouri, among the District states, that capital accounts increased the most rapidly in relation to assets. Member banks in both of these states experienced a relative rise in total capital funds about five times as large as the percentage gain in total assets. These two states also, it will be noted, experienced the greatest improvement in net current earnings as a per cent of assets—pointing up again the importance of retained earnings as a primary source of additions to bank capital.

PROSPECTIVE DEVELOPMENTS

It seems quite unlikely that the next decade and a half will witness a repetition of the remarkable gains that have been made over the postwar years in District bank earnings. The doubling of net current earnings as a per cent of assets that has occurred at District banks since 1946 was generated, in part, by striking alterations in the structure of earning asset portfolios that can scarcely be expected to recur. The increase in loans as a per cent of total assets, and the corresponding decline in relative amounts of Government securities and cash held by banks, point to reduced liquidity cushions and increased risk positions which weigh importantly in bank management decisions. Furthermore, the long-run increase in interest rates on individual earning assets of banks that has played such a prominent role in enlarging bank income during the postwar years may well have run its course.

Year-to-year changes in gross and net current rates of return on assets at District banks shown in Chart 1 indicate that during years in which the ratio of gross earnings to assets has grown relatively little—such as in 1954 and 1958—the ratio of net current earnings to

assets has declined. Accordingly, it might be thought that if gross earnings ratios of District banks were to level out at existing rates of about 4 per cent of total assets and remain there for a considerable length of time, prospects for net current earnings rates would be quite bearish.

Such a view would rest on the assumption that costs would continue to increase as a per cent of bank assets in line with the postwar trend, an assumption that might well prove to be excessively pessimistic. For one thing, it fails to take account of the fact that a significant portion of the long-run increase in costs experienced by banks in the postwar years has been intimately connected with forces responsible for the expansion in bank gross earnings rates. Viewed in long-run perspective, for example, the rise in interest payments on time deposits at District banks since 1951 appears to reflect the general advance of interest rates on nearly all classes of financial assets. Thus, if these rates did not advance markedly further, the growth of time deposit expenses could be expected to slow down. Absence of further increases in bank loans as a per cent of assets also would serve to temper the increase in wage and salary outlays as a per cent of assets. Additionally, rising wage rates and prices of other commodities and services banks use clearly have been important factors in boosting bank costs in the postwar years, but here, too, the more moderate advance of overall wage rate and price levels that has been in evidence since about 1958 offers room for optimism.

What does seem clear, however, is that a leveling out of gross rates of return on bank earning assets near current levels would imply a distinct change in the environmental factors determining bank net income positions. In such circumstances, significant improvements in net earnings rates would be reserved to those banks that are successful in increasing operating efficiency, thereby warding off the encroachment of rising input prices on net income.

BANKING IN THE TENTH DISTRICT

District and States	Loans				Deposits				Loans				Deposits			
	Reserve City Member Banks		Country Member Banks		Reserve City Member Banks		Country Member Banks		Reserve City Member Banks		Country Member Banks		Reserve City Member Banks		Country Member Banks	
	August 1962 Percentage Change From								July 1962 Percentage Change From							
	July 1962	Aug. 1961	July 1962	Aug. 1961	July 1962	Aug. 1961	July 1962	Aug. 1961	June 1962	July 1961	June 1962	July 1961	June 1962	July 1961	June 1962	July 1961
Tenth F. R. Dist.	†	+11	-1	+12	†	+9	†	+8	†	+11	+1	+11	+1	+7	+2	+8
Colorado	+2	+12	†	+18	+2	+10	+2	+13	†	+9	†	+17	+3	+8	+3	+12
Kansas	+1	+30	†	+14	†	+30	-1	+6	-3	+17	+5	+6	†	+8	+4	+5
Missouri*	†	+8	-1	+11	†	+6	+1	+9	+1	+9	+1	+13	-2	+2	+1	+7
Nebraska	+1	+13	-3	+12	†	+4	+1	+8	-1	+11	†	+12	+2	+4	+3	+7
New Mexico*	**	**	+3	+11	**	**	+1	+5	**	**	-1	+7	**	**	+1	+4
Oklahoma*	-1	+11	-3	+6	-3	+11	†	+10	-1	+14	-2	+10	+1	+12	†	+10
Wyoming	**	**	†	+13	**	**	†	+5	**	**	†	+13	**	**	+1	+7

* Tenth District portion only. **No reserve cities in this state. † Less than 0.5 per cent.

NOTE: Due to the reclassification of certain Topeka and Wichita banks on August 23, 1962, from reserve city to country bank status, data for August 1961 have been adjusted to produce comparability with current figures.

PRICE INDEXES, UNITED STATES

Index	Aug. 1962	July 1962	June 1962	Aug. 1961	July 1961
Consumer Price Index (1957-59=100).....	105.5	105.5	105.3	104.3	104.4
Wholesale Price Index (1957-59=100).....	100.5	100.4	100.0r	100.1	99.9
Prices Received by Farmers (1910-14=100)....	244	240	239	240	235
Prices Paid by Farmers (1910-14=100).....	305	305	305	301	300

r Revised.

TENTH DISTRICT BUSINESS INDICATORS

District and Principal Metropolitan Areas	Value of Check Payments			Value of Department Store Sales		
	Percentage change from previous year					
	Aug. 1962	July 1962	Eight Months 1962	Aug. 1962	July 1962	Eight Months 1962
Tenth Federal Reserve District.....	+6	+9	+8	+2	+4	+3
Denver.....	+4	+6	+8	0	+1	+1
Wichita.....	-1	+2	+6	-3	-1	+1
Kansas City.....	+6	+10	+7	+7	+9	+7
Omaha.....	+15	+11	+8	+3	+3	+1
Oklahoma City.....	+18	+9	+12	+4	+8	+6
Tulsa.....	+2	+7	+6	+4	+7	+4