The economy recently passed the two-year mark in its recovery from the recession which ended in November 1970. The record of business cycles over the past two decades indicates that two of the three previous recoveries were halted in less than three years. The recovery following the recession of 1953-54 lasted two years and eleven months, and the recovery following the 1957-58 downturn endured two years and one month.

However, the expansion following the 1960-61 recession moved past the so-called "fragile" stage into a mature, well-rounded recovery which, despite brief periods of slowing, did not end until late 1969. Stabilization actions played a strong role in determining the duration of the expansion in all cases.

The evidence surveyed by this article indicates that the current recovery is no longer in the fragile stage of its development. Recent stimulative monetary and fiscal actions combined with the present upward momentum of the economy suggest that the current business expansion might well continue for an extended period of time.

BUSINESS DEVELOPMENTS

One way of gauging the current strength of the economy is by relating its progress to earlier recoveries at comparable stages in the business cycle. Several economic variables are compared in Chart I by setting their actual values equal to 100 at the trough of the various cycles. An analysis of the recovery by spending sectors follows.

Production, Employment, and Prices

The data for four economic indicators in the chart are compiled to give a comparison of the current recovery with the average of the three preceding ones.

The charts trace out the movements of real product, industrial production, payroll employment, and the GNP price deflator from eight quarters prior to the recession troughs to eight quarters after.

The top tier of the chart shows GNP in 1958 prices, the broadest measure of overall real economic activity. Real product did not increase as rapidly in the first year of the latest recovery period as in previous comparable periods. However, real product accelerated to the point where it matched the average of the previous periods after seven quarters and surpassed the average by the eighth quarter. A similar picture is illustrated by industrial production. Industrial production growth was sluggish in 1971 in comparison with the first year of previous recoveries. By the end of the second year of the recovery, the gap between the two lines had narrowed sharply.

Payroll employment did not decline as much in 1970 as the average of the previous recessions, nor did the unemployment rate rise to the levels observed in the 1957-58 and 1960-61 recessions. Partially reflecting the mildness of the downturn, employment gains in 1971 were modest in comparison with the first year of other recoveries. However, payroll employment rose at a more rapid rate in the second year of the latest recovery than the average rate of the previous corresponding periods.

Prices, as measured by the GNP price deflator, increased at a much more rapid rate prior to the trough of the latest recession than in previous recessions. Not surprisingly then, price advances were more difficult to curb in 1971 than in the first year of previous recoveries. It can be seen by the slopes of the two lines that after the first year the progress in slowing inflation was quite comparable with the average of the previous periods.

In summary, the indicators of real economic activity suggest that 1971 was weaker than the average

\[\text{1 Turning points cited in this article are those identified by the National Bureau of Economic Research.}\]
initial recovery year and 1972 was considerably stronger than the average second year of a recovery period. Moreover, there is no apparent slowing indicated by fourth quarter 1972 data. Real product, for example, increased at an 8.4 percent annual rate from the third to the fourth quarter of 1972, compared with a 7.2 percent rise in the preceding year. The current strength of the indicators of real growth, given some remaining capacity for expansion, imply considerable economic momentum.

**Spending Sectors**

An analysis of the various spending components indicates sectors that have been increasing at slow or rapid rates in the past and suggests which direction they may take in the near future. Several components of GNP are traced in Chart III, which is similar in terms of cyclical comparisons to Chart I. All GNP components in Chart III are price deflated in order to separate the real trends from the price developments.

**Consumption** — Consumer outlays, in real terms, have increased somewhat more rapidly over the first two years of the most recent recovery than the average of comparable periods in previous recoveries. At the end of the first year of the latest recovery, consumption expenditures were slightly below the average for the previous periods. However, during the second year of the expansion, consumer expenditures rose considerably above the “average” line. This recent spurt in consumption spending occurred despite substantial tax overwithholding in 1972.

Purchases of durable goods, especially autos, have accounted for a sizable portion of the recent gains in consumer expenditures. The elimination of the excise tax on automobiles and a re-alignment of international exchange rates have been important stimuli to domestic automobile sales.

**Fixed Investment** — Nonresidential investment expenditures, which consist of producers’ durable goods
and structures, moved approximately in line with the index of previous periods until the eighth quarter following the trough. At this point, expenditures (price deflated) in the recent recovery moved well above the line representing the average of the three preceding periods. Business assistance programs, such as the investment tax credit and accelerated depreciation, have been partially responsible for recent gains in plant and equipment expenditures. Surveys, such as those of the Department of Commerce, indicate that plant and equipment expenditures in 1973 may well surpass those of the year just ended.

Outlays for residential structures demonstrate the most significant departure from previous recovery periods. The expenditure patterns for residential structures in the current and earlier cycles are fairly similar during the eight quarters preceding the trough of the recession. However, these expenditures (in real terms) accelerated at a very rapid rate in the first four quarters after the trough of the 1969-70 recession and did not turn down as they did in the second year of previous recovery periods.

A fall in mortgage rates from 8.4 percent at the end of 1970 to 7.6 percent at the end of 1972 provided stimulus to the housing sector as did the 17 percent annual rate of increase in deposits at savings institutions over that period. Although government-subsidized housing starts fell from over 425,000 units in 1971 to 337,000 units in 1972, all private starts rose from 2.1 million to about 2.4 million. A continued slowing of subsidized housing starts, therefore, would not necessarily signal the end of the housing boom if conditions remained favorable to the private housing sector. However, mortgage interest rates and interest rates competitive with those of savings institutions have recently begun to rise. These two factors may tend to slow the recent rapid growth in housing starts.

**Government** — Government purchases of goods and services, which include state, local, and Federal Government purchases, declined considerably in the eight quarters preceding the trough of the latest business cycle and did not rise until the latter part of the first year of recovery. In 1972, however, the index of these price-deflated outlays topped their previous average for all four quarters. State, local and Federal non-defense expenditures have risen rapidly in recent years, but have not been subject to much year-to-year varia-

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Footnotes:

2Mortgage interest rate data are based on the effective rate on new homes. The mortgage rate for 1970 is the average rate for the last three months of the year, and the rate for 1972 is the average of October and November.
Fiscal Developments

Federal expenditures increased at a rapid pace in 1972. On a national income accounts basis, these expenditures rose 15.6 percent from the fourth quarter of 1971 to the fourth quarter of 1972, compared with a 9 percent increase in the year ending late 1971 and a 5.8 percent annual rate of increase in the preceding two years. The pattern of accelerating Federal expenditures has had a pronounced effect on the net budget position over the past few years.

The Federal budget, after being in surplus by $4.7 billion in fiscal year 1969, was in deficit by increasing amounts the next three years. The deficit was $1.3 billion in 1970, $19.7 billion in 1971, and $21.1 billion in 1972. Presently, the anticipated deficit for fiscal year 1973 is $26.6 billion.\(^3\)

Budget deficits stimulate the economy in two ways. First, there is usually a temporary direct influence of the budget on economic activity regardless of how the deficit is financed. Second, sizable deficits tend to be underwritten by monetary expansion.

In the first half of calendar year 1973, the Treasury is expected to borrow funds from the market, largely in order to meet refunds of last year's tax overwithholding. Generally, the first half of the calendar year is marked by little or no Treasury borrowing because of heavy inflows of tax receipts. Since the private sector is also expected to compete vigorously for funds in the near future, upward pressure on some interest rates is likely. Efforts by stabilization authorities to resist the rise in interest rates could result in accelerated monetary growth.

Monetary Actions

Monetary actions of the Federal Reserve and Treasury are reflected in movements of monetary aggregates and interest rates. Although the relationship between the aggregates and interest rates is complex, one pattern which has emerged over the years is a tendency for both to rise during much of the upswing phase of the business cycle. Initially, an acceleration in the rate of increase of monetary aggregates is reflected in a decline in interest rates as the monetary authorities attempt to stimulate spending. As economic activity begins to accelerate in response to the increased monetary expansion, the demand for credit increases, resulting in higher interest rates. Sometime later, as the economy nears full capacity utilization, the rate of inflation gradually accelerates. The acceleration of price advances leads creditors to demand yet higher interest rates to offset anticipated future inflation.

Monetary Aggregates — Purchases and sales of U.S. Treasury securities by the Federal Reserve are reflected in changes in the monetary base, a combined balance sheet of the Federal Reserve and Treasury "monetary" accounts. It has been observed that over a period of several months, the growth pattern of the money stock corresponds to that of the monetary base. In turn, marked and sustained changes in the money stock have led changes in economic activity by a few months.

One approximate method of gauging monetary policy actions in the first two years of a recovery period is to examine changes in the rates of growth of the money stock.\(^4\) For purposes of making comparisons with earlier periods, it is useful to relate the rate of monetary growth to its prevailing trend rate or, alternatively, to deflate the money stock by the price level (M/P). The latter approach is employed here and the results are given in Table 1.\(^5\)

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\(^3\)The recently released budget message for fiscal year 1974, which has not yet been acted upon by Congress, projects a $12.5 billion deficit on a national income accounts basis.

\(^4\)All money stock computations in this section are based on data available prior to the February 1973 revision. For further information on this revision, see the statistical release entitled "Money Stock Measures," Federal Reserve Board of Governors (February 1, 1973).

\(^5\)Relating money (M) to prices (P) in ratio form is not meant to imply that the monetary authorities can directly control M/P. They can, however, control the supply of M within close tolerances. When the supply of M exceeds the public's
The data in Table I indicate that the money stock relative to prices actually fell slightly in the first two years of the recoveries which began in 1954 and 1958. The finding of non-stimulative monetary actions for these particular periods is not surprising in view of the brevity of the recoveries which began in 1954 and 1958. In order to combat inflationary pressures, stimulative actions were reversed at an early stage in those two recoveries, as suggested by the switch from a positive rate of change in the M/P ratio in the first year to a negative figure in the second year.

The money/prices ratio increased at a 1.2 percent rate in the first two years of the long recovery which began in 1961. Even more stimulative was the 3.4 percent rate of increase of the money/prices ratio from the fourth quarter of 1970 to the fourth quarter of 1972. The money stock had to increase at a considerably more rapid pace than it had in the earlier recoveries in order to attain the 3.4 percent figure, since prices were rising at a more rapid rate than in the earlier comparable two-year periods.

The ratio increased 2.8 percent in the first year of the latest recovery, but accelerated to a 4 percent increase in the year ending fourth quarter 1972. Prices rose 3 percent from the fourth quarter of 1971 to the fourth quarter of 1972, compared with a 3.6 percent increase in the preceding year. For the same periods the nominal money stock increased 7.2 percent and 6.6 percent, respectively. That is, acceleration of the M/P ratio in the second year of the recent recovery was due to both a slowing in price rises and an increase in the growth rate of the money stock.

In addition to the increased monetary stimulus in 1972, income velocity—the rate at which the money stock turns over—also accelerated. For the two-year recovery period, velocity increased in the latest recovery at little more than half the average for the three preceding two-year periods (Table II). However, in each of the three earlier recoveries velocity increased at a slower rate in the second year than in the first. In the 1970-72 recovery velocity rose at a more rapid rate in the second year.

**Interest Rates**—Interest rates in the recent recovery period have not displayed a pattern similar to earlier recovery periods. By the end of the second year, interest rates are normally above or near the levels prevailing at the start of the recovery. At the end of the second year of the recoveries begun in 1954 and 1958, interest rates for three-month Treasury bills (a short-term rate) and corporate AAA bonds (a long-term rate) were well above their initial levels.

In the recovery begun in 1961 the Treasury bill rate rose 56 basis points in the first two years and the corporate bond rate remained relatively unchanged (down 7 basis points). By contrast, the Treasury bill yield in the fourth quarter of 1972 was almost 50 basis points lower than in the fourth quarter of 1970; the corporate AAA rate was down 77 basis points from the level of fourth quarter 1970.

There are a number of factors which contributed to the unusual behavior of interest rates in the past.

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two years. The nominal money stock increased at greater rates recently than in earlier recovery periods. This more rapid growth of money probably contributed to short-run downward pressure on interest rates. The demand for funds, which picks up with business activity, is more difficult to quantify. However, after a rather sluggish first-year recovery in 1971, the strong business rebound in 1972 and early 1973 suggests intensifying upward pressures on interest rates.

Another possible factor influencing the behavior of interest rates during the past two years is the progress made in curbing inflation. Prices were rising much more rapidly at the start of the current recovery than in previous episodes, and thus there was considerably more room for them to decelerate than before. The drop in the rate of price increases from over 5 percent in late 1970 to about 3 percent at the end of 1972 could have been translated into a reduction in the inflationary premium built into market interest rates.

Finally, the controls program, in particular the awareness on the part of the business community of the potential exercise of direct interest rate controls, has probably had some restraining influence on certain yields. This influence was most apparent in such highly publicized interest rates as the "prime" rate charged by large commercial banks. The prime rate, like most other rates, has begun to increase in recent months.

**SUMMARY**

The economic recovery from the 1969-70 recession moved off to a slow start in 1971, but accelerated rapidly last year. Business activity apparently has now advanced to the levels of the first two years of earlier recovery periods and appears to have sufficient momentum to continue into 1973 at a brisk pace. Some spending sectors, such as residential construction, are likely to taper off in 1973, but others, most notably inventory accumulation, are expected to surge.

Total spending responds strongly to monetary and fiscal actions. The successively larger deficits of the Federal budget in the past few years will be followed by another deficit of considerable size in the current fiscal year. Money stock growth has increased at accelerating rates since 1969, and far surpasses the growth rates of the first two years of previous recovery periods.

Interest rates thus far have remained below their levels of two years ago, in contrast to earlier comparable periods. However, the rapid pace of business activity, a sizable Federal budget deficit, and possible anticipation of a pickup in the inflation rate may prompt a return of interest rates to their normal cyclical pattern.
Relative Movements in Wages and Profits

by ALBERT E. BURGER

Controlling prices and wages involves the Government heavily in determining the relations between wages and profits in general and in particular industries and sectors and in many other aspects of the distribution of income. This Government involvement raises the question of the fairness of the outcome. The meaning of the question itself is difficult because, of course, people will differ about what a fair outcome would be.¹

The American economy is presently experiencing a strong upswing from the 1969-70 recession. Concurrent with the economic recovery, gains in wages and salaries and in corporate profits have accelerated. From the third quarter of 1970 to the third quarter of 1972, corporate after-tax profits in the nonfinancial sector have risen at a 14.2 percent annual rate and compensation of employees at a 7.3 percent rate.

Since prices and wage rates have been subject to control under the New Economic Program begun in August 1971, some observers have viewed the more rapid rise in corporate profits as reflecting a bias of the control program. Concern has been expressed that distribution of the share of income originating in the corporate sector has been biased against wages and salaries in favor of corporate profits.

The phase of the business cycle is especially relevant when making comparisons between growth rates of profits and wages. It is incorrect to base conjectures about “bias” either in favor of profits or wages on their relative movements during only one phase of an economic expansion. Corporate after-tax profits, as shown in Chart I, have exhibited large cyclical variation, falling sharply during economic contractions and rising rapidly during recoveries. Wages and salaries, on the other hand, have declined relatively little during economic contractions in the past 20 years and have risen steadily, but more slowly than profits, in the recovery period.

The ratio of corporate after-tax profits to compensation of employees in the nonfinancial corporate sector is used to compare the relative movements of profits and wages in the present recovery with past cyclical movements. An increase in this ratio indicates that the profits share of corporate income is rising relative to the wages share.

As shown in Chart II, the ratio of profits to wages has exhibited large cyclical variation. In general, the ratio has risen steadily following a trough in economic activity, has peaked about midway through the expansion and then has begun to decline. This decline has continued in the peak-to-trough period of the business cycle and then has reversed in the following recovery period. Over the early stage of a business cycle expansion the share of corporate income going to profits has risen, but during the later phase of an economic expansion the wages share has risen relative to the profits share.

Adjustment of Firms to Changes in Demand

The goal of a business firm is to maximize the wealth of owners.² Therefore, the firm must consider not only current profits, but also expected future profits. Actions taken by the firm in the current period to alter its level of employment and size of capital stock can be expected to affect its operations in future periods. The cyclical movement of the ratio of profits to wages reflects the process by which firms adjust to changes in product demand.

At any point in time, business firms have a stock of capital that is the result of past investment decisions. This inherited capital stock can be considered a fixed factor when analyzing the short-run response of business firms to deviations in demand from expected levels.³ Although the stock of capital is fixed in the


²For an additional discussion of points raised in this section, see Armen A. Alchian and William R. Allen, University Economics, 3rd ed. (Belmont, California: Wadsworth Publishing Co., 1972), especially Chapters 15, 16, 17 and 18.

³The degree of variability associated with a factor is most usefully considered in terms of the costs involved in altering the inputs of that factor. "When a proprietor says that he can quickly buy more steel sheet, but requires 7 months to obtain..."
short run, within limits, firms can vary the utilization rate of the inherited capital stock.

Firms base their capital expansion plans on expectations of future demand for output, inflation, and future labor costs relative to capital costs. Given these expectations, as well as other factors, firms attempt to adjust their capital stock to produce an expected level of output at minimum cost. If output demand deviates from what firms had expected, firms will find the scale of plant they have constructed is larger or smaller than what they would have built had they accurately forecast output demand.

For example, consider the case of a fall in demand for goods and services. Suppose firms had built up a capital stock during the previous expansion based on expectations of continued increases in demand. The scale of plant firms have constructed will be larger than what they would have built if they had correctly anticipated the slowing in output demand. Consequently, per unit costs of producing the actual output rate will be greater than if firms’ expectations had been realized.
In the early stages of an economic recovery, the per unit cost of output falls as demand increases such that firms operate their inherited capital stock at lowest minimum average cost. If, as the expansion proceeds, demand expands more rapidly than firms can economically expand their capital stock, then per unit costs begin to rise.

**Labor as a Quasi-Fixed Factor** — The number of workers employed by a firm is usually considered to be more variable in the short run than the stock of capital. However, a strong case has been made that, in the short run, a firm’s labor force should not be considered a completely variable factor, but as a quasi-fixed factor. A quasi-fixed factor has been defined as one where total employment cost is partially variable and partially fixed.

From a firm’s viewpoint labor is surely a quasi-fixed factor. The largest part of total labor costs is the variable-wages bill representing payments for a flow of productive services. In addition the firm ordinarily incurs certain fixed employment costs in hiring a specific stock of workers. These fixed employment costs constitute an investment by the firm in its labor force. As such, they introduce an element of capital in the use of labor. Decisions regarding the labor input can no longer be based solely on the current relation between wages and marginal value products but must also take cognizance of the future course of these quantities.  

Treating labor as a quasi-fixed factor has very important implications for the short-run response of firms to unexpected changes in demand for output. The greater the costs of hiring and training workers, the less variable the resource becomes. Therefore, firms react to changes in output demand by varying the rate of utilization of labor as well as changing the level of employment.

Faced with a deviation of output demand from expected levels, firms do not know whether the change is only a very short-run phenomenon, or a permanent change in demand. Suppose that firms did react to every short-run increase or decrease in product demand by changing the level of employment. If the change in product demand turned out to be only a temporary phenomenon, then firms would again have to alter their employment as product demand returned to its previous level. The period of

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employment would be shortened, and hence the period over which fixed employment costs could be amortized would be shortened.\(^5\)

Therefore, firms tend to hoard workers in the initial phases of a downturn in demand, making most of the adjustment to labor inputs in the form of a decreased utilization rate of their labor force. As the decrease in demand is maintained, firms eventually find it less costly to alter the size of their labor force, and employment begins to fall more rapidly. During upswings in demand, firms find it less costly to increase the utilization rate of their existing labor force, rather than incur large fixed costs involved in hiring and training new workers. When the added costs of increased utilization of labor exceed the costs associated with altering labor inputs by adding more workers, employment begins to rise.\(^6\)

**Labor Productivity and the Wage Share** — Recognizing that in the short run firms may vary the utilization rate of capital and that the number of workers employed by a firm is a quasi-fixed factor, rather than a completely variable factor, one can construct an explanation for the observed inverse relationship between measures of labor productivity and the wages share of corporate income over the business cycle. As shown in Chart III, an acceleration in output per person is associated with a decrease in the labor share relative to the profits share (a rise in the profits/wages

\(^5\)"The periodic rent, representing the amortization of these fixed employment costs, drives a wedge between the marginal value product and the wage rate." See Oi, "Labor as a Quasi-Fixed Factor," p. 542.

\(^6\)"Less costly" refers to the present value of costs, not necessarily to current costs. The discounted cost of hiring an additional worker is the sum of the present value of expected wage payments and hiring-training costs. Profit maximization results when the discounted costs of a worker just equal the discounted revenue generated by the worker.
ratio). A deceleration in output per person is associated with a rise in the labor share.

When output demand deviates from what firms had expected, firms adjust their inputs of capital and labor. Adjustments are based on the relative costs of available alternatives. In the short run, the costs to firms of adjusting their stock of capital is very large, hence firms adjust the utilization rate of the existing capital stock. Because of the quasi-fixed nature of the firm’s labor force, most of the adjustment in labor inputs initially occurs in the utilization rate of the labor force rather than the level of employment.

When the demand for output falls short of what firms expected, the number of workers is reduced less than proportionately to the decrease in output. The interrelated effects of a reduction in capital utilization and labor force utilization result in a sharp drop in output per person. When demand for output exceeds expected levels, firms increase the utilization rate of capital. Because of the costs of hiring and training new workers, firms tend to increase the utilization rate of their existing labor force. Consequently, output per person rises rapidly.

As the economic expansion continues, firms increase their level of employment. In many cases, the added workers will make less of a contribution to output than members of the firm’s existing labor force. New workers must be trained to perform the tasks specific to the firm. During the initial training period, the new workers’ marginal product is very low as trained workers must devote part of their time to instructing the new workers. Consequently, the growth in output per person slows markedly.

These cyclical fluctuations in output per person do not imply that workers suddenly become much less “productive” in cyclical downturns or much more “productive” in upturns. The cyclical pattern of output per person is endogenously determined in the process by which firms adjust to deviations in output demand from expected levels.

Cyclical Behavior of Factors Influencing the Profits/Wages Ratio

The movements of factors influencing the cyclical behavior of the profits/wages ratio since the third quarter of 1953 are presented in Table I. There are two major sets of factors in these tables. The first set represents cost factors such as wage rates (compensation per manhour), unit labor costs, output per person, and costs of material inputs (wholesale prices of industrial commodities). The second set of factors represents adjustment factors by firms. These include employment, manhours (employment times average weekly hours), capacity utilization, prices of output of finished goods in manufacturing, and output.

The top tier of Table I illustrates the movements of these factors in the initial stages of an expansion in aggregate demand, covering the period from trough to four quarters later. The middle tier divides the trough-to-peak period of each cycle in half in order to show the differences in the movements of these factors after an economic expansion has become fully developed. The bottom tier illustrates the movement of these factors from the peak in economic activity to the trough. This comparison shows adjustments of these factors to a marked slowdown in demand from its previous expansion path. These tables are intended to illustrate the general relative movements of these factors, not to represent precise numerical relationships between the factors.

A rising profit share does not correspond to a more rapid increase of output prices relative to wage rates. Periods when the profit share rises rapidly are periods of very moderate increases in output prices in the manufacturing sector. As output prices accelerate, the profits share actually begins to fall. Movements in the profits/wages ratio appear to be most closely related to changes in output per person, which reflect the adjustment of firms to cyclical variations in output demand.

As shown in Table I, in the initial stages of an expansion in demand in the manufacturing sector, prices of manufactured goods increase moderately. However, capacity utilization rises rapidly and, although employment also rises, manhours rise more rapidly representing increased utilization of the employed labor force. Consequently, output per person rises very rapidly and unit labor costs decline. Profits expand sharply while compensation of employees rises moderately.

As shown in the second tier of Table I, after the expansion has fully developed, output prices rise more rapidly, but so do wage rates. The rapid increase in capacity utilization halts, and the expansion in labor inputs now appears mostly as increased employment. The growth of output per person slows markedly to about a 1.5 percent rate, and unit labor costs rise. The growth of profits halts while wages continue to expand.

When demand falls, as shown in the third tier of Table I, firms decrease output by adjusting downward...
### Table I

**FACTORS INFLUENCING PROFITS/WAGES RATIO**

(Annual Rates of Change)

**Trough to Four Quarters Later**

<table>
<thead>
<tr>
<th>Period</th>
<th>Wage Rate</th>
<th>Unit Labor Cost</th>
<th>Output Per Person</th>
<th>Wholesale Prices of Industrial Commodities</th>
<th>Employment</th>
<th>Manhours $^4$</th>
<th>Capacity Utilization</th>
<th>Output Prices $^6$</th>
<th>Output</th>
<th>Profits $^7$</th>
</tr>
</thead>
<tbody>
<tr>
<td>III/54-III/55</td>
<td>4.2%</td>
<td>-1.6%</td>
<td>8.0%</td>
<td>6.7%</td>
<td>5.6%</td>
<td>7.7%</td>
<td>8.9%</td>
<td>-0.8%</td>
<td>14.1%</td>
<td>35.3%</td>
</tr>
<tr>
<td>II/58-II/59</td>
<td>4.9%</td>
<td>-2.1%</td>
<td>7.9%</td>
<td>2.3%</td>
<td>6.9%</td>
<td>9.4%</td>
<td>8.9%</td>
<td>1.3%</td>
<td>18.2%</td>
<td>31.6%</td>
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<tr>
<td>1/61-1/62</td>
<td>4.4%</td>
<td>-3.1%</td>
<td>10.7%</td>
<td>-0.3%</td>
<td>3.8%</td>
<td>6.7%</td>
<td>10.4%</td>
<td>1.3%</td>
<td>18.2%</td>
<td>31.6%</td>
</tr>
<tr>
<td>IV/70-IV/71</td>
<td>5.4%</td>
<td>-2.2%</td>
<td>6.8%</td>
<td>7.7%</td>
<td>2.6%</td>
<td>6.3%</td>
<td>10.4%</td>
<td>1.3%</td>
<td>18.2%</td>
<td>31.6%</td>
</tr>
</tbody>
</table>

**Trough to Mid-Point of Expansion and Mid-Point of Expansion to Peak**

<table>
<thead>
<tr>
<th>Period</th>
<th>Wage Rate</th>
<th>Unit Labor Cost</th>
<th>Output Per Person</th>
<th>Wholesale Prices of Industrial Commodities</th>
<th>Employment</th>
<th>Manhours $^4$</th>
<th>Capacity Utilization</th>
<th>Output Prices $^6$</th>
<th>Output</th>
<th>Profits $^7$</th>
</tr>
</thead>
<tbody>
<tr>
<td>III/54-1/56</td>
<td>4.6%</td>
<td>-2.3%</td>
<td>3.5%</td>
<td>3.5%</td>
<td>4.9%</td>
<td>6.2%</td>
<td>5.6%</td>
<td>-0.2%</td>
<td>8.7%</td>
<td>21.6%</td>
</tr>
<tr>
<td>1/56-III/57</td>
<td>6.8%</td>
<td>-4.1%</td>
<td>1.4%</td>
<td>3.1%</td>
<td>0%</td>
<td>-1.5%</td>
<td>-1.5%</td>
<td>2.8%</td>
<td>0.9%</td>
<td>4.2%</td>
</tr>
<tr>
<td>II/58-II/59</td>
<td>4.9%</td>
<td>-4.7%</td>
<td>12.9%</td>
<td>2.3%</td>
<td>6.9%</td>
<td>16.4%</td>
<td>14.0%</td>
<td>20.8%</td>
<td>63.0%</td>
<td>13.2%</td>
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<td>II/59-1/60</td>
<td>4.5%</td>
<td>-4.1%</td>
<td>1.7%</td>
<td>0%</td>
<td>0%</td>
<td>-3.8%</td>
<td>1.3%</td>
<td>6.9%</td>
<td>10.1%</td>
<td>25.6%</td>
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<td>1/61-III/65</td>
<td>3.9%</td>
<td>-1.4%</td>
<td>6.5%</td>
<td>4.0%</td>
<td>2.8%</td>
<td>4.5%</td>
<td>3.7%</td>
<td>10.1%</td>
<td>9.0%</td>
<td>7.8%</td>
</tr>
<tr>
<td>III/65-IV/69</td>
<td>6.5%</td>
<td>4.2%</td>
<td>1.6%</td>
<td>2.7%</td>
<td>2.4%</td>
<td>3.3%</td>
<td>-1.3%</td>
<td>4.2%</td>
<td>4.0%</td>
<td>10.2%</td>
</tr>
</tbody>
</table>

**Peak to Trough**

<table>
<thead>
<tr>
<th>Period</th>
<th>Wage Rate</th>
<th>Unit Labor Cost</th>
<th>Output Per Person</th>
<th>Wholesale Prices of Industrial Commodities</th>
<th>Employment</th>
<th>Manhours $^4$</th>
<th>Capacity Utilization</th>
<th>Output Prices $^6$</th>
<th>Output</th>
<th>Profits $^7$</th>
</tr>
</thead>
<tbody>
<tr>
<td>III/53-III/54</td>
<td>4.1%</td>
<td>2.7%</td>
<td>0%</td>
<td>0.5%</td>
<td>9.0%</td>
<td>10.2%</td>
<td>-13.7%</td>
<td>-1.4%</td>
<td>9.0%</td>
<td>3.5%</td>
</tr>
<tr>
<td>III/57-III/58</td>
<td>3.6%</td>
<td>7.7%</td>
<td>0%</td>
<td>0.5%</td>
<td>11.2%</td>
<td>13.3%</td>
<td>-19.1%</td>
<td>1.0%</td>
<td>16.8%</td>
<td>34.1%</td>
</tr>
<tr>
<td>II/60-1/61</td>
<td>1.9%</td>
<td>3.1%</td>
<td>-0.5%</td>
<td>0.5%</td>
<td>6.5%</td>
<td>8.0%</td>
<td>-11.5%</td>
<td>-0.3%</td>
<td>9.0%</td>
<td>24.1%</td>
</tr>
<tr>
<td>IV/69-IV/70</td>
<td>7.7%</td>
<td>5.8%</td>
<td>-0.3%</td>
<td>3.7%</td>
<td>7.3%</td>
<td>9.2%</td>
<td>-12.0%</td>
<td>4.5%</td>
<td>7.6%</td>
<td>-22.5%</td>
</tr>
</tbody>
</table>

---

1Employee compensation divided by manhours.
2Compensation divided by output.
3Output divided by employment.
4Employment multiplied by average hours worked.
5Federal Reserve Board index of capacity utilization.
6Consumer price index of commodities less food.
7Corporate profits after tax liability for nonfinancial corporations.
8Compensation of employees in nonfinancial corporations.

**NOTE:** Profits and compensation of employees data pertain to nonfinancial corporations. All other data pertain to total manufacturing.

**Sources:** U.S. Department of Commerce, U.S. Department of Labor and Federal Reserve System.
An Alternative Measure of the Profits Share of Corporate Income

The introduction of tax laws permitting more liberal asset depreciation in recent years has led some observers to question the comparability of profits in previous periods with profits in more recent periods. The basis for such a view is that, if firms are depreciating capital at a faster rate than in previous business cycles, then the fall in the profits/wages ratio would be somewhat greater and the rise somewhat less than previously. One way to set an upper bound on the possible bias introduced into recent movements of the profits/wages ratio by accelerated depreciation is to use the cash flow/wages ratio. In this ratio, depreciation, estimated by reported capital consumption allowances, is added to after-tax profits.

The cash flow/wages ratio is presented in Chart IV along with the profits/wages ratio for comparison purposes. Relative to previous peak-to-trough periods, the most recent decline in the cash flow/wages ratio is less pronounced than the decline in the profits/wages ratio. The general pattern of movement of the two ratios is essentially the same. The effect of adding an estimate of depreciation into the ratio is to reduce the magnitude of the cyclical variations of the ratio.1

<table>
<thead>
<tr>
<th>Period</th>
<th>Profits/Wages</th>
<th>Cash Flow/Wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>IV/55 - II/58</td>
<td>-15.1%</td>
<td>-6.4%</td>
</tr>
<tr>
<td>II/59 - I/61</td>
<td>-18.0</td>
<td>-7.8</td>
</tr>
<tr>
<td>IV/65 - IV/70</td>
<td>-11.6</td>
<td>-5.7</td>
</tr>
</tbody>
</table>

1Comparing the expansion peak in the cash flow/wages ratio and the expansion peak of the profits/wages ratio to their business cycle trough values gives the following annual rates of change:

Variations in after-tax profits are much greater than variations in depreciation over the cycle. For example, from the midpoint in an expansion to the trough of the business cycle, after-tax profits fall while reported depreciation continues to rise. In the two previous comparable business cycle periods, the rate of decline of the profits/wages ratio was approximately twice as great as the cash flow/wages ratio, and this relationship has continued in the most recent period.

On balance, use of the after-tax profits/wages ratio does not appear to bias significantly the analysis of relative movements of profits and wages. In the last few years, any downward bias introduced into reported after-tax profits by accelerated depreciation has been largely, if not completely, offset by the effect of inflation on the replacement cost of capital, technological obsolescence, and obsolescence due to more restrictive laws such as pollution control and safety. Tax laws require that reported depreciation be based on original cost. In a period of accelerating inflation replacement costs exceed original cost. For some capital goods, such as computers, rapid technological change has made capital purchased by firms economically inefficient before it has been fully depreciated.2 In other industries, subject to more restrictive laws on pollution and safety, technically efficient means of production have been rendered economically inefficient due to the large added costs of modifying existing equipment to meet pollution or safety standards.

Current Business Cycle

As shown in Chart II, the behavior of the profits/wages ratio in the prolonged economic expansion that began in early 1961 and peaked in the fourth quarter of 1969 was very similar to previous periods of expanding economic activity. About midway through the expansion the ratio peaked and the wages share began rising relative to the profits share. By the end of 1969, the profits/wages ratio had fallen to about the same level as at the start of the recovery in early 1961. From trough to peak, the ratio averaged 0.133. This compares with previous trough-to-peak averages of 0.125 in the period II/1958-II/1960 and 0.147 in the period III/1954-III/1957.

From the fourth quarter of 1969 to the business cycle trough in the fourth quarter of 1970, this ratio fell to its lowest level in the preceding 20-year span. The profits share of corporate income fell markedly relative to the wages share as the ratio reached 0.070, compared to previous lows of about 0.100, a level reached generally close to the troughs of earlier downturns.

In the first two quarters of 1971, the profits/wages ratio rose from its historically low level at the end of 1970. However, the rise was quite small compared to previous recovery periods. The ratio remained at about the same level in the first two quarters of 1971 as in the second and third quarters of 1970, noticeably below any level experienced in the previous 20 years.

In August 1971 wage and price controls were instituted. In commenting on the “fairness of controls,”

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Chart IV
Cash Flow Compared to After-Tax Profits

Source: U.S. Department of Commerce

Shaded areas represent periods of business recessions as defined by the National Bureau of Economic Research.
Latest data plotted: 3rd quarter preliminary

the Council of Economic Advisers (CEA) in August 1972 stated:

If these standards were precisely and universally followed, the outcome would be somewhere between preservation of the relative shares of wages and profits as they existed at the beginning of the program and a moderate increase in the profits share such as ordinarily occurs in a business recovery although possibly of smaller size.8

The profits/wages ratio rose from an average of 0.085 in the two quarters before the freeze to 0.094 in the third quarter of 1972, a 10.6 percent rise over a period of five quarters. Therefore, one of the goals of controls, as stated by the CEA, seems to have been realized. The profits/wages ratio rose moderately after the imposition of controls and the percentage rise seems to be in line with previous recoveries. For example, the ratio rose 8.8 percent from the average of the two quarters after the trough in early 1961 to the fourth quarter of 1962, also a period of five quarters.

However, in the same section on “fairness of controls” the CEA stated:

A basic principle of the system of controls is that it should try to avoid changing the distribution of income that would occur in the course of a strong noninflationary expansion.

When comparing the recent rise in the profits/wages ratio with earlier economic recoveries it appears that the distribution of corporate income is still heavily weighted in favor of wages. The profits/wages ratio was at an historically low level in the two quarters prior to controls, and even with its recent rise it has remained below any previous level in the entire period from 1952 to the present. Furthermore, it has remained below the previous trough low points of about 0.100 since the second quarter of 1969, a period of 13 quarters. Therefore, the profits share relative to the wages share remains far below what it has been in previous expansions.

Outlook for the Profits/Wages Ratio

The historically low profits/wages ratio prevailing now is related to the length of the previous expansion. Given the prolonged expansion, the inherited capital stock in late 1969 was much larger than in previous expansions. As the 1961-69 expansion continued, the

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8Economy at Mid-1972, pp. 46-47.
experience of significant slowdowns in demand faded into the background, while total spending and inflation accelerated giving firms an incentive to expand their capital stock. As the expansion progressed, wage demands rose rapidly inducing firms to change the factor mix of output toward more capital and less labor. Also, liberalized asset depreciation rules and changes in tax laws concerning investment tax credits during this period added an incentive for capital expansion. The 1969 downturn in economic activity left firms with a large inherited capital stock relative to the lower than expected demand for output. The result was a much sharper fall in the profits/wages ratio than in previous periods.

Given these characteristics of the current business cycle, one would expect that the current rise in the profits/wages ratio would be somewhat slower than in previous recovery periods. Output would have to expand by a greater amount to result in lowest minimum average cost given the inherited capital stock. From the third quarter of 1970 to the third quarter of 1972, output in the manufacturing sector rose at only a 4.8 percent annual rate.9 There was almost no increase in the reported capacity utilization rate over this period. There was no increase in employment in the manufacturing sector. Average weekly hours rose somewhat, indicating an increase in the utilization rate of existing labor force. Output prices rose at about a 3 percent rate, considerably faster than in previous expansions. Wage rates, however, also rose very rapidly compared to previous recoveries, increasing at about a 6 percent rate. As output continues to expand, firms should experience a continued rise in output per person and an improvement in profits. This would be the expected consequence of moving down along the average cost curve associated with their scale of plant.

In the absence of controls, the profits/wages ratio would be expected to continue to rise as the recovery progresses. Increases in wage rates depend upon the growth of output, but also appear to be largely determined by previous rates of price increases. If the rate of inflation continues to decelerate, then, given the way the market has operated in the past to distribute corporate income between profits and wages, a rise in the profits/wages ratio well above 0.133, its average during the previous expansion, should seem to be indicated given the extremely low level of the ratio in the first phase of the current recovery. Any attempt to use economic controls to hold down the profits/wages ratio below this level would indicate a bias in favor of the wages share at the expense of the profits share.10

9The third quarter of 1970 is used as the comparison period instead of the fourth quarter of 1970, the trough quarter, because of the large effect on output of the labor strike in the automobile industry in the fourth quarter of 1970.

10This assumes that after-tax profits are not significantly biased by any of the factors discussed in the screened section of this article.
FUNCTIONS performed by the Federal Reserve System can be divided into three broad categories: economic stabilization, bank supervision, and the performance of numerous services for commercial banks, the U.S. Government, and the public. The economic stabilization role is primarily conducted on a System-wide basis through the Board of Governors and the Federal Open Market Committee (FOMC), while the service and supervisory roles are largely responsibilities of the twelve Federal Reserve Banks. Since this Bank annually reviews economic stabilization policy decisions elsewhere,¹ this article will review only the supervisory and service operations.

The Federal Reserve Bank of St. Louis and its branches at Little Rock, Louisville, and Memphis serve the Eighth Federal Reserve District, which includes all of the state of Arkansas and parts of Illinois, Indiana, Kentucky, Mississippi, Missouri, and Tennessee. A change in the geographical makeup of the Eighth District occurred in 1972; 24 counties in western Missouri containing 26 member and 92 nonmember banks were transferred to the Tenth Federal Reserve District to be served by the Federal Reserve Bank of Kansas City. The transfer of these counties, which are economically more aligned with Kansas City than with St. Louis, resulted in shorter distances for check and cash delivery routes and thus in improved service for the banks in the area. This was the first change in district boundaries since 1926, when two New Mexico counties were transferred from the Dallas to the Kansas City District. At the end of 1972 there were 430 member and 976 nonmember banks in the Eighth District. Although fewer in number than nonmember banks, member banks held nearly 60 percent of total deposits in the District.

SUPERVISION

One of the major functions of the Federal Reserve Banks is supervision of state member banks and bank holding companies to insure a safe, efficient banking system.

A major supervisory function is the annual examination of state banks which are members of the Federal Reserve System to evaluate their assets, liabilities, capital adequacy, liquidity, operations, and management while assuring compliance with applicable laws and regulations. The information obtained from these examinations is used by banking authorities to correct unsatisfactory conditions and to assist banks in improving their operations. Examiners from the Federal Reserve Bank of St. Louis examine the 95 state member banks in the Eighth District, usually in conjunction with examiners from the state supervisory authority. All national banks are required by law to be members of the Federal Reserve System, but they are examined by representatives of the Comptroller of the Currency. Other insured banks are examined by the Federal Deposit Insurance Corporation (FDIC) and state supervisors, while the few noninsured banks are examined by state examiners only.

Federal Reserve Banks also supervise bank holding companies. At the end of 1972, the St. Louis Reserve Bank had jurisdiction over 14 multiple bank holding companies headquartered in the Eighth District² and 72 one-bank holding companies registered in the District. Applications to form bank holding companies and for bank holding companies to acquire bank or bank-related subsidiaries are processed by the Federal Reserve Banks. The Reserve Banks have been delegated authority by the Board of Governors to approve certain types of bank holding company applications; the remaining applications are processed and forwarded to the Board of Governors for final disposition.

Bank holding companies are required to file annual reports which are reviewed by the Examination Department of this Bank for completeness and accuracy. These reports are analyzed to determine the financial condition of the holding company and its subsidiaries and to assure compliance with applicable laws

¹Annual reviews of FOMC monetary actions for the years 1964 through 1971 are contained in Reprints 13, 17, 22, 28, 39, 57, 68, and 76, available on request from this Bank.

²These 14 multi-bank holding companies had 56 bank subsidiaries in the Eighth District and 12 in other districts.
and regulations. Inspections of bank holding companies are also conducted to evaluate the management of the holding company and its nonbanking subsidiaries. Examination reports of subsidiary banks are analyzed to determine the soundness of the banks and to appraise their management.

Other supervisory functions include the admission of state banks to membership in the System and the approval of bank mergers and new branches of state member banks.

SERVICES

In addition to its supervisory role, the Federal Reserve Bank of St. Louis and its branches perform numerous services for banks, the Government, and the public; these services include collecting and transferring funds, distributing coin and currency, maintaining the reserve accounts of member banks, serving as fiscal agent for the Government, conducting economic research, and performing educational functions concerning the banking system, Federal Reserve operations, and stabilization policy.

Collection and Transfer of Funds

The Federal Reserve System plays a central role in the payments mechanism and is presently embarked on a program designed to accelerate the transfer-of-funds process. Checks drawn on commercial banks are at present the means of settling most nonbank financial transactions. Payment by check offers many advantages over payment by cash, including less risk from theft or loss, greater convenience in making many types of transactions, and provision of a record of disbursements. The use of checks is facilitated by the collection and clearing operations of the Federal Reserve Banks, which provide a mechanism for settlement of checks collected by commercial banks. Settlement is accomplished by entries to the reserve accounts of member banks.

With a growing economy, the number of checks written per year has risen at a rapid rate. The St. Louis Federal Reserve Bank and its branches cleared 513 million checks with a dollar value of $171 billion in 1972. This represented a 6.7 percent increase in number and a 9.8 percent increase in dollar value over the 1971 levels (see Table I).

Automation has been increased in an effort to improve the efficiency of check clearing operations; virtually all of the checks cleared by the St. Louis Bank in 1972 were processed by computer. With the anticipation of a continued increase in check volume, still more rapid means of transferring funds have been investigated and are being developed. The goal of such efforts is an Electronic Funds Transfer System (EFTS) in which electronic signals replace paper checks as the means of transfer.

Although such a system will evolve over a number of years, a substantial amount of funds are already transferred by electronic means, through the Federal Reserve Communications Network. These wire transfers are used for large transactions such as those resulting from interbank loans, check collection, and U.S. Treasury obligations where immediate payment is desirable. In 1972, 410,000 wire transfers totalling $397 billion were made by the four offices of the St. Louis Bank, an increase of 15.2 percent in number.
and 13.7 percent in value over the 1971 levels. The number of transactions was small compared to the number of checks processed, but the value of funds transferred by wire in 1972 exceeded the value of checks processed by $226 billion.

Following the Board of Governors' "Statement of Policy on the Payments Mechanism" in June 1971, Regional Check Processing Centers (RCPCs) were established at strategic locations around the country to give overnight clearing service to participating banks. The Federal Reserve Bank of St. Louis and its branches at Little Rock, Louisville, and Memphis began RCPC operations in 1972. By the end of 1972, the St. Louis RCPC was able to offer overnight clearing services to banks in the City of St. Louis and eight surrounding counties in Missouri and Illinois. At the same time the Little Rock RCPC zone had expanded to include 42 Arkansas counties, while the Louisville zone included 41 Kentucky and Indiana counties and the Memphis zone contained 35 counties in Tennessee, Arkansas, and Mississippi.

Significant changes in check collection procedures and reserve requirements were also implemented during 1972. Before these changes took place, banks outside overnight check clearing zones were allowed to delay payment to the Reserve Bank for one or more days after being presented a check drawn against them. This practice resulted in a form of Federal Reserve credit known as "float."3 Under a change in

3Float results when a bank presenting a check to the Reserve Bank is given credit for the check before the bank against which the check is drawn pays the Reserve Bank. The longer the time period between crediting the bank presenting the check and collecting the funds from the bank against which the check is drawn, the greater the amount of float. On the Federal Reserve balance sheet, float is the difference between the value of cash items in process of collection on the asset side and deferred availability cash items on the liability side.

the Federal Reserve System's Regulation J ("Collection of Checks and Other Items by Federal Reserve Banks") implemented on November 9, 19724, all banks using the Federal Reserve check collection system must remit for checks drawn against them in immediately available funds the same day the checks are presented for payment. This accelerated collection and transfer of funds was designed to reduce float.

The change in check collection procedures was purely technical, and the loss of reserves resulting from reduction in float was not intended to result in any change in the stance of monetary policy. The reduction in reserves was more than offset by a release of reserves caused by a simultaneous change in the System's Regulation D ("Reserves of Member Banks"), which reduced certain required reserve ratios. The purpose of the Regulation D change was to restructure reserve requirements on net demand deposits by eliminating the distinction between banks based on their location. Before the change, deposits at "Reserve City Banks" were subject to higher required reserve ratios than those at "Country Banks" of the same size. Now, reserve requirements are determined solely by the amount of deposits of the bank. All member banks of equal deposit size are required to meet the same required reserves5 (see Table II).

**Distributing Currency**

Although checks are the major means of payment in this country, coin and paper currency still play an important role. Currency is more universally accept-

4The change was originally scheduled for implementation on September 21 but was delayed until November 9 by court action.

5Changes to Regulations D and J are discussed in greater detail in the Federal Reserve Bulletin (July 1972), pp. 626-630.
As of February 1, 1973

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General American Life Insurance Company, St. Louis, Missouri

**Deputy Chairman of the Board**

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Humko Products, Division of Kraftco Corporation,
Memphis, Tennessee

BRADFORD BRETT, President, The First National Bank of
Mexico, Mexico, Missouri
FRED I. BROWN, Jr., President, Arkansas Foundry Com-
pany, Little Rock, Arkansas
EDWIN S. JONES, Chairman and Chief Executive Officer,
First National Bank in St. Louis, St. Louis, Missouri

HARRY M. YOUNG, Jr., Farmer,
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**Chairman of the Board**

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Southland Building Products Co., Little Rock, Arkansas

W. H. KELLEY, President and Chief Executive Officer,
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arkana, Arkansas
EDWARD M. PENICK, President and Chief Executive
Officer, Worthen Bank & Trust Company, National
Association, Little Rock, Arkansas
W. M. PIERCE, President, Arkansas Business Development
Corporation, Little Rock, Arkansas

AL POLLARD, President, Al Pollard & Associates, Little
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T. G. VINSON, President, First National Bank, Batesville,
Arkansas
FIELD WASSON, President, First National Bank, Siloam
Springs, Arkansas

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George E. Reiter, Jr., Assistant Vice President

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L. Terry Britt, Vice President and Manager

Paul I. Black, Jr., Assistant Vice President and Assistant Manager

Anthony C. Cremerius, Jr., Assistant Vice President

Charlie L. Epperson, Jr., Assistant Vice President

*Appointments to these positions effective March 1, 1973.
**Appointment to this position effective February 16, 1973.
able than checks and is a more convenient, less time consuming, and cheaper method of settling relatively small transactions. The demand for coins has increased with the increased use of vending machines.

The public adjusts its money holdings between demand deposits and currency according to its preferences for holding each. The demand for currency, for example, usually rises sharply before Christmas. To meet the public's demand for currency, member banks order funds from their Reserve Bank, which charges the order to the banks' reserve accounts; member banks with excess currency deposit it in their reserve accounts. Nonmember banks generally receive currency from and transfer excess currency to member banks. At the Reserve Bank, the usable currency is then redistributed, and the unfit is removed from circulation to be destroyed.

Coin and paper currency handled at the four offices of the St. Louis Bank increased in 1972 as the demand for a hand-to-hand medium of exchange rose with increased economic activity. More than 266 million pieces of paper currency valued at nearly $2 billion were counted by the St. Louis Bank in 1972. This represented a 7 percent increase in number and a 5.5 percent increase in value over 1971 figures. Pieces of coin counted in 1972 declined as a result of new counting procedures implemented during the year. Under the new procedures, coins are counted and wrapped in one operation rather than two.

**Lending Activity**

Federal Reserve member banks may borrow from their Reserve Bank over short-term periods to meet reserve deficiencies under certain conditions. The volume of these borrowings is influenced by the discount rate (the rate charged on borrowings from Reserve Banks) and market interest rates. Use of the borrowing privilege, called the "discount window," normally increases when the discount rate is low relative to the Federal funds rate (the rate at which one commercial bank lends funds to another, usually for one business day) or to rates of other short-term instruments such as Treasury bills and prime commercial paper. Conversely, loans to member banks usually decline when the discount rate rises relative to these other rates.

During the entire year of 1972, the discount rate remained at 4.5 percent, having been reduced from 4.75 percent on December 13, 1971. Short-term market interest rates rose during 1972. Member bank borrowings from the St. Louis Bank was, accordingly, higher in 1972 than in 1971, especially in the second half of the year as the differential between money market rates and the discount rate increased (see Table III). Daily average member bank borrowings increased from $2.6 million in September to $41.1 million in December. In 1972, 198 advances totalling $1.35 billion were made to 25 banks. This represents a four-fold increase over 1971 when advances totalled $337.1 million. Daily average outstandings in 1972 were $6.6 million, compared to $1.5 million in 1971.

**Fiscal Agency**

Federal Reserve Banks also serve as bankers to the Federal Government. The functions they perform as fiscal agent include the handling and transfer of Government funds and assistance in the management of the public debt.

The principal Government checking accounts from which the Treasury makes its disbursements are maintained at the Federal Reserve Banks. When the Government collects taxes or sells securities to the public, the payments received are normally deposited initially in Treasury tax and loan accounts at those commercial banks which have been designated special depositories. The Treasury periodically calls in funds from these accounts and uses them to replenish its working balances at the Reserve Banks.

Reserve Banks also play a significant role in the management of the public debt. They assist in marketing new Government securities by (1) circulating subscription forms and receiving applications for the purchase of the securities, (2) allotting the securities according to the Treasury's directions, and (3) delivering them to the purchaser. In addition, the Reserve Banks redeem securities at maturity, make security exchanges, and pay interest by redeeming coupons.

In 1972 more than 10 million savings bonds and 400,000 other Government securities with a total value of more than $21 billion were issued, exchanged, or redeemed by the Federal Reserve Bank of St. Louis. In addition, 706,000 Government coupons with a value of more than $200 million were paid by this Bank.

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\(^{[6]}\)The interest rate charged on borrowings from Reserve Banks is still referred to as the discount rate, although most lending is now in the form of advances. The Board of Directors of each Reserve Bank sets the discount rate for the Bank subject to review and determination by the Board of Governors.

\(^{[7]}\)The discount rate at all twelve Federal Reserve Banks was raised to 5 percent effective January 15, 1973.
An additional fiscal agency activity is the redemption of Government food coupons. These redemptions showed a substantial increase in 1972, when 130 million coupons with a total value of $274 million were received and counted by this Bank. This represented a 44.2 percent increase in number and a 9.9 percent increase in value over 1971 redemptions.

Research

The Research Department of the St. Louis Reserve Bank collects and analyzes a broad range of regional, national, and international economic data. These analyses are used by the President of this Bank in the formulation of monetary policy recommendations at the meetings of the Federal Open Market Committee. Additionally, information and data related to economic developments are made available to the public through this Review and other publications.8

An increasing amount of Research Department activity is devoted to the study of bank market structure. Included in this activity is the Research Depart-

8A list of the recurring publications of the Research Department is contained in the January 1973 issue of this Review.

ment’s analysis of competitive and service factors involved in bank holding company and merger applications.

Bank Relations and Public Information

The four offices of the St. Louis Bank endeavor to maintain personal contact with all banks in the Eighth District, to assist member banks with their operations related to the Federal Reserve, and to provide educational programs on economic and banking topics to the public.

One of the services available to member banks is the Federal Reserve "Functional Cost Accounting Program," which provides a cost-income profile of each participating bank’s major functions. These data enable an individual bank to compare current operating data with its previous operating statistics as well as with a group of banks of similar size.

During 1972, officers and staff members of the Federal Reserve Bank of St. Louis and its branches delivered 304 addresses before groups of bankers, businessmen, and educators. This Bank was represented at 284 banker, 51 professional, and 244 miscellaneous meetings. Under the bank visitation program, 1,308 banks were visited. During 1972, 249 groups requested films, and 5,257 visitors toured the four offices.

FINANCIAL STATEMENTS

Total assets of the Federal Reserve Bank of St. Louis and its branches at the end of 1972 were $3.71 billion, a decline of 6.9 percent from 1971 (see Table IV). The decline resulted primarily from a $400 million decrease in cash items in process of collection caused by the new check collection procedures described above. This decrease was partially offset by a $188 million increase in the Gold Certificate account to $534 million.9 Two-thirds of the Bank’s assets were held in U.S. Government securities, primarily short-term bills and notes. Remaining assets, including the Special Drawing Rights account, notes of other Federal Reserve Banks, Federal agency obligations, and bank premises, totalled $219 million.

9This change in the Gold Certificate account was caused in part by revaluation of gold in 1972.
Table IV

COMPARATIVE STATEMENT OF CONDITION

(Dollar Amounts in Thousands)

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>December 31, 1972</th>
<th>December 31, 1971</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Government Securities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bills</td>
<td>$1,065,852</td>
<td>$1,157,788</td>
</tr>
<tr>
<td>Certificates</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Notes</td>
<td>1,317,964</td>
<td>1,365,056</td>
</tr>
<tr>
<td>Bonds</td>
<td>124,403</td>
<td>126,175</td>
</tr>
<tr>
<td><strong>TOTAL U.S. GOVERNMENT SECURITIES</strong></td>
<td>$2,508,219</td>
<td>$2,649,019</td>
</tr>
<tr>
<td>Discounts and Advances</td>
<td>51,800</td>
<td>—</td>
</tr>
<tr>
<td>Acceptances</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Federal Agency Obligations</td>
<td>47,117</td>
<td>18,621</td>
</tr>
<tr>
<td><strong>TOTAL LOANS AND SECURITIES</strong></td>
<td>$2,607,136</td>
<td>$2,667,640</td>
</tr>
<tr>
<td>Gold Certificate Account</td>
<td>534,206</td>
<td>346,208</td>
</tr>
<tr>
<td>Special Drawing Rights</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Federal Reserve Notes of Other Banks</td>
<td>35,124</td>
<td>40,140</td>
</tr>
<tr>
<td>Other Cash</td>
<td>21,120</td>
<td>17,475</td>
</tr>
<tr>
<td>Cash Items in Process of Collection</td>
<td>444,584</td>
<td>854,530</td>
</tr>
<tr>
<td>Bank Premises (Net)</td>
<td>14,609</td>
<td>14,682</td>
</tr>
<tr>
<td>Other Assets</td>
<td>34,143</td>
<td>26,644</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td>$3,705,922</td>
<td>$3,982,319</td>
</tr>
</tbody>
</table>

LIABILITIES AND CAPITAL ACCOUNTS

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th>December 31, 1972</th>
<th>December 31, 1971</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Member Bank — Reserve Accounts</td>
<td>$814,166</td>
<td>$1,015,178</td>
</tr>
<tr>
<td>U.S. Treasurer — General Account</td>
<td>142,418</td>
<td>153,419</td>
</tr>
<tr>
<td>Foreign</td>
<td>9,860</td>
<td>9,520</td>
</tr>
<tr>
<td>Other Deposits</td>
<td>11,178</td>
<td>27,851</td>
</tr>
<tr>
<td><strong>TOTAL DEPOSITS</strong></td>
<td>$977,622</td>
<td>$1,205,968</td>
</tr>
<tr>
<td>Federal Reserve Notes (Net)</td>
<td>2,319,569</td>
<td>2,118,926</td>
</tr>
<tr>
<td>Deferred Availability Cash Items</td>
<td>335,415</td>
<td>584,961</td>
</tr>
<tr>
<td>Other Liabilities and Accrued Dividends</td>
<td>19,406</td>
<td>22,112</td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES</strong></td>
<td>$3,652,012</td>
<td>$3,931,967</td>
</tr>
</tbody>
</table>

| CAPITAL ACCOUNTS                    |                   |                   |
| Capital Paid In                     | 26,955            | 25,176            |
| Surplus                              | 26,935            | 25,176            |
| Other Capital Accounts              | —                 | —                 |
| **TOTAL CAPITAL ACCOUNTS**          | $53,910           | $50,352           |
| **TOTAL LIABILITIES AND CAPITAL ACCOUNTS** | $3,705,922        | $3,982,319        |

MEMORANDA: Contingent liabilities on acceptances purchased for foreign correspondents decreased from $8,667,000 on December 31, 1971 to $6,068,000 on December 31, 1972.

Table V

COMPARATIVE PROFIT AND LOSS STATEMENT

(Dollar Amounts in Thousands)

<table>
<thead>
<tr>
<th></th>
<th>1972</th>
<th>1971</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Earnings</td>
<td>$141,543</td>
<td>$136,856</td>
<td>3.4%</td>
</tr>
<tr>
<td>Net Expenses</td>
<td>23,757</td>
<td>21,912</td>
<td>8.4%</td>
</tr>
<tr>
<td>Current Net Earnings</td>
<td>117,786</td>
<td>114,944</td>
<td>2.5%</td>
</tr>
<tr>
<td>Net Additions (+) or Deductions (—)</td>
<td>— 1,590</td>
<td>+ 3,551</td>
<td>—</td>
</tr>
<tr>
<td>Net Earnings Before Payments to U.S. Treasury</td>
<td>$116,196</td>
<td>$118,495</td>
<td>1.9%</td>
</tr>
<tr>
<td>Distribution of Net Earnings:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>$1,544</td>
<td>$1,474</td>
<td>4.7%</td>
</tr>
<tr>
<td>Interest on Federal Reserve Notes</td>
<td>112,873</td>
<td>115,887</td>
<td>2.6%</td>
</tr>
<tr>
<td>Transferred to Surplus</td>
<td>1,779</td>
<td>1,134</td>
<td>56.9%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>$116,196</td>
<td>$118,495</td>
<td>1.9%</td>
</tr>
</tbody>
</table>

Liabilities of the St. Louis Bank and its branches declined to $3.65 billion, 7.1 percent lower than the year-earlier figure. The reduction in deferred availability cash items, also resulting from the check collection procedure changes, was largely responsible for the decline. Federal Reserve Notes, the principal type of currency in circulation, amounted to $2.3 billion, more than 60 percent of the Bank's liabilities. This amount represents a 9.5 percent increase over the amount outstanding at the end of 1971. Deposits, consisting mainly of member bank reserve accounts, amounted to $978 million.

Federal Reserve Banks' earnings arise from interest on Government securities, interest on loans to member banks, and reimbursements for certain fiscal agency functions. In 1972, the portion of the System's earnings allocated to the St. Louis Bank and its branches totalled $141.5 million, an increase of 3.4 percent from a year earlier (see Table V). After statutory dividends of $1.5 million were paid to member banks and operating expenses of $23.8 million were met, $1.8 million was transferred to surplus and $113 million, or 79.8 percent of total earnings, was paid to the Treasury as interest on Federal Reserve Notes.