

US corporate profits suffer from financial crisis but remain large relative to overall national income

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- US domestic corporations, both financial and non-financial, have experienced considerably bigger erosion in operating profits than during the first year of previous cyclical downturns over the past half century.
- Yet, even with the plunge, profits remain at historically high levels as a share of overall national income.
- Corporations have demonstrated a formidable ability to adjust rapidly to the contraction in aggregate demand, through large-scale job cuts and aggressive reductions in capital expenditures, most visibly by financial institutions.
- The result is that the worst of the recession is probably behind us. Boosted by an even more aggressively accommodative monetary policy as well as by sizable fiscal stimulus, a modest economic recovery is likely to begin sometime this summer or fall.

Recessions always shrink profits of non-financial corporations ...

Non-financial corporations, ranging from computer and software producers, machinery makers, oil refiners, chemical companies, paper factories, retailers, and many others, are always vulnerable to recessions. They have relatively large installed capacity, inflexible fixed costs, and large workforces. A sudden fall in demand leaves them with excess capacity and a fall in revenues that can't be easily replaced. In the current recession that began late in 2007, moreover, several industries were already being hard hit by severe problems that transcended mere cyclical fluctuations. Housing-related industries were hurt by the collapse of the housing bubble, while manufacturers of auto and parts were struggling from protracted pressures that threatened their existence. Indeed, numerous large auto parts makers had been forced into bankruptcy, with little hope of being able to restructure and return to normal ownership any time soon.

Therefore, it will come as little surprise to even the most casual observer of the US economy that non-financial corporations collectively have suffered mightily in the current recession. As shown in the table below, the plunge of over USD 250 billion in the operating profits of domestic non-financial corporations represented the worst performance in the first year of any previous recession over the past half century. Managements have reacted with aggressive steps to lower labor costs, primarily through layoffs or by renegotiating wage and benefit agreements, but also through strong measures to reduce capital expenditures. The annualized 28.8% reduction in real equipment and software purchases was one of the sharpest ever recorded. And judging from the continued slump in capital goods orders, the process is continuing.

NON-FINANCIAL PROFITS FALL IN YEAR 1 OF RECESSIONS

Change in profits in year 1 after the peak of the previous expansion	USD bn change	% change
Current, IV/07-IV/08	-259.4	-24.1
I/01-IV/01*	-60.5	-15.7
III/90-I/91*	-3.3	-1.2
III/81-III/82	-26.5	-14.4
IV/73-IV/74	-15.1	-16.9
IV/69-IV/70	-11.3	-16.5
II/60-I/61*	-4.7	-11.1

* Recession lasted less than a full year

Source: Bureau of Economic Analysis, Federal Reserve

... but until this recession, financial corporations were usually spared

In sharp contrast, financial corporations do not normally record steep reductions in operating profits during recessions. More often than not, financial corporations, including commercial banks, thrift institutions, insurance companies, and mutual funds, increase their earnings during business downturns or at least hold on to most of the profits they were making at the cyclical peak. The reason is that monetary policy is almost always eased during recessions, so that the cost of funding existing assets falls considerably. The additional income resulting from a widening in net interest margins is sufficient to offset higher realized loan losses. This recession has been totally different, however.

FINANCE SECTOR PROFITS DON'T NORMALLY SUFFER FROM RECESSION; THIS TIME THEY WERE CRUSHED

Change in profits in year 1 after the peak of the previous expansion	USD bn change	% change
Current, IV/07-IV/08	-111.6	-28.4
I/01-IV/01*	+33.7	+14.4
III/90-I/91*	+17.1	+18.9
III/81-III/82	-0.9	-3.3
IV/73-IV/74	-0.3	-1.4
IV/69-IV/70	+3.1	+21.7
II/60-I/61*	+0.1	+1.2

* Recession lasted less than a full year

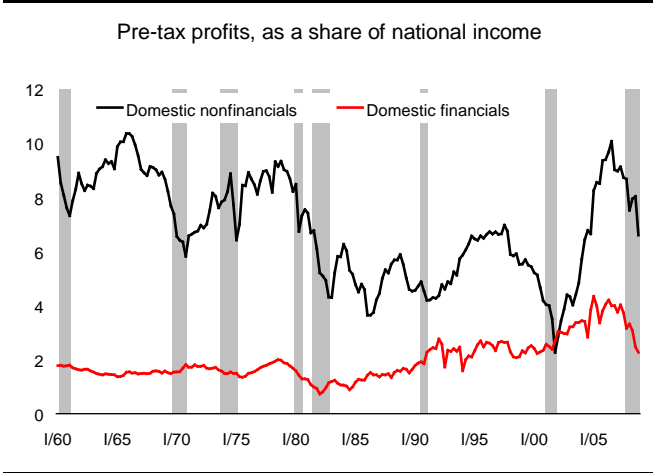
Source: Bureau of Economic Analysis, Federal Reserve, UniCredit Research

The underlying reason why this time is so different is that there have been extraordinary tensions in the money and credit markets. These strains began in the summer of 2007 but greatly worsened during the final months of 2008. The financial meltdown led to a massive deterioration in the balance sheets and in income generation of all types of financial institutions, not just the biggest commercial and investment banks. Heavy losses on loans and investments swamped the any improvement in cash flow from normal operations. And the Fed's aggressive easing of monetary policy, to almost zero for the federal funds rate in December 2008, was only partially reflected in the cost of funds in the money markets. Net interest margins did not widen as they usually do in recessions. Therefore, financial institutions were unable to "earn their way" out of the mess.

Corporate profits share of national income still historically high

Ironically, despite the sharp deterioration in the operating profits of US corporations, combining domestic financial and non-financial sectors, the level of profits that remain is still reasonably high. That is because corporations came into this recession with profits close to their long-term peaks relative to total national income. As a result, even in a nasty recession, pre-tax profits of all domestic corporations (financial and non-financial together) came in at 8.9% of national income in 2008 Q4. That ratio had fallen from the near record 11.8% at the time the business expansion peaked in 2007 Q4. But even at the lower level, it was no worse than the historical average of 8.8% and well above the average of 8.2% experienced during past recessions (grey shaded areas in the following chart).

CORPORATE PROFITS RETAIN A HEALTHY SHARE OF TOTAL NATIONAL INCOME, DESPITE RECENT SLUMP



officials have obviously concluded that neither near-zero fed funds rates, or the intense monetary accommodation pursued up to now, or the large fiscal stimulus program enacted by the US government were sufficient to ignite a sustainable recovery. They have committed themselves to a scale of direct involvement in credit creation unimaginable just a few months ago. The immediate stock and bond market reaction was a rousing vote of confidence. But participants in the foreign currency markets were not so sure these moves were appropriate. Concerns about the inevitable tensions over reversing these actions were evident as the US dollar depreciated. Volatility in the financial markets is bound to heighten in the months to come.

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