materials during the first half of the year. At the same time, the crucial aerospace and housing industries saw some signs of an end to the recent softness in their markets.

The resultant increase in employment and income provided the underpinning for continued gains in retail sales throughout the District. Overall, sales during the spring quarter rose about 7 percent above the levels prevailing during the tax-cut period of last spring. Some retailers reported declines, however. In particular, apparel stores and furniture-appliance stores both suffered sales decreases of at least 5 percent below year-ago levels. But auto dealers, here as elsewhere, recorded a substantial (16 percent) year-to-year gain in sales.

—Regional Staff

At Western Banks

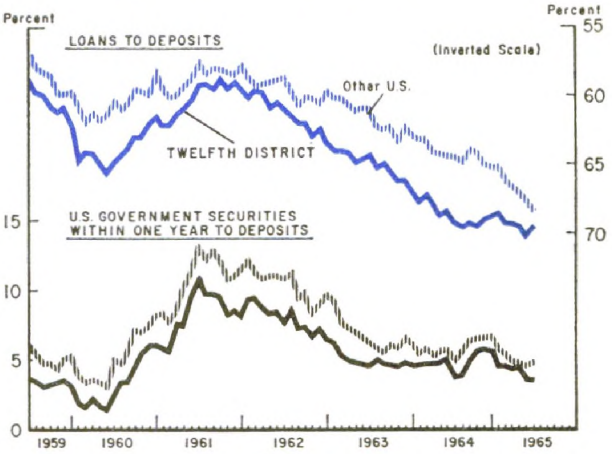
THE STRONG demand for credit which characterized the national banking scene during the second quarter was much less evident at the regional level. In fact, a $506-million loan increase at Twelfth District member banks was little more than half as great as the contra-seasonal rise recorded in the first quarter of 1965, while nationally, the second-quarter increase almost matched the record first-quarter gain. On the other hand, District banks invested in municipal and Federal Agency securities at more than double the national rate, as they had during the first three months of the year. Consequently, an $852-million net investment in "other" securities in the first six months of 1965 more than offset a $482-million reduction in holdings of U. S. Government securities (all series seasonally adjusted).

Although District banks displayed less credit growth than other banks, they remained in a tighter liquidity position than banks nationally, as measured by either the ratio of loans to deposits or the ratio of short-term Governments to deposits. Thus, District banks may simply have had less flexibility than other banks in expanding their loan portfolios.

After posting a $264-million increase in demand deposits adjusted in the first quarter of the year, District banks gained only $95 million more in such deposits in the succeeding three-month period. In the time-and-savings category, the $496-million second-quarter increase was about 25 percent smaller than the inflow recorded in the first quarter, when the higher interest rates paid on such deposits had their greatest initial impact.

For each of these deposit categories, the total first-half increase was somewhat greater than the gain recorded in January-June 1964. Nonetheless, the composition of interest-bearing deposits shifted somewhat between these two periods. Savings deposits increased twice as fast in the first half of 1965 than in the comparable period of 1964, but negotiable time certificates of deposit grew only half as fast as in the earlier period. Since February,

Liquidity positions remain tight, especially for District banks



Source: Federal Reserve Board; Federal Reserve Bank of San Francisco

District banks have not competed aggressively with New York banks for large-denomination CD's. But the large New York banks which have recently increased their capital stock may now become less interested in issuing CD's and may thus remove some of the upward pressure on rates. In that case, District banks might assume a more prominent role in the market.

Business dominates demand

In line with the early-1965 pattern, the business sector accounted for almost half the second-quarter loan expansion. But the $300-million gain[1] in business borrowing at District weekly reporting member banks fell somewhat short of the increase recorded in the comparable period of 1964, despite heavy mid-June tax borrowing by corporations with increased liabilities under the stepped-up corporate tax schedule. The District business loan gain also fell short of the increase recorded at weekly reporting banks elsewhere, primarily because of the very strong business demand for credit at the New York money market banks.

District business borrowing was widely based during the April-June quarter, just as in the rest of the nation. Public utilities accounted for the largest proportion of total borrowing, reversing their first-quarter pattern of net repayments. Meanwhile, petroleum industry borrowing continued heavier than last year, reflecting the very large 1965 construction program of California refineries. Food, liquor, and tobacco processors made large net repayments in the second quarter, partly because repayments normally made earlier in the year were limited by the first-quarter dock strike. Bankers acceptances, also influenced by the dock strike, showed a decline in the April-June period. But other major borrowing categories were on the plus side.

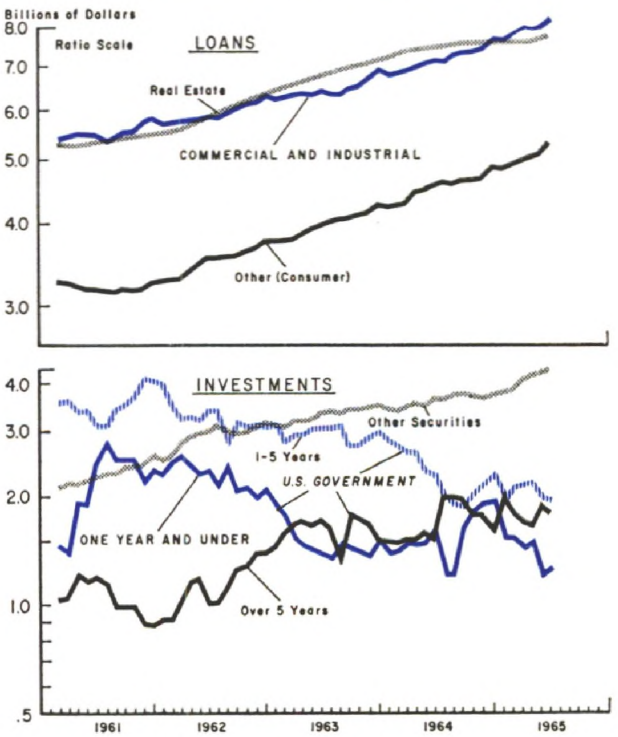
[1]Data for weekly reporting member banks are not seasonally adjusted.

While loans continued to expand, the cost of short-term business borrowing dropped 6 basis points below the first-quarter average to 5.05 percent in the early-June survey period. The decline in average interest cost was due to an increase in the dollar volume of loans made at the 4½-percent rate available to borrowers with prime credit ratings. But rates on smaller loan-size categories (under $500,000) were higher in June than in other recent survey periods. In addition, the spread continued to widen between the average rate paid by borrowers with formal or informal lines of credit and borrowers without established credit lines. Thus, the survey results partially supported other evidence regarding the firming of price and non-price terms of lending in recent months.

Other shifts in assets

In the first half of 1965, mortgage portfolios of District weekly reporting banks fell

Business, consumer loans increase along with municipal security holdings



Source: Federal Reserve Bank of San Francisco

SELECTED BALANCE SHEET ITEMS OF WEEKLY REPORTING MEMBER BANKS IN LEADING CITIES

(dollar amounts in millions)

	Twelfth District				U. S. Minus Twelfth District		
		Net change				Net change	
	Outstanding 6/30/65	Second Quarter 1965 Dollars	Second Quarter 1965 Percent	2nd Qtr. 1964 Percent	Outstanding 6/30/65	2nd Qtr. 1965 Percent	2nd Qtr. 1964 Percent
ASSETS							
Loans adjusted and investments[1]	$33,431	+781	+ 2.39	+2.71	$125,007	+ 4.77	+ 3.26
Loans adjusted[1]	24,087	+674	+ 2.88	+4.13	86,839	+ 6.68	+ 4.44
Commercial and industrial loans	8,154	+300	+ 3.82	+5.16	38,690	+ 5.23	+ 0.40
Real estate loans	7,712	+143	+ 1.89	+1.63	13,437	+ 5.33	+ 4.08
Agricultural loans	1,048	+ 48	+ 4.80	+8.76	558	+ 2.95	— 1.75
Loans to nonbank financial institutions	1,634	+ 83	+ 5.35	+4.62	8,197	+11.58	+ 9.48
Loans for purchasing & carrying securities	435	— 76	—14.87	—4.66	6,983	+17.60	+15.73
Loans to foreign banks	320	— 10	— 3.03	+4.56	1,257	+ 1.05	+11.26
Other loans (mainly consumer)	5,190	+202	+ 4.05	+6.25	19,617	+ 4.81	+ 5.88
Total Securities	9,344	+107	+ 1.16	—0.57	38,168	+ 0.67	+ 1.02
U. S. Government securities	4,880	—296	— 5.72	—3.27	19,374	— 2.10	— 0.31
Other securities	4,464	+403	+ 9.92	+3.71	18,794	+ 3.70	+ 2.79
LIABILITIES							
Demand deposits adjusted	12,215	—128	— 1.04	—0.97	51,592	+ 1.04	+ 0.50
Total time and savings deposits	19,968	+572	+ 2.95	+1.92	53,848	+ 4.07	+ 3.02
Savings	14,458	+137	+ 0.96	—0.08	28,669	+ 2.38	+ 1.42
Other time	5,510	+435	+ 8.57	+8.58	25,179	+ 6.05	+ 5.19

[1] Exclusive of loans to domestic commercial banks and after deduction of valuation reserves; individual loan items are shown gross.
Note: Quarterly changes are computed from March 31, 1965 - June 30, 1965 and from April 1, 1964 - July 1, 1964.
Source: Board of Governors of the Federal Reserve System; Federal Reserve Bank of San Francisco.

below their outstanding business loans for the first time since mid-1962. Nonetheless, the second quarter witnessed a reversal of the recent deceleration in the rate of expansion of mortgage loans. Real estate loans rose $143 million during the quarter, after increasing only nominally in the first three months of the year. Thus, the heavy time-deposit inflow of early 1965 apparently has triggered renewed interest in mortgage financing on the part of District banks. And since the ratio of real estate loans to savings deposits at midyear—53 percent—was lower than the year-ago figure, District banks may have room for further expansion of their mortgage holdings, despite the continued aggressive competition for mortgages from nonbank institutions.

District consumers continued to rely heavily on bank credit to finance the endless stream of cars moving from the assembly lines to the highways, and thus they helped to accelerate the already fast pace of consumer lending during the spring quarter. (Throughout the year to date, auto financing has accounted for just about 50 percent of extensions of consumer credit.) The total first-half increase in consumer loans was nearly double the gain for January-June 1964.

Non-bank financial institutions increased their debt at District banks by $83 million during the second quarter. Sales finance companies borrowed heavily during the two weeks preceding the June tax date, and then, following the usual pattern, made large repayments in the following weeks.

Average borrowings by brokers and dealers were higher during the second quarter than in any other quarter of the current business expansion. In recent months District banks financed a significant proportion of their loans to Government securities dealers by purchasing Federal funds (member-bank excess reserves on deposit with the Federal Reserve) from other banks and reselling those funds to

dealers, so as to take advantage of the higher dealer buy rates. Increased time-deposit interest costs have made banks particularly alert to situations of this type, with their possibilities for arbitrage.

Discounting increases

Twelfth District banks operated under greater reserve pressure during the second quarter, as did their counterparts in the rest of the nation. Borrowings at the Federal Reserve discount window were $63 million on a daily average basis, compared with $14 million during the first quarter of the year. And along with the increase in the dollar volume of borrowing went an increase in the number of banks resorting to the discount window. Discounts exceeded excess reserves on a daily average basis throughout the quarter; the result was net average borrowed reserves of $37 million for the April-June period, in contrast to net free reserves of $17 million during the preceding quarter.

In addition, District banks were net purchasers of Federal funds on interbank transactions, except for the first three weeks in April. However, some of the more active net-purchase banks in the interbank Federal funds market were not using these funds to bolster their reserve position but, rather, were reselling the funds to Government securities dealers at higher rates. As indicated above, such arbitraging activity intensified during recent months.

At midyear, District banks generally were lagging behind the gains in earnings reported by banks elsewhere in the country. Moreover, net earnings per share at many major District banks were generally lower than in the first half of 1964, despite wide variation among individual banks. But, on a more optimistic note, earnings improved between the first and second quarters, as the initial effects of higher interest costs on time and savings deposits were offset by earnings from expanding loan volume and increased investment in tax-exempt securities.

—*Ruth Wilson*

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market quoted a spot price of almost $1 a pound, and the Chilean government raised its export price from 42 to 62 cents a pound. But domestic producers continued to hold the price line unchanged at 36 cents for each pound of the increasingly scarce metal.

District petroleum output continued to expand in early 1966. Production of crude ran about 9 percent above the year-ago pace, and refining activity increased apace. But with consumption also rising, inventories remained largely unchanged from year-ago levels except for some expansion of residual-fuel stocks. So, in this as in other regional industries, pressure was being maintained on the gas pedal rather than the brake as the year advanced into spring.

Regional Staff

At Western Banks

In the Twelfth District, as in the nation, the first-quarter expansion in bank loans did not match the unusually high loan increase registered in the comparable period of 1965. Yet District member banks came under somewhat greater reserve pressure than in the year-ago period, as evidenced by their increased borrowing, both at the Federal Reserve Bank discount window and through the purchase of Federal funds, and by their substantial reduction in holdings of U. S. Government securities. A more restrictive monetary policy contributed to this increased tightness, along with a sharp slowdown in the growth of time and savings deposits. District member banks had net borrowed reserves of $2 million (daily average basis) during the first quarter, as compared with free reserves of $16 million in the comparable period of 1965.

The ratio of loans to deposits, already higher than at any time since the 1920's, edged up further—reaching 72 percent for weekly reporting banks during February and March. At the same time, the ratio of short-term Government securities to deposits declined sharply from 4.7 to 2.6 percent between the end of December and the end of March. So with liquidity declining, District banks had less flexibility with which to meet rising credit demands.

Favorable developments

On the other hand, several favorable developments led to generally higher earnings for District banks in early 1966 than in the corresponding period of 1965. The average rate of return on most types of loans rose following the December 1965 increase in the discount rate. The bellwether, the prime rate on commercial loans, rose ½ percent in December and ½ percent more (to 5½ percent) in early March.

Concurrently, District banks limited the increases in rates which they offered on time and savings deposits. They did not raise the rate on passbook savings, since they were already paying the 4-percent maximum permitted under Federal Reserve Regulation Q. And, although major District banks offered competitive rates on large-denomination certificates of deposit, they failed to raise their rate on savings certificates until the latter part of the quarter. Thus, the margin between loan income and interest expense on deposits became much more favorable in the first quarter of 1966 than it had been during most of 1965.

But this rate relationship then changed again after most major California banks began offering 5 percent on savings certificates. The effect of the higher rate was a substantial (about $430 million) shift of funds in the first

week of April out of passbook savings into the higher-interest savings certificates—with no absolute increase in the total amount of time and savings deposits. Simultaneously, District banks raised their rates on large-denomination negotiable time certificates to meet competition from banks in the East and elsewhere for these corporate funds.

In the light of these developments, interest costs on deposits can be expected to rise relatively more steeply in the current quarter than in the first three months of the year. If credit demands remain strong in the near future, as seems likely, upward pressure on loan rates also will continue. Nonetheless, barring any further change in the prime rate, the margin between loan income and interest expense may not widen as it did earlier in the year.

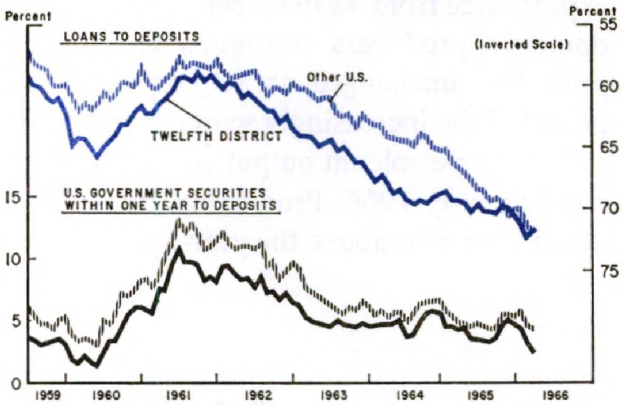
Contra-seasonal loan increase

District member banks recorded a less-than-seasonal decline in total credit in the first quarter, but the reduction was in contrast to a large increase in the year-ago period. Loans, however, increased contra-seasonally, just as they did last year. Again, as during 1965, commercial and industrial firms continued as the major source of bank borrowing. Although tax-connected borrowing by the business sector in March was less than last year, the speed-up in corporate tax payments—with a large payment scheduled for mid-April—has put renewed pressure on business corporations for further bank financing during the current quarter.

Borrowing by both durable and nondurable goods manufacturers was fairly strong in the early months of this year, reflecting the strong improvement in District business conditions. Moreover, metal fabricators, oil and gas producers, and service industries all recorded greater increases in bank indebtedness in the first quarter than in the year-ago period.

For District business borrowers, the average cost of short-term funds rose 27 basis points over the quarter, from an average rate of 5.27 percent in the first half of December to 5.54 percent in the first half of March, as a result of the two successive prime-rate increases. Nevertheless, the increase was less than that reported by New York City banks or by banks in the rest of the country. In March, 28 percent of the dollar volume of loans made in the survey period was at the new 5½-percent prime rate and 32 percent bore the old 5-percent prime rate. The increase in the cost of borrowing was greater for large loans ($200,000 and over) than for the smaller loan-size categories—as it had been in the September-December period. The dollar volume of long-term loans was only 3 percent of the volume of total loans in the March reporting period—the same proportion as in December, but well below the 7-percent share reported a year ago.

Declining liquidity restricts banks' flexibility in meeting credit demands



Mortgage and consumer financing

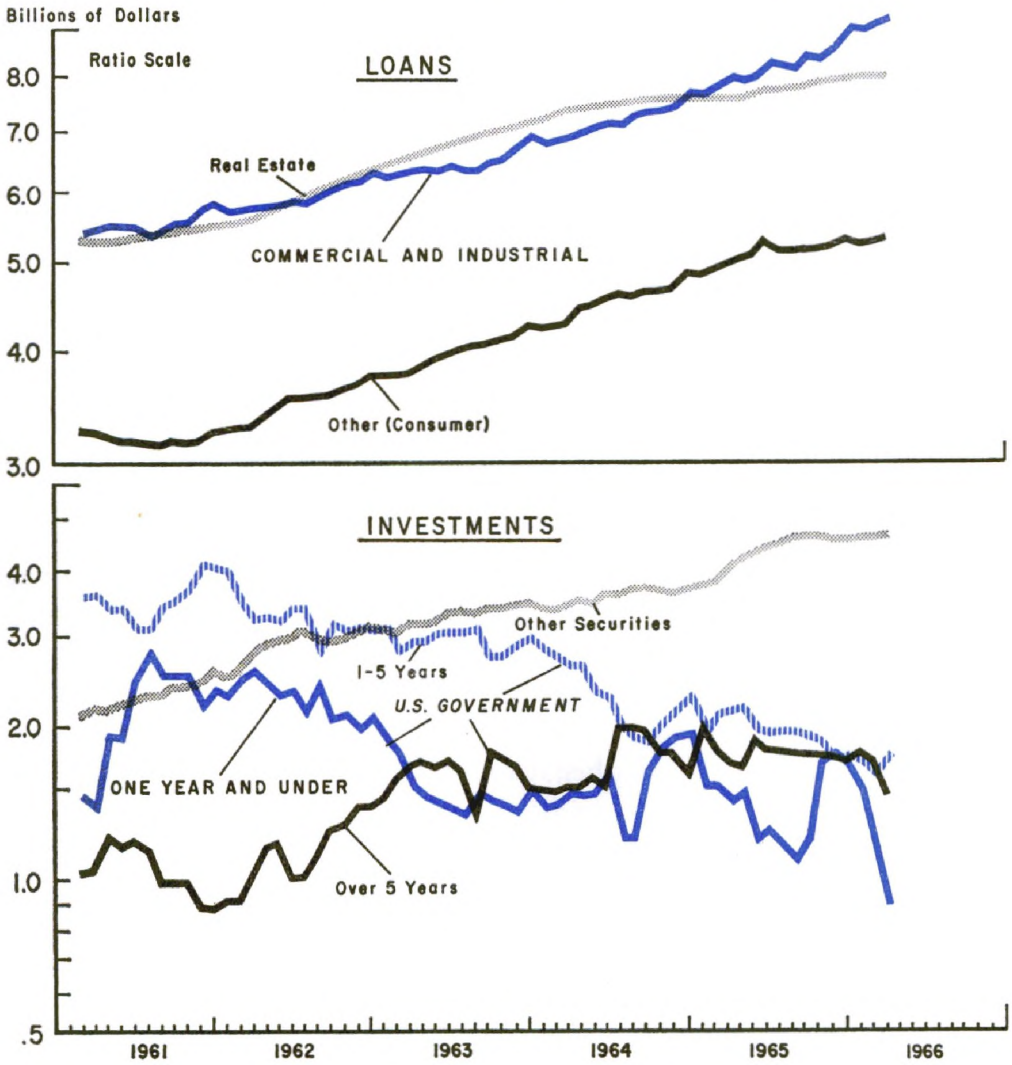
District weekly reporting member banks recorded only a 0.2-percent increase in mortgage loans in first-quarter 1966, as against a 2-percent gain elsewhere. This development partly reflected the weakness of the Western housing market, but it also reflected a more extensive use by major District banks of the practice whereby they sell mortgages out of their portfolios to other investors, but retain

servicing of the loans. This procedure enables these banks to maintain their customer relationships yet provides funds which can be reinvested in new mortgages or used for other types of lending.

Consumer lending, like mortgage lending, just held its own during this January-March period. A year ago the consumer sector had been a strong source of expansion. But District banks now find themselves on somewhat of a treadmill, as a constantly increasing volume of repayments offsets their new extensions of credit. In the early part of the second quarter, consumer demand for bank financing rose seasonally as individuals sought funds to meet income-tax payments. Their needs over the April tax date were greater than in April 1965, even though withholdings last year more nearly matched required tax payments than they did in 1964.

District bank loans to sales finance companies remained above the first-quarter level of last year, as borrowing ran particularly high around the March tax date. However, loans to other nonbank financial institutions (including mortgage companies) declined sharply, in accordance with the seasonal pattern of the last several years. Loans to brokers and dealers for purchasing and carrying securities remained generally below the year-ago level, but the volume of loans to others for carrying securities remained at a postwar high.

Business sector accounts for contra-seasonal loan increase . . . short-term security holdings drop



Security portfolios reduced

The tighter position of District banks was most evident in the securities segment of their balance sheets. Mainly to meet loan demands and reserve requirements, District weekly reporting banks reduced their total security holdings by $882 million from the end of the year through March 31, as against a $171-million reduction in the comp-

SELECTED BALANCE SHEET ITEMS OF WEEKLY REPORTING MEMBER BANKS IN LEADING CITIES

(dollar amounts in millions)

	Twelfth District				U.S. Minus Twelfth District		
		Net Change First Quarter 1966				Net Change	
	Outstanding 3/30/66	Dollars	Percent	1st Quarter 1965 Percent	Outstanding 3/30/66	1st Quarter 1966 Percent	1st Quarter 1965 Percent
ASSETS							
Loans adjusted and investments[1]	$34,075	—675	— 1.94	+ 1.04	$129,587	— 0.86	+ 0.52
Loans adjusted[1]	25,279	+207	+ 0.83	+ 2.21	93,131	+ 1.13	+ 2.63
Commercial and industrial loans	9,046	+214	+ 2.42	+ 3.60	43,594	+ 4.30	+ 6.45
Real estate loans	7,944	+ 16	+ 0.20	+ 0.32	14,923	+ 2.12	+ 2.36
Agricultural loans	1,028	— 29	— 2.74	— 1.28	620	— 2.52	— 6.23
Loans to non-bank financial institutions	1,643	— 47	— 2.78	+ 1.70	8,975	— 2.74	— 2.14
Loans for purchasing and carrying securities	471	+ 97	+25.94	+12.06	5,564	— 7.97	— 4.55
Loans to foreign banks	272	— 17	— 5.88	+ 7.84	1,279	— 3.62	— 0.80
Other loans (mainly consumer)	5,318	+ 11	+ 0.21	+ 2.70	20,350	+ 0.06	+ 1.37
Total securities	8,796	—882	— 9.11	— 1.82	36,456	— 5.61	— 3.71
U. S. Government securities	4,088	—971	—19.19	— 9.13	17,386	— 9.41	— 9.98
Other securities	4,708	+ 89	+ 1.93	+ 9.40	19,070	— 1.84	+ 4.21
LIABILITIES							
Demand deposits adjusted	12,474	—450	— 3.48	— 3.95	53,818	— 5.19	— 7.49
Total time and savings deposits	21,235	+320	+ 1.53	+ 4.40	59,766	+ 4.22	+ 7.12
Savings	14,954	—109	— 0.72	+ 3.01	30,157	— 0.47	+ 4.50
Other time, I.P.C.	3,428	+655	+23.62	+22.46	20,732	+12.16	+11.05

[1]Exclusive of loans to domestic commercial banks and after deduction of valuation reserves; individual loan items are shown gross.
Note: Quarterly changes are computed from December 29, 1965 — March 30, 1966 and from December 30, 1964 — March 31, 1965.
Source: Board of Governors of the Federal Reserve System; Federal Reserve Bank of San Francisco.

arable period last year. All of the reduction occurred in U. S. Government securities, with about two-thirds of the amount in Treasury bills. At the same time, District weekly reporting banks raised their holdings of "other" securities (mainly tax-exempts) only 2 percent, as against a 9-percent gain in January-March 1965. Yet, for the first time in the postwar period, "other" security holdings of these banks exceeded their portfolios of U. S. Government securities.

Decline in savings flow

District weekly reporting member banks recorded a seasonal decline in demand deposits adjusted. They also recorded only a $320-million gain in total time and savings deposits, compared with a first-quarter gain of $818 million in 1965. The major divergence was in passbook savings, which declined $109 million compared with a $418 million rise in the corresponding period last year. Part of the reduction was accounted for by transfers of funds from passbook savings to saving certificates, but this also had occurred in the early months of 1965. District banks, therefore, appear to be experiencing a reduced inflow of savings—just like their counterparts elsewhere.

The other major difference in time-deposit behavior was a larger than seasonal ($241 million) decline in time deposits of states and political subdivisisons. On the positive side, District banks substantially expanded their large denomination CD's. The net increase in outstandings was $314 million—nearly a 20-percent quarterly gain, as against only a 5-percent gain elsewhere. *Ruth Wilson*