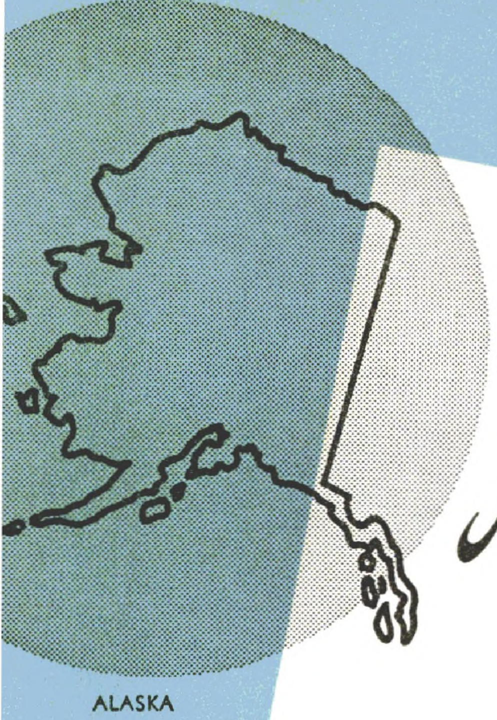
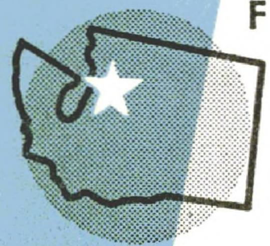
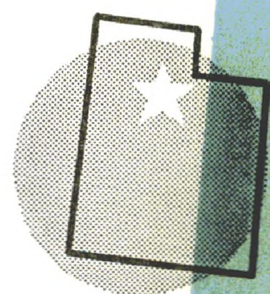


Monthly Review

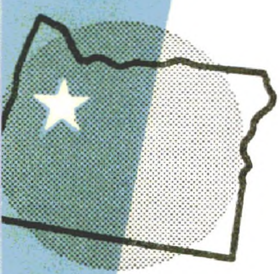
FEDERAL RESERVE BANK OF SAN FRANCISCO
TWELFTH FEDERAL RESERVE DISTRICT

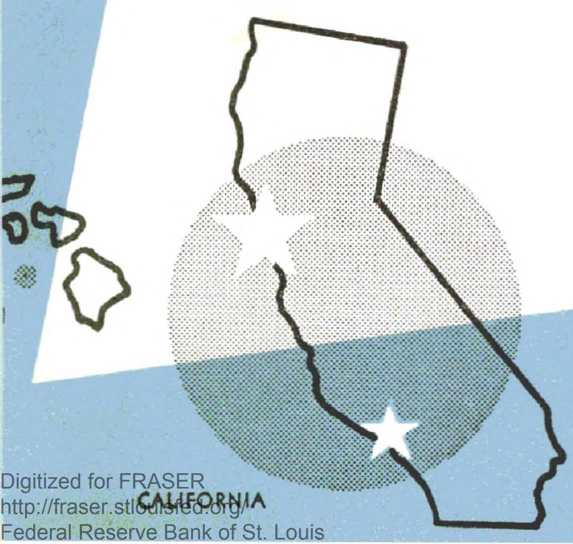


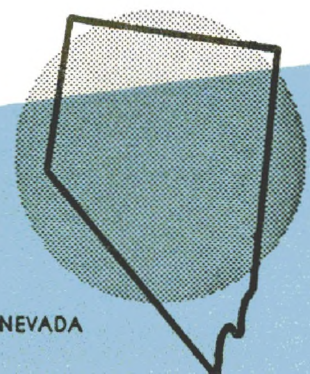
November 1963

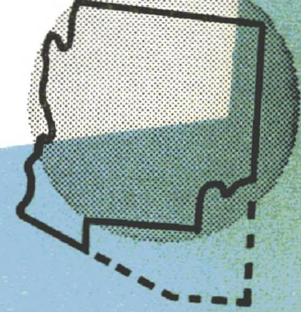


In This Issue









Waiting for '64

THE economy entered the final quarter of 1963 in fairly healthy shape, despite some sluggishness in employment and industrial production, but the question now intriguing most observers concerns the prospects for tax cuts. Gross national product increased at a respectable $9 billion annual rate in the July-September quarter; yet, according to Treasury Secretary Dillon's recent testimony before the Senate Finance Committee, the quarterly gains in the first half of 1964 could be one-third greater if the tax bill is enacted—but one-third less if the bill goes down to defeat.

One business publication contends that the economy even now possesses "immense strength," because of the high spending levels attained without benefit of tax cuts. But the counterargument can be made that recent favorable indicators — for example, the strong initial reception of the '64 auto models, or the substantial increase projected for business plant-equipment spending this quarter—simply mean that the spending plans of consumers and businessmen are already being influenced by the expectations of a favorable decision. If this point of view is correct, the stimulus would be greater now—and less next year—than currently anticipated. But neither hypothesis will receive a thorough testing for some months to come, that is, until all sectors of the economy have had an opportunity to adjust their spending plans to the final Congressional decision.

Up and up, sluggishly

Meanwhile, a backward look reveals a broad-scale advance in third-quarter activity, despite some end-of-quarter sluggishness. The GNP increase, to a seasonally adjusted annual rate of $588½ billion, occurred in response to increased spending by all major sectors—$4 billion in consumption spending, over $3 billion in private investment, and over $2 billion in government spending.

The increase in consumer spending, which was greater in the third quarter than in the preceding quarter, developed in the face of a slowdown in the rate of growth of personal income. The latter, in turn, reflected a slower expansion in employment during the quarter, particularly in relatively high paying industries such as construction and manufacturing.

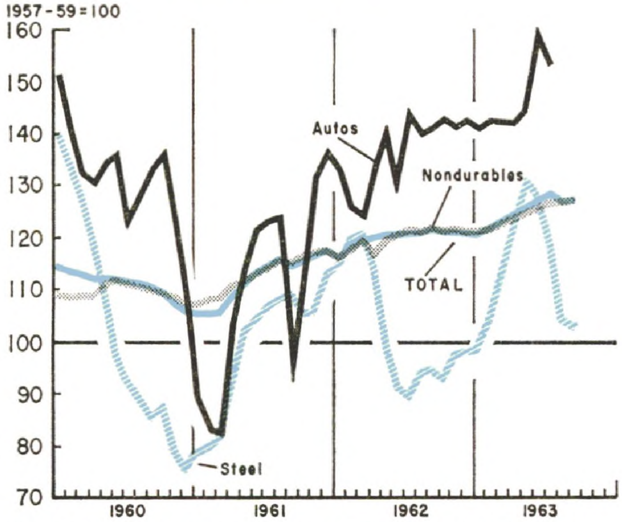
Investment outlays increased at a slightly faster rate in the third quarter, but the pattern of investment expenditures shifted somewhat. Outlays for nonresidential construction and for inventories, which had shown little if any gain in the preceding quarter, advanced at a faster clip, whereas housing and producers' equipment did not rise much above the record levels achieved earlier. The substantial gain in government outlays, meanwhile, centered almost entirely in the state and local government sector.

But while the economy was recording a strong third-quarter advance, activity in a number of key lines was exhibiting somewhat less strength as the quarter ended. Retail sales, for example, reached a new peak during July and then receded in both August and September, to the lowest level since last November. However, weekly data indicate that sales regained considerable momentum during October, partly in response to the initially favorable reception accorded '64 model cars. This, of course, is a significant factor in assessing the outlook for the months ahead.

Vigor regained?

Industrial production, at 126 percent of the 1957-1959 level, ended the quarter on a note of less vigor, but it showed signs of renewed expansion in October. After a sustained rise of over 4 index points during the second quarter, output peaked in July, receded in August, and ended the quarter at a level slightly below that which obtained in June. To a large extent, this decline was attributable to inventory cutbacks by steel consumers following the labor con-

Wide swings in steel, autos underlie stable production



Source: Board of Governors of the Federal Reserve System.

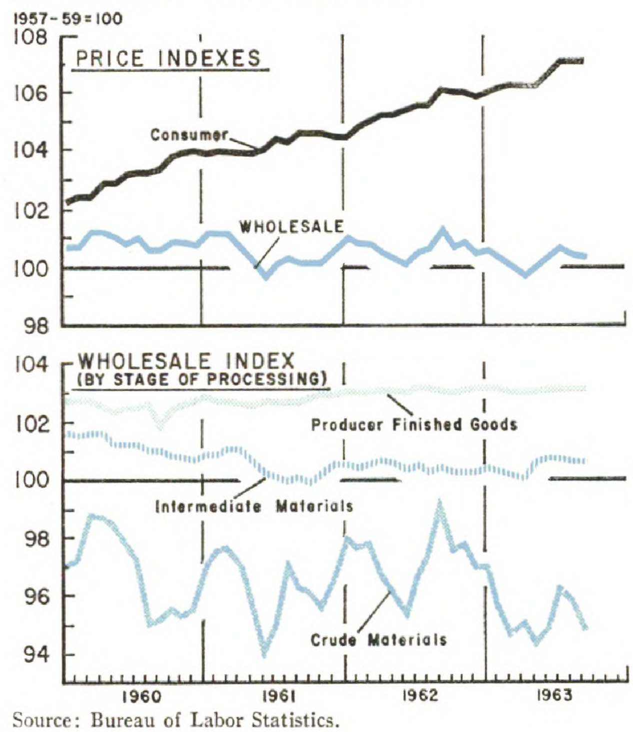
tract settlement, and to an attendant reduction in iron and steel output; from one quarter to the next, this amounted to a 15 percent decline. But the production index also dropped because of August's reduction in automobile output, which occurred when virtually all auto makers closed down for model changeovers at the same time.

In September and October, production of automobiles regained considerable momentum, but the rise in steel output was somewhat less vigorous. However, prospects for further gains brightened in September with a rise in factory orders to a record $36 billion (seasonally adjusted). The gain, which followed a decline in August, was accompanied by a rise in the backlog of unfilled orders.

In the construction sector, continued buoyancy seems likely on the basis of September's record level of housing starts, as well as a third-quarter dollar volume of construction awards that was 12 percent above the year-ago dollar volume. In the investment field, continued gains in corporate profits and depreciation allowances imply continued ability to finance plant and equipment expenditures in coming months. The inventory sector also looks strong, among other reasons because inventory-sales ratios for manufacturers and retailers continue at lower levels than those which prevailed during the comparable periods of previous postwar cycles. (On the other hand, in manufacturing, the ratios of unfilled orders to both sales and inventories also are relatively low.)

Another factor deserving attention is the environment of price stability supporting the current expansion. Following a modest rise in June and July, retail prices held steady through September, at a level one percent above a year ago. Notwithstanding selected increases in the price of steel products during September and early October, as well as further gains in the prices of various nonferrous metals, wholesale prices currently are lower than they were in July, and are even lower than they were five years ago. The relative stability in prices thus reduces the likelihood that speculative factors will influence the spending and investment decisions of consumers and businesses.

Retail prices up, but stability continues at wholesale level



Source: Bureau of Labor Statistics.

Parallel developments

Twelfth District economic activity generally paralleled national activity during the third quarter, surpassing it in some sectors and falling short in others. Employment rose by somewhat less in the District than in the nation, notwithstanding an appreciable recovery in manufacturing which was related to August's settlement of the strike and lockout affecting District lumber mills. Employment in District defense and space-related industries registered a further (albeit slight) decrease during the third quarter, despite the rise in the dollar volume of defense prime contract awards placed in the District during the preceding quarter. (Incidentally, the fragmentary data available earlier incorrectly indicated a decline, rather than a slight increase, in second-quarter contract awards.) A more rapid rate of growth in the District labor force, in conjunction with the less rapid rise in employment, also contributed to a further increase in District unemployment, in contrast to a slight decline nationally.

On the other hand, consumer spending appeared to exhibit about the same strength in the District as in the nation, while construction activity generally showed more vigor here than elsewhere. Developments in the agricultural sector revealed mixed trends; District farmers enjoyed a relatively sharp gain in receipts from crop marketings, but total agricultural employment declined rather sharply, and, in fact, accounted for almost all of the nation's third-quarter drop in farm employment.

New car sales exhibited somewhat more third-quarter strength in the District than in the nation, even though sales in both areas fell below second-quarter levels. Through August, new car registrations in the District recorded a cumulative 8 percent gain over the year-ago figure—a slightly lower rate of increase than in the nation as a whole. Most District states reported gains of 7 to 9 percent, although

Idaho and Oregon lagged behind the average and Nevada recorded a striking 15 percent gain.

Industrial activity vigorous

Construction contract awards, although lower in the third than in the preceding quarter, were considerably higher than a year ago. (The gain was 19 percent, as compared with a national gain of 12 percent.) A sharp rise in awards for commercial and industrial establishments, and especially a 39 percent cumulative year-to-year increase in heavy engineering projects, indicates the continued strength of fixed investment spending in the District as a whole. But the gain in total awards has been somewhat spotty. California and Nevada, for example, have recorded very large increases, whereas Idaho and Arizona have suffered year-to-year declines.

Steel production, in the District as in the nation, began to recover by the end of the quarter from the inventory liquidation which followed on the heels of June's labor contract agreement. The end-of-quarter strengthening of new orders boosted District production in October to a level 6 percent above the year-ago figure, although below this June's level. In this new atmosphere of rising demand for steel mill products, most major steel producers throughout the nation announced minor price increases on products accounting for about 35 percent of the steel market; these increases, along with those posted in April, raised the average price about 2 percent above its year-ago level.

Settlement of the lumber strike and lockout in mid-August meanwhile reversed the price and production patterns which had prevailed in that industry earlier in the quarter. Mill orders picked up from their strike-depressed levels following the labor settlement, as lumber wholesalers and retailers responded to a "brisk" level of sales. But this resumption of production to prestrike levels was accompanied by a sharp decline in lumber prices, to levels only slightly above those of a year ago. This development was accentuated by the deeper penetration of the American market achieved by British Columbia mills as a consequence of the work stoppage here.

District petroleum refining hummed along at 85 percent of capacity during most of the third quarter, roughly the same as a year ago, but dropped to 81 percent of capacity during September. Stocks of gasoline and residual oil declined from their relatively high midyear levels to levels more in line with those which prevailed in 1962. Crude prices remained unchanged in this somewhat stable situation, whereas elsewhere in the nation production increased and crude prices declined.

District farmers posted a 10 percent gain in cash receipts between July-August 1962 and the comparable period this year; nationally, the figure was unchanged. (The gain was especially sizable for the wheat states of the Northwest.) The rise in receipts resulted primarily from heavier marketings, since prices received by District farmers seemed to have averaged somewhat less than during the comparable months of 1962. But despite the rise in income, employment on District farms declined during the third quarter to a level almost 5 percent (23,000) below a year ago; the decline was accompanied by a fairly sharp drop in the number of foreign agricultural workers in California, Arizona, and Nevada.

But the jobless rolls increase

The result of these production trends was a third-quarter rise in District employment figures (Alaska and Hawaii data not available). In nonfarm employment, the District's 1 percent quarter-to-quarter gain outpaced the national increase; in total employment, the reverse was true because of the sharp drop in District farm payrolls. The key manufacturing sectors were lumber and wood products, which showed a sharp rise following the August strike settlement, and defense-related industries, which recorded another minor decline. (Aircraft-ordnance-electrical equipment employment now stands 4 percent below the December 1962 peak.)

Since the labor force continued to rise more rapidly in the District than elsewhere, unemployment during the quarter rose 4 percent here while declining nationally. Largely under the influence of developments in California and Washington, the District unemployment rate rose from 5.8 percent of the labor force in June to 6.0 percent in September—in contrast to a national decline from 5.7 to 5.6 percent. Compared with a year ago, the national rate has remained unchanged but the District rate has moved somewhat above that national average. The situation cannot be attributed to lagging employment, since the number of jobs has increased more rapidly here than elsewhere over the past year, but rather to an expanding labor force which has increased at double the national rate. Under these circumstances, therefore, District observers are waiting—perhaps even more impatiently than their colleagues elsewhere—to measure the impact on business activity of Congress' final tax-cut decision.

Smooth Adjustment

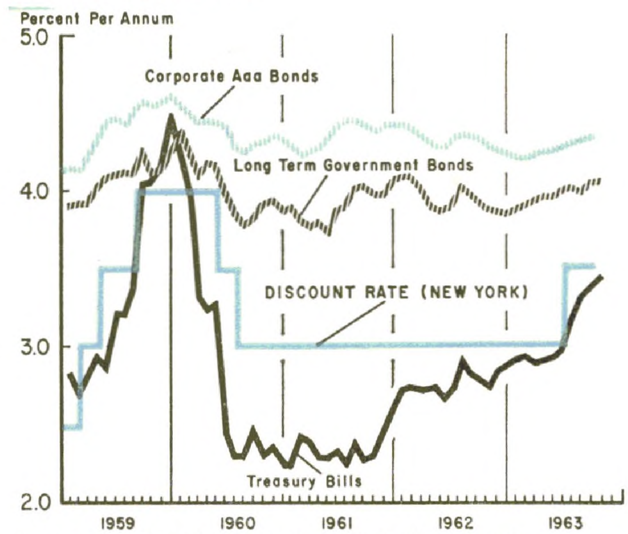
RECENT financial developments have reflected a generally smooth adjustment to mid-July's monetary policy measures, including the increase from 3 to 3½ percent in the discount rate—the rate member banks must pay when borrowing from the Federal Reserve Banks. As in the first half of the year, monetary policy has been influenced by the necessity to keep short-term interest rates in reasonable alignment with rates obtainable abroad, so as to contribute to an improvement in the capital accounts of the nation's balance of payments. The financial sector's recent performance also has reflected the impact of the continuing economic expansion on bank loan demand.

The third-quarter monetary situation continued to reflect the midyear policy shift of "somewhat less ease." Consequently, member banks' net free reserves (excess reserves less borrowing from the Federal Reserve Banks) declined during the third quarter to a daily average level of $128 million — more than $100 million under the preceding quarter's level. Moreover, average free reserves then fell somewhat further in the following four-week period. The decline in reserve balances was concentrated in reserve city banks, which have had net borrowed reserves for over a year.

More costly borrowing

Member bank borrowings from the Federal Reserve Banks rose substantially during the third quarter, and banks' alternate source of borrowed funds, Federal funds, also became more costly. (Federal funds are reserves on deposit with a Federal Reserve Bank which a member bank may lend to other banks that need funds to meet their required reserves.) The Federal funds rate throughout most of the quarter remained consistently at the effective ceiling set by the 3½ percent discount rate. In addition, Federal funds became quite scarce on several occasions during this period because of the generally lower level of excess reserves and the banks' increased borrowing needs.

Spread narrows as short-term interest rates rise

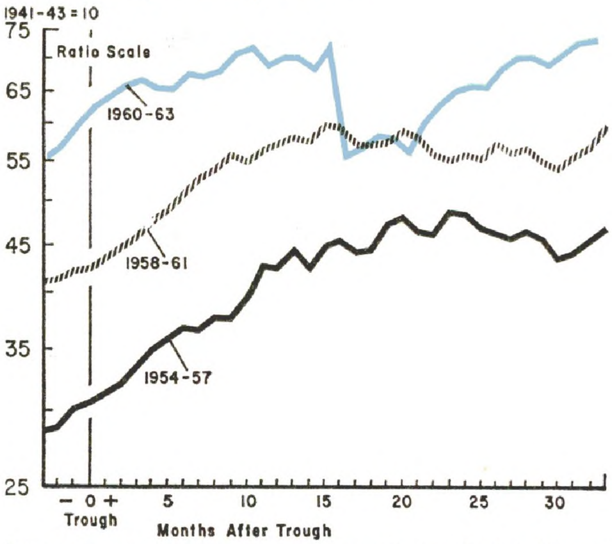


Source: Board of Governors of the Federal Reserve System.

As the third quarter progressed, short-term interest rates tended to rise above the levels established at the time of the discount rate increase. The rate on 91-day Treasury bills, which had averaged slightly less than 3.00 percent in June, rose to 3.38 percent in September, and then increased further to 3.47 percent by mid-October. The yields on bills of longer maturities moved up more or less in unison with those for 91-day bills, and yields on other money market instruments increased in a similar fashion.

Following July's revision of Regulation Q, which permitted banks to pay up to 4 percent on time deposits and certificates with maturities of 90 days and over, the average rate on 6-9 month negotiable time certificates issued by New York City banks rose in several steps, from 3⅛ percent in July to 3¾ percent in early October. Adjustments were also made on rates paid on time certificates of longer

Stock prices rise, contrary to usual cyclical pattern



Source: Standard and Poor's. Business cycle troughs dated August 1954, April 1958, and February 1961.

maturities. As a result, negotiable time certificates of deposit remained competitive money market instruments, and banks experienced no abrupt decline in the outstanding volume of this type of time deposit.

Intermediate- and long-term United States Government bond yields moved slightly higher in July, leveled off in August, and then rose again in September and October. The rate on long-term issues reached 4.05 percent at the time of the Treasury's pre-refunding and junior advance refunding operations in mid-September. The Treasury offering was highly successful; about 28 percent of the eligible securities held by the public were exchanged for one of the three new issues offered, and the average maturity of the marketable debt consequently lengthened by over four months.

Bulls on the bourse

The bull market in stocks, which dates from last fall's Cuban crisis, continued rising into the fourth quarter, albeit with brief intervals of caution and profit-taking. Both major stock indexes, Standard and Poor's and the Dow Jones industrial average, set new historic highs in late September, and then broke those records with new highs in late October. Trading volume rose sharply in September, averaging 5.5 million shares, but buying appeared to be selective. Market optimism was ascribed to investor confidence in the general state of the economy, particularly as reflected in rising earnings and dividends.

The market's behavior in the present business cycle provides an intriguing contrast to its behavior in earlier postwar cycles. In each of the three preceding cycles, stock indexes rose sharply during the first 18 months or so of the cyclical expansion, and then leveled off for a prolonged period of time; in this cycle, the indexes followed their initial spurt with the mid-1962 slump, and followed that in turn with a second year-long expansion. Market observers thus are faced with the question whether the indexes are only making up for lost time, or whether the economy is witnessing—for the first time in the postwar period—a strong market expansion occurring in the mature phase of a business cycle expansion.

To ensure that speculative excesses do not develop during this new bull market, the Federal Reserve Board in early November raised margin requirements for credit purchases from 50 to 70 percent, that is, to the level that had prevailed between mid-1960 and mid-1962. The Board's action took cognizance of the fact that the 50-percent-margin period experienced not only a 30 percent rise in stock prices but also a 43 percent rise in stock market credit. Most of this credit increase, in fact, occurred just in the past half-year.

September's solid strength

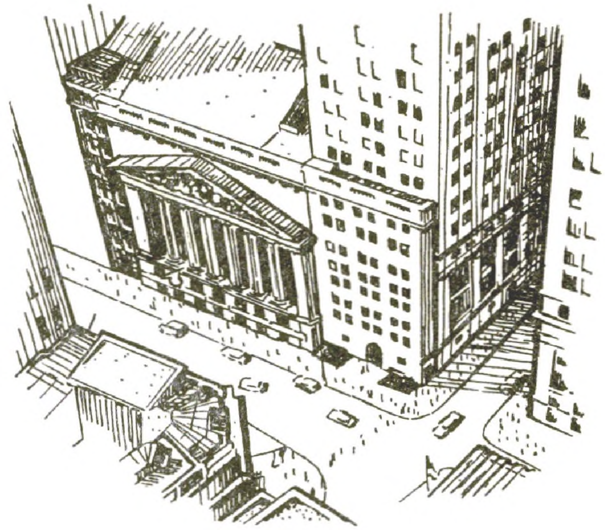
The banks, like the bourse, have shown recent strength. Commercial bank credit (seasonally adjusted) increased substantially in September following a small decline in July and a moderate expansion in August. The annual rate of growth for 1963 to date thus amounts to a solid 7.4 percent, although it falls below last year's 8 percent rate.

The quarterly loan expansion of $3.2 billion (seasonally adjusted) was concentrated in September, when normal tax-related borrowing by business firms and by nonbank financial institutions was augmented by credit extended to brokers and dealers at the time of the Treasury pre-refunding operations. Business borrowing in September increased more than seasonally, but less than it did in the corresponding period last year. Heavy mortgage activity, however, brought the 9-month annual rate of growth in this category to 15.6 percent, compared with 12.3 percent for 1962 as a whole. The quarterly expansion in consumer loans was at about the same pace as a year ago.

Bank holdings of United States Government securities declined $4.3 billion in the third quarter, but this reduction was partially offset by increases of $1.5 billion in other securities (both figures seasonally adjusted). Shifts in bank portfolios of Treasury issues reflected the exchange of $3.4 billion of securities maturing within 5 years for longer term issues offered in the September prerefunding. Banks also made net additions to their bill holdings in September, including an allotment of $365 million of one-year bills.

Action at discount window

Twelfth District banks adjusted relatively smoothly to the new environment of the 3½ percent discount rate. As in the rest of the nation, however, member banks operated under somewhat more reserve pressure than in the first half of the year. Reserve city banks in the District fairly consistently recorded net borrowed reserves during the third quarter; that is, their borrowings from the San Francisco Reserve Bank exceeded their excess reserves throughout most of the period. In July, a relatively large number of banks used the discount window of the San Francisco Reserve Bank, and daily borrowings averaged over $20 million. In August, bank recourse to discounting slackened, but in late September



—as bank reserves came under increased pressure—borrowings again rose sharply. To cover unusually large reserve deficiencies in the September 25 statement week, District banks also made net purchases of Federal funds to supplement their Reserve Bank borrowings. (Throughout the rest of the quarter, however, District banks as a group remained net sellers of Federal funds.) In early October, banks continued to resort to the discount window but were net sellers of Federal funds on a reduced volume of transactions.

Weekly reporting member banks[1] in the District ended the third quarter with a net gain of $307 million in loan and investment portfolios. While this increase in total bank credit was less than half that registered in the preceding quarter, it was slightly greater than 1962's third-quarter gain. The loan expansion of $451 million, however, was well below the $609 million increase of third-quarter 1962.

Slow growth in business loans

Business firms in the District increased their borrowings only one third as rapidly as they did in the comparable 1962 quarter. In

[1]This discussion is based on data for weekly reporting member banks, since more detailed information is available on a current basis for these banks than for all member banks. Weekly reporting banks hold about 90 percent of the total assets of all District member banks. The District vs. U. S. comparisons are also based on data for weekly reporting member banks.

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

(dollar amounts in millions)

	Twelfth District				United States		
	Outstanding Sept. 25, 1963	Net change from 2nd Quarter 1963 Dollars	Net change from 2nd Quarter 1963 Percent	Net change from 3rd Qtr. 1962 Percent	Outstanding Sept. 25, 1963	Net change from 2nd Qtr. 1963 Percent	Net change from 3rd Qtr. 1962 Percent
ASSETS:							
Loans adjusted and investments[1]	29,087	+307	+ 1.1	+ 1.1	134,264	+ 0.9	+ 1.1
Loans adjusted[1]	19,854	+451	+ 2.3	+ 3.6	87,063	+ 2.8	+ 3.0
Commercial and industrial loans	6,387	+ 66	+ 1.0	+ 3.3	35,944	+ 1.1	+ 2.1
Real estate loans	6,904	+217	+ 3.2	+ 4.3	17,409	+ 3.8	+ 4.6
Agricultural loans	924	— 53	— 5.4	— 2.9	1,465	— 4.4	— 6.3
Loans to nonbank financial institutions	1,313	+ 89	+ 7.3	+ 9.5	7,691	+ 5.5	+ 3.1
Loans for purchasing and carrying securities	399	+ 51	+14.7	+30.2	6,271	+10.1	+19.2
Loans to foreign banks	219	+ 2	+ 0.9	+ 3.2	801	+10.0	—13.2
Other (mainly consumer)	4,059	+ 91	+ 2.3	+ 1.1	19,443	+ 2.0	+ 0.9
U. S. Government securities	5,850	—217	— 3.6	— 4.2	28,066	— 7.6	— 4.9
Other securities	3,383	+ 73	+ 2.2	— 1.0	19,135	+ 6.0	+ 4.5
LIABILITIES:							
Demand deposits adjusted	12,016	+261	+ 2.2	+ 2.3	61,609	— 0.7	— 0.7
Time deposits	16,269	+111	+ 0.7	+ 1.2	56,466	+ 2.9	+ 2.2
Savings accounts	12,827	+286	+ 2.3	+ 3.7	37,147	+ 2.2	+ 3.7

[1]Exclusive of loans to domestic commercial banks and after deductions of valuation reserves; individual loan items are shown gross.
Source: Board of Governors of the Federal Reserve System and Federal Reserve Bank of San Francisco.

fact, the entire $66 million increase in business borrowing occurred in September, when business firms had to meet quarterly corporate tax payments and when food, liquor, and tobacco processors faced seasonal credit needs. A decline in the average interest rate on short-term business loans was further evidence of some slackness in credit demand from the business sector; the rate was 5.24 percent in September 1963, as compared with 5.37 percent in both June 1963 and September 1962. The proportion of the dollar volume of loans made at the prime rate, which has remained at 4.50 percent since August 1960, rose from 27 percent in June to 37 percent in September because of the increasing percentage of large loans ($200,000 and over) made at this favorable rate.

Real estate loans continued to expand more rapidly than other categories, as District banks consistently added to their mortgage portfolios despite intense competition in the mortgage market from other types of lenders. The $217 million gain for the quarter brought the net increase in real estate loans for the January-September period to $598 million—almost one third of the total national increase for the same period. Meanwhile, consumer loans increased twice as fast as they did in the corresponding period last year. Consumer financing by District banks continued to be dominated by the auto market; new extensions of credit for car financing were maintained at the high second-quarter rate in both July and August.

Security financing also contributed to the third-quarter gain in District bank loan portfolios; substantial amounts of credit were extended to brokers and dealers in September for financing and carrying United States Government securities at the time of the Treasury pre-refunding operations, and most of these loans were not repaid until the first part of October. In addition, some non-bank financial institutions continued to exhibit a strong demand for bank credit, since they accounted for about $100 million of the third-quarter loan expansion.

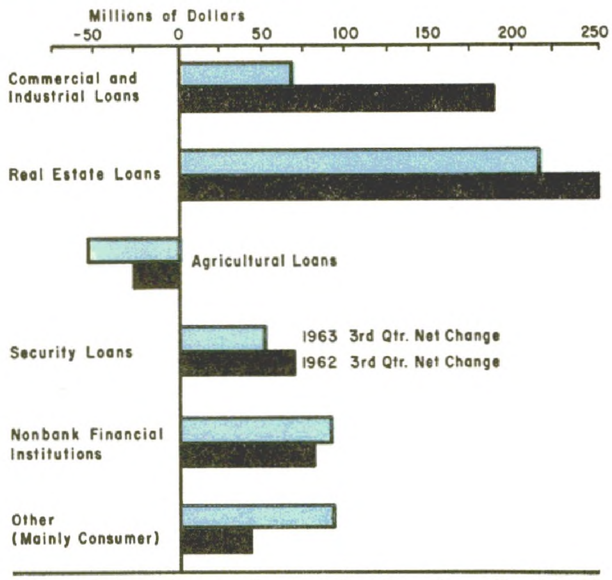
As loan portfolios expanded, District banks reduced their security holdings by $144 million. The reduction, however, centered in intermediate-term Treasury issues. At the same time, banks continued to add other securities to their investment portfolios, although in somewhat smaller volume than in the second quarter. In August, District banks made substantial shifts out of long-term United States bonds into securities with shorter maturities, but the Treasury's pre-refunding and junior advance refunding operations in September counteracted this movement. As a result of exchanges made in that offering, District bank holdings of long-term Government bonds increased $69 million (net) for the quarter as a whole. However, short-term Treasury notes and bonds recorded an even larger quarterly gain ($157 million).

Mixed performance in deposits

In the deposit categories, District banks in the third quarter showed a somewhat mixed performance in relation to banks elsewhere. Demand deposits adjusted — defined as total deposits less deposits of the United States Government and domestic commercial banks, and less cash items in the process of collection—increased by 2.2 percent in the District but decreased by 0.7 percent in the nation as a whole. Savings accounts increased 2.3 percent during the quarter at District banks; this performance was slightly better than the third-quarter performance of banks nationally, in marked contrast to their relative situation in the first half of the year. But the story was different with other time deposit categories. The national total increased substantially during the third quarter, but the District total dropped by $175 million, primarily because of seasonal reductions in time deposits of states and political subdivisions.

In the District, time deposits of individuals, partnerships, and corporations remained relatively stable in the third quarter after rising $450 million in the first half of the year. This

Mortgage loans dominate scene as business lending lags



Source: Federal Reserve Bank of San Francisco (Twelfth District data).

stability somewhat masked a seasonal shift in holdings of negotiable time certificates of deposit; over $100 million in certificates issued by District banks matured in the first half of September, which suggests that corporations are using this money market instrument extensively to meet quarterly tax payments.

As a consequence of these generally favorable third-quarter developments, District banks appear to be faring well on the profit side. Most of the banks that publish third-quarter data show increases in net earnings above the corresponding figures for 1962—substantial increases in the case of nine-months data.

Savings high, mortgages higher

Savings growth continued strong at savings and loan associations as well as at commercial banks during the third quarter. With a gain of almost $1 billion, insured savings and loan associations in Twelfth District states continued to outpace associations elsewhere in attracting savings; this 4.9 percent third-quarter District increase contrasted to a 1.8 percent gain nationally. Moreover, with a net increase of over $1.0 billion in mortgage holdings during the quarter, the mortgage portfolio of these associations at the end of September exceeded total outstanding loans of all Twelfth District weekly reporting member banks. Following the pattern of the first half of 1963, extensions of mortgage funds by District associations exceeded their net inflow of savings. Borrowings (including advances from the Home Loan Bank) consequently rose 10 percent during the quarter.

The national spotlight was again directed to California savings and loan associations in September when it appeared that there might be a general move toward a 5 percent dividend rate on savings. A few of the smaller associations increased rates to 4.9 and 5.0 percent, but there was no general increase to these levels. However, most of the Bay Area and San Diego associations that had lowered their dividend rates to 4.5 percent in June made upward adjustments to 4.80 or 4.85 percent for the fourth quarter in order to meet the intense competition for savings funds.

The over-all financial situation as the year drew to a close reflected the strengths and weaknesses—mostly strengths—of the general business situation. With the January-September period showing a 2.7 percent annual rate of gain in currency and demand deposits (and a 13.7 percent gain in time deposits), the nation's money supply seemed ample to finance a continuing expansion into 1964. The expansion admittedly was being financed at a higher level of interest rates in some—but not all—sectors, yet the general atmosphere reflected a smooth adjustment to the mid-year policy changes.

Federal Agency Securities: The Demand

THE increased supply of Agency securities —securities issued by five Federal agencies which are involved in housing and agricultural credit programs—has been a key factor in improving the marketability and liquidity of these instruments. Supply, however, is not the only reason for the expansion of the Agency market. Rising demand on the part of commercial banks, corporations, non-bank financial institutions, state and local governments, and individuals has helped to broaden this as well as other financial markets in recent years. The present article examines this rising demand, and thus complements an earlier article which considered the factors determining the increased supply of such securities.

The growth and broadening of the market for Agency securities can be dated from 1955. By the end of 1962, every major investor group held more than a nominal share of the supply of these investments. However, the market is dominated by the consumer sector (largely individuals) and by commercial banks and nonfinancial corporations. Holdings of all three of these groups tend to fluctuate from year to year, reflecting changes in supply to some extent, but reflecting market conditions and interest rate differentials also. Other types of investors have increased their small holdings gradually during recent years.

Banks dominate the market

In the first postwar decade, commercial banks were the only important investment outlet for Agency securities. Although banks have continued to play an important role, their holdings nonetheless have not grown with the supply of Agency securities over the postwar period as a whole. The bank share of the gradually rising supply declined during the 1945-55 period, from about three-quarters to one-half of the total. Then, after the more rapid expansion of Agency securities got under way in 1955, the share held by commercial banks declined further—to as low as 15 percent in mid-1960—before recovering to about one-fourth of the total at the end of 1962. Fluctuations in holdings generally have reflected cyclical influences and changes in supply, particularly of Fannie Mae and Federal Home Loan Bank obligations.

Commercial banks normally tend to sell off Treasury securities to make loans in periods of business expansion and to increase such investments during recessions as loans provide a declining source of earning assets. In the 1955-62 period, the banks generally followed the same pattern in handling their portfolios of Agency securities.

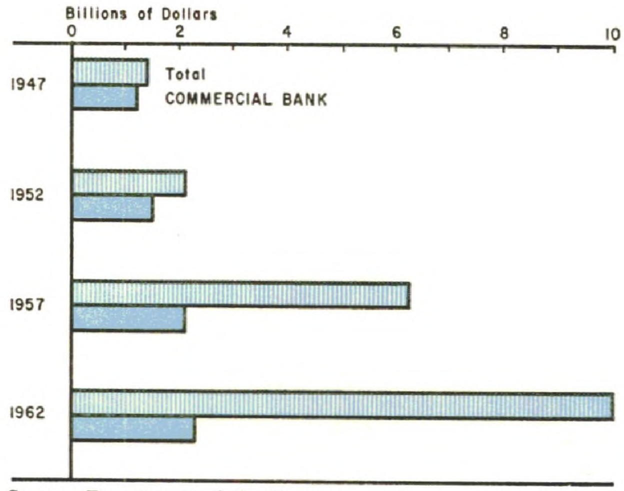
One exception occurred in 1955, when holdings of Agency issues increased by about $500 million, even though banks were then making large reductions in their Government securities portfolios to finance a sharp expansion in loan demand. In January, banks purchased two-thirds of the first Fannie Mae issue, a $570 million 3-year note, which was the largest Agency issue sold up to that time. Later in the year, banks also absorbed part of the increase in Federal Home Loan Bank borrowings.

Bank holdings of both Treasury and Agency securities declined during 1956 and then remained stable until late 1957, at which time the recession brought easier market conditions and a resumption of security purchases. In October 1957, banks acquired half of an $800 million Fannie Mae issue, and they also took half of a similar issue in January 1958. In the latter part of 1959, Agency holdings declined while portfolios of Treasury securities continued to increase; however, both subsequently declined until the onset of the 1960-61 recession.

Banks and the differential

The record up to 1961 suggests that the higher yield on Agency securities was not sufficient to induce substantial portfolio shifts during easy money periods. On the other hand, banks did make sizable investments in

Banks increase Agency security holdings, but total rises faster

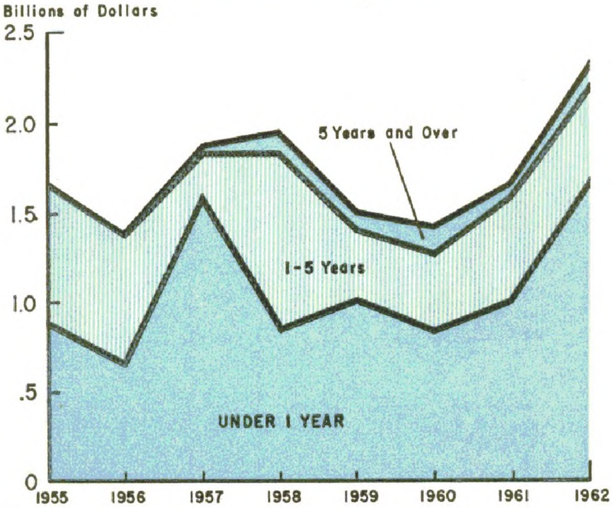


Source: Department of the Treasury.

each of the three relatively large Fannie Mae sales mentioned above. Thus, the small size of most Agency issues evidently offset the attractions of greater yield and limited commercial bank participation in the Agency market during these periods.

In 1962, yield differentials assumed more importance in commercial bank investment policy, and banks made larger acquisitions of Agency securities than in any previous year. This intensified interest in Agency obligations was a by-product of prevailing market conditions. Bank loan demand was relatively moderate in the business expansion that began early in 1961; the recovery itself was not of boom dimensions, and, furthermore, many traditional bank borrowers turned towards other sources of financing, such as the commercial paper market or internally generated cash flows. In addition, since loan demand was less strong, demand deposits also expanded less rapidly than in earlier cyclical periods. Time deposits, however, on which banks pay interest, increased substantially at commercial banks, partly because the Federal Reserve Board at the beginning of 1962 raised the permissible ceilings on time deposit interest rates to 3½ and 4 percent from the previous 3 percent maximum.

Short-term securities predominate in commercial bank portfolios



Source: Department of the Treasury.

This change in Regulation Q had a strong impact on commercial bank investment policies in 1962. With the inflow of time deposits increasing sharply, banks found it necessary to cover higher interest payments by finding investments that would return higher yields than those available on most Treasury securities. They stepped up purchases of state and local government bonds as well as longer term Treasury issues and began to compete more aggressively for mortgage loans. They also increased their purchases of Agency securities, particularly in the short-term area. Between December 1961 and December 1962, commercial banks reduced their portfolios of short-term Governments by $1.3 billion and increased their holdings of short-term Agency securities by nearly $700 million. Supply conditions helped account for the concentration of purchases in short-term Agency issues, since the Federal Home Loan Bank's short-term borrowings accounted for most of the $1.5 billion increase in outstanding Agency obligations during 1962.

In recent years, corporations have come to play a prominent role in the money markets, both as borrowers and lenders of funds. Since they have large cash flows which their managers seek to employ as fully as possible, corporations have become increasingly active in the market for short-term Government securities. They also constitute a sizable share of the market for short-term Agency issues.

What to do with cash flow

Corporations absorbed about one-fifth of the increase in outstanding Agency issues between the end of 1954 and the end of 1962, about the same proportion as that taken by commercial banks in this period. They were particularly active buyers of Agency securities in 1957 and 1959, but absorbed almost none of the $2 billion increase in the supply of Agency issues in 1961 and 1962.

Corporate holdings of Agency securities generally move in the same direction as their holdings of short-term Treasury investments. In the 1960-62 period, corporations failed to increase their holdings of such securities but instead expanded their participation in the markets for commercial paper and other higher yielding short-term investments. During the latter part of this period, negotiable certificates of deposit became a popular choice for short-term investment. Corporate holdings of short-term Treasury securities ranged between $8-9 billion during this period, except around quarterly tax dates, when they dropped to around $7.5 billion. Holdings of Agency issues, mostly short-term issues, were generally about one-tenth as great as their holdings of Governments.

Since the introduction of Fannie Mae's discount notes in early 1960, corporations have been the largest single investor group in this category, usually holding about one-third of the total. Holdings have varied mostly with changes in supply, which declined in 1962 as Fannie Mae's financing requirements declined.

Institutions hold one-fifth

The investment policies of mutual savings banks, life insurance companies, fire-casualty-marine insurance companies, and savings and loan associations have been marked by a tend-

OWNERSHIP OF FEDERAL AGENCY OBLIGATIONS, 1945-62
(billions of dollars)

End of year:	Total	Commercial Banks	Corporate Business	Consumer Sector	State-Local Govts.	Mutual Savings Banks	Savings-Loan Assns.	Insurance Companies
1945	1.1	.8	—	.3	—	—	—	—
1946	1.3	1.1	—	.1	—	—	—	*
1947	1.4	1.2	—	.1	—	—	—	*
1948	1.6	1.3	—	.2	—	.1	—	*
1949	1.5	1.3	—	.2	—	*	—	*
1950	1.9	1.7	—	.2	—	*	—	*
1951	2.2	1.6	.1	.3	.1	*	—	*
1952	2.1	1.5	.1	.3	.1	*	.1	.1
1953	2.1	1.3	.1	.3	.1	.1	.1	.1
1954	2.1	1.4	.1	.3	.1	.1	.1	.1
1955	3.6	1.8	.3	.9	.2	.1	.1	.1
1956	4.2	1.6	.4	1.2	.3	.2	.3	.2
1957	6.3	2.1	.8	1.9	.4	.3	.5	.3
1958	5.8	2.2	.6	1.6	.3	.3	.5	.3
1959	8.0	1.7	1.2	3.1	.4	.4	.6	.4
1960	7.9	1.6	1.1	3.1	.4	.5	.7	.5
1961	8.5	1.7	1.3	4.0	.4	.5	.3	.3
1962	10.0	2.3	1.2	4.8	.5	.6	.3	.3

*Less than $50 million.
Source: 1945-60—Board of Governors of the Federal Reserve System (*Flow of Funds/Saving*, Supplement 5); 1961-62—Department of the Treasury (*Treasury Bulletin*, Survey of Ownership). Consumer sector shown as residual for survey years; survey tends to understate holdings by financial institutions.

ency to liquidate holdings of United States Government securities and to devote an increasing share of their funds to relatively safe but higher yielding investments. Life insurance companies began selling off Governments early in the postwar period, while casualty companies did not do so until the mid-1950's. Savings and loan associations have gradually added to their portfolios of Treasury securities, but these have declined sharply in proportion to total assets.

All these types of savings institutions have gradually increased their small holdings of Agency securities since 1955, so that as a group they accounted for about one-fifth of the total amount outstanding by the end of 1960. Most of them, moreover, made further net acquisitions of Agency securities in 1961 and 1962.

Savings-type institutions hold Government securities partly for purposes of liquidity, and partly because of legal restrictions on alternative investments, but — unlike commercial banks or corporations — they do not need to emphasize the shorter maturities. As investors, savings institutions traditionally devote the bulk of their Government portfolios to higher yielding, long-term maturities; yet, although their holdings of short-term Governments still are relatively small, they have shown increasing interest in short-terms as a result of experiencing wide swings in Government bond prices during the 1950's. In addition, Agency issues—mostly those with maturities of less than five years—now supplement short-term Governments in their portfolios.

Mutual savings banks derive most of their income from mortgage loans and securities. Their holdings of Governments have declined in relation to total assets throughout the postwar period; at the same time, their preference for the shorter maturities has increased. Savings bank investments in Agency securities rose from about $100 million at the end of 1955 to about $600 million in 1962, or to nearly 11 percent of their holdings of Treasury securities. The yield differential has been an important factor in this growing role of

Agency securities as a supplement to Governments.

Savings and loan associations devote as much of their assets as possible to residential mortgage loans and certain other types of loans associated with home purchase and maintenance. Outside their major area of investment, legally permissible investments for federally chartered savings and loan associations are limited to United States Government securities and the obligations of the Federal Home Loan Banks and the Federal National Mortgage Association.

Varying liquidity requirements

Government securities are held primarily to meet legal reserve and liquidity requirements. Beyond this, liquidity needs are met largely through borrowings from the Federal Home Loan Banks. Increased holdings of Governments in the postwar period thus reflect mostly asset growth and corresponding increases in legally required assets. Agency issues do not help meet legal investment requirements, but associations increased their investments in them from $100 million at the end of 1955 to $700 million at the end of 1960 because of the yield advantage they offered in comparison with Treasury issues.

Since 1960, however, savings and loan associations (at least the larger ones) have recorded little change in their holdings of Agency securities. Their interest in purchasing Agency securities for yield purposes was probably weakened by the narrowing of the yield differential between Agency and Treasury issues in the 1961-62 period, especially since Agency securities (as noted above) do not help to meet their legal investment requirements.

Insurance companies also have increased their holdings of Agency securities since 1955, but they remain a minor factor in the market. Life insurance companies hold comparatively little; this is not surprising, however, in view of their tendency throughout the postwar period to liquidate their Government securities portfolios and invest their funds in corporate securities (particularly bonds) and residential mortgages. High yield and safety are the investment qualities these investors emphasize. They do not rely on Government securities for liquidity purposes to the same extent that other investors do, since their liquidity needs are met largely from the generally stable inflow of premium payments.

Property and casualty companies operate differently, however, since they have large liquidity requirements because of the nature of the insurance they underwrite. Both stock and mutual companies devote about half their total assets to investments that are considered highly liquid, such as Treasury securities and state and local bonds. During recent years these investors actually have reduced the proportion of their assets invested in Governments, but meanwhile they have added to their small holdings of Agency securities. Like mutual savings banks, they favor relatively short-term Agency issues.

State and local governments are not heavy investors in Agency issues, but their holdings have risen gradually since the mid-1950's. At the end of 1962, general funds and pension funds combined held $480 million, or slightly less than 5 percent of outstanding Agency securities. Some state and local governments only recently have adopted policies or regulations permitting them to invest in Agency issues, and for this reason they may become an increasingly important investor group. Their holdings of Agency securities are equivalent to about 4 percent of their investments in Treasury obligations. Pension funds hold mostly the longer-term Federal Land Bank and Fannie Mae issues, while the general funds concentrate on the shorter maturities of all Agency securities. State and local government bodies are relatively active in the market for Fannie Mae discount notes, which provide the liquidity of Treasury bills at slightly higher yields.

The differential persists

Individuals and other investors, such as nonprofit organizations, have absorbed a large proportion of the Agency securities issued since 1954. In years when large increases occurred in the supply of Agency securities—such as 1955, 1957 and 1959—individuals were the largest purchasers. Although individuals own relatively large amounts in all maturities, they are the principal investors in the 5-15 year maturities. For this group, the safety of Agency securities, combined with the continuation of a yield differential, make them highly competitive with Governments as personal investments.

Several factors have helped account for the narrowing of the yield differential between Agency and Treasury securities in recent years. A substantial long-term growth in supply (provided it is not excessive) is a prerequisite for such a development. When a particular type of security is in very scarce supply relative to other investments, the issuer must offer a yield advantage in order to secure a ready market. But a broadened market—evidenced in the case of Agency securities by an increase both in absolute terms and in proportion to the supply of marketable Federal securities—has tended to narrow the differential over time. Moreover, market conditions peculiar to the 1961-62 period have enhanced the demand for Agency issues and operated to reduce further their yield advantage.

The market may regard some differential as necessary, however, because Agency securities are not direct obligations of, nor are they guaranteed by, the Federal Government. Some differential is likely to persist, moreover, because the Agency market—being only a small-scale copy of the Government securities market—cannot compete equally with the breadth and depth offered by that market. The incentive to invest in Agency securities still depends partly on their yield advantage, which makes them attractive investments for smaller commercial banks, individuals, and similar investors who desire securities to hold to maturity.

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BANKING AND CREDIT STATISTICS AND BUSINESS INDEXES—TWELFTH DISTRICT[1]

(Indexes: 1957-1959=100. Dollar amounts in millions of dollars)

Year and Month	Condition items of all member banks[2,7]: Loans and discounts	U.S. Gov't securities	Demand deposits adjusted[3]	Total time deposits	Bank debits index 31 cities[4,5]	Bank rates on short-term business loans[6,7]	Total nonagricultural employment	Total mf'g employment	Carloadings (number)[5]	Dep't store sales (value)[5]	Retail food prices[7,8]
1929	2,239	495	1,234	1,790	19	....	...	...	110	18	53
1933	1,486	720	951	1,609	8	....	...	...	56	11	34
1939	1,967	1,450	1,983	2,267	14	....	...	...	83	19	38
1953	9,220	6,639	10,515	7,997	69	4.14	86	86	108	74	93
1954	9,418	7,942	11,196	8,699	71	4.09	85	84	103	74	93
1955	11,124	7,239	11,864	9,120	80	4.10	90	90	112	82	92
1956	12,613	6,452	12,169	9,424	88	4.50	95	96	112	91	94
1957	13,178	6,619	11,870	10,679	94	4.97	98	101	103	93	97
1958	13,812	8,003	12,729	12,077	96	4.88	98	96	96	98	101
1959	16,537	6,673	13,375	12,452	109	5.36	104	103	101	109	101
1960	17,139	6,964	13,060	13,034	117	5.62	106	103	95	110	103
1961	18,499	8,278	14,163	15,116	125	5.46	108	103	94	115	104
1962	....	....	....	....	141	....	113	109	104	123	...
1962											
October	20,460	7,471	13,969	16,934	142r	....	114	111	104	121	106
November	20,589	7,501	14,012	16,827	144r	....	114	110	102	128	105
December	21,102	7,608	14,431	17,093	146	5.50	115	111	101	127	106
1963											
January	21,035	7,454	13,917	17,390	146	....	116	111	90	127	107
February	21,403	7,130	13,527	17,532	149	....	116	111	105	128	107
March	21,480	7,130	13,646	17,760	152	5.46	116	111	105	130	107
April	21,714	7,103	14,175	17,868	147	....	116	110	99	118	107
May	21,894	7,069	13,427	18,111	152	....	116	110	103	129	106
June	22,140	7,153	13,610	18,264	152	5.53	116	108	...	127	106
July	22,277	7,002	14,030	18,363	159	....	116	108	...	128	108
August	22,517	6,905	13,838	18,426	164	....	117	110	...	132	107
September	22,895	6,949	13,975	18,446	167	5.47	117p	110p	...	125	107
October	22,993p	6,848p	14,416p	18,703p	165	....	...	...	...	...	...

Year and month	Industrial production (physical volume)[5]: Lumber	Petroleum[7]: Crude	Petroleum[7]: Refined	Cement	Steel[7]	Copper[7]	Electric power	Waterborne Foreign Trade Index[7,9,10]: Exports: Total	Exports: Dry Cargo	Exports: Tanker	Imports: Total	Imports: Dry Cargo	Imports: Tanker
1929	84	91	61	34	...	89	13	96	61	193	20	55	*
1933	35	54	39	17	...	15	11	55	...	...	12	...	...
1939	62	70	49	35	16	70	17	82	43	190	16	41	1
1952	101	112	90	77	92	100	61	86	81	101r	33	61	18
1953	102	114	95	82	105	98	69	71	56	113	51	70	41
1954	101	111	92	83	85	90	73	67	57	96	44	71	28
1955	107	111	96	90	102	104	82	84	72	117	52	80	35
1956	104	109	100	97	108	114	89	101	105	91	75	86	69
1957	93	106	103	93	114	113	95	117	124	96	95	93	97
1958	98	98	96	99	94	101	97	89	86	96	92	95	91
1959	109	96	101	108	92	86	107	95	90	108	112	113	112
1960	98	95	104	101	102	112	115	122	123	120r	133	117	142
1961	95	96	108	105	111	119	124	126	134	104	134	116	145
1962	97	96	111	111	100	128	131	115	123	92	144	126	155
1962													
September	98	96	113	115	90	119	133	105	121	61	153r	122	171r
October	98	97	112	120	88	127	132	96	105	72	158	154	161
November	104	97	113	115	91	127	135	93	91	99	163	127	183
December	103	97	113	121	100	127	131	154	157	144r	134	124	140
1963													
January	101	96	113	122	98r	125	142	127	139	94	123	128	120
February	94	96	111	118	123r	130	134	132	145	96	111	119	107
March	104	97	110	122	123r	134	137	144	164	90	114	131	104
April	91	98	108	105	134r	135	136	153	155	148	166	155	172
May	93	98	112	111	141r	127	135	...	...	...	...	...	...
June	94	98	116	111	131p	121	...	...	...	...	...	...	...
July	...	97	115	127	109p	105	...	...	...	...	...	...	...
August	...	98	116	118	105p	105p	...	...	...	...	...	...	...
September	...	...	...	117	104p	...	...	...	...	...	...	...	...

[1] Adjusted for seasonal variation, except where indicated. Except for banking and credit and department store statistics, all indexes are based upon data from outside sources, as follows: lumber, National Lumber Manufacturers' Association, West Coast Lumberman's Association, and Western Pine Association; petroleum, cement, and copper, U.S. Bureau of Mines; steel, U.S. Department of Commerce and American Iron and Steel Institute; electric power, Federal Power Commission; nonagricultural and manufacturing employment, U.S. Bureau of Labor Statistics and cooperating state agencies; retail food prices, U.S. Bureau of Labor Statistics; carloadings, various railroads and railroad associations; and foreign trade, U.S. Department of Commerce. [2] Annual figures are as of end of year, monthly figures as of last Wednesday in month. [3] Demand deposits, excluding interbank and U.S. Government deposits, less cash items in process of collection. Monthly data partly estimated. [4] Debits to total deposits except interbank prior to 1942. Debits to demand deposits except U.S. Government and interbank deposits from 1942. [5] Daily average. [6] Average rates on loans made in five major cities, weighted by loan size category. [7] Not adjusted for seasonal variation. [8] A new index now combining not only Los Angeles, San Francisco, and Seattle food indexes but also Portland. Reweighted by 1960 Census figures on population of standard metropolitan areas. [9] Commercial cargo only, in physical volume, for the Pacific Coast customs districts plus Alaska and Hawaii; starting with July 1950, "special category" exports are excluded because of security reasons. [10] Alaska and Hawaii are included in indexes beginning in 1950. *p*—Preliminary. *r*—Revised. * Less than 0.5 percent.