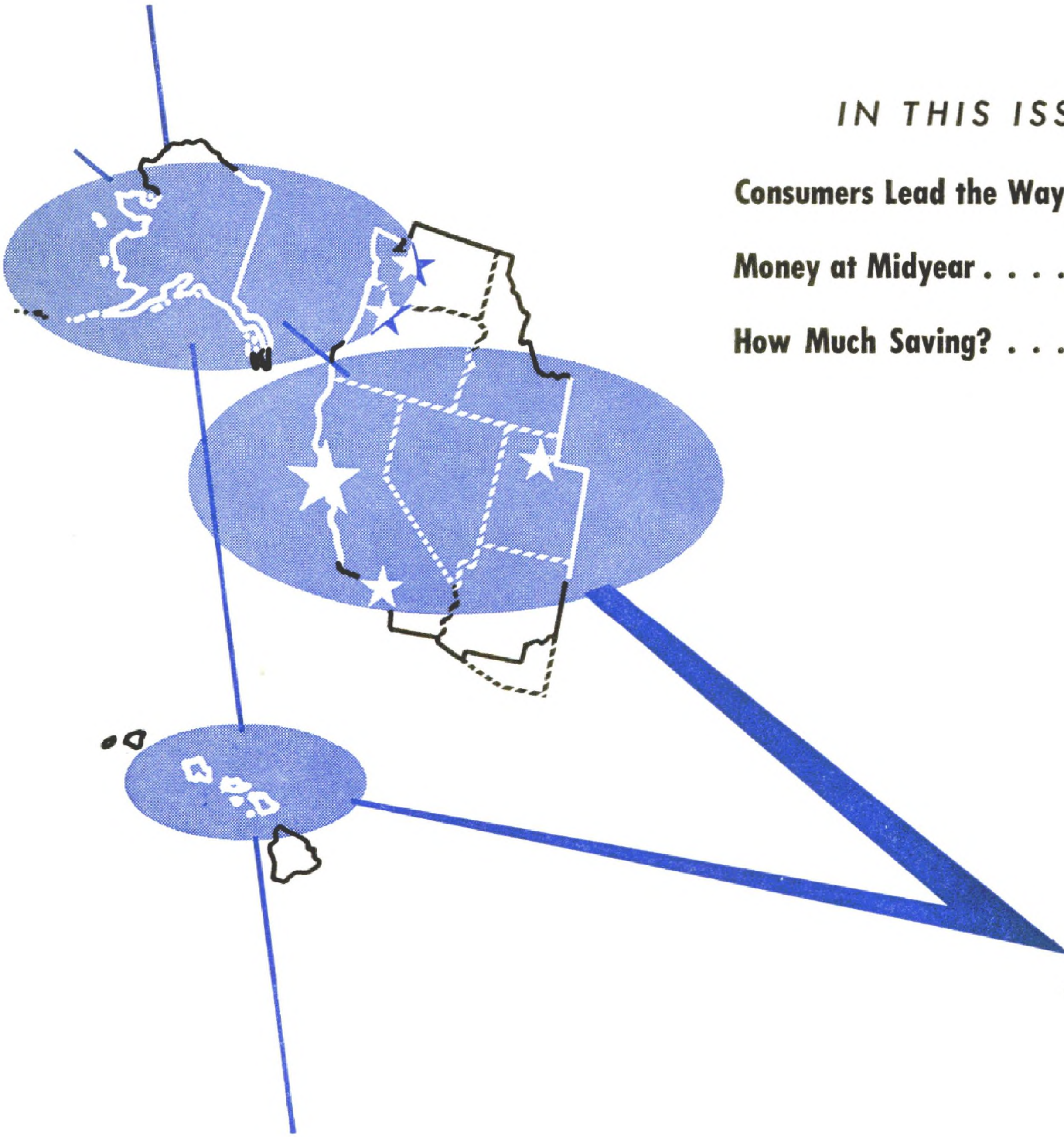
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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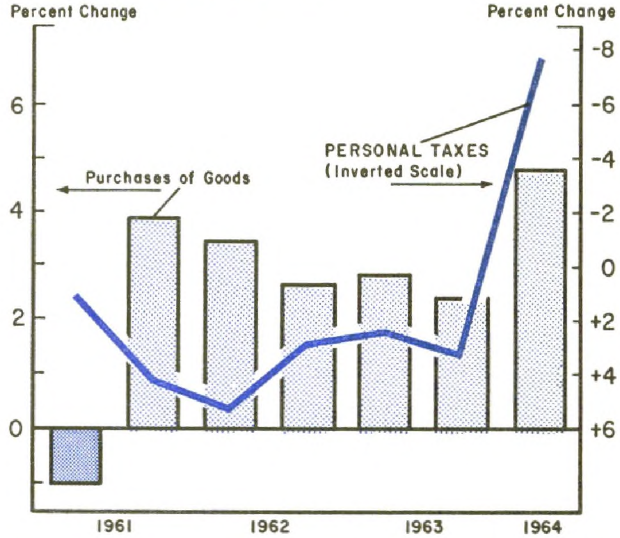
Consumers Lead the Way

THE national economy at midyear put together a winning combination of a four-month-old tax cut and a forty-month-old cyclical expansion. GNP rose to a \$618.5 billion annual rate in the April-June quarter, on the heels of the fourth successive quarterly gain of \$10 billion or so in total production, and business seemed capable of digesting those gains and going on to even greater heights. Forecasting, therefore—at least on the surface—suddenly seemed to be the easiest possible job in the world.

Under the surface, of course, the vigilant researcher could uncover some troublesome signs. First of all, there were two discernible aspects to Federal budget trends. There was the obvious aspect: the underwriting of a broad cyclical expansion by virtue of reductions in personal and corporate taxes. But there was also the less obvious aspect: the impact (at least future impact) of reductions in Federal expenditures. (This second face of the budget creates special difficulties for the West; as noted below, this defense-oriented region already has displayed symptoms of a mild case of the flu in response to the sneezes heard throughout Pentagon corridors.)

On the national scene, the vigilant researcher could also discern less strength than formerly in some business indicators. In fact, recent strength has been shown by only about half of the several dozen indicators that generally portend changes in business activity. Housing starts, new durable-goods orders, the average factory work week, and other key leading indicators have been pointing sideways or downward for several months now. Then again, the nagging fear persists that the scattered price increases posted by some industries will be the forerunners of broad-scale inflationary pressures that could endanger the entire expansion.

Consumer spending jumps
as personal taxes fall



Note: Chart shows semi-annual changes in personal taxes (from all sources) and in consumption expenditures (except food and services).

Source: Department of Commerce; Federal Reserve Bank of San Francisco

Spend, spend . . . save, save

Yet, with all this, the consumer has seen to it that very few clouds darken the current picture. Between the last quarter of 1963 and the second quarter of 1964, consumers gained a \$20-billion increase in take-home pay on the heels of a \$7-billion reduction in personal taxes, and they responded by increasing their spending by twice the amount of the tax cut —or by almost the same increase as in the entire preceding year. (All figures are seasonally adjusted annual rates.) But despite the whopping increase in spending, consumers increased personal saving by \$6 billion in the second quarter alone (to \$35.5 billion) and in the process raised the saving rate from 7.0 to 8.2 percent. This development should be good news for retailers, however, since consumers may now feel uncomfortably affluent with such a high rate of saving.

When the tax cut first took hold, some businessmen expressed disappointment with the fact that all of the tax savings were not immediately spent. But their expectation was rather unrealistic, since numerous consumption studies over the years have indicated that spending responds only with a lag to changes in income. The average consumer, after all, is a creature of habit, and he probably needs time to adjust to the idea of receiving several extra dollars every payday. However, if he makes this adjustment during the second half of this year—that is, if he now reduces the saving rate from its recent high level to the historical norm of about 7 percent, and if he continues to benefit from a rising flow of income—he will duplicate his strong spending performance of the first half and thereby provide a massive stimulus to the continuing expansion.

Some observers suggest that this spending increase is by no means a sure thing. Some argue that consumers actually increased their rate of spending in anticipation of the tax cut and that henceforth they will allocate much of their increased take-home pay to debt repayment and other forms of saving. Moreover, the latest quarterly survey of the Michigan Survey Research Center reported that spending plans of only 5 percent of survey respondents were significantly affected by the tax cut. Despite what the respondents reported, however, consumers obviously have been spending more even if they could not identify the source of the extra dollars. (Incidentally, about $200,000 in foundation money will soon be added to the spending stream, as the Survey Research Center undertakes a two-year-long study of the tax-cut impact.)

Invest, invest

Business, at any rate, seemed to be betting on a continued consumer upsurge. Business spending on plant and equipment increased sharply in the first half of 1964 and more of the same is due to come—specifically, a 12-percent increase in total 1964 spending over the already high 1963 level, according to the latest Commerce-S.E.C. survey. The sturdy gain in business spending plans and the upward tilt in business optimism, along with the continued relative stability in producer-goods prices, suggest that the business investment boom of 1962-1964 will record twice as great a gain in real terms as did the famous boom of 1955-1957.

Other investment categories recently have shown somewhat less strength. Residential construction actually peaked in March and by June was down about 6 percent, at a $26.4-billion annual rate. Moreover, the trend in housing starts has been declining for some months now, especially because of a drop in apartment-building permits in New York and several other metropolitan areas. The factors underlying the housing market remain strong, of course; incomes are rising, credit availability is good, and more and more young families should soon be entering the housing market. Even so, the recent decline in starts suggests that the housing boom of the early '60's may have gone too far too fast.

Inventory investment was relatively low during the January-June period. Business inventories increased during that period at less than a $3-billion annual rate—substantially below the pace recorded in each of the two preceding years. The slowness of stocks to expand probably involved both a conservative policy on the part of purchasing agents and an unexpectedly high level of economic activity. The upturn in business spending in anticipation of the tax cut, along with the upsurge in consumer buying after the cut, undoubtedly boosted spending faster than adjustments in industrial output could be made. In other words, some involuntary liquidation of stocks may have occurred. But now, assuming that a strong sales pace is maintained, any tendency to restore historical inventory-sales ratios could lead to substantial stockbuilding.

Stern-visaged budget

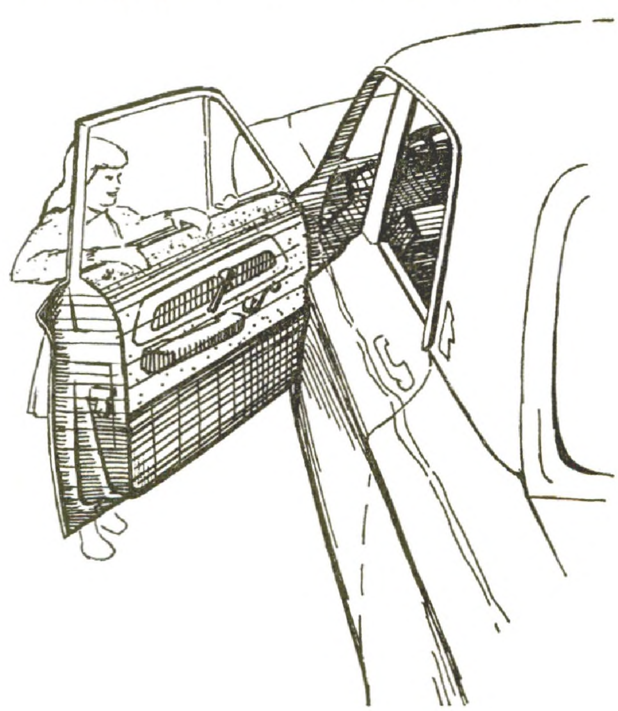
Government expenditures jumped in the second quarter of 1964, under the impetus of a strong recovery in defense spending from an unexpectedly low first-quarter rate. This stimulus may well be lacking in future quarters, however, since military spending is scheduled to decline about 2 percent between fiscal 1964 and fiscal 1965. In particular, Secretary McNamara has sent Congress a budget containing a $2 billion cut, to $21.3 billion, in the crucial procurement-R&D category, and one of his assistants has recently reinforced the message by telling a New York business group: "Defense is not a growth industry."

Here, then, is the second face of the Federal budget—a somewhat stern face which tends to offset some of the happiness engendered by the budget's tax-cut aspect. This second face has been turned especially towards the West—but then, of course, the smiling face of the budget has also been evident in this region. Western consumers, after all, also received a tax cut, and they have exhibited just as much readiness to spend their higher post-tax-cut paychecks as anyone else. Thus, retail sales at District stores were 7 percent higher in the first five months of this year than in the comparable period of 1963. (By way of contrast, the national increase for the same period was 5.5 percent.) The strong sales performance was especially evident in the auto field. New car registrations during the January-June period were almost 10 percent above the year-ago level, as opposed to an 8-percent gain elsewhere in the nation. The auto sales pace was especially strong in California, Hawaii, and Nevada.

Offsets to anxiety

Apart from the tax-cut effect, why should consumption spending hold up so well in the face of prospective defense-spending cutbacks and reductions in District defense-related payrolls? The answer is that the West has been successful—for the first time in the postwar period—in maintaining a steadily rising trend in nonmanufacturing employment in the face of a decline in the crucial defense-related sector. This development assumes particular significance in view of the gloom that now pervades much of the defense industry. In the words of one business publication, "A mood of suspicion, apprehension, and even anxiety has begun to pervade the front office of major producers." There is suspicion that the Pentagon has more contract cutbacks in store; there is apprehension that few, if any, new weapon systems will be developed during the rest of the decade; and, in addition, there is anxiety about the fate of the unique resources of engineering and scientific talent that the industry has assembled in recent years.

Actually, the squeeze has been evident for more than a year. Defense and space firms in District states have reduced their workforce by 10 percent since late 1962; these companies employed 589,000 this past July, after

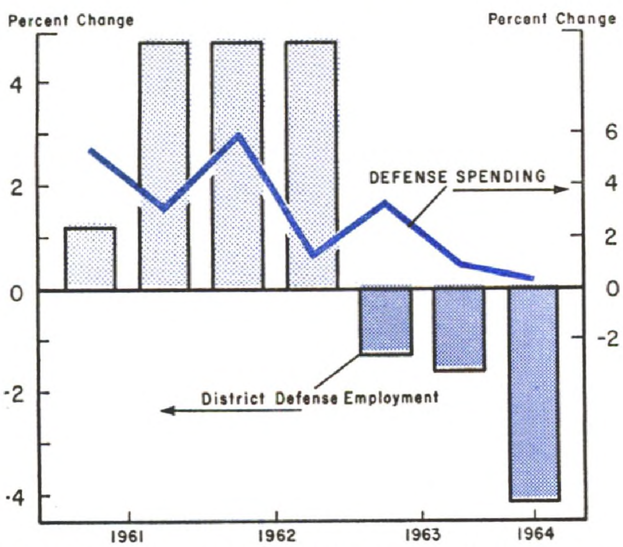


laying off 26,000 workers during 1963 and 43,000 in the first seven months of this year alone. Admittedly, month-to-month declines in employment have been progressively smaller since March. But even so, the industry by no means can be certain that employment will stabilize now at the recent level.

Yet, despite the stiff reduction in employment in this key sector, few signs have developed to date of a cumulative effect on other industries. Over the past year, for example, District employment in nondefense manufacturing has increased almost 3.5 percent, and employment in nonmanufacturing activities has risen just as rapidly. Employment gains have been greatest in trade, service, and government employment; in fact, in every major nonfarm category except construction, jobs have increased at a substantially faster pace in the District than elsewhere in the nation.

Nonetheless, the problem still remains of generating enough growth through nondefense activities to hold unemployment at a moderate level. The Western jobless rate drifted upward from 5.5 percent in December 1963 to about 6.0 percent this July—in a period in which the national rate dropped from 5.5 to 4.9 percent. Moreover, every District state during this period recorded a rising level of unemployment, on a seasonally adjusted basis. During the second quarter, meanwhile, total District employment (seasonally adjusted) dropped slightly, partly because of adverse weather conditions that delayed crop harvesting, and partly because of recent declines in food processing and lumber as well as in defense-related manufacturing.

Slow growth of defense spending causes drop in Western jobs



Note: Chart shows semi-annual changes in national-defense expenditures and in Twelfth District defense-related employment. Sources: Department of Commerce; Federal Reserve Bank of San Francisco.

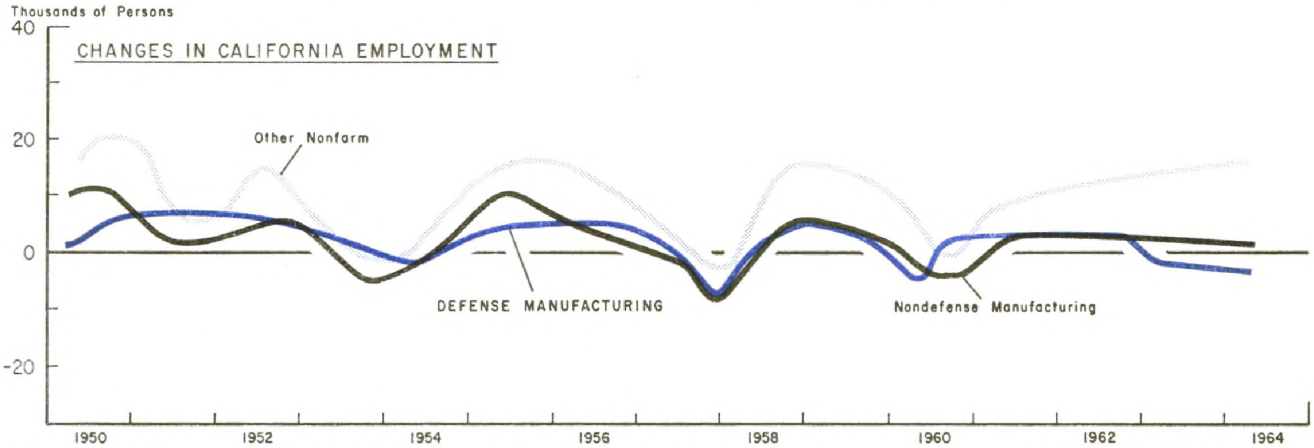
Strengths and weaknesses

One source of strength in the District economy has been steel. On the basis of heavy demand from construction and canning industries, District steel producers in recent months have exceeded their strong 1963 performance, while producers elsewhere have lagged behind their year-ago pace. This successful record has been tempered, however, by increased import competition; in the January-May period, steel imports into West Coast ports were 21 percent higher than in the comparable period of 1963.

Nonferrous metals producers have also experienced a high and rising level of demand in recent months. Copper orders were stimulated by strike-hedge stockpiling, in anticipation of a strike which has idled 7,500 employees of one major Western producer throughout midsummer. Yet, despite the strike and despite renewed Chilean efforts to obtain a price hike, the quotation for refined copper has remained at 32 cents a pound since the posting of a one-cent increase in mid-March. But zinc producers raised their price for the prime Western grade by one-half-cent a pound in April, while aluminum producers—with output breaking records and operations at full capacity—posted a similar increase for ingots and mill products in June.

Both the lumber and plywood industries recorded strong production records in the

Nonfactory employment continues rising despite defense downturn, upsetting normal parallel movement of defense and nondefense jobs



Note: Chart shows smoothed curve based on 3-month moving average.
Sources: California Departments of Employment and Industrial Relations; Federal Reserve Bank of San Francisco.

first half of 1964; in fact, lumber orders and shipments reached their highest levels since 1959. But demand in the second quarter eased off from the exceptionally high level attained earlier in the year, especially since large wholesaler and retailer inventories restrained replacement buying.

The District farm picture was somewhat mixed. Cash receipts during the January-June period were 1 percent above the figure for the comparable period of 1963—about the same year-to-year gain as that recorded elsewhere in the nation. With prices below year-ago levels, the rise in District returns stemmed from heavier marketings.

In the livestock sector, cattle feeding activity has remained at a relatively high level in the face of the currently low level of prices. In the crop sector, production prospects indicate a continued high level of marketings. Vegetable output in the District will be boosted by an 11-percent rise in California acreage devoted to the production of tomatoes for processing. Deciduous fruit output should also increase, despite lower grape and apple production. (Nationally, the apple crop is expected to be the largest in 27 years.)

The housing picture, meanwhile, remained as murky in the West as it did in the rest of the country. During the second quarter, contract awards for new housing declined 3.6 percent below the first-quarter level, while housing starts in the (13-state) West also fell off from their first-quarter peak. On the other hand, nonresidential contract awards in the District increased 9 percent during the April-June period. (All data are seasonally adjusted.) Thus, although the longest postwar housing boom shows signs of hesitation, the strength in business and public-works construction continues unabated.

On balance, then, the West showed substantial strength at midyear, even though it had to confront both faces of the Federal budget. Nonetheless, there were strong grounds for optimism. The prospect of expenditure cuts certainly raises the specter of fewer jobs and more jobless. At the same time, the prospect of a continuing tax-cut effect raises the happier possibility of a broad-scale consumption and investment upsurge. In this situation, perhaps the only certain thing that can be said is that forecasting will not be so easy after all.

Money at Midyear

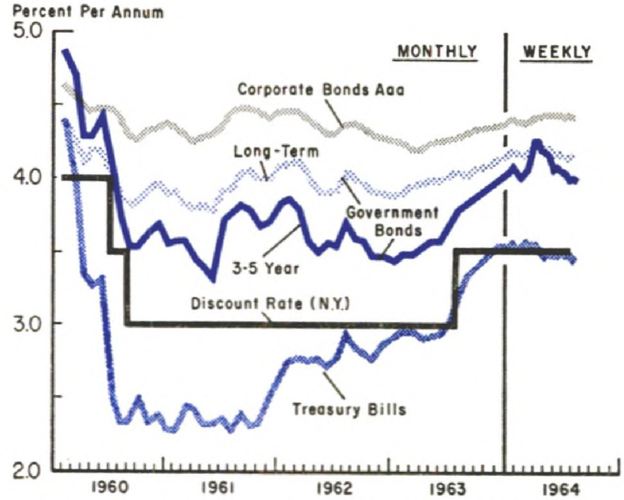
THE continued expansion in the nation's output of goods and services was accompanied during the second quarter by a corresponding increase in financial activity. Business firms, consumers, and governments (particularly state and local governments) all stepped up their gross credit demands, but these demands continued to be accommodated without any evidence of strain. But while overall credit volume increased, some shifts occurred in the pattern of credit demands and financial flows. This was particularly evident in an accelerated pace of business borrowing from banks and from the capital market, and in a relative shift in the flow of new consumer savings into securities rather than into banks and other financial intermediaries.

Nevertheless, the supply of loanable funds was adequate to accommodate the demand at a level of interest rates generally somewhat lower than that which prevailed during the earlier months of the year. In fact, in some cases—91-day Treasury bills, long-term government bonds, and high-grade municipals—rates declined below the levels prevailing last December. Yields on corporate bonds edged up slightly, while those on mortgages held fairly steady, albeit with some tendency to ease. But in all cases, yields in both the short- and long-term spectrum of the maturity range remained well below the levels attained during the last mature expansion late in 1959.

Strong market expectations

Monetary policy, always with one eye cocked on balance of payments developments, registered little change during the second quarter—at least as measured by the customary indicators of reserve and credit availability. After allowance for seasonal factors, total bank credit expanded at a slower rate than during the December-March period, but this was due to a decline in bank investment portfolios which partially offset a more rapid increase in loans. Excess reserves of the banking system averaged somewhat lower than in the preceding three months, but bank borrowings also were down, with the result that the average level of free reserves was virtually unchanged.

Interest rates generally ease during second quarter



Source: Board of Governors of the Federal Reserve System.

Financial markets were influenced by more than just System operations. Perhaps equally important were the optimistic public statements made by many financial leaders regarding the orderly and balanced growth occurring in the aftermath of the tax cut. These assessments materially affected market expectations and helped contribute to the modest decline in most yields throughout the maturity range. This shift in market psychology represented a reversal of the situation in the first quarter, when growing expectations of *future* pressures likely to develop from a post-tax-cut expansion in the economy—and a presumed attendant shift in monetary policy in the direction of restraint—contributed to a modest rise in yields.

Easy Treasury position

Another basic factor contributing to the shift in market expectations was a much lower than expected Treasury deficit. On June 30, when the Treasury closed its books on the 1964 fiscal year, it reported a deficit of $8.3 billion. This was substantially below the $11.9 billion estimate cited in the original budget message of January 1963, and was even $0.5 billion below official estimates made as recently as this May. The improvement was even more striking in the consolidated cash budget; the cash deficit of $4.7 billion compared with a January 1963 estimate of $10.3 billion. (The cash budget reflects overall cash payments to, and receipts from, the public, and thus is a better measure of the Treasury's demands upon the money and capital markets than is the administrative budget.)

The budgetary improvement resulted from the combined influence of lower than expected spending and higher than expected revenues. Most of the savings in spending were made in the area of defense outlays, while a considerable part of the rise in revenues was due to the fact that the tax cut did not become effective until March 1, a month later than originally scheduled.

In any event, the Treasury's operating cash balance was $10.2 billion at the end of the fiscal year, about $2 billion higher than had been anticipated as recently as May. This welcome development was accompanied by a net second-quarter decline in outstanding marketable debt (despite an increase in total gross debt); it also conveyed implications of reduced borrowing needs in the months ahead. These, then, were major factors conditioning market expectations and contributing to the decline in yields. Thus, after rising by about 2 basis points in the first quarter, yields on 3-month Treasury bills declined by 7 basis points through June and by an additional basis point through July (to 3.46 percent). Similarly, after rising during the first quarter, yields on 3-5 year issues and long-term Governments also recorded net declines (to 3.99 percent and 4.14 percent, respectively, at the end of July).

In the state and local government sector, higher levels of spending were accompanied by a somewhat larger volume of debt offerings in the second quarter (about $2.6 billion), but these too were absorbed by the market at a level of yields below that of the first quarter (3.11 percent on high-grade municipals in June, versus 3.16 percent in March). Investor reappraisal of the outlook for general credit conditions appears to have been a major contributor to the decline in yields. In fact, yields declined an additional 2 basis points during July, in spite of a somewhat heavier calendar of prospective summer offerings.

Corporate and consumer cash

In the business sector, rising outlays for plant, equipment, and inventories were accompanied by a substantial increase in external financing, both from banks and from the bond and equity markets. To a considerable degree, however, the larger volume of new stock and bond issues (altogether $4.6 billion, as compared with $2.4 billion in the first quarter) reflected a massive $1.2-billion utility offering in April. Apart from this issue, new stock offerings were only slightly greater than during the first quarter. A significant portion of the proceeds again appear to have been used for the retirement of outstanding securities—an indication of continuing high levels of corporate liquidity.

At $2.9 billion, debt issues were up considerably (from $2.2 billion), and also carried a slightly higher yield (4.41 percent in June and July from 4.38 percent in March). On the other hand, the rise in business borrowings from banks took place at a generally stable level of interest rates; moreover, the relatively modest dimensions of borrowing over the

June tax date, and a net decline thereafter, indicated a further rise in funds from internal sources and a further moderation in the demand for bank financing. Additional evidence of continuing high levels of corporate liquidity also was provided by the sustained, albeit slower, growth in business holdings of time certificates of deposit.

For their part, consumers devoted half of their $12-billion second-quarter gain in disposable income to saving, in contrast to a decline in both the amount and the relative rate of personal saving during the first quarter. The pattern of this saving, moreover, was somewhat different from the first-quarter pattern; a relatively larger portion went into securities rather than into savings at financial intermediaries. This development contrasts with the general trend over the last year or so, but it also is more typical of consumer saving habits during cyclical expansions. A single major utility offering reportedly absorbed hundreds of millions of dollars of the savings of individual investors. On the other hand, every category of the public's liquid-asset holdings, except demand deposits and currency, increased by a smaller amount in the April-June period than in the preceding quarter, on a seasonally adjusted basis. Consequently, the ratio of liquid assets to GNP declined slightly (to 82.1 percent) following a succession of quarterly rises dating from 1961.

An increasing proportion of personal saving took the form of stepped-up debt repayments, but these apparently were no higher in relation to disposable income (14 percent) than during the January-March period. Although consumer credit extensions were down from the earlier 1964 pace, they continued to rise at a relatively faster rate than debt repayments. As a result, outstanding debt also increased and contributed to a slight decline in the liquid asset to debt ratio. Finally, a continuing rise in mortgage lending by financial institutions, at a pace in excess of residential construction expenditures, suggested a continuing use of mortgage credit for nonhousing purposes—for the financing of cars, vacation travel, and perhaps even the purchase of stock.

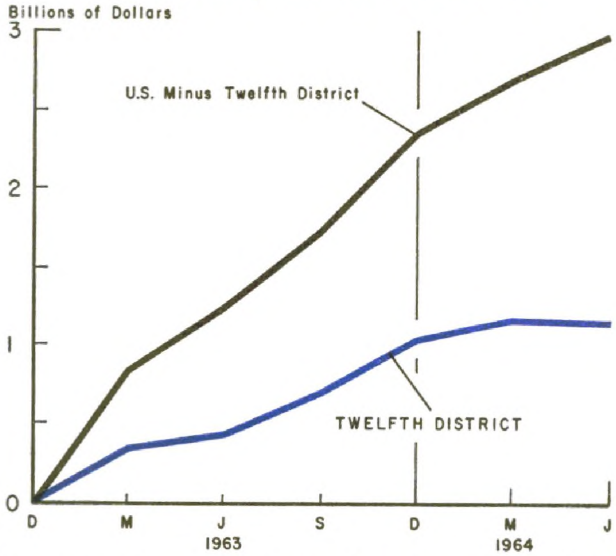
Accelerated lending pace

The nation's commercial banks continued to play a major role in financial markets during the second quarter, although total bank credit recorded a smaller expansion than in the January-March period. (On a seasonally adjusted basis, the gains were $3.7 billion and $4.9 billion, respectively.) Loans, however, expanded at an accelerated pace—some $5.0 billion, or 13 percent on an annual rate basis. This increase was financed in part by a $2.2-billion decline in portfolios of U. S. Government securities; on the other hand, bank holdings of other securities continued to increase. Undoubtedly the most significant development, however, was a $1.7-billion net rise in business borrowings. Real estate loans also showed a larger increase ($1.4 billion) than in the preceding quarter, while a somewhat slower growth was evident in consumer loans ($0.7 billion).

Total bank deposits increased by $3.5 billion; nevertheless, they failed to match earlier gains, largely due to a considerable slowdown in all time and savings categories except time certificates of deposit. Consequently, the commercial-bank loan-deposit ratio rose from 59.3 percent in March to 60.9 percent in June —a record high for recent years, even after allowance for seasonal factors. Other measures of bank liquidity, such as the ratio of holdings of short-term U. S. Government securities to loans, also showed some tightening.

Notwithstanding the slower growth in total deposits, the nation's money supply rose at an accelerated pace in the second quarter (3.6 percent, on a seasonally adjusted annual-rate basis). This significant gain in the money supply reflected business and consumer needs for

Savings inflow levels off
at District banks, but not elsewhere



Note: Chart shows cumulative net change in savings deposits at weekly reporting member banks.
Sources: Board of Governors of the Federal Reserve System; Federal Reserve Bank of San Francisco.

higher cash balances to finance a growing volume of transactions in an expanding economy.

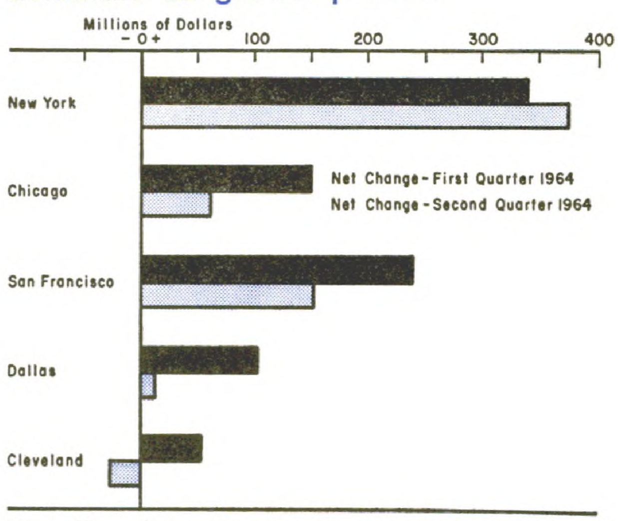
District deposit shifts

Twelfth District member banks, like their counterparts elsewhere, were under approximately the same amount of reserve pressure during the April-June period as during the first three months of the year. But while banks elsewhere maintained a net free reserve position throughout the entire quarter, District banks had daily average net borrowed reserves of $20 million or more for about half of the bi-weekly settlement periods. Nevertheless, borrowings from the Federal Reserve Bank, on a daily average basis, were slightly below the first quarter level, and in addition, District banks had slightly higher daily average net sales of Federal funds.

Weekly reporting member banks in the District recorded a $553-million gain in total deposits—or more than enough to offset the first-quarter decline. (All data in this section are unadjusted for seasonal variation.) However, demand deposits adjusted—that is, total demand deposits less U. S. Government deposits and deposits of domestic commercial banks—registered a net decline, in contrast to an increase in the corresponding period of 1963. In addition, the flow of funds into total time and savings deposits, while roughly equal to the first-quarter volume, was at a slower rate than a year ago. The most significant change in this sector occurred in the savings-deposit category, which showed a net decline of $4 million for the quarter, in sharp contrast to a $69-million increase in the year-ago period. Gains in May and June were insufficient to offset a net withdrawal of $105 million in April, when individuals apparently drew heavily on their bank savings to meet personal income tax payments and perhaps to purchase stocks. In the rest of the nation, weekly reporting banks registered a $286-million net increase in savings accounts for the quarter as a whole; however, this represented a substantially smaller growth than in the second quarter of 1963.

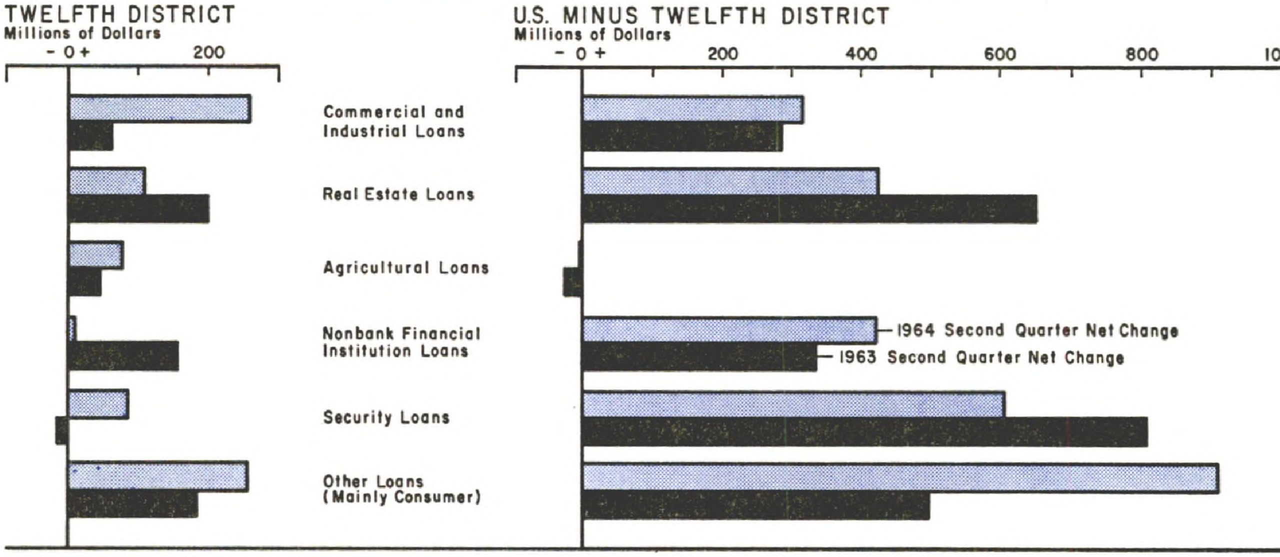
Large-denomination negotiable time certificates of deposit contributed significantly to the second-quarter deposit growth at District weekly reporting banks, even though this category expanded at a slower rate than

New York, San Francisco districts
dominate CD growth picture



Note: Chart shows quarterly changes in outstandings of negotiable time certificates of deposit, by Federal Reserve District.
Sources: Board of Governors of Federal Reserve District; Federal Reserve Banks

District banks exhibit strength in business and consumer loans
. . . throughout nation, mortgage lending lags below year-ago pace



Sources: Board of Governors of the Federal Reserve System; Federal Reserve Bank of San Francisco.

in the January-March period. Slightly over one-third of the total second-quarter increase in time deposits was in the form of CD's; moreover, for the first two quarters as a whole, one-half of the expansion in time deposits was in that form. At weekly reporting banks elsewhere, the percentage gain in CD's was well below that in the District, but CD's still accounted for 65 percent of their second-quarter gain in total time deposits and comprised 23 percent of the outstanding amount of such deposits at midyear. (District banks at midyear held only 7 percent of their time deposits in that form.)

The future outlook for CD's may be affected by a recent ruling aimed at discouraging savings and loan associations from "unsound use" of this form of investment. As of mid-July, according to a Federal Home Loan Bank Board ruling, CD's acquired under certain circumstances cannot be counted as part of the cash an association needs to meet the liquidity-reserve requirement of 7 percent of savings capital. An association cannot count a newly acquired CD as cash if it receives "consideration" paid by anyone besides the issuing bank—or if the association's total deposits in the issuing bank exceed the greater of $10,000 or one-fourth of one percent of the bank's total deposits.

Business loan boom

Total credit expanded by $775 million at District banks during the second quarter. This 2.6-percent gain was nearly double that for weekly reporting banks outside the District, and was only slightly less than the increase recorded by District banks during the comparable period of 1963. Loan portfolios expanded by $817 million, or 4 percent—the same rate of increase experienced by banks elsewhere in the nation. But in District banks, unlike banks elsewhere, this was accompanied by only a relatively small reduction ($216 million) in their security portfolios. This reduction was confined to holdings of U. S. Governments, and occurred almost entirely in issues maturing in 1-5 years, with a less than offsetting increase in securities in the within-one-year range. Meanwhile, holdings of other securities increased by $174 million, in contrast to the first-quarter trend in this form of investment.

The increase in credit at District weekly reporting banks centered in loans to commercial and industrial firms, with loans to consumers a close second. District business borrowing increased by 4 percent during the quarter as compared with a 1-percent gain elsewhere; in addition, the loan increase was four times greater than in the second quarter of 1963. But the pattern of business borrowing generally was the same in the District as in the rest of the nation, with the notable exception of public utilities. After a first-quarter decline, loans to this group recorded a strong gain in the District, in contrast to a further decline elsewhere, and accounted for a significant part of the increase in total business loans.

Borrowing by District construction firms also posted a fairly strong increase in spite of the less than seasonal gain in construction activity, and so too did borrowing by manufacturers of durable goods. Fabricated-metal manufacturers, with the exception of the transportation-equipment group, borrowed heavily during the second quarter and thereby reversed a trend that had prevailed for over a year. (This increase also coincided with a strong seasonal increase in employment in the industry.) At midyear, however, bank loans to manufacturers of transportation equipment were still below the year-ago level, probably as a consequence of past and projected defense-industry cutbacks.

Other loans outpace mortgages

In the "other loan" category, a 6-percent second-quarter increase substantially exceeded the gains recorded during both the preceding quarter and the comparable period of 1963. The gain, which largely reflected automobile financing, was comparatively greater than that reported by banks outside the District. Together with the net decline in savings deposits, the increase might also indicate relatively greater strength in spending on the part of District consumers.

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

(Dollar amounts in millions)

	Twelfth District				U. S. Minus Twelfth District		
	Outstanding June 24, 1964	Net Change: Second quarter 1964 Dollars	Second quarter 1964 Percent	2nd Qtr. 1963 Percent	Outstanding June 24, 1964	Net change: 2nd Qtr. 1964 Percent	2nd Qtr. 1963 Percent
ASSETS							
Loans adjusted and investments[1]	$30,714	+775	+ 2.6	+ 2.9	$110,459	+ 1.4	+ 2.7
Loans adjusted[1]	21,776	+817	+ 3.9	+ 3.5	73,193	+ 4.0	+ 4.2
Commercial and industrial	7,064	+260	+ 3.8	+ 1.1	31,684	+ 1.0	+ 1.0
Real estate loans	7,424	+110	+ 1.5	+ 3.1	11,451	+ 3.9	+ 6.9
Agricultural loans	1,001	+ 79	+ 8.6	+ 5.1	569	— 0.4	— 4.1
Loans to nonbank financial institutions	1,374	+ 11	+ 0.8	+14.7	6,946	+ 6.5	+ 6.0
Loans for purchasing and carrying securities	454	+ 85	+23.0	— 3.9	6,153	+11.0	+17.8
Loans to foreign banks	274	+ 16	+ 6.2	+ 9.1	924	+14.8	+16.7
Other (mainly consumer)	4,553	+258	+ 6.0	+ 4.9	17,154	+ 5.6	+ 3.4
U. S. Gov't Securities	5,304	—216	— 3.9	+ 0.4	20,974	— 5.9	— 4.1
Other securities	3,634	+174	+ 5.0	+ 4.4	16,292	0	+ 8.5
LIABILITIES							
Demand deposits adjusted	11,969	—127	— 1.1	+ 4.2	50,056	— 1.0	— 1.5
Time deposits	17,694	+401	+ 2.3	+ 2.7	45,388	+ 2.9	+ 3.3
Savings accounts	13,303	— 4	0	+ 0.1	25,545	+ 1.1	+ 1.8

[1] Exclusive of loans to domestic commercial banks and after deductions of valuation reserves; individual loan items are shown gross.
Note: Quarterly changes are computed from the last Wednesday of the first quarter to the last Wednesday of the second quarter.
Source: Board of Governors of the Federal Reserve System; Federal Reserve Bank of San Francisco.

The increase in mortgage lending, on the other hand, was less than in the first quarter and only half as great as in the corresponding period of 1963. This development reflected the net decline in savings deposits, and it probably also reflected the recent slowdown in housing activity. Loans to brokers and dealers for financing and carrying U. S. Government securities fluctuated rather widely throughout the second quarter, but exceeded the volume of financing in the corresponding period of 1963. Loans for financing other securities rose sharply throughout the quarter and remained well above the year-ago level. Loans to sales and personal finance companies meanwhile declined, but an offsetting rise occurred in loans to other nonbank financial companies.

Despite the overall increase in District demands for bank credit, interest rates on both short- and long-term business loans carried lower average interest rates than in either March 1964 or June 1963. On short-term loans, the average rate declined from 5.29 percent in March to 5.19 percent in June, and 40 percent of the total dollar volume of loans was made at the 4.5 percent prime rate, compared with 33 percent in March 1964 and only 27 percent in June a year ago.

In other District financial developments, the second-quarter slowdown in the growth rate of savings flows was just as evident at nonbank savings institutions as it was at commercial banks. In contrast to the trend in the rest of the nation, share accounts at savings and loan associations in most District states not only recorded a smaller growth than during the second quarter of 1963, but also a much smaller growth than during the first quarter of this year. Mortgage lending, however, while below the year-ago pace, was slightly greater than in the first quarter—in spite of the levelling off in District construction activity—and it also exceeded the flow of new savings by a significant margin.

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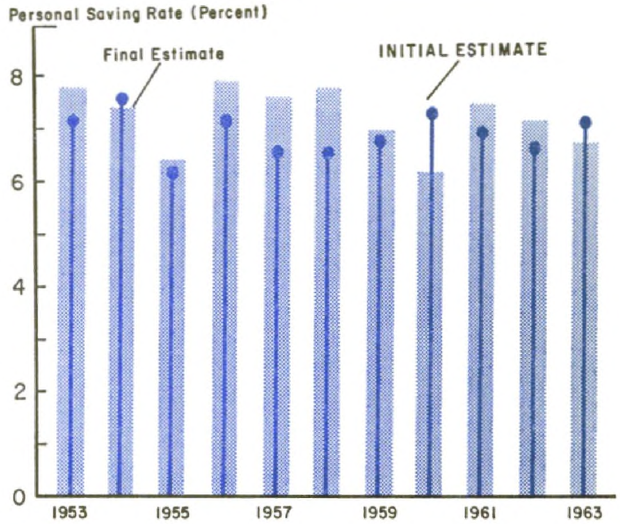
How Much Saving?

Consumers today are in the business spotlight. Upon receiving a $12-billion increase in take-home pay (at an annual rate) in the April-June quarter, they spent half and saved the other half of this substantial gain—in striking contrast to their usual allocation of disposable income. But economists (and not only businessmen) are now watching warily for a return to a more normal consumption-savings pattern, since the anticipated size of the tax cut's total impact on spending was based on the assumption that consumers over the long run save just about 7 percent of their take-home pay and spend all the rest. Although the general expectation is that the normal pattern will soon be re-established, the present situation does raise the question of what the savings figures in recent years have actually shown.

In the pre-tax-cut period, much of the Congressional and business discussion centered around the size of the reduction needed to bring the economy up to full-employment levels. The Council of Economic Advisers, in its presentation, stated that the total demand for goods and services should have been about $30 billion higher than it actually was in recent years in order to hold unemployment at 4 percent of the labor force, and that a tax cut of about $11 billion would be required to close this $30-billion gap. In brief, the Council argued that a $11-billion reduction could lead to a $30-billion increase in total spending if 1) consumers maintained their traditional consumption-savings pattern and thereby brought about a multiplier effect capable of augmenting the impact of each tax-cut dollar, and 2) business responded to the increased spending with new investment in their usual way.

Saving-rate estimates cluster normally around 7-percent level



Sources: Department of Commerce; Federal Reserve Bank of San Francisco.

Key role of consumption

Consumption spending, in other words, would initiate a process of cumulative expansion throughout the economy. Consumers would spend most of the increase in their take-home pay, and these initial increases in spending would stimulate production and employment, generating additional incomes. As manufacturers' sales rose, businessmen would activate idle production lines, hire additional workers, place orders for new buildings, equipment, and materials—and this expansion would then spread further throughout the economy.

The expansion would be limited by certain "leakages." A large fraction of the increase in total production would not become part of consumers' take-home pay; some would be skimmed off in taxes, and some would be held by corporations as retained earnings. In turn, a portion of each additional dollar of consumers' pre-tax income would be skimmed off in taxes or personal saving, but ultimately about one-half of each additional dollar of

GNP generated by the tax cut would end up as consumption expenditure.

The multiplier applicable to the initial increase in spending resulting from tax reduction (with account taken of the various leakages) would work out to roughly 2. This multiplier effect—along with the effect of the cumulative indirect effects on business inventory investment and plant and equipment investment — would then lead to an overall expansion several times greater than the initial tax reduction.

Problems of estimating

The Council's tax-cut argument thus depends to a great extent on the amount that the consumer keeps out of the spending stream in the form of saving. But how precisely can the saving rate be measured? Here is the rub; saving estimates are sometimes inexact, since personal saving is computed as the residual between after-tax income and expenditures, and it is thus dependent on the accuracy of the estimates of these underlying determinants. Consequently, in this period when consumer spending and savings habits are so important, past developments in estimates of consumer saving require close watching.

Personal saving, as shown in the Department of Commerce's national-income accounts, is equal to disposable personal income less personal consumption expenditures. (As such, saving conceptually includes not merely cash and bank deposits but changes in pension and life insurance reserves, as well as increases in homeowners' equity and the equity of noncorporate and nonprofit entities in plant, equipment, and inventories.) The Commerce estimates of personal saving cannot be entirely satisfactory, since the errors and limitations present in the hundreds of series that make up the income and expenditure totals do not completely cancel out and therefore tend to be transmitted into the saving estimates.

In view of the difficulties in estimating personal saving, it should not be surprising that certain differences have developed between the initial estimates made for any time period and the later estimates based on more complete and up-to-date information. For example, Commerce's initial saving estimate for 1963 was $1.8 billion higher than the $27.5-billion estimate now available. Conversely, the initial estimate for 1962 was $1.6 billion below the $27.8-billion "final" estimate for that year. (Even "final" estimates may be revised further in later years.) Yet, despite these variations, which now give us a 7.2-percent saving rate in 1962 and a 6.8-percent saving rate in 1963—instead of just the other way around, as the initial estimates suggested —the rough 93 to 7 allocation between personal consumption and saving seems to have been maintained in these as well as in most other postwar years.

Initial and "final" estimates

These differences, of course, were actually due to changes in estimates of the underlying income and consumption series. In some cases, where adequate data were continually available on an up-to-date basis, changes in the underlying estimates were quite small. In other cases, where such data were unavailable, variations in estimates unavoidably were rather large.

On the income side, differences between initial and "final" estimates have been noticeable in all components: wages and salaries, proprietors' income, and other income (such as property and transfer income). Differences in wage and salary estimates, however, have generally been smaller than differences in the other components, primarily because adequate wage and salary data are continually available for the preparation of income estimates. But several shifts have occurred recently in the direction of these variations. Since 1960, several of these series have been overestimated initially—and thus have contributed to an initial overestimate of saving—whereas throughout most of the 1950's all of these series normally were initially underestimated.

On the consumption side, differences between initial and "final" estimates have been relatively stable throughout the postwar period. In most years, initial estimates of expenditures for durable goods and services have run below the later estimates and thus have contributed to an overestimate in the initial saving figure. On the other hand, initial estimates of nondurable goods spending have consistently run above the later estimates and have thereby contributed to an underestimate in the initial saving rate.

As a result of these conflicting trends in estimates of the underlying income and expenditure series, the initial saving figure each year normally has underestimated the final figure in both dollar and percentage terms. This was not true in 1963; as already noted, the latest saving estimate was 6.8 percent instead of the initial 7.2 percent. In addition, this was not true in either 1960 or 1954, and especially in two low-saving early postwar years, 1948 and 1949. But in all other postwar years, the initial saving estimate was lower than the estimate now considered final. Again, however, it should be emphasized that these differences developed from variations in estimates of the underlying income and expenditure series.

The question thus arises about the reliability of these underlying series. On the income side, a high rating of reliability is assigned to wages, salaries, and transfer payments, which account for the great bulk of total income. Among other income components, somewhat less reliability is attached to estimates of proprietors' income and property income (especially rental income). On the consumption side, a basic question of reliability arises because few components of that total can be estimated as accurately as the leading income series, such as wages and salaries, and also because consumption estimates suffer from the complexity of estimating procedures and from the infrequency in timing of Census and other necessary data.

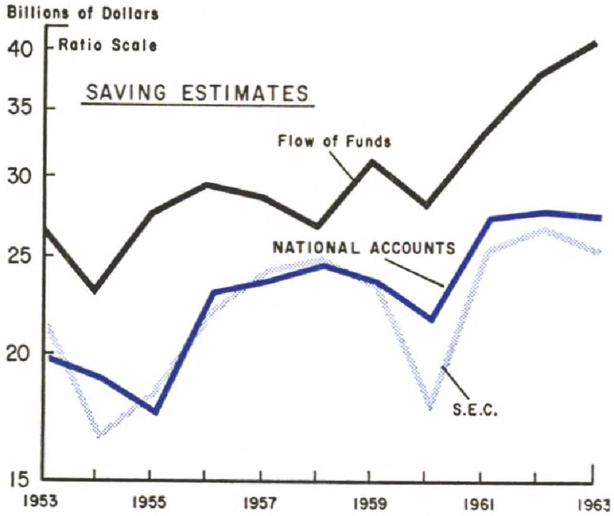
Alternative measure

Consequently, since personal saving is computed as the difference between the two much larger totals of income and consumption, it is subject to substantial error. Small errors in either of those two totals (if not offsetting) could give rise to large errors percentagewise in estimates of personal saving and even errors in movement. Thus, it becomes essential not only to measure these underlying series as closely as possible, but also to check the saving estimate for reasonableness against other estimates.

An alternative measure is provided by the Securities and Exchange Commission through direct estimates of changes in personal assets and liabilities that let out conceptually to be equal to savings. The S.E.C. saving estimate includes the net investment in tangible assets (such as housing) of individuals, noncorporate enterprises, and nonprofit institutions, plus their increase in financial assets (currency, bank deposits, savings and loan shares, securities, and insurance reserves), less their increase in debt (on mortgages, consumer loans, trade, and bank debt). Data deficiencies make the S.E.C. measure of personal saving also subject to error, but the availability of a series which is generally statistically independent provides a very useful check of reliability of the Commerce series.

In each of the last four years, the S.E.C. estimate has been somewhat below the Commerce estimate. In 1963, for example, the S.E.C. estimate was $25.4-billion instead of the $27.5-billion figure obtained by subtracting consumption from disposable income—which means a 6.3 percent saving rate instead of one of 6.8 percent.

Rising trend over decade shown by all saving series



Sources: Board of Governors of the Federal Reserve System; Department of Commerce; Securities and Exchange Commission.

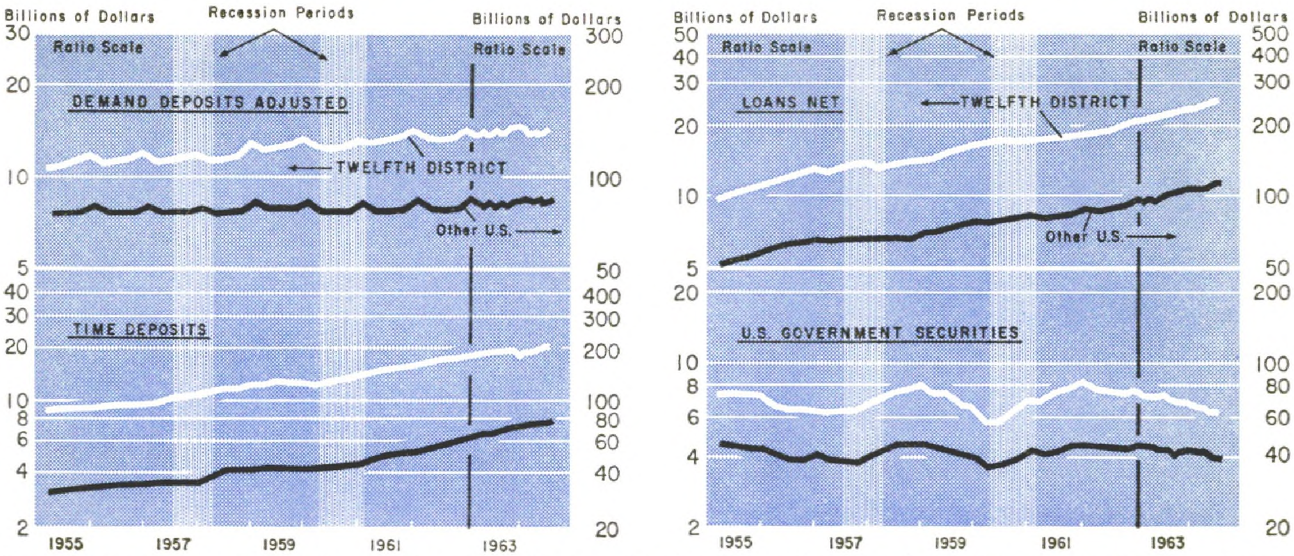
Flow-of-funds estimate

Both of these measures show a gradually rising trend in personal saving over the past decade or more. According to the Commerce estimate, saving rose about 40 percent between 1953 and 1963; according to the S.E.C. measure, saving rose at a slower pace. But a somewhat different movement, and a much stronger trend—about a 50-percent increase over the decade—is provided by the separate measure of personal saving published in the Federal Reserve flow-of-funds accounts. The flow-of-funds estimate increased from $26.5 billion to $40.9 billion between 1953 and 1963, but more than half of that gain occurred in the 1961-63 period alone—in a period in which other estimates showed considerable stability in saving.

The difference in movement may be due largely to conceptual differences in the various series. In the flow-of-funds accounts, net saving of consumers and nonprofit organizations includes several items that are excluded from the Commerce saving estimate—specifically, net purchases of consumer durable goods and saving through government life insurance and retirement funds. In view of such developments as the recent consumer durable-goods boom, a reconciliation of the two saving estimates would probably show somewhat slower growth over the past several years than is indicated by the flow-of-funds estimate, although perhaps not so much stability as is indicated by the Commerce estimate.

Nonetheless, despite all the difficulties in measurement presented by the various series, all estimates show a substantial increase in saving over the past decade. Moreover, they generally support the arguments pointing to long-term stability in the rate of saving to disposable income. Tax-cut proponents, with their emphasis on the multiplier effect, will be more than happy if that historical stability is soon regained in the post-tax-cut atmosphere.

Condition Items of all Member Banks — Twelfth District and Other U. S.



Source: Federal Reserve Bank of San Francisco. (End-of-quarter data shown through 1962, and end-of-month data thereafter; data not adjusted for seasonal variation.)

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] Seasonally Adjusted				Bank debits Index 31 cities[5, 6]	Bank rates on short-term business loans[7, 8]	Total nonagri-cultural employ-ment	Dep't. store sales (value)[6]	Industrial production (physical volume)[6]		
	Loans and discounts[3]	U.S. Gov't. securities	Demand deposits adjusted[4]	Total time deposits					Lumber	Refined[8] Petroleum	Steel[8]
1951	7,751	6,370	9,512	6,713	57	3.66	80	68	99	87	97
1952	8,703	6,468	10,052	7,498	59	3.95	84	73	101	90	92
1953	9,090	6,577	10,129	7,978	69	4.14	86	74	102	95	105
1954	9,264	7,833	10,194	8,680	71	4.09	85	74	101	92	85
1955	10,827	7,162	11,408	9,130	80	4.10	90	82	107	96	102
1956	12,295	6,295	11,580	9,413	88	4.50	95	91	104	100	109
1957	12,845	6,468	11,351	10,572	94	4.97	98	93	93	103	114
1958	13,441	7,870	12,460	12,099	96	4.88	98	98	98	96	94
1959	15,908	6,495	12,811	12,465	109	5.36	104	109	109	101	92
1960	16,628	6,764	12,486	13,047	117	5.62	106	110	98	104	102
1961	17,839	8,002	13,676	15,146	125	5.46	108	115	95	108	111
1962	20,344	7,336	13,836	17,144	141	5.50	113	123	98	111	100
1963	22,915	6,651	14,179	18,942	157	...	117	129	102	112	117
1963											
July	21,761	7,059	14,044	18,290	158	...	116	128	95	115	107
August	21,890	6,958	13,990	18,334	162	...	117	132	102	116	105
September	22,236	6,968	14,102	18,409	166	5.47	117	125	105	113	105
October	22,387	6,698	14,106	18,727	167	...	118	127	108	112	104p
November	22,673	6,730	14,272	18,923	170	...	118	130	106	110	114p
December	22,915	6,651	14,179	18,942	167	5.47	118	136	111	110	112p
1964											
January	23,256	6,575	14,332	19,342	163	...	119	135	115	111	116p
February	23,544	6,832	14,222	19,520	168	...	119	137	114	115	123p
March	23,763	6,893	14,287	19,685	166	5.47	119	133	114	113	136p
April	23,953	6,559	14,243	19,773	170	...	119	134	101	111	143p
May	24,102	6,541	14,170	19,813	167	...	119p	139	105	112	142p
June	24,394	6,489	14,347	19,876	167	5.46	...	137	...	...	131p
July	24,836p	6,212p	14,390p	20,150p	166	...	...	...	...	...	...

[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, U.S. Bureau of Mines; steel, U.S. Department of Commerce and American Iron and Steel Institute; nonagricultural employment, U.S. Bureau of Labor Statistics and cooperating state agencies. [2] Figures as of last Wednesday in year or month. [3] Total loans, less valuation reserves, and adjusted to exclude interbank loans. [4] Total demand deposits less U.S. Government deposits and interbank deposits, and less cash items in process of collections. [5] Debits to demand deposits of individuals, partnerships, and corporations and states and political subdivisions. Debits to total deposits except interbank prior 1942. [6] Daily average. [7] Average rates on loans made in five major cities, weighted by loan size category. [8] Not adjusted for seasonal variation. p—Preliminary. r—Revised.