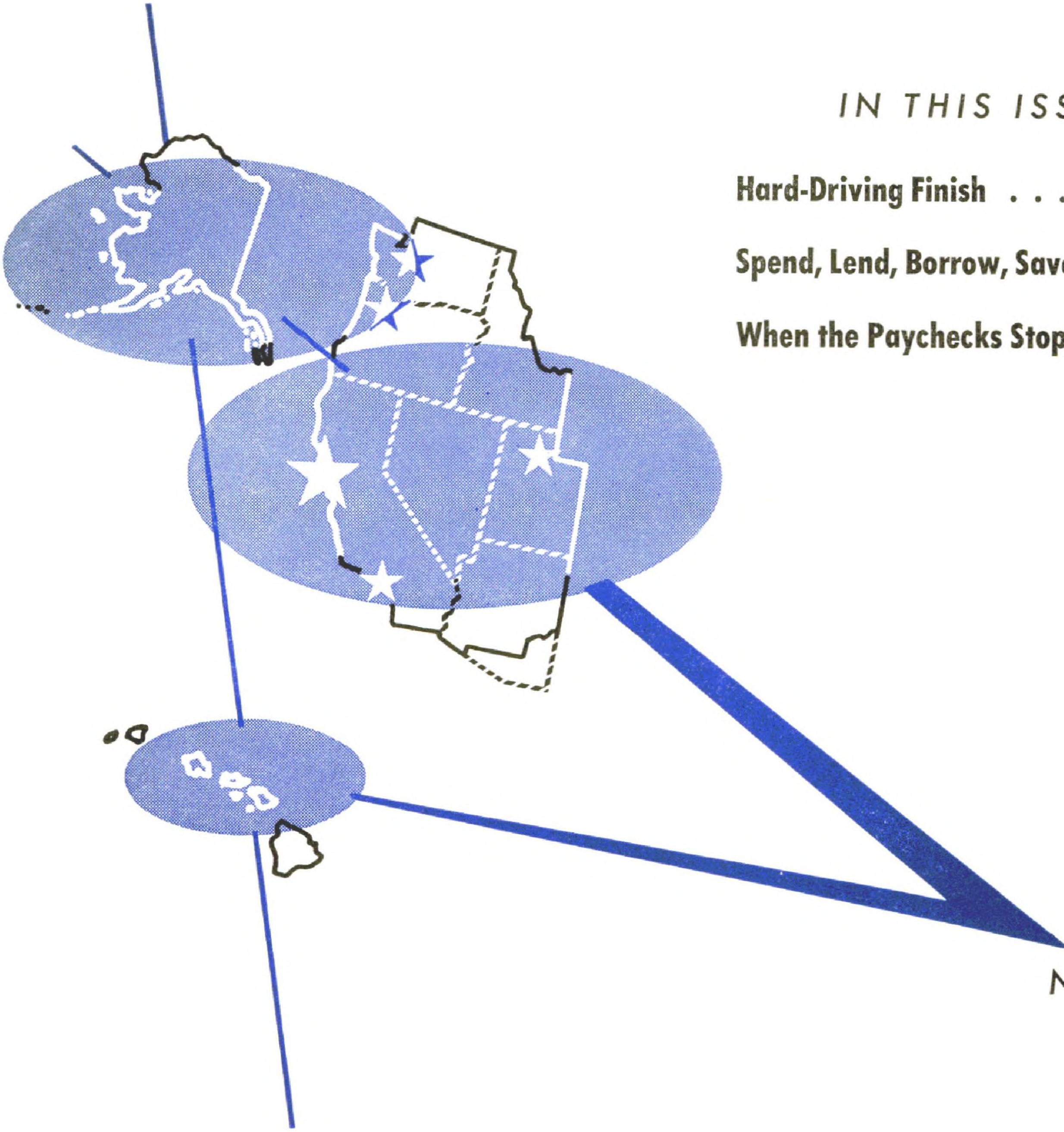
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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NOVEMBER
1964

1914 FIFTIETH ANNIVERSARY 1964

Hard-Driving Finish

. . . As a strongly expansionary year comes to a close, business analysts ask — too fast or too slow?

Spend, Lend, Borrow, Save

. . . Businesses, consumers, and governments all increased their gross credit demands during the third quarter of the year.

When the Paychecks Stop

. . . Transfer payments have grown phenomenally in recent decades, and their continued growth seems all-but-certain.

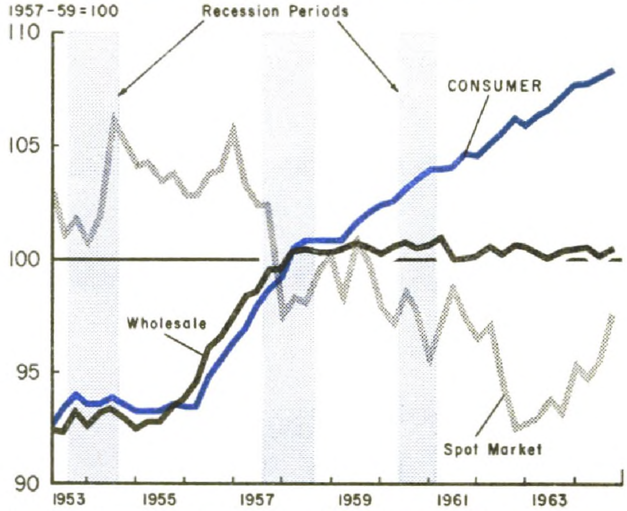
Hard-Driving Finish

Economics has been largely overshadowed by politics in recent months, but business analysts now are able to concentrate again on the state of the economy rather than the state of the nation. Specifically, they can now investigate the question that crops up at this advanced stage of every business expansion—too fast or too slow? So far, there are two conflicting answers. While anticipating that the economy will add a hard-driving finish to a very prosperous year, some observers worry about an over-rapid pace of advance and, indeed, discern shortages of men, materials, or machinery developing in 1965. (Among other pieces of evidence, they point to a 15-percent rise since the turn of the year in spot prices of industrial materials.) Other observers, however, question whether the recent rate of expansion can be sustained far into 1965, especially in view of the recent downturns in housing and defense spending and the waning stimulus from 1964's massive tax cut.

Third-quarter statistics provide the backdrop for these conflicting speculations. In that period, GNP increased about $10 billion to a $628.4-billion annual rate (seasonally adjusted). The gain in total output was just about the same as the gain recorded in each of the four preceding quarters. But when account is taken of the (perhaps involuntary) slow-down in the rate of inventory accumulation, a different picture emerges. In fact, the quarterly gain in final sales (GNP minus inventory change) shows up as one of the strongest in the expansion to date.

Consumption spending dominated the third-quarter situation, as consumers saved somewhat less and spent considerably more than in the immediate aftermath of the tax cut. The advance in business plant-equipment spending also continued unabated during the quarter. Government expenditures in the aggregate

Upsurge in spot market prices
gives rise to inflationary fears



Sources: Department of Labor; Department of Commerce.

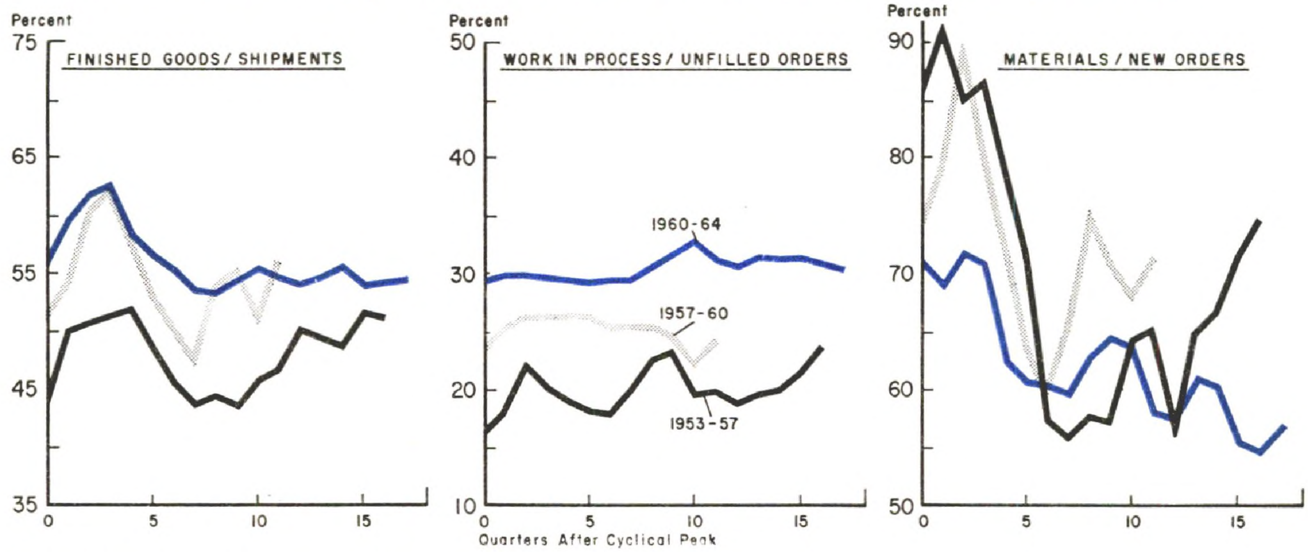
remained relatively stable, although defense spending fell off from the unusually high second-quarter level. Meanwhile, residential construction continued to decline from the record high attained early this year.

Pressures on prices

Looking towards 1965, inflation-minded critics discern several worrisome signs—for example, on the labor front. A major steel producer tried to recruit 1,000 workers for its Chicago operations in the hitherto-depressed Pennsylvania mill towns, and obtained less than half of the number required. (And still, the national unemployment rate remains above 5 percent.) In addition, the auto industry negotiated a greater-than-guidelines wage settlement, and the cost implications of that event prompted Treasury Undersecretary Roosa to question whether such settlements might not constitute a "fundamental risk" to a further improvement in the nation's balance of payments.

Some signs of strain have also developed on the machinery and materials front. Durable-goods manufacturers are now trying to work down an order-book that has expanded by 10

Hard-goods firms show decline in ratio of materials stocks to new orders, but maintain stable inventory ratios at final and intermediate stages of production



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

percent since the beginning of the year. Until recently, order backlogs of steel producers grew quite rapidly. Not surprisingly, then, these producers maintained full-schedule operations throughout October, even in the face of a month-long strike over local-union issues at the auto firm which normally takes one-tenth of the nation's total steel output.

In view of all the pressures, incipient or actual, business pundits are focussing their attention increasingly on the price situation. The consumer and wholesale indexes have furnished no clues; consumer prices are edging upward, as they have throughout practically all of the past decade, while the wholesale index is now completing its seventh straight year of crabwise movement. But the commodity spot-price index furnishes strong evidence of accumulating pressures. As already noted, prices of industrial raw materials have risen about 15 percent since the turn of the year—and most of the gain has taken place just within the past several months.

Whether bottlenecks actually develop, however, will greatly depend on the strength of demand. Business plant-equipment spending for the present looks strong; anticipated spending for the current quarter is about 12 percent above the year-ago level, and it may turn out even higher, since actual expenditures have exceeded anticipated expenditures consistently this year. Government spending may rise only slowly, especially in view of Secretary McNamara's announcement that defense outlays will be more than $1 billion below the preceding year's total in fiscal 1965. But consumers meanwhile will be dealing with the substantial increase in take-home pay—an 8-percent increase over the past year—that has been generated jointly by the tax cut, favorable wage settlements, and a broadly based business expansion.

Consumer buying plans thus will help determine whether 1964's hard-driving finish generates enough momentum for a strong 1965. Consumer incomes are probably high enough to support a fourth-straight phenomenal auto year or to cushion the current decline in housing; the major question is how the consumer will allocate his recently expanded budget. But this, of course, is only one of the factors determining the size and shape of the 1965 economy.

Depleted stockroom?

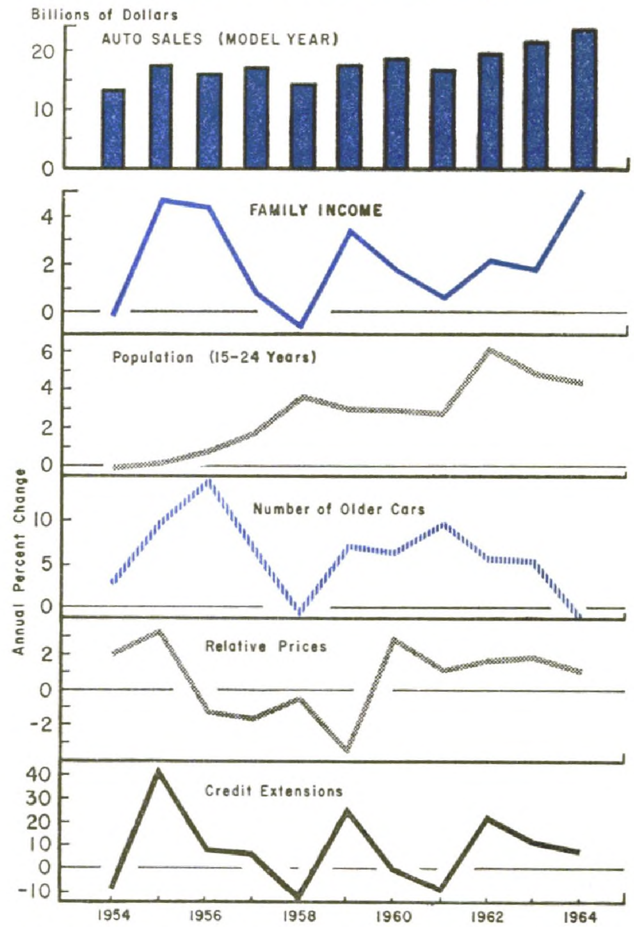
Another question concerns the strength and the direction of inventory spending. The increase in stocks was relatively low last quarter, as it has been in most periods since early 1962, but the latest Commerce Department survey of inventory expectations suggests that further increases are in store. Manufacturers have projected a moderate expansion in inventory spending for this quarter; more important, at the beginning of the last quarter only 13 percent of the group considered their inventories to be too high, whereas 29 percent thought so at the peak of the last expansion in 1960.

A more objective picture of the inventory situation can be gained by comparing the status of manufacturers' stocks with the status of their orders and shipments. In the durable-goods sector, for instance, the ratio of finished-goods inventories to shipments has fluctuated somewhat less in recent years than in the two preceding business cycles. The same relative stability has been evidenced by the ratio of work-in-process inventories to unfilled orders. In addition, the ratio of materials inventories to new orders has dropped substantially during this expansion, to levels considerably below those recorded at corresponding points of previous cycles. These developments suggest that businessmen have been surprised by the rapid pace of the expansion and have involuntarily reduced their stocks, at least at the initial stage of the production process. But they also support the conclusion that purchasing agents and their trusty computers have been successful in maintaining an optimum stockroom balance and in holding the materials inflow at the minimum possible level necessary for efficiency.

Fourth record year?

A major question in the outlook concerns the ability of the auto industry to put together its fourth "back-to-back" record year. Con-

Strong gain in consumer income
supports another record auto year



Note: Bar chart shows dollar sales of autos and parts in each model year (beginning one quarter before calendar year). Line chart shows annual percentage change in factors affecting auto sales—family income in 1963 dollars, population aged 15-24, number of cars 5 years or older (at beginning of model year), difference between changes in consumer price index and new-car price index, and amount of auto credit extended.
Sources: Department of Commerce, *Automotive News,* Department of Labor, Board of Governors of the Federal Reserve System.

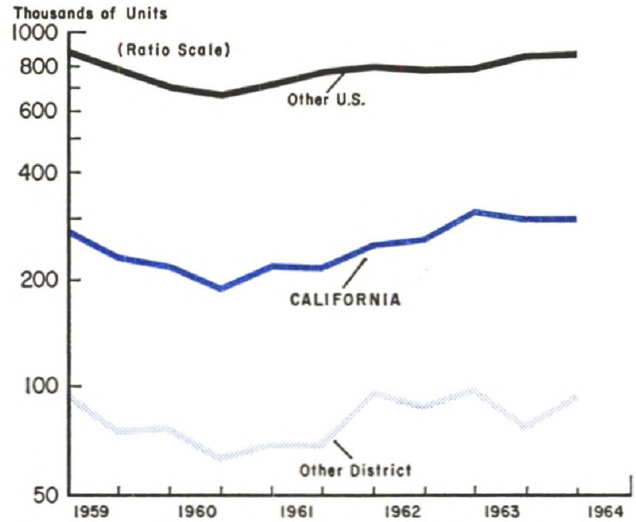
sumers purchased $20 billion worth of auto and parts in the 1962 model year and followed that up with a $22-billion total in 1963—and then they raised their spending to about $24 billion in the model year just ended. The industry attempted to keep the string going into 1965 by offering prospective buyers a choice of 343 models at relatively stable prices, and it tried to achieve a strong start on the production end by negotiating a substantial settlement in its labor contract renewal. But then a major part of the industry bogged down in a prolonged dispute over local-union work standards.

Steel mills and parts supliers, which continued to run at full tilt while the production lines of their largest customer remained motionless, soon found their inventory facilities under strain. Some managed to shift their production to other accounts, but others by late October were contemplating production cutbacks and layoffs to ease the situation. Then again, the auto market was complicated by the loss of perhaps 500,000 scheduled units by the end of October. This development put a heavy strain on consumer brand loyalties; in fact, it opened the possibility of permanently lost sales, since many consumers who were disappointed by empty showrooms at model-introduction time may now sit out the rest of the year as well.

Nonetheless, the industry's market researchers could still point confidently to the strength of the factors underlying consumer demand. The record 1964 model year, like its several predecessors, was based on such factors as the easy availability of auto credit, the relatively slow growth of auto prices, the large number of old cars headed for the scrapheap, and the increasingly large number of young drivers headed for auto showrooms. But probably the strongest determinant of the high '64 sales rate was the substantial gain during the year in average consumer income—a gain from which the industry expects to benefit in 1965 also.

The outlook is somewhat more questionable in residential construction, the other major consumer "investment" sector. Despite the high level of consumer income and the easy availability of mortgage money, spending for new housing fell about 5 percent between the first and the third quarters of this year, while housing starts dropped off steeply from the peak attained a year ago. In this situation, housing analysts tend to believe that the industry has temporarily outrun its market—more specifically, that there may be a dearth of newlyweds and retired individuals capable

Housing activity weakens in West, in contrast to situation elsewhere



Note: Chart shows semi-annual average of housing starts, at annual rate, but without seasonal adjustment.
Source: Department of Commerce.

of renting the higher-priced apartment units that the industry has constructed with such abandon in the last several years.

Strengths and weaknesses

On the national scene, then, the amount of forward momentum carried into 1965 may well depend on such things as consumer spending plans for cars and housing and on businessmen's inventory response to changing consumer plans. On the regional scene, the situation will be influenced by these factors but also by developments in the crucial (and now somewhat uncertain) defense spending sector.

Consumer spending in Twelfth District states has been quite strong throughout most of the year. For instance, retail store sales during the first nine months of the year were 8 percent above the year-ago level, as compared with a 6-percent increase for the rest of the nation. During the same period, new car registrations in the District were 14 percent above the year-ago figure, as compared with a 10-percent gain elsewhere.

On the other hand, that better-than-national performance was lacking in the housing field.

In fact, the widely discussed housing downturn could be described substantially as a Western phenomenon. Housing starts in the 13-state West fell about 10 percent below the year-ago level during the first nine months of this year, whereas starts increased 4 percent elsewhere in the nation (cumulated basis). The problem could be further described in terms of the apartment-housing situation, especially in view of the continuance of the wide spread between Western and national rental vacancy rates. The rates averaged about 9.7 and 7.3 percent, respectively, in the first half of this year.

Much of the strength in consumer spending undoubtedly has developed because of the continuing expansion of aggregate employment throughout the year — and probably much of the downturn in residential construction could be traced indirectly to the continuing downturn in defense-related employment. Total employment in the District averaged 9.65 million during the third quarter (seasonally adjusted) for an 0.4-percent quarterly gain and a 2.3-percent gain over the past year. Moreover, the District—unlike the rest of the nation—recorded a quarterly increase in nonfarm employment, despite a job decline in durable-goods manufacturing.

How much for defense?

About 47,000 workers were laid off by District defense manufacturers during the first three quarters of 1964, for a total of 74,000 layoffs since the December-1962 peak. Yet, even though the labor force in the District exceeds 10 million, those relatively few layoffs possess considerable significance. If, for example, the 74,000 jobs lost since the peak had been transferred from the unemployment to the employment column, the District unemployment rate would have dropped by this September to the national rate of 5.3 percent instead of rising to 6.0 percent as it actually did.

Admittedly, the layoffs have tapered off as the year has progressed. Defense employment in District states declined by 21,000 in the first quarter, 16,000 in the second quarter, and 9,000 in the third quarter—and defense jobs thus totalled 585,000 in September. The third-quarter reduction was confined largely to California firms, primarily in the Los Angeles and San Diego areas.

Nonetheless, the defense picture remains mixed. Recent layoffs have occurred in the face of a relatively stable inflow of new business to District firms, including one $500 million follow-on contract to a California firm for the Apollo moon-shot program. Moreover, the order backlog nationally for military and commercial aircraft has actually increased in the last several months. But Defense Secretary McNamara recently announced that total spending by his agency in fiscal 1965 will be more than $1 billion below the total spent in the 1964 fiscal year — and District firms normally account for almost one-third of all Pentagon contract awards.

From farm to forge

Mixed performances were also recorded recently by other major District industries. In the third quarter, lumber felt the repercussions of the slowdown in housing activity. Lumber ordertaking remained in the doldrums, while prices gradually drifted downward to levels below those prevailing during the post-strike period a year ago. In October, however, a rise in orders cushioned the price downturn.

Steel output in the District rose during October to a level 22 percent above the year-ago figure, although somewhat below the 1964 high registered in May. National production meanwhile reached a level 36 percent above the year-ago figure. The difference developed in large part because producers outside the District are the major beneficiaries of the inventory hedge-buying program now being undertaken by auto manufacturers.

District petroleum refineries increased their processing activity during the third quarter, and they also increased their imports because of lagging production of domestic crude oil. (Foreign crude accounted for more than one-third of District crude supplies during the quarter.) But despite the expansion in demand for refined products, prices (especially gasoline prices) weakened during the period. In the California market, where gasoline sales exceed 18 million gallons daily, prices per gallon were down as much as 7 cents below normal.

In the farm sector, prices were generally depressed during the third quarter, but receipts were maintained at year-ago levels because of heavy marketings. Crop production prospects generally improved during the period, so that the Western harvest may well reach record proportions. Incidentally, the role of Mexican workers in this performance has been just as great as in earlier years; at the seasonal peak, bracero employment reached 69,000, or about the same as in 1963.

Beef-cattle sales during the third quarter were particularly heavy—about 16 percent more than in the year-ago period. Low beef prices meanwhile discouraged the importation of foreign beef; inspections, in fact, ran about one-third below the year-ago level during the third quarter.

With only several exceptions, then, Western producers and consumers have been performing just as admirably as their counterparts elsewhere in the nation. Gains in employment, income, and consumer spending have been especially noteworthy. The record to date thus suggests that a strongly expanding year will end with a hard-driving finish, and that the expansion will carry into the new year and thereby ease the task of 1965 in solving the problems posed by the defense and housing sectors during 1964.

Rise in Discount Rate

On November 23, the Board of Governors of the Federal Reserve System approved actions by the directors of five Federal Reserve Banks (Boston, New York, Philadelphia, Chicago, and St. Louis) increasing the discount rates of those banks from 3½ to 4 percent. The Board of Governors also increased the maximum rates that member banks are permitted to pay on savings deposits and time deposits. The System's actions, which were taken "to maintain the international strength of the dollar," followed in the wake of the rise in the British Bank rate from 5 to 7 percent. The Federal Reserve Bank of San Francisco moved to the 4-percent rate on November 25.

The permissible maximum rate on savings deposits was set at 4 percent; previously, the 4-percent maximum was permissible only for deposits of one year or more. The permissible maximum rates on time deposits and certificates of deposit were set at 4 percent for maturities of less than 90 days and 4½ percent for all longer maturities; for those same maturities, the maximum rates previously permissible were 1 percent and 4 percent, respectively.

These Federal Reserve actions were designed, first, to counter possible capital outflows that might be prompted by any widening spread between interest rates in this country and higher rates abroad, and, second, to ensure that the flow of savings through commercial banks remains ample for the financing of domestic investment.

Spend, Lend, Borrow, Save

BUSINESSES, consumers, and governments all increased their gross credit demands during the third quarter of the year. Overall, the volume of credit demands roughly matched the second-quarter volume, but some shifts occurred in the pattern of flows.

Business borrowing remained vigorous, both at the nation's commercial banks and in the bond and equity markets, while consumers stepped up their short- and intermediate-term borrowing to finance a higher level of spending. State and local governments recorded both a further rise in expenditures and a further increase in debt offerings, while the Federal government, notwithstanding a less-than-seasonal rise in spending, also resorted to cash borrowing to finance a part of its expenditures. (Of course, much of the Treasury borrowing represented the usual seasonal need for funds.)

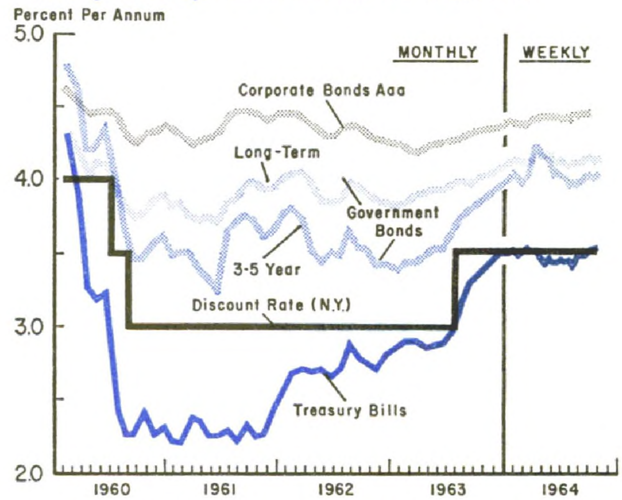
Rising level, narrower spread

On balance, the money and credit markets accommodated the rising demand for loanable funds at a level of interest rates which was somewhat higher—and a structure of rates which was somewhat narrower in terms of yield spread—than that prevailing at mid-year. Nevertheless, yields on many debt instruments, both short- and long-term, were no higher in the early fall than they were in the first part of the year. But then, of course, the late-November rise in the discount rate cast a new complexion on events.

During the first quarter, the tax cut encouraged expectations of inflationary pressures and thus stimulated a general upward movement in yields; during the ensuing quarter, the orderly response of the economy to the tax cut brought about a modification of those expectations and contributed to a decline in most yields. Then, as the third quarter progressed, market psychology once again shifted towards expectations of less ease in monetary policy, and yields consequently firmed.

External as well as domestic factors contributed to this shift in expectations. One such factor was the possibility that a threatened increase in the U.K. Bank rate would bring about a compensatory adjustment in short-term rates in this country. (As it turned out, the U.K. response to balance-of-payments difficulties initially took the form of a 15-percent surcharge on all imports except foodstuffs and basic raw materials, but finally involved a rise from 5 to 7 percent in Bank rate.) Another factor was the prospect of at least a normal expansion in business activity during the forthcoming fall season. Underscoring and reinforcing these considerations was a strong demand for bank credit and an accelerated growth in the money supply. Member-bank excess reserves averaged somewhat higher in the summer quarter than in the April-June period, but a relatively greater increase in borrowings resulted in a modest decline in average free reserves—and the market attached considerable weight to that development in its assessment of the outlook.

Interest rates edge upward,
while yield spread tends to narrow



Source: Board of Governors of the Federal Reserve System.

The Treasury's role

Market rates on Treasury obligations reflected the general upward shift in the yield structure and the narrowing of the yield spread. Outstanding marketable debt rose by about \$2.5 billion during the third quarter, following a second-quarter decline, and the rise was accompanied by a significant shift in the composition of the debt structure. As the result of a successful July refunding, U. S. Government bonds in the 5-10 year maturity range increased by about \$8 billion and 20-year-and-over maturities rose by somewhat over \$1 billion. Conversely, outstanding issues in the 1-5 year maturity range declined by about \$8 billion while within-one-year issues (other than Treasury bills) declined by about \$1 billion.

These changes in the maturity structure of the debt were accompanied by a slight rise of about 4 basis points in the average yield on long-term Governments and by virtual stability in the yield on 3-5 year issues. Yields in these two categories averaged 4.16 and 4.05 percent, respectively, in early October. In both cases, yields were well below the 1964 highs attained early in April.

Apart from the July refunding, the Treasury met its cash requirements partly by drawing down its operating balances and partly through the issue of Treasury bills. The Treasury ended the 1964 fiscal year with a cash balance of \$10.2 billion—substantially higher than expected, but still about \$1 billion below the year-ago level. Nevertheless, the net third-quarter reduction in cash balances was only half as great as that which occurred during the comparable period of 1963, primarily because of increased sales of bills and a less-than-seasonal rise in cash expenditures.

Subsequent to the July refunding, the Treasury resorted to the bill market to raise new cash; in fact, a \$2.6-billion net increase in outstanding bills accounted for all of the net increase in marketable debt during the period. The increase was accompanied by a rise of about 7 basis points in yields on 91-day Treasury bills (to 3.57 percent) and an increase of about 20 basis points in yields on 6-month bills (to 3.73 percent) between July and early October.

In the state and local government sector, a third-quarter increase in spending was accompanied by an increase in debt offerings, just as in the earlier part of the year. New issues totalled about \$2.6 billion — substantially more than the third-quarter total of any other recent year. Yet, notwithstanding this heavy volume of new offerings and a prospect of more to come, and notwithstanding the near-record inventory of unsold issues hanging over the market, yields on high-grade municipals held fairly stable during the quarter. Yields had dropped somewhat between March and June, but the early October average of 3.11 percent was quite close to the midyear level. Continued active interest by commercial banks was a factor contributing to this stability.

Strong credit demands

In the business sector, an increase in outlays for plant, equipment, and inventories was financed in part by continued recourse to the bond and equity markets and to the nation's commercial banks. This strong demand for financing, together with a sharp slowdown in the growth of corporate holdings of time certificates of deposit, might suggest a decline in corporate liquidity margins, notwithstanding the continued strength in business sales and profits.

Corporate bond and equity offerings during the third quarter amounted to only about half the second-quarter volume (which was inflated by a single large utility offering) but yields on corporate debt still moved slightly higher during the quarter. On the other hand, a rise in business borrowing from commercial banks was accommodated at about the same average interest cost as during the preceding quarter, although non-price terms of borrowing stiffened somewhat.

Consumers resorted to debt financing to help finance a sharply rising level of purchases, and at the same time they reduced both the amount and rate of their personal saving. Consumer credit extensions increased over their second-quarter pace, but so too did debt repayments; consequently, outstanding instalment debt increased at about the second-quarter rate. Following the pattern set early in the year, automobile financing accounted for about half of the net increase in consumer credit.

Mortgage borrowing also continued at a vigorous pace during the July-September quarter. Borrowing once again exceeded the rate of expenditure for new residential construction, which suggests that mortgage credit continues to provide a vehicle for financing nonhousing expenditures as well as existing housing. Mortgage lending institutions meanwhile received an accelerated flow of savings, but the cost of mortgage credit as well as non-cost terms of borrowing remained virtually unchanged until around the end of the quarter, when signs of ease became apparent.

Two sides of the ledger

In response to the strong credit demands emanating from all sectors of the economy, the nation's commercial banks recorded the largest gain in bank credit since the first quarter of 1963 (seasonally adjusted basis). The expansion in portfolios of both U. S. Governments and tax-exempts contributed significantly to this increase; the former rose by $1.2 billion, reversing a second-quarter decline, while the latter increased by the same amount and thereby recorded the largest increase of the past year. Bank loans, however, rose at only half their second-quarter pace, with a $3.0 billion gain, as business, mortgage, and consumer loans all showed slower rates of expansion.

On the other side of the ledger, commercial bank deposits rose by about $5.6 billion during the quarter (seasonally adjusted basis), with time and savings deposits accounting for $3.2 billion of the increase. This increase was particularly noteworthy in view of a declining rate of growth in time certificates of deposit; these increased by less than $300 million, far below the gains of about $1 billion recorded in each of the two preceding quarters. The relatively faster rise in yields on other short-term money-market instruments tended to place these CD's at a competitive disadvantage during the third quarter, especially since the contractual rates paid by most banks had already reached the 4-percent limit imposed by Regulation Q.

The slowdown in CD growth is significant because CD's, like other time-deposit categories, carry relatively low reserve requirements and thus enable banks to expand credit more than is possible where the deposit growth centers in the demand category. But where yields on alternative forms of investments are rising, and where an expanding economy requires larger demand balances and currency for transactions purposes, the potential "exposure" of any investment subject to rate ceilings also may be increased. It may have been for this reason that one major bank recently announced the introduction of a "consumer certificate of deposit," non-negotiable, but paying an annual rate of 4 percent on deposits of $2,000 or more held for at least six months.

And now, unsecured notes

During the third quarter, moreover, several major banks introduced yet another credit-market instrument—unsecured notes. These notes, like debentures, constitute a debt offering and thus are considered to be a form of borrowing. As such, unsecured notes under present laws and regulations are not subject to reserve requirements or FDIC insurance premiums (as are CD's), nor are they subject to any statutory interest rate ceiling. If the market should accept these notes on a par with time CD's, they would be a relatively "cheaper" source of funds, on a net basis, for the issuing bank at any given level of interest rates. For many banks, however, the market in these notes may be considerably smaller and hence thinner than that for CD's, and as a result the notes may have to be sold at yields somewhat higher than those offered on CD's.

For national banks, the issuance of unsecured notes is limited by a statutory restriction on total borrowing by a national bank to an amount not exceeding the sum of its capital plus half of its surplus; nonetheless, even this restraint allows considerable potential for the use of the new instrument by the nation's largest banks. State-chartered banks would be governed by whatever restraints are contained in the applicable state legislation.

District growth and pressures

In the Twelfth District, member banks during the third quarter were under somewhat more reserve pressure than in the second quarter—and clearly were in a tighter position than a year ago. Excess reserves rose along with required reserves, but the level of bank borrowings at the Federal Reserve discount window was nearly twice the daily average for the second quarter. Average borrowed reserves of District banks exceeded their excess reserves (i.e., banks had negative free reserves) in over half of the bi-weekly settlement periods during the summer quarter.

Reserve pressure was also evident in District banks' transactions in Federal funds (purchases or sales of bank reserves on deposit with Federal Reserve Banks). In all but two weeks during the quarter, District banks were net purchasers of Federal funds in transactions with other banks. In late September, however, their interbank purchases were partially offset by heavy sales of Federal funds to Government securities dealers, since some banks at that time took advantage of the arbitrage between the purchase rate from banks and the higher selling rate to dealers. District banks, like banks elsewhere, thus showed alertness in utilizing every available means of increasing their supply of loanable funds.

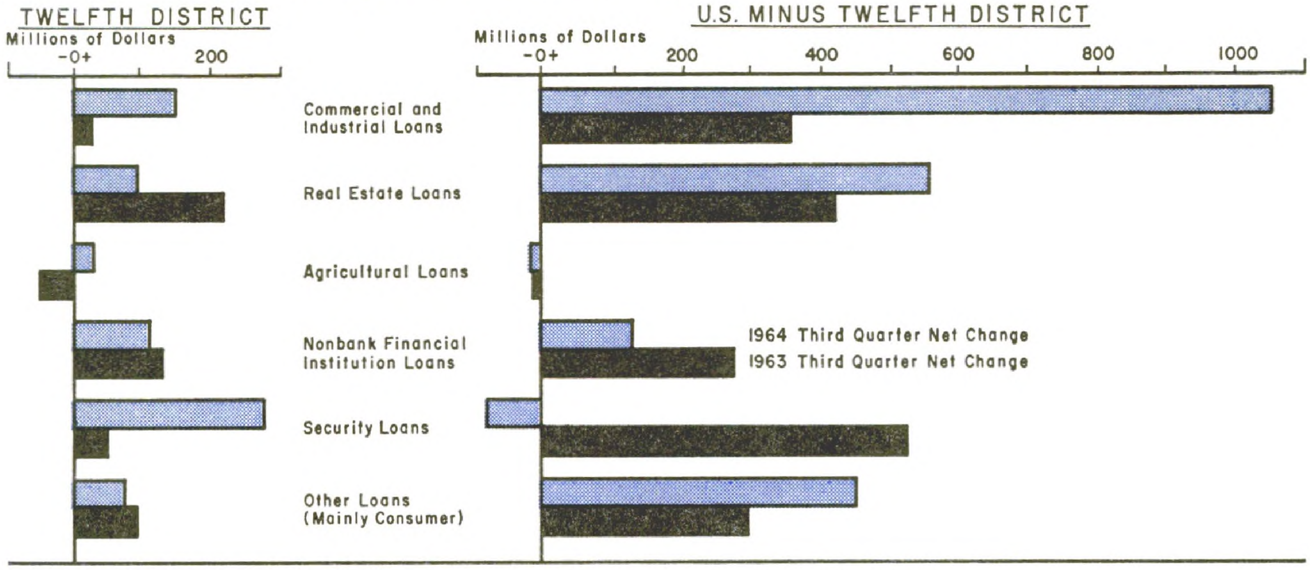
Weekly reporting member banks in the Twelfth District recorded a $920 million gain in total credit during the third quarter. This gain exceeded the second-quarter District increase, but fell slightly behind the recent pace of expansion at weekly reporting banks elsewhere. District banks added to both their loans and securities, but loans accounted for over two-thirds of the total increase in bank credit. It should be noted, however, that over one-third of the total expansion was due to bank financing of Government securities dealers—a form of short-term lending which characteristically fluctuates widely even over short time periods.

The total quarterly increase in security portfolios exceeded $200 million and was about evenly divided between U. S. Government securities and municipals. The net increase in Governments was due to bank investment in Treasury bills, which were acquired mostly in September; this net gain contrasted with the actual decline recorded in the first half of the year. In the municipal and Government-agency category, District banks also recorded a gain, although a smaller one than in the April-June period.

Mixed lending performance

Business demand for credit from District banks followed a rather irregular course during the third quarter, just as in the preceding period. Almost the entire net gain occurred in the month of August, although borrowing

District banks display strong gain in business loans, but lag behind year-ago pace in most other categories . . . other banks generally show increases



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

was also heavy over the mid-September tax date. The third quarter performance was far stronger than a year ago, largely because of heavy seasonal borrowing by food, liquor, and tobacco dealers and a contra-seasonal increase in bank indebtedness by retail firms.

Total loans to durable-goods manufacturers increased slightly during the third quarter, despite the continuing lack of loan demand from the metals-machinery-transportation equipment categories, which continued to reflect the weakness in the defense-manufacturing sector. Loans to nonbank financial institutions also expanded less than in the preceding period, since sales finance companies failed to expand their borrowing as much as they usually do around the quarterly corporate tax-payment date.

Business loan rates remained virtually unchanged nationally, but Western firms paid a higher average rate in the first half of September than in other recent periods. The average interest rate on short-term business loans at District metropolitan banks was 5.32 percent in September—13 basis points above the June rate and 8 basis points above the September-1963 average. In addition, only 33 percent of the total dollar volume of loans reported in the survey period was made at the prime rate of 4½ percent—compared with 40 percent in June and 37 percent a year ago. There was also some evidence of firmer loan terms, just as there was at banks elsewhere in the country.

The quarterly gain in District-bank mortgage holdings roughly matched the second-quarter gain, but—unlike the situation elsewhere—it fell far short of the year-ago increase. The relatively weaker District performance reflects both the downward trend in Western housing starts and the plenitude of mortgage funds available at competitive financial institutions. These developments have led to intense competition for mortgages—and to some indication of shading of rates and liberalization of terms. District banks probably have also been influenced in their mortgage-investment decisions by a slowdown earlier this year in their savings-deposit inflow and by their relatively high ratio of real estate loans to savings deposits.

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

(dollar amounts in millions)

	Twelfth District				U. S. Minus Twelfth District		
	Outstanding 9/30/64	Net Change: Third Quarter 1964 Dollars	Net Change: Third Quarter 1964 Percent	Net Change: 3rd Qtr. 1963 Percent	Outstanding 9/30/64	Net change: 3rd Qtr. 1964 Percent	Net change: 3rd Qtr. 1963 Percent
ASSETS							
Loans adjusted and investments[1]	$31,634	+920	+ 3.00	+ 1.07	$145,878	+ 3.43	+ 0.81
Loans adjusted[1]	22,481	+705	+ 3.24	+ 2.32	97,784	+ 2.88	+ 2.94
Commercial and industrial	7,213	+149	+ 2.11	+ 0.41	39,953	+ 3.33	+ 1.23
Real estate loans	7,521	+ 97	+ 1.31	+ 3.25	19,533	+ 4.90	+ 4.17
Agricultural loans	1,028	+ 27	+ 2.70	— 5.42	1,578	— 3.34	— 2.70
Loans to nonbank financial institutions	1,487	+113	+ 8.22	+10.90	8,558	+ 1.80	+ 4.42
Sales finance, personal finance, etc.	(548)	+ 31	+ 6.00	+ 6.38	(4,515)	— 0.63	— 0.13
Other	(939)	+ 82	+ 9.57	+13.87	(4,043)	+ 5.08	+10.44
Loans for purchasing and carrying securities	728	+274	+ 60.35	+14.66	6,796	— 1.38	+ 9.84
Brokers and dealers:							
U. S. Govt. securities	(376)	+267	+244.95	+70.89	(1,236)	+40.98	+49.05
Other securities	(228)	+ 9	+ 4.11	— 8.94	(3,558)	—10.39	— 3.94
To others:							
U. S. Govt. securities	(3)	— 4	— 57.14	+25.00	(81)	—10.34	—26.32
Other securities	(121)	+ 2	+ 1.68	+10.98	(1,921)	+ 3.45	+ 7.93
Loans to foreign banks	258	— 16	— 5.84	+ 0.92	1,239	+ 6.17	+13.89
Other (mainly consumer)	4,627	+ 74	+ 1.63	+ 2.29	22,234	+ 2.64	+ 1.97
U. S. Government securities	5,406	+102	+ 1.92	— 3.58	27,207	+ 3.94	— 8.61
Other securities	3,747	+113	+ 3.11	+ 2.21	20,887	+ 5.21	+ 6.89
LIABILITIES							
Demand deposits adjusted	12,417	+448	+ 3.74	+ 2.22	63,722	+ 2.50	— 1.32
Time deposits	18,030	+336	+ 1.90	+ 0.69	64,719	+ 2.87	+ 3.87
Savings accounts	13,694	+391	+ 2.94	+ 2.28	39,873	+ 2.48	+ 6.32

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

District banks recorded a slowdown in consumer loan growth, thus moving against the national trend, but their loan expansion for the year to date still exceeded the rate of increase at banks elsewhere. As in the first half of the year, loans for financing automobiles accounted for nearly two-thirds of net instalment-credit extensions in the District—a higher percentage of the total than nationally.

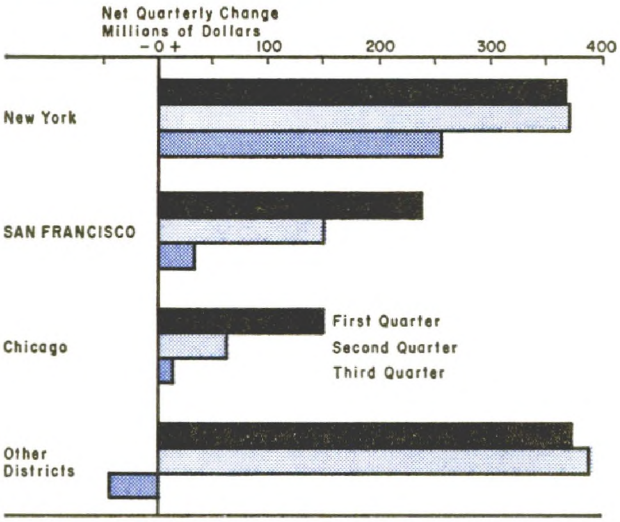
Time deposits and other flows

District weekly reporting banks recorded a $448 million gain in demand deposits adjusted during the summer quarter[1] in striking contrast to their second-quarter decline. On the other hand, total time and savings deposits showed a slower rate of growth, despite a striking $391-million rise in the savings-deposit inflow. The gain in savings was equal to the year-ago gain, even after subtracting the amount due to the crediting of quarterly interest, which was not reflected in the September data for 1963.

Other time categories showed a different pattern. Deposits of states and political subdivisions fell sharply, although partly for seasonal reasons, and negotiable time certificates of deposit recorded a declining rate of growth. Nevertheless, the San Francisco District stood second to New York in CD growth, just as it did in the earlier part of the year. The gap in

[1] Total demand deposits less cash items in the process of collection, U. S. Government deposits, and deposits of domestic commercial banks.

Significant slowdown in CD growth evident in all districts



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

outstandings thus continued to narrow between the Twelfth District and the Chicago District, which ranks next to New York in the volume of large-denomination CD's outstanding.

In other District financial developments, the net flow of savings into savings and loan associations was greater in the third quarter than in the preceding three-month period. However, the cumulative increase from the first of the year trailed the gain for the comparable 1963 period by 13 percent. The net expansion in mortgage portfolios exceeded the net increase in savings—as it had in the first half of the year—and part of the difference was financed by advances from the Federal Home Loan Board and other borrowings. But the rate of mortgage investment at these institutions, as at commercial banks, remained well under the year-ago pace.

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When the Paychecks Stop

THE nation is suffering from a disappearance of job opportunities and from a weakening of the traditional link between jobs and income, according to the Ad Hoc Committee on the Triple Revolution. That committee—a group of social scientists concerned with the "triple revolution" of automation, modern weaponry, and civil rights—thus has proposed to meet the problem with a guaranteed income for everybody ("an unqualified commitment by society to provide every individual and every family with an adequate income as a matter of right"). Needless to say, the proposal has been widely criticized in recent months, but the discussion has served to draw attention to the fact that incomes unconnected with current production—that is, transfer payments—are already growing at a very rapid pace.

Transfer payments—the payments used to maintain the income of families whose paychecks have stopped by reason of unemployment, disability, retirement, or death of the family breadwinner—have increased 40-fold in the West and 20-fold in the rest of the nation since 1929. (In per capita terms, they have increased about 15-fold in both areas.) In achieving this phenomenal growth record, transfer payments have played an important role in stabilizing the fluctuations in the business cycle as well as in redistributing income from higher to lower income groups. But how successful have they been in their stabilization role? How successful have they been in maintaining income for all segments of the population? And, more important, will they continue to grow as rapidly in the future as in the past?

Growth, and growth again

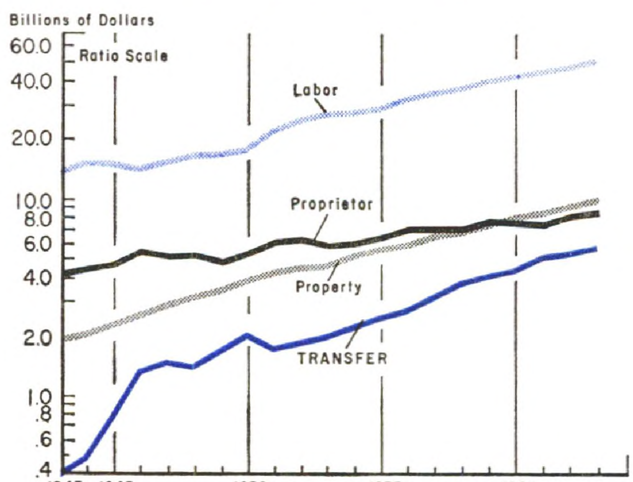
The past growth of transfer payments has indeed been phenomenal. They increased several-fold during both the depression decade and World War II. Then, during the last two decades, these payments increased 12-fold in Twelfth District States, from $1/2 billion to $6 billion annually, while they increased 10-fold in the rest of the nation, from $3 billion to $30 billion annually. Thus, since 1929, transfer payments have increased from less than 2 percent to more than 8 percent of personal income, both in the West and in the rest of the nation.

In all sections, the most striking gains in transfer payments occurred in the early postwar period, primarily under the impetus of substantial payments to veterans for education and retirement benefits. Transfer payments thenceforth continued to grow at a rapid pace, although not much faster than the types of income associated with current production. In any case, the West and the rest of the nation have participated equally in the recent rapid gains of both nonproduction (transfer) income and production income.

The aged and the jobless

Several types of payments have increased in close relationship with the over-65 popu-

Transfers rise faster in West than other sources of income



Source: Department of Commerce (Twelfth District data) lation. The West, during the postwar period, has recorded a gain in this age bracket from 1.2 million to more than 2.2 million persons. During that period, veterans' pensions in the West have grown from about $250 million to almost $500 million annually. Similarly, public assistance to the aged has increased from about $200 million to about $400 million.

One type of benefit—payments to old-age-survivors-disability insurance beneficiaries — has increased even faster. OASDI payments in the nine District states did not surpass $100 million until 1950, but they now total more than $2 billion annually. This sensational increase in OASDI benefits reflects not only the growth of the West's over-65 population; it also reflects the increasing percentage of beneficiaries among the aged and the increasing size of the average benefit check.

Several other types of transfer payments have also shown a rising trend, but a trend fluctuating in response to the fluctuations of the business cycle. An obvious example is unemployment insurance benefits. For instance, when unemployment in Twelfth District States rose from about 400,000 in 1957 to almost 600,000 in 1958, unemployment benefits jumped from $280 million to $560 million. But, then, as unemployment dropped to an average of 450,000 in 1959, insurance benefits also dropped, to about $390 million. General assistance payments followed a similar path, rising sharply in the 1958 recession year and declining in the 1959 recovery year. The same close relationship of unemployment insurance and general assistance payments to the level of unemployment was also obvious in the other cyclical movements of the postwar period.

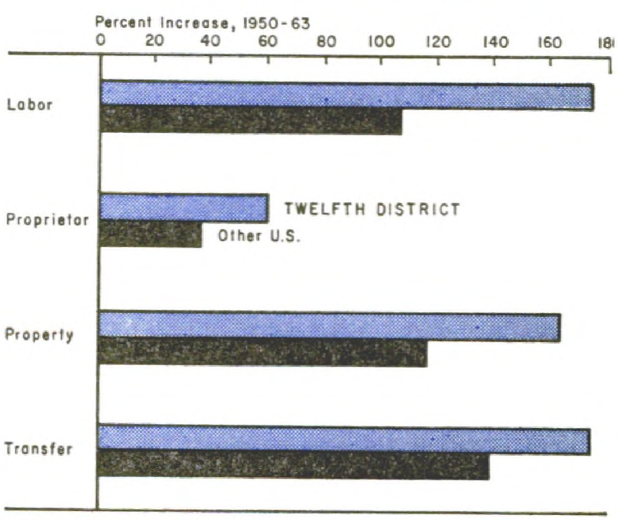
The general trend of transfer payments thus has been affected by the cyclical movement of unemployment payments and the slow or moderate rise of assistance payments and veterans' benefits. These factors, however, have been put in the shade by the continued rapid rose of OASDI benefits. Besides, the recent rapid growth of this public insurance program has been matched by the substantial growth of private income-maintenance programs (primarily employee-benefit plans); employer contributions for such programs came under the heading of "other labor income," which since 1950 has quadrupled in the West and tripled in the rest of the nation.

Response to modern life

The general trend throughout the century has been from private charity to private and public insurance. This trend represents the development of an institutional mechanism through which a highly industrialized urban economy channels income to nonworking groups in the same manner that the wage market mechanism channels income to earners.

Insurance programs represent a response to several characteristic features of an industrial economy: the mobility of the population, the widening area of consumer choice, and the importance of a sustained flow of consumer income and purchasing power. In most countries, for example, social insurance began as a program for those who were first drawn into the wage economy and made dependent on a cash income; thus, the first type

West outstrips rest of nation with record of rapid income growth



Source: Department of Commerce

of program to be adopted was insurance against risks incurred in factory accidents or in wartime injury. But the trend has been toward an increasingly broad coverage of risks and of population groups.

War on the business cycle

These various transfer payments — which were originally designed to insure wage earners against the risks of unemployment and disability and to provide them income in their old age—have increasingly served to smooth economic fluctuations as well. Transfer payments, of course, are only one part of the policymaker's set of cyclical stabilizers. But in recent decades they have helped to cushion the depressant forces associated with the downswing of the business cycle. Production has remained somewhat unstable, but the structure of the economy has changed in ways which have limited the effects of recessions on the lives of individuals—on the numbers who receive an income and on the amount of income they receive. Thus, much of the personal security derived in earlier ages from living on farms and in closely knit family units—security which had been disrupted by the onrush of industrialization and urbanization—has lately been restored through the development of the transfer mechanism and other new institutions.

Because of these new trends, the movement of aggregate personal income may no longer be quite so closely linked to the movement of aggregate physical production. During the postwar period the nation has suffered several brief but sizable setbacks in production; for example, in the 1957-1958 recession, industrial production dropped 14 percent. In earlier times, personal incomes would have responded decisively to such a decline in production. On that occasion, however, transfer payments rapidly increased, and, along with other cyclical stabilizers, maintained personal income at a stable level.

An essential role in stabilizing income during the several postwar cycles was played by the cyclically responsive unemployment insurance system. Another essential role was played by the burgeoning OASDI program. These systems, designed originally to overcome different types of individual risks associated with an industrial economy, thus have worked just as effectively to overcome the general industrial problem of the business cycle.

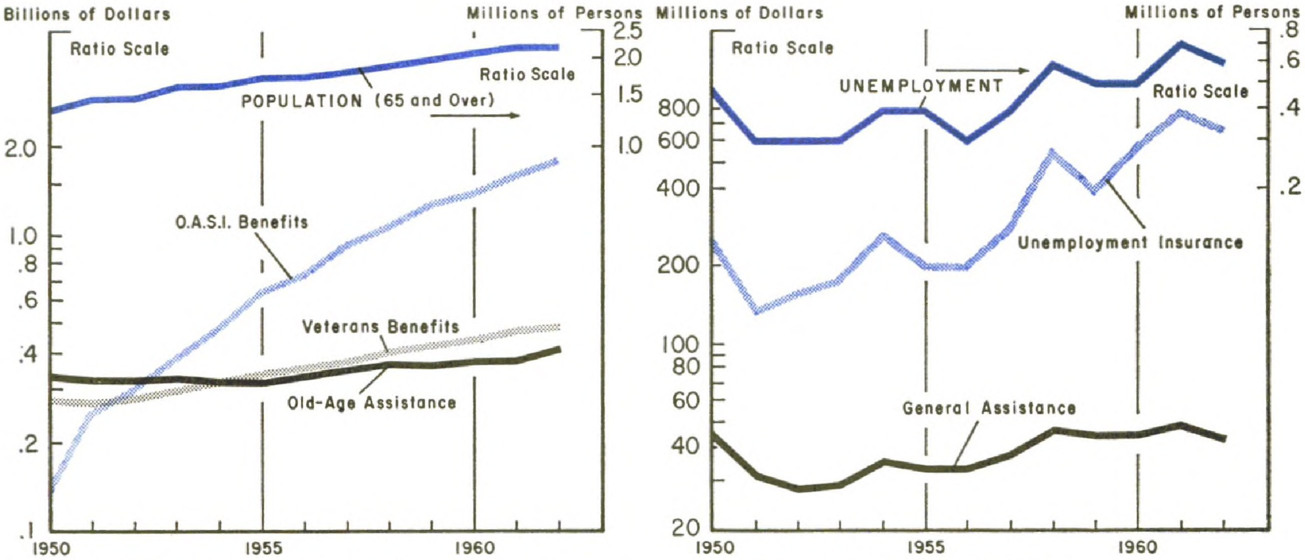
War on poverty

These programs, moreover, have been effective in the fight against poverty. In other words, they have played an important role in the attempt to break the vicious circle in which poverty breeds poverty. This is the situation described by the Council of Economic Advisers in its 1964 Annual Report: "A poor individual or family has a high probability of staying poor. Low incomes carry with them high risks of illness, limitations on mobility, and limited access to education and training. Poor parents cannot give their children the opportunities for better health and education needed to improve their lot. Thus the legacy of poverty is passed from parents to children."

Transfer payments play a key anti-poverty role because poverty would be more prevalent and more serious if such payments were unavailable. In 1960, for example, transfers constituted 7 percent of total family income in the nation, but they amounted to 43 percent of the total income of low-income spending units. Moreover, many people have been kept from falling into a lower-income status through their receipt of retirement and other benefits.

In general, the lower the income the more important the role of transfer payments in maintaining income. About two-thirds of all families with less than $1,000 in income receive transfer income, while such payments

Old-age insurance benefits expand at much faster rate than aged Western population . . . jobless benefits reflect unemployment shifts



Sources: Social Security Administration; Department of Labor; Bureau of the Census (Twelfth District data)

go to only about one-half of those in the $2-3,000 bracket and to a little over one-third of those in the $3-5,000 bracket.

These payments represent a shift in income from higher income groups to lower income groups, even though the shift is modified by the regressive nature of the taxes used to finance insurance-type programs. In general, the various programs work to shift income from taxpayers to nontaxpayers, from younger to older workers (whenever past service is recognized in adopting or liberalizing pension plans), and, most fundamentally, from the actively productive members of society to those who have ceased to contribute to current output. This transfer of resources, of course, is not altogether new; the working population has long contributed voluntarily to the care of relatives or through government to the care of the needy. Indeed, it may be argued that social insurance and supplementary programs have only institutionalized and liberalized the provisions previously made for those no longer able to support themselves.

Spurious trend?

In any case, the transfer mechanism may tend to overemphasize the trend towards income redistribution. The most rapidly growing type of transfer payment—the contributory or insurance type — works to average income over time, but any averaging of this type tends to reduce relative income dispersion. In fact, as personal income distributions move increasingly from a when-earned to a when-disbursed basis, the question may be raised as to what extent the long-term drift toward income equality represents changes in the timing of the compensation for services currently rendered rather than changes in the earning capacity of those engaged in production.

The method of financing contributory transfer systems also raises questions about the strength of the trend towards income redistribution. The lower income brackets benefit most from such transfer payments, of course, but these brackets also pay a greater proportion of their income for their insurance protection. In other words, OASDI and similar programs are financed through regressive taxes—taxes which become increasingly regressive as the contribution rate increases over time. (The OASDI system originally called for a 1-percent employee contribution rate on the first $3,000 of earnings; now, however, that rate is 3.625 percent on the first $4,800 of earnings, and it will rise to 4.625 percent three years from now.) In this case, then, the attainment of complete insurance protection may tend to hinder the attainment of income redistribution.

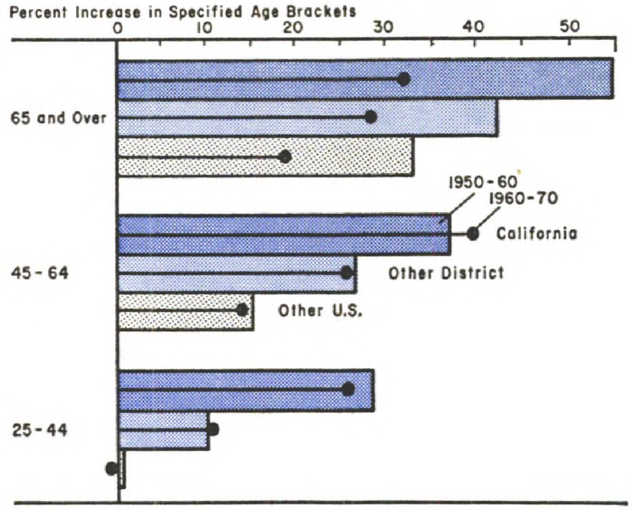
Growth all but certain

The income-redistribution effects of contributory transfer programs consequently are not quite so clear-cut as they might appear at first glance. One clear-cut conclusion does arise, however, from any analysis of the subject: the continued growth of private and public expenditures on such programs appears all but certain.

A strong expansionary pressure in the field of private pensions will arise from the eventual maturity of such systems, as more and more workers become covered and then retire. The number of private pension beneficiaries increased from 0.7 million to 2.3 million between 1950 and 1960; the number of beneficiaries in 1980 should be almost 8 million. The dollar volume of pension payments should also expand rapidly, in view of the expanded coverage and the expanded size of the average pension check as well as the growth in the number of beneficiaries.

Another strong expansionary pressure will arise from the maturity of the public pension system, especially the OASDI program. Here, too, the number of beneficiaries will continue rising; retirement and survivor beneficiaries, who increased from 2.6 million to 11.8 million between 1950 and 1960, should total more than 25 million in 1980. Under present law, moreover, the average annual payment to retirees will double between 1950 and

Aged population grows faster than rest of adult population



Source: Bureau of the Census.

1980. More important, the *actual* average benefit will probably be even higher, in view of the Congressional tendency to increase benefits in line with increased earnings of covered workers. (If the 1964 House bill had passed, average benefits would have risen 5 percent.)

Retirement pressures

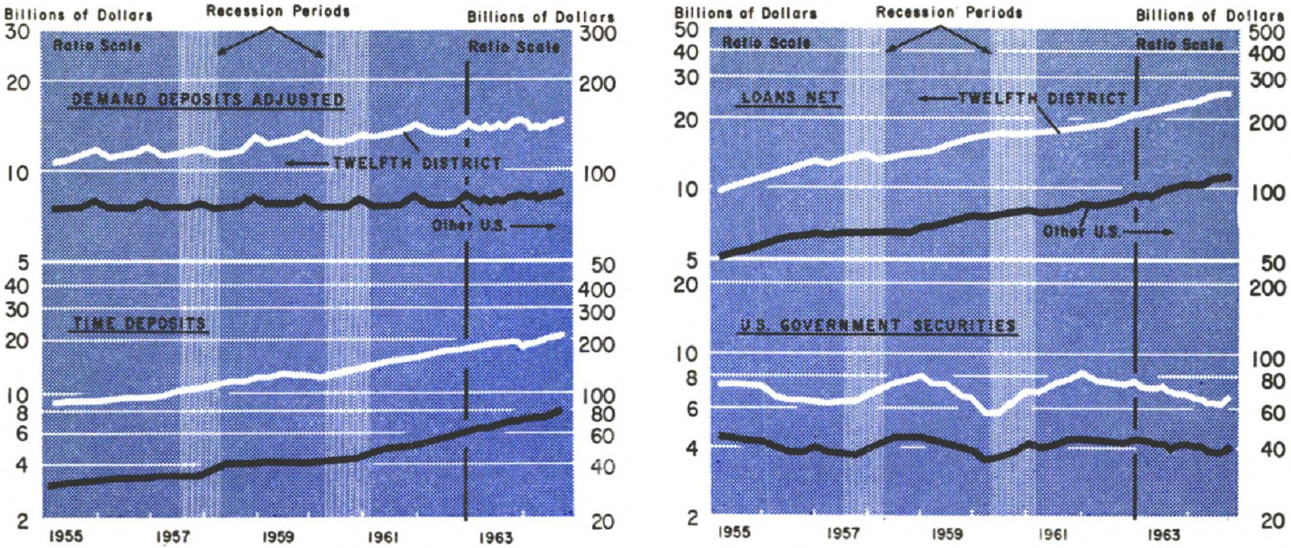
Another strong pressure to expand total pension payments results from the current downward push on the average age of retirement. The squeeze has developed because of the rapid pace of modern industry, which frequently obsolesces the skills of older workers, and also because of the job demands of the young workforce which is expanding as a result of the postwar population boom. In earlier years, the income-maintenance cost of unemployed older workers could have been allocated to the unemployment insurance system. Now, however, much of this cost is allocated to public and private pension plans through the mechanism of enforced retirement at younger ages.

This trend became evident in 1961, with the passage of an amendment to the Social Security Act, which permitted the payment of reduced retirement benefits to male workers at the age of 62. The same trend was also strongly evident in the similar changes made in many private pension agreements. Between 1953 and 1959, for example, the proportion of auto workers who retired before age 65 increased from 4 percent to 19 percent, and the proportion has increased even more in the last few years. In fact, the trend will probably accelerate as a result of this year's auto contract, which permits—and even encourages—retirement at age 60.

The increased numbers of beneficiaries and of early retirees, along with the expansion of average benefit payments, thus create a strong trend towards higher expenditures on private and public pensions. Expansionary pressures on unemployment benefits may be somewhat weaker, however, especially if unemployed workers drop out of the labor force instead of continuing to look for work—and also, of course, if the economy remains generally buoyant. Expansionary pressures on noncontributory assistance programs may also be relatively weak, particularly in view of the past and future growth of contributory insurance plans. Even so, some expansion of assistance payments can be expected, because of the continuing needs of those who have so far been unable to break out of the vicious circle of poverty and who have failed to qualify for insurance plans.

The general picture, then, is one of continuing expansion in transfer payments, even in the absence of the guaranteed income demanded by the Ad Hoc Committee. But, paradoxically, that goal of guaranteed income may eventually be achieved through the income-insurance approach—the approach underlying the rapid expansion of private and public retirement plans. These plans are based on a close relationship between past production and future income, and their rapid growth bears witness to the continued applicability of the Puritan Ethic to the American economy.

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											
October	22,387	6,698	14,106	18,727	167	...	118	127	108	112	102
November	22,673	6,730	14,272	18,923	170	...	118	130	106	110	110
December	22,915	6,651	14,179	18,942	167	5.47	118	136	111	110	112*p*
1964											
January	23,256	6,575	14,332	19,342	163	...	119	135	115	111	116*p*
February	23,544	6,832	14,222	19,520	168	...	119	137	114	115	123*p*
March	23,763	6,893	14,287	19,685	166	5.47	119	133	114	113	136*p*
April	23,953	6,559	14,243	19,773	170	...	119	134	101	111	143*p*
May	24,102	6,541	14,170	19,813	167	...	119	139	106	112	142*p*
June	24,394	6,489	14,347	19,876	167	5.46	119	137	105	114	131*p*
July	24,836	6,215	14,369	20,152	166	...	119	141	111	115	121*p*
August	24,865	6,170	14,362	20,195	175	...	120	143	107	118	121*p*
September	25,251	6,507	14,674	20,452	167	5.51	120	137	121	121	129*p*
October	25,141*p*	6,472*p*	14,580*p*	20,601*p*	173	...	...	...	...	...	132*p*

[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.