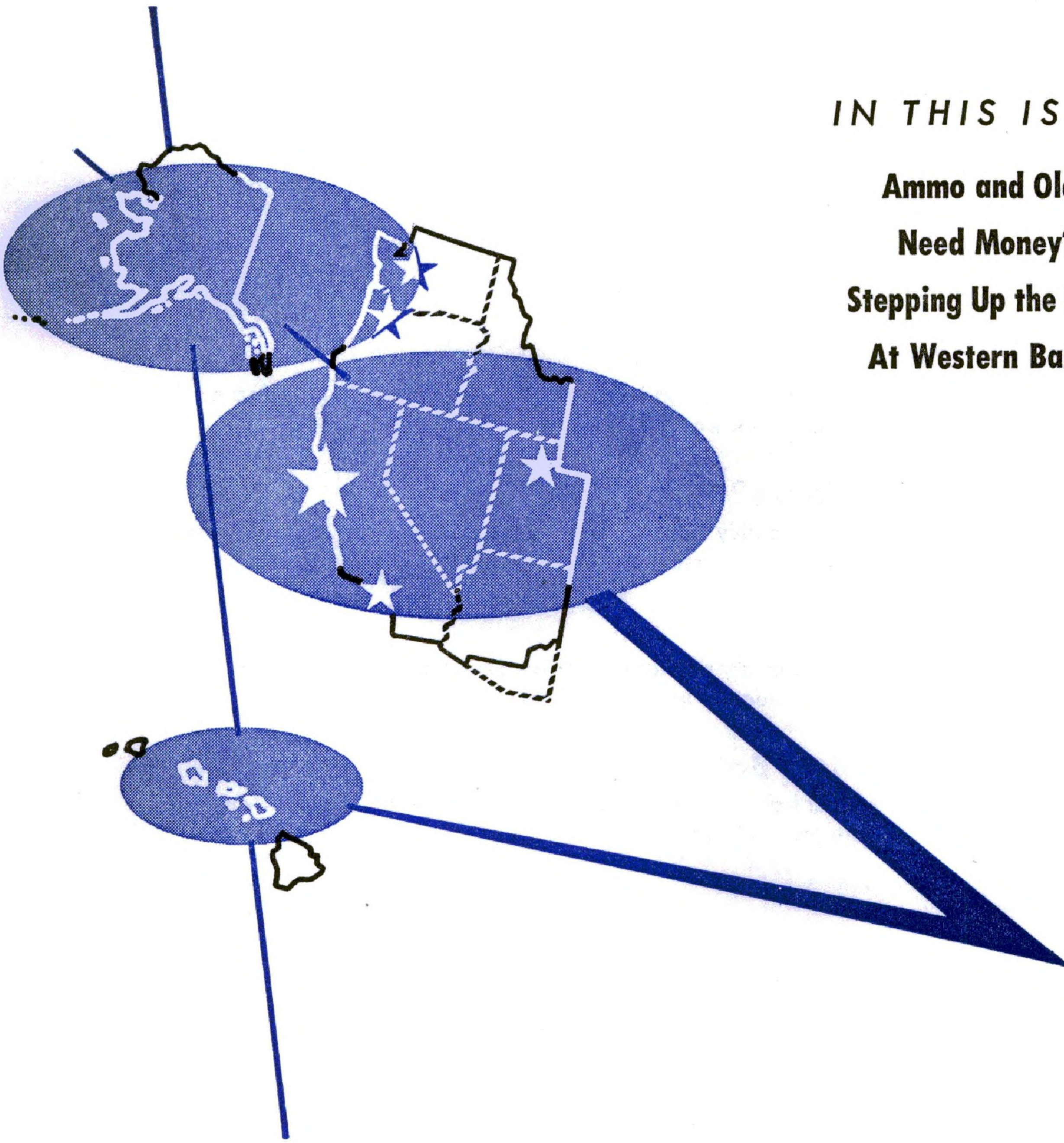
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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Editor: William Burke

Ammo and Oleo

THE nation's guns-and-butter economy continued to surge upward in early 1966, as GNP rose 2½ percent in the January-March quarter to a $714-billion annual rate. Consumers, businesses, and government agencies all accelerated their buying pace, but the defense boom and the plant-equipment boom dominated the headlines.

Part of the GNP increase represented higher prices, as business purchasing agents spent more to keep production lines humming and as housewives spent considerably more to replenish family larders. Nonetheless, most of the first-quarter gain represented a real gain in physical output—witness durable-goods production, which has now risen as much in the past twelve-month as in the two previous years combined.

Since last fall, the Federal Reserve production index has increased about 1 percent a month—far above the average gain of the 1961-65 expansion—and the output of business equipment has increased more than 1½ percent monthly. Vigorous advances have been reported in all three business-equipment categories — commercial, industrial, and freight-passenger equipment.

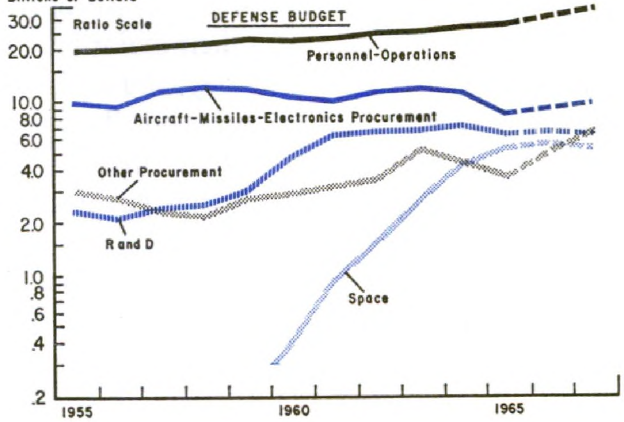
Commercial equipment production has climbed steeply over the past year after remaining stable in the 1963-64 period. The hefty gains in this category have reflected the need to furnish new office buildings and stores with the most up-to-date and sophisticated equipment, especially electronic data-processing equipment. Production of industrial goods meanwhile has risen sharply as a consequence of the rapid expansion of business investment plans. And the boom in freight-passenger equipment has developed because of stepped-up requirements of several major customers—the military, the railroads, and the commercial airlines.

On the firing line

Defense spending jumped 6 percent in the first quarter (and 10 percent over the past half year) to a $55-billion annual rate in early 1966. At that figure, defense spending was almost up to the level projected for fiscal 1967 in the Administration's budget document. But even with this sudden increase in dollar spending, defense expenditures held stable at about 7½ percent of GNP, the same relatively low level maintained in 1965. By way of contrast, defense spending in the Korean period jumped from 5 percent of GNP in 1950 to 13½ percent in 1953.

The rapid expansion of the defense sector in the 1965-66 period is due partly to the increased cost of feeding, supplying, and paying 400,000 new military recruits and hiring 80,000 new civilian employees for the Pentagon. In addition, an important share of the increased spending is due to procurement of major equipment, especially conventional weapons. The Vietnam war requires substantial purchases of helicopters and transport and tactical airplanes, along with ground vehicles and anti-submarine and fleet-support equipment. On the other hand, the fiscal 1967

Pentagon spending plans dominated by conventional-war requirements



budget envisions a levelling off in spending for strategic retaliatory forces and research and development.

Throughout early 1966, most business analysts have been concerned with the impact of rising defense spending on business activity when it is added atop a boom in the plant-equipment sector. In other words, they have been worried that the economy could not produce substantially more ammo and oleo without simultaneously creating unbearable inflationary pressures.

It is true that an expansion in activity in any one sector of the economy could produce inflation if no slack were being generated in the other sectors. And it is true that this potential problem becomes more likely to occur as the expansion increases in magnitude, as it does when two or more sectors—defense and capital investment in this case—expand simultaneously by sizeable amounts. Nonetheless, in the highly productive technology that is ours, considerable slack is continuously being generated by the expansion and advancement of technology. The presence or absence of inflationary pressures thus depends on the rate of increase in expenditures in relation to the speed with which new productive capacity comes on stream.

Moreover, some observers argue that the greatest impact of the Vietnam boom has already occurred, in view of the historical fact that the principal impact of military procurement takes place long in advance of the actual expenditure of funds. Government procurement actions exert their major impact on the markets for men, money, and materials at the order stage. Thus, their contribution to economic activity occurs during the production period prior to the actual government purchase.

Without doubt, the Vietnam buildup has already involved a very strong impact on business activity. Military prime contract awards, at about $24 billion in the first three quarters of fiscal 1966, have run about one-third higher than awards in the comparable period of fiscal 1965. But with defense spending nearing its budgeted peak and with new obligations actually budgeted to decline, any new stimulus will come about only through the further escalation of Vietnam requirements. Yet the latter possibility is easily imaginable, in view of all that has happened since the budget was published in January—in particular, the development of plans to increase the Vietnam commitment from 250,000 to 400,000 troops.

On the production line

Business fixed investment rose about 5 percent in the first quarter, to a $75½ billion annual rate, and this sector undoubtedly will expand even more in coming months. The Commerce-SEC survey projects a 16-percent gain in plant-equipment spending in calendar 1966, and the more recent McGraw-Hill survey indicates an even larger 19-percent gain. If even the lower figure is correct, plant-equipment spending will rise just as rapidly this year as in 1965—and of course spending could be considerably higher, in view of the fact that last year's gain was initially estimated at only 12 percent rather than the 16 percent actually achieved.

Certainly a number of upward pressures are still in evidence. Business to date has needed every bit of new capacity that it could bring on stream, and until recently it has been able to obtain the funds to meet its expansion needs. On the other hand, ample financing is not quite so certain today as it was in the earlier years of this plant-equipment boom. Businessmen are now encountering signs of a credit squeeze at their banks, and they are also faced with the possibility of a termination of the 7-percent investment credit as well as the certainty of Administration pressures to reduce nonessential expansion plans.

Inventory accumulation averaged about $8 billion (annual rate) in early 1966—about the same high rate maintained during the second half of 1965. Purchasing agents in many industries continued to scramble for stocks in the winter months, but signs of a less voracious appetite for inventory began to appear as the year advanced.

In autos, dealers now have a record 1.6-million new cars in stock, and in view of the relative weakness of sales in April they may find this level of inventories to be excessive. In steel, producers are operating at a high but stable level of 140-million tons annual production, and steel consumers appear to be generally satisfied with the moderate amount of inventory accumulation made possible at this production level.

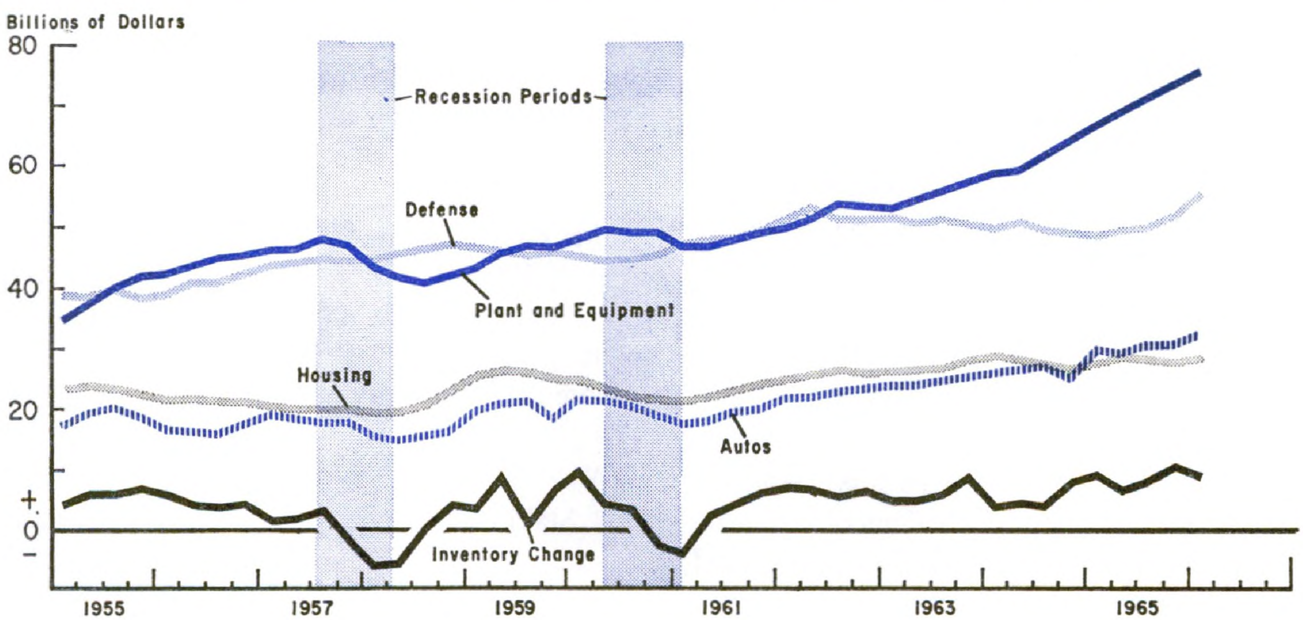
In the showrooms

Consumer spending in first-quarter 1966 was up sharply, with major gains occurring in food (up 3 percent to a $105-billion annual rate), and autos (up 5 percent to a $31½-billion rate). With families buying at such a frantic pace, the saving rate dropped to only 4.8 percent of disposable income from the average 5.5-percent level maintained throughout the 1961-65 boom.

The sustained four-year-old auto expansion extended into the first quarter of 1966, undoubtedly because of the continuing strength of the factors which provided the underpinning for the earlier upsurge. Last year's boom benefitted from a sharp rise in personal income; in real terms, per capita disposable income increased as much in the last two years as in the eight preceding years combined. Reduced auto prices were also important, as retail prices of new cars remained on the downtrend as they had ever since 1960. Then, again, ample auto credit was available through 1965, as interest rates remained low and maturity terms stable. Also, there was a heavy replacement need, as scrappage increased from 4.3 to 5.7 million cars over the 1961-65 period. And, finally, there was the rapid expansion in the number of persons of driving age, with the number of 18-year-old civilians increasing over one-third in 1965 alone.

Yet, some questions occurred about the strength of the boom as the spring quarter got

Defense boom and plant-equipment boom control the headlines, but almost all segments of the economy accelerate their spending pace



underway. In April, only about 8.2-million new car sales were recorded, at an annual rate, as against the 9.7-million first-quarter rate. As a result, Detroit's marketing men began to see weaknesses where only strengths had been apparent heretofore. In recent months, income gains have been restricted by increases in social-security and withheld income taxes—and also by rising prices, especially rising prices of necessities such as food. Moreover, in the credit field, auto financing has not been quite so easy to obtain as before. And as far as drivers are concerned, more and more young men are now forced to rely on military car pools rather than used-car lots for their transportation needs.

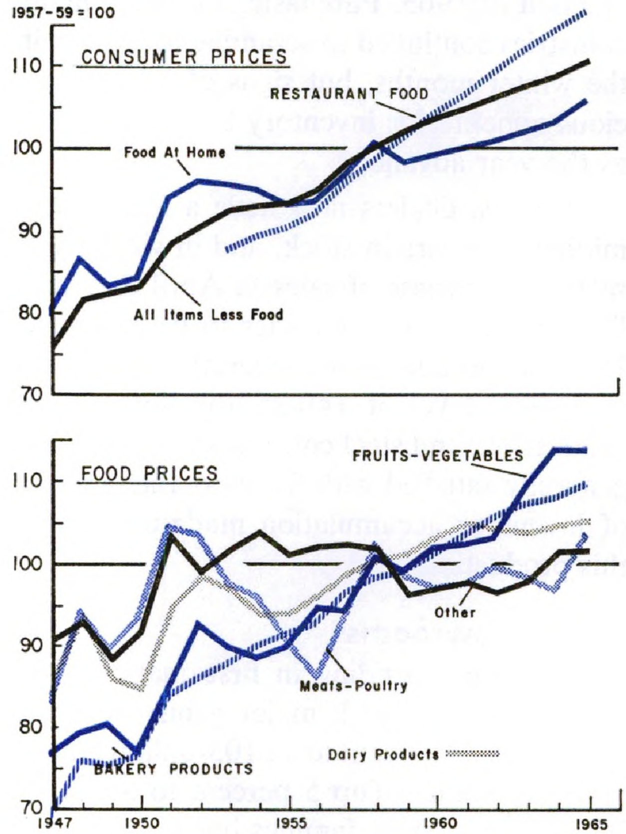
New housing, another consumer big-ticket item, recovered to a $28-billion annual rate in the first quarter of 1966. Nonetheless, there were few signs of a strong upturn in this somewhat depressed industry, especially as the first-quarter annual rate of housing starts (1.5 million) remained only about even with the relatively low 1965 average.

The Vietnam war was involved in this housing picture, to the extent that service call-ups tend to curb the formation of new households while defense demands take men and skilled labor away from residential construction. More important, builders were increasingly concerned about the lessened availability and higher costs of mortgage funds. They remember that new housing starts dropped 20 percent in less than a year during the 1959-60 period of financing stringency. And although few builders foresee a decline of any such magnitude today, even fewer foresee any near-term upsurge under present conditions.

Pressure on prices

In general, as the spring quarter got underway, a rapid production pace was visible almost everywhere, although signs of a slightly less frantic pace were cropping up here and there. At the same time, indications of price

Sudden jump in meat prices
boosts cost of family budgets



pressure were evident on every hand, although again, scattered signs of possible softening were occasionally visible. Yet, in the March survey of the National Association of Purchasing Agents, not one single purchaser reported any indications of lower prices.

The average household was most concerned with the very evident increase in the consumer price index. This index rose 1.2 percent in each of the years 1962, 1963 and 1964, but the rate of increase then doubled between early 1965 and early 1966. The basic reason: food no longer is a bargain. Virtually all of the past year's advance in the price index for commodities is attributable to higher food tags, since the retail price of food has risen twice as fast as the price of other items.

Stability in food prices was the keynote until about a year ago. Farm prices trended downward for years under the impact of heavy supplies, wholesale food prices remained relatively stable, and retail prices increased only modestly. Then, however, a sudden jolt occurred in 1965 as livestock supplies sank and prices soared. The number of hogs on the farm dropped one-tenth below the 1960-64 average in early 1965, the number of cattle and poultry failed to increase enough to offset the heavy demand for meat—and the housewife consequently suffered.

Agriculture Secretary Freeman recently tried to appease housewives, and thereby irritated many of his farm supporters, by announcing that farm prices should drop 6 to 10 percent by late 1966 as the supply situation improves. (In April alone, farm prices dropped 2 percent.) But farm-price declines do not necessarily show up at the checkout counter; USDA food specialists suggest that retail prices may drop only about 2 percent by yearend, thereby erasing only about one-third of the increase recorded over the past year. Yet, with 7 percent more little pigs now coming to market, the price trend may turn down.

Pressure on policy

With pressures on capacity and on prices continuing to be evident in spring 1966, the question for policymakers today is whether greater fiscal efforts should be taken to slow down the pace of growth to a more sustainable rate. MIT Professor Paul Samuelson, the man who wrote the textbook, recently said, "The issue is no longer growth vs. stagnation. It is maintainable long-term growth vs. a frenzied scrambling for limited resources." Thus, in the view of Professor Samuelson and his supporters, "The President should bring in a tax program before midyear."

Proponents of a tax increase argue that the economy needs a strong dose of fiscal restraint, over and above the measure of restraint that has already been achieved. Receipts on a national-income basis originally were estimated to rise from $120 billion in fiscal 1965 to $129 billion in fiscal 1966. Actually, receipts may run about $1 billion higher on this basis, because of the continued acceleration in business activity; in addition, another $2 billion may be pulled in by a recently instituted twice-a-month tax collection for 75,000 large employers, although this latter development does not show up in the national-income accounting. And, according to current projections, revenues in fiscal 1967 will rise even faster than in the fiscal period now coming to a close.

The 1967 budget calls for a record $7-billion increase in income-tax collections. This increase should develop because of the rise in personal income and in corporate profits resulting from the business boom, because of the rise in tax liabilities resulting from a shift of taxpayers to higher tax brackets, and because of the reduction in under-withholding and deferred payments caused by the institution of graduated withholding rates. The budget also anticipates a minor increase in excise-tax collections arising from the restoration of auto and phone excises and a rise in transportation user charges—plus a substantial $5-billion increase in social-security tax collections because of two successive rate increases and the recent lifting of the social-security tax base to $6,600. Thus, a surplus instead of the previously expected deficit may develop in fiscal 1967—just as is apparently happening in the closing months of fiscal 1966.

In general, the 1967 budget seems to say (1) that the national economy can grow considerably and provide large increases in tax revenues as it grows, and (2) that the cost of the Vietnam war will not require more resources than were originally budgeted. If either of these two assumptions turns out to be wrong, price pressures may become increasingly dangerous, and tax-increase demands may become increasingly clamorous.

William Burke

Need Money?

As the boom continued, the nation's credit markets exhibited a vigorous amount of activity during the first quarter of 1966. The business sector again accounted for the bulk of these credit demands, as the bond market witnessed a record amount of first-quarter borrowings and the commercial banks experienced heavy business demands for bank credit. State and local governments also increased the volume of their debt to near-record proportions. Consumers added heavily to their borrowings but they also stepped up the volume of repayments, so outstanding consumer debt grew at a slower pace than heretofore. For its part, the Federal Government covered its cash deficit largely by drawing on its operating balances.

Monetary policy moved further in the direction of firmness during the quarter, against a backdrop of continued strong credit demands and mounting pressures on the price level. As member commercial banks moved to meet these credit demands in the face of a slowdown in their deposit growth, they increased their borrowings from the Federal Reserve System by $17 million to a $477-million average during the quarter (and to $551 million in March). Banks' excess reserves declined, and their net borrowed reserves rose by $67 million to $134 million for the quarter (and to $250 million in March).

Admittedly, reserve positions were tighter in earlier periods of monetary stringency, but the situation nonetheless in early 1966 was quite tight, as evidenced by a decline in commercial-bank liquidity to a postwar low. Moreover, the nation's money supply increased during the quarter only at a 4-percent annual rate—somewhat below the average 1965 growth.

Most obvious symptom

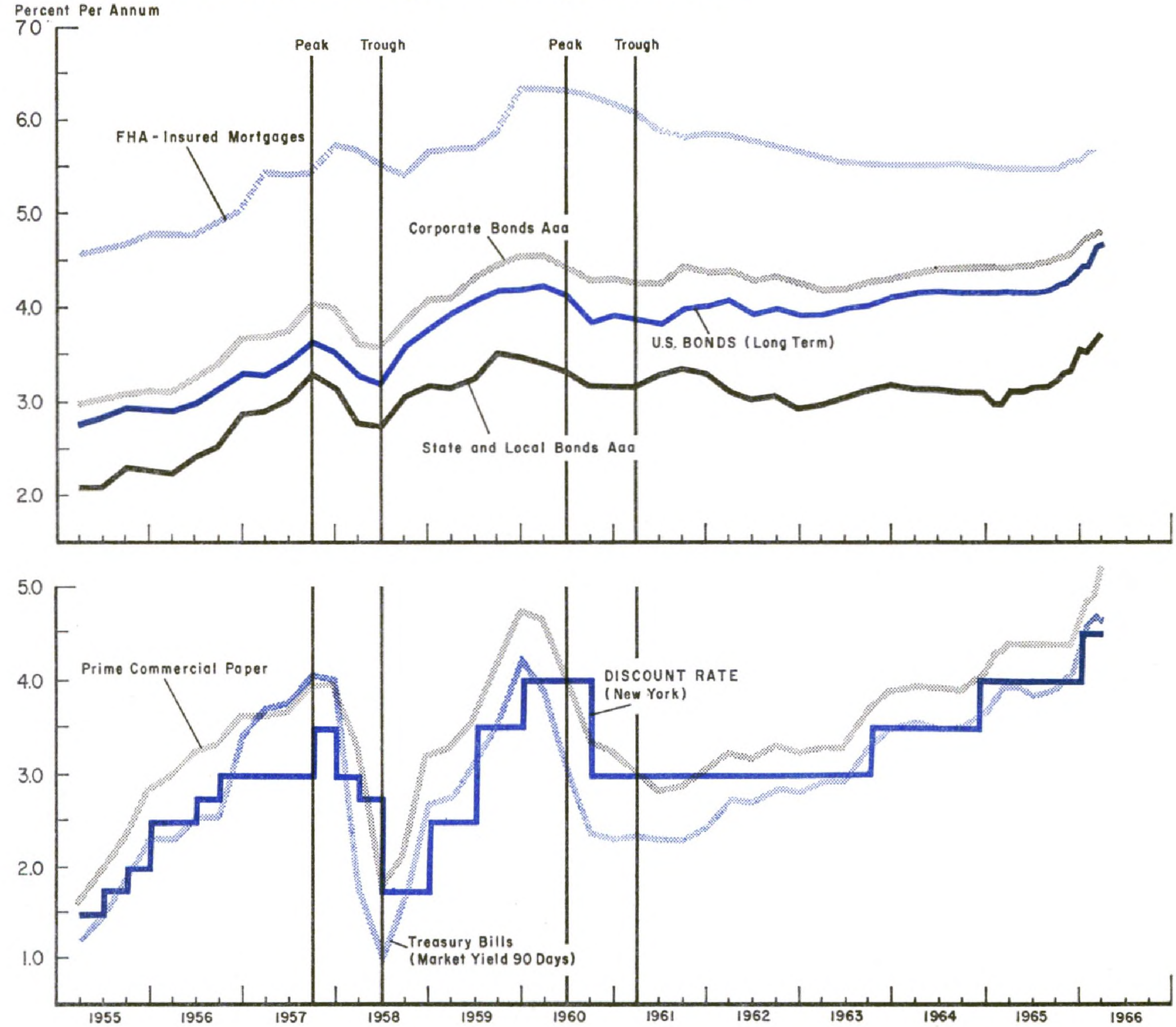
The most obvious symptom of tightness was the rising level of interest rates. Some yields reached postwar highs during the quarter, although the yield pattern became somewhat mixed during the latter part of the period. A number of factors were involved in this shifting pattern—the record volume of corporate, municipal, and agency offerings, the budget uncertainties created by the Vietnam war, and the possibility of a tax increase to offset mounting price pressures.

Yields on top-rated corporate issues rose 26 basis points, to a record 4.99 percent by the end of the quarter, as the market attempted to absorb a record $4.4 billion in corporate debt offerings. The mortgage market also firmed, as yields on conventional and government-backed mortgages reached three-year highs. This development primarily reflected the continued reduced flow of savings into mortgage-lending institutions and the continued strength of competing credit demands, rather than any increase in demand for mortgages.

At the short end of the maturity range, commercial paper rates increased rapidly to 5.25 percent by the end of March. But the Treasury 90-day bill rate, after rising sharply around the turn of the year, drifted down from 4.66 percent to 4.50 percent between mid-February and late March. Yields on a wide range of other debt instruments behaved similarly, with sharp rises in early 1966 being followed by some retreat thereafter.

In the tax-exempt market, firmer prices and easing yields developed after the withdrawal of a $400-million New Jersey turnpike issue. In the bill market, easing yields were attributable to the expectation of higher tax receipts arising out of the business boom or possible tax increases. The decline in the yield on Treasury bills occurred in the face of heavy liquidation of bills by commercial banks, and

Monetary tightness seen in rising level of interest rates . . .
some yields reach all-time highs in first-quarter 1966



also in the face of an early-March increase in the prime rate, which the market apparently discounted in advance.

Banks' pivotal position

Commercial banks continued to occupy a pivotal position in the credit markets during early 1966, with a $5.9-billion increase in total bank credit (seasonally adjusted). This increase, however, fell somewhat short of the average 1965 pace of credit expansion, despite the substantial strength of business borrowing needs. Mortgage lending increased at about the 1965 pace, with a $1.1 billion increase, but slower growth occurred in consumer loans, security loans, and especially in municipal and agency issues, for a combined increase of $1.4 billion. But most important, banks reduced their holdings of U. S. Government securities (especially bills) by $2 billion—or about two-thirds of the entire 1965 reduction.

The liquidation of securities was made necessary by banks' efforts to accommodate the rapid pace of business credit demands. The $3.4-billion increase in business loans (a 20-

percent annual growth rate) roughly matched the early-1965 pace of expansion despite the absence of the several special factors which boosted total borrowing last year—that is, the need to finance shipments delayed by the East Coast dock strike, and the need to finance inventories accumulated as a steel-strike hedge. Moreover, business loan demand this year was extensive as well as intensive; 14 of 18 major industrial groups increased their borrowings from weekly reporting banks during the quarter.

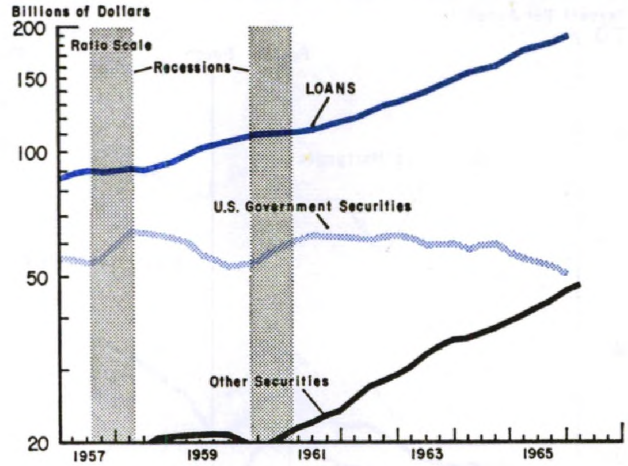
The banks reacted to the heavy credit demand by boosting the prime rate to 5 percent in December and to 5½ percent in early March. This move was undertaken, at least partly, to encourage borrowers to shift their long-term financing demands from the banks to the capital market. At the same time, the Administration encouraged businesses and state and local governments to postpone their capital spending plans wherever possible to reduce the mounting pressures on supplies of labor and material.

Higher price for deposits

Bank deposit growth slowed down from the average 1965 pace, as demand deposits rose $1.1 billion and time deposits $2.6 billion during the quarter (seasonally adjusted). In addition to the slower growth, banks experienced higher prices for their borrowed money as the quarter progressed. Faced with firming yields on other market instruments and with the maturing during March of $16 billion in time deposits (including $4 billion in large-denominaton certificates of deposit), banks increasingly relied on price in order to compete for the available supply of loanable funds.

In early March, an increasing number of banks moved to the 5½ percent permissible ceiling on longer-term CD's and to 5¼ percent on shorter-term CD's. Meanwhile, in order to tap the market for smaller savings, they progressively reduced the minimum denomination of CD's.

Banks reduce Treasury-bill holdings in order to meet loan demand



In addition, banks expanded their issuance of nonnegotiable CD's so as to forestall the loss of funds held in passbook savings at the increasingly noncompetitive 4-percent rate permitted under Federal Reserve Regulation Q. This tactic worked rather well; following the crediting of quarterly interest in the last week in March, banks experienced a very sharp decline in their savings accounts but a concomitant gain in funds held in the form of savings certificates and time deposits.

Savings and loan associations attempted to maintain their competitive position in this scramble for savings in several different ways. Some Western associations took advantage of a Home Loan Bank Board ruling which permitted a 5-percent rate on 6-month $2,500 special certificate accounts. Moreover, some of these associations posted a 5-percent rate on their regular savings accounts, even though they limited their borrowing privileges at the Home Loan Bank by such a move. But despite all this, savings and loan associations and mutual savings banks recorded a slower rate of savings inflow during early 1966 than in the year-ago period, and the commercial banks continued to garner the lion's share of funds flowing into savings institutions.

Verle Johnston

Stepping Up the Pace

THE Western economy stepped up its pace sharply in recent months. Total employment increased by about 1½ percent in both the fall and winter quarters, in contrast to the 1-percent average quarterly gain recorded during the preceding year, and the faster pace was visible in practically all of the region's major industries.

With employment opportunities increasing, the jobless rate dropped to 4.7 percent in the first quarter of 1966—down from 5.3 percent in the fall quarter and 5.6 percent in January-September 1965. But the West's jobless figure still appeared strikingly high when compared with the 3.7-percent rate achieved nationally in early 1966.

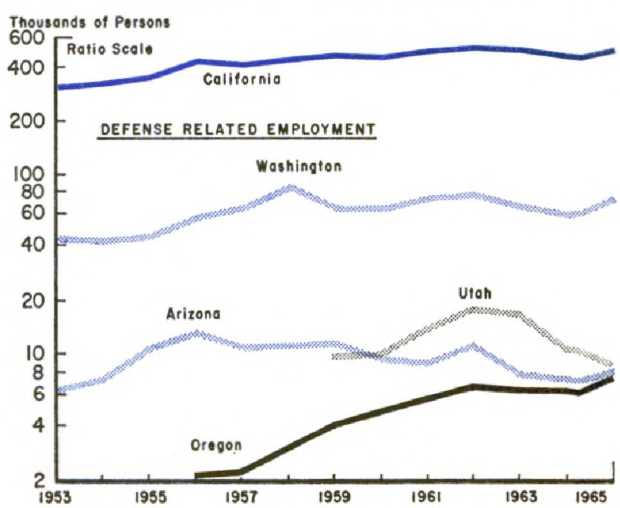
Western retail sales continued rising throughout early 1966, with most of the strength being concentrated in the nondurable-goods sector. Nondurable sales during the January-March period ran about 9 percent above year-ago levels, while durable sales were about 3 percent higher. The durables market was beset by a definite slowdown in new-car sales; in the early part of the year, new-car registrations dropped 11 percent below the year-ago pace, in contrast to a 4-percent year-to-year gain elsewhere in the nation. Thus, just as during 1965, Detroit's sales managers received far better news from other sections of the country than from their normally ebullient Western market.

Aerospace and construction

The recent strength in regional activity was highlighted by a jump in aerospace manufacturing, which by March employed almost as many workers as at the late-1962 peak (634,000). But the quarterly gain of 5 percent in aerospace jobs was somewhat more a consequence of the commercial aircraft boom than of the demands of the Vietnam war. The backlog of commercial jet orders increased during the quarter to roughly twice the year-ago level, and the backlog jumped again in April as the first orders came in for the aircraft of the future—a 490-passenger transport capable of 5,800-mile flights at speeds 10 percent faster than that of present-day jets. With a multi-billion-dollar market projected for this new transport plane in the 1969-75 period, a substantial gain in the region's aircraft industry seems assured, even though much of the production work will be carried out in other sections of the country.

In the construction sector, housing activity continued weak but other construction remained strong during the early months of 1966. In the District, residential building awards remained at the low late-1965 level of about $900 million, and elsewhere housing awards dropped 6 percent to about $4,430 million (seasonally adjusted quarterly totals). The continued Western slump has been blamed on the lessened availability of mortgage money and on rising construction costs, as well as on the earlier overbuilding which has left a sticky vacancy problem as its residue.

Recovery in aerospace activity boosts employment to near-peak levels



First - quarter awards for nonresidential building and heavy engineering projects suggest a continuation of the 1965 boom in the West and a speedup of the building pace elsewhere. Awards in District states dropped about 3 percent below the abnormally high pace of late 1965, to about $1,140 million, and awards elsewhere jumped 19 percent to about $6,605 million.

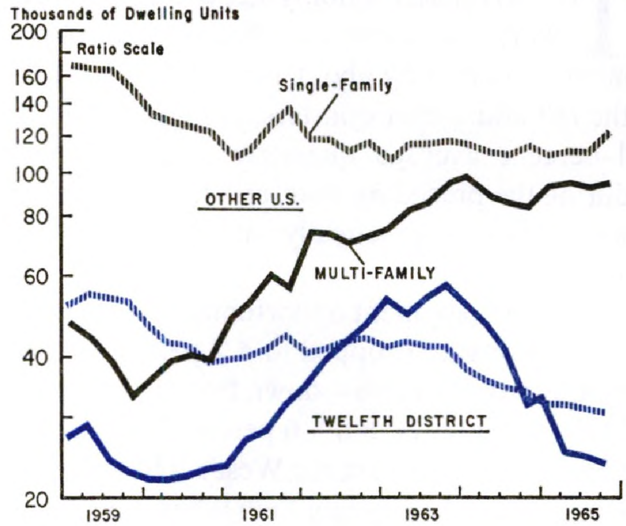
Farms and forests

The regional boom was marked during early 1966 by heightened activity on the farms, in the forests, in the oilfields, and in the mines and mills. With output rising almost everywhere, prices of most primary products came under heavy pressure.

Farm cash receipts rose about one-fifth above the near-record level of early 1965, especially under the spur of rapidly rising prices for most farm products. But future production plans were mixed. For some major crops, such as wheat and cotton, sizeable reductions in plantings were underway; on the other hand, a substantial expansion of tomato acreage was scheduled, as increased usage of mechanical harvesters was planned for this important processing crop. In the livestock sector, an expansion in marketings is in prospect at least until midyear. The movement of cattle from feedlots exceeded the year-ago pace during the first quarter, and the volume of cattle marketings should be even higher in the current quarter.

The lumber-plywood industry by early spring was hard put to keep up with burgeoning demand. Prices rose spectacularly during this period, partly because of the boost to orders resulting from strike-hedge buying, military purchases, and heavy industrial demand, and partly because of the curtailment of shipments because of shortages of logs and of box cars. By early April, prices of key grades of lumber were one-fourth above year-ago levels (ranging $78 to $80 per thousand board-feet), and prices of quarter-inch sanded plywood were up one-third (to $86 per thousand square-feet).

Western housing slump continues, especially in apartment sector



Mines and mills

Western steel producers increased their output sharply above the reduced pace of late 1965, largely thanks to the strong pace of industrial and commercial construction. Indeed, production in early 1966 ran only 5 percent below the frantic pace maintained in the early months of 1965, when steel consumers were accumulating inventory rapidly as a hedge against a possible steel strike.

Aluminum producers strained their capacity during this period to meet the sharply rising demands of the civilian economy, along with defense set-asides equal to one-tenth of the industry's total shipments. With demand booming in this fashion, one major producer announced a $100-million expansion of primary reducing facilities at Longview, Washington and Troutdale, Oregon.

The copper shortage failed to ease in early 1966, despite the expansion of production at Western mines, the establishment of export quotas, and the release of substantial amounts of stockpiled metal. In the aftermath of strikes at Zambian and Chilean mines, the London market quoted a spot price of almost $1 a pound, and the Chilean government raised its export price from 42 to 62 cents a pound. But domestic producers continued to hold the price line unchanged at 36 cents for each pound of the increasingly scarce metal.

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

Regional Staff

At Western Banks

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

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

Favorable developments

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

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

But this rate relationship then changed again after most major California banks began offering 5 percent on savings certificates. The effect of the higher rate was a substantial (about $430 million) shift of funds in the first week of April out of passbook savings into the higher-interest savings certificates—with no absolute increase in the total amount of time and savings deposits. Simultaneously, District banks raised their rates on large-denomination negotiable time certificates to meet competition from banks in the East and elsewhere for these corporate funds.

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

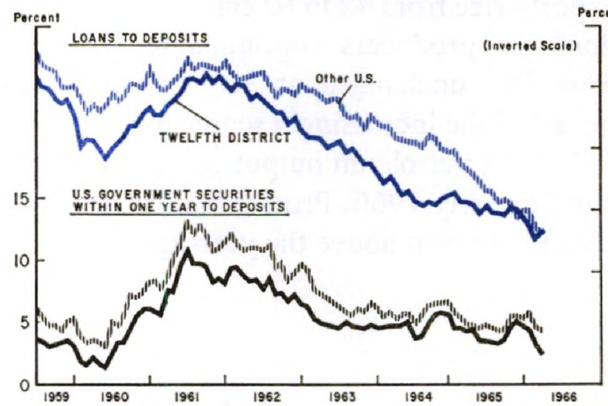
Contra-seasonal loan increase

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

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

For District business borrowers, the average cost of short-term funds rose 27 basis

Declining liquidity restricts banks' flexibility in meeting credit demands



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

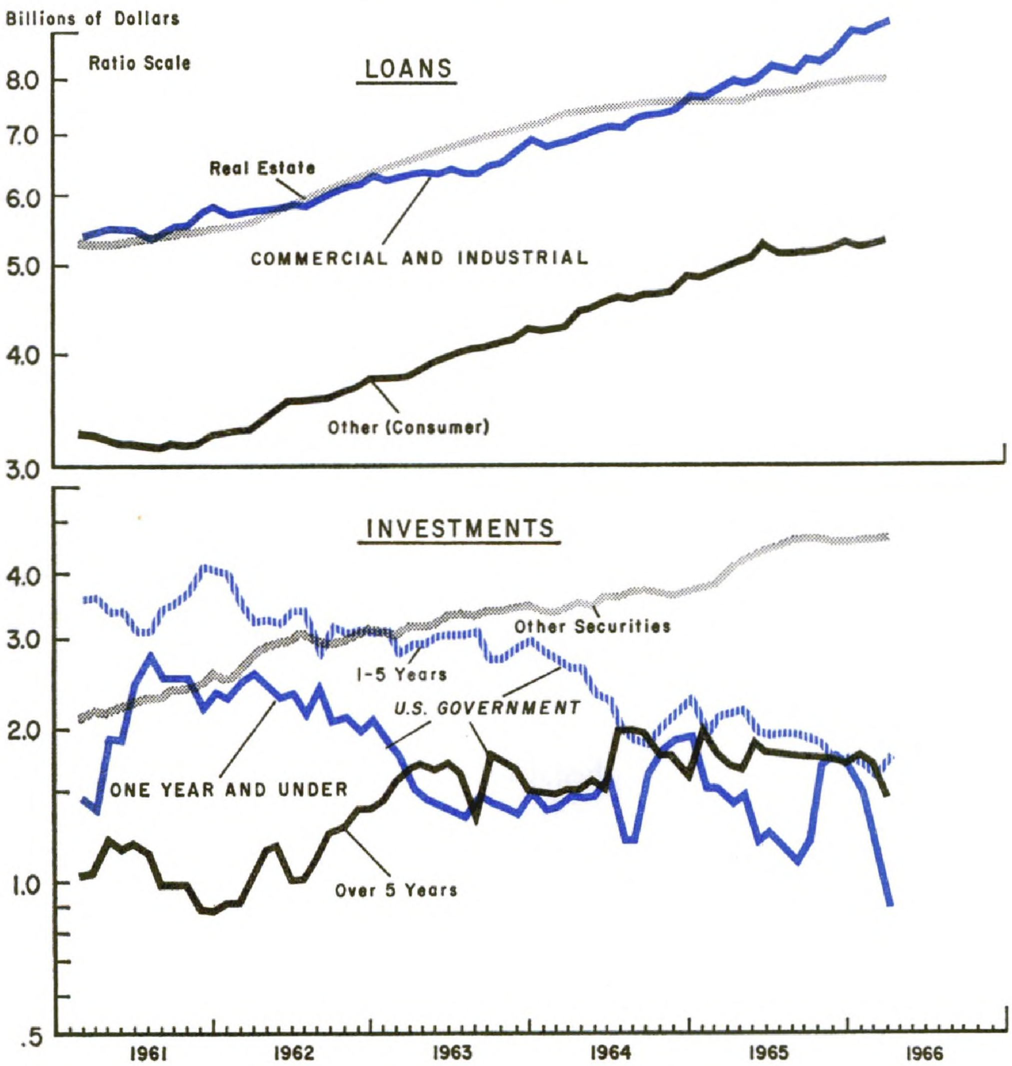
Mortgage and consumer financing

District weekly reporting member banks recorded only a 0.2-percent increase in mortgage loans in first-quarter 1966, as against a 2-percent gain elsewhere. This development partly reflected the weakness of the Western housing market, but it also reflected a more extensive use by major District banks of the practice whereby they sell mortgages out of their portfolios to other investors, but retain servicing of the loans. This procedure enables these banks to maintain their customer relationships yet provides funds which can be reinvested in new mortgages or used for other types of lending.

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

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

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



Security portfolios reduced

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

SELECTED BALANCE SHEET ITEMS OF WEEKLY REPORTING MEMBER BANKS IN LEADING CITIES
(dollar amounts in millions)

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

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

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

Decline in savings flow

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

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

Ruth Wilson