

*A review by the* **Federal Reserve Bank of Chicago**

# Business Conditions

**1963 April**



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# THE Trend OF BUSINESS

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## —as reflected in employment in midwestern states

Although retail sales have moved to a new high plateau in recent months, there has been no corresponding improvement in such measures of physical activity as industrial production and employment, which have been stable since last summer. Actually, the relatively slow rise in employment has been a persistent problem. This article examines the differing trends in employment during the past decade in the five Seventh Federal Reserve District states—Illinois, Indiana, Iowa, Michigan and Wisconsin—in comparison with national developments.

Total civilian employment in the United States averaged close to 68 million in 1962, a record level and more than 1 million above the previous year. There was, however, little further improvement in the second half of the year or thus far in 1963. The national picture is reflected in varying degree in the Midwest. In some labor market areas in this region, principally in Indiana and Michigan, increases in employment between 1961 and 1962 exceeded the national gain, but in most cases these areas had had larger than average declines in the 1960-61 recession.

Forty-six of the nation's 150 major labor market areas were estimated to have a "substantial surplus" of workers in February with local unemployment rates of 6 per cent or more. Three of the 23 areas in the Seventh District were in the substantial surplus category. Seven centers in the nation (three in the

District) were in a relatively favorable position with estimated unemployment of less than 3 per cent in January. There had been 10 areas in this group in December.

### A longer look

Recent trends in employment can be interpreted most effectively when examined against the background of experience over several years. Annual averages are used since these smooth out month-to-month variations caused by temporary developments such as auto model changeovers, major strikes, unusual weather conditions and similar factors. Because of the relatively small changes in employment since mid-1962 both in the nation and the Midwest, annual averages for last year are fairly representative of the situation at the present time.

The figures most commonly cited on current changes in employment and unemployment are based upon a nationwide sample of 35,000 households which are interviewed monthly. Estimates of total employment from this survey include all workers—the self-employed and those engaged in agriculture as well as wage and salary workers. The nature of the sample does not permit estimates by regions or states. The following analysis mainly utilizes different data which are based upon monthly reports made by employers to state agencies. This procedure provides figures on nonfarm wage and salary employ-



ment for the nation, the states and many individual areas.

Total nonfarm wage and salary employment in 1962 averaged 2.3 per cent higher in the nation than in 1961. Gains for the five District states ranged from 1.5 per cent for Iowa to 3.7 per cent for Indiana. For Illinois, Michigan and Wisconsin the increases were about 2 per cent. These gains exceeded the declines during 1961 and carried total employment to record levels in 1962 for the United States and each of the Seventh District states except Michigan. Employment in Michigan was 13 per cent below the peak level of 1955 when auto output was at a record high.

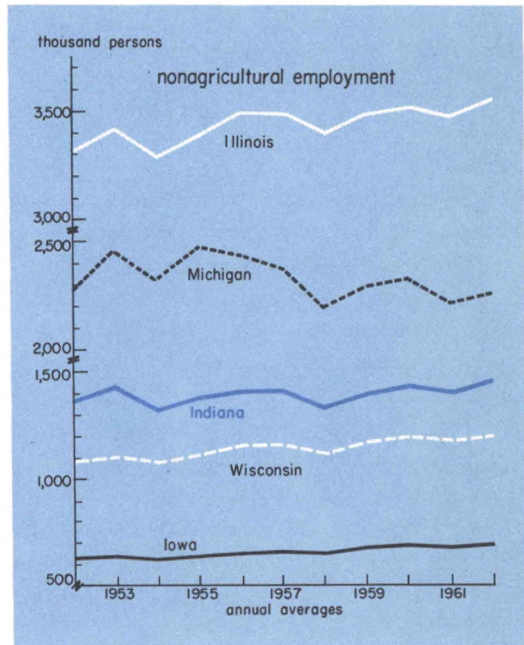
During the past five years wage and salary employment has increased at an average annual rate of about 1 per cent. In the preceding ten years, 1947-57, the rise was at an annual rate of about 2 per cent. Only in Iowa among the District states has nonfarm employment increased at a more rapid rate than in the nation in recent years.

### Industry differences

One of the striking developments in the employment picture in the past five years is the marked difference in the performance of broad industry groups. During 1962 employment in each of the major industry categories—manufacturing, mining, construction and public utilities, including transportation—averaged lower than in 1957 while each of the “service” industries—wholesale and retail trade, finance and insurance, government and miscellaneous services—had higher employment. These trends were evident in each of the District states.

The postwar highs in employment in both manufacturing and mining were reached in 1953. For construction and utilities the high tide in employment occurred in 1956. In

### Employment was at a record level in 1962 in all District states except Michigan



trade, finance, service and government, however, employment was higher in 1962 than in any preceding year.

Manufacturing employment, despite the downward drift during the past 10 years, remains the largest of the major components of total employment. In 1953, manufacturing employment amounted to 35 per cent of total wage and salary employment, the same proportion as in 1947. By 1957 this share had dropped to 33 per cent and by 1962 had slipped to 30 per cent.

During the early postwar years demand for manufacturing workers, especially production workers, was strong and attracted personnel from possible jobs in trade, service and government. Part of the rise in employ-

ment in these categories in recent years, therefore, reflects the decline in labor requirements in manufacturing. The table shows how employment changes have varied:

	Per cent change, 1957-62	
	Nonfarm employment	Manufacturing employment
United States	+4.6	-2.5
Illinois	+1.8	-4.4
Indiana	+3.7	-2.8
Iowa	+5.1	+2.4
Michigan	-4.7	-9.7
Wisconsin	+4.1	-2.2

Iowa, the least industrialized of the District states, is the only one with higher manufacturing employment in 1962 than in 1957, while Michigan, the most highly industrialized, had the largest decline. Michigan's experience stems from a variety of factors. Foremost are the continuing decentralization of the automotive industry to other areas, the continuing substitution of machines for manpower—a long-term development which is now commonly called “automation”—and a smaller volume of defense work.

### The surge in productivity

In recent years attempts have been made to explain the relatively high level of unemployment in terms of increasing mechanization of a variety of jobs. Evidence is seen almost everywhere in the form of automatic elevators, materials handling equipment, punch tape machine tools and dial telephoning.

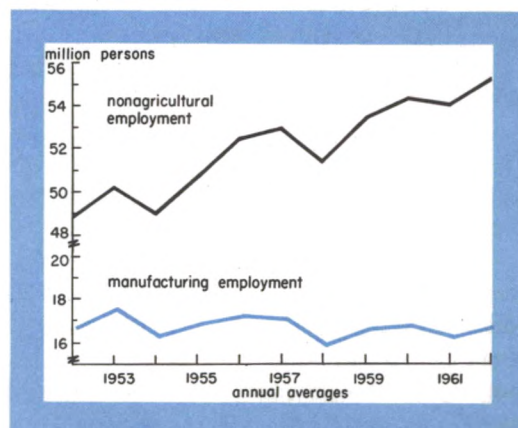
The pressures upon business managers to reduce manpower requirements, always present, have been given added stimulus in recent years by the effects of increasing wage rates and generally stable product prices. These developments, together with investment in new facilities, have permitted production to be concentrated in the most efficient plants

and has resulted in a rapid rise in production per man-hour.

Only a few years ago, in 1957 and 1958, there was widespread concern over the failure of output per man-hour to increase more rapidly. Between 1955 and 1957 it rose only a little over 1 per cent a year in all nonfarm industries and by less than 1 per cent a year in manufacturing. In the 1947-55 period production per man-hour had risen about 3 per cent annually, both in manufacturing and nonmanufacturing industries.

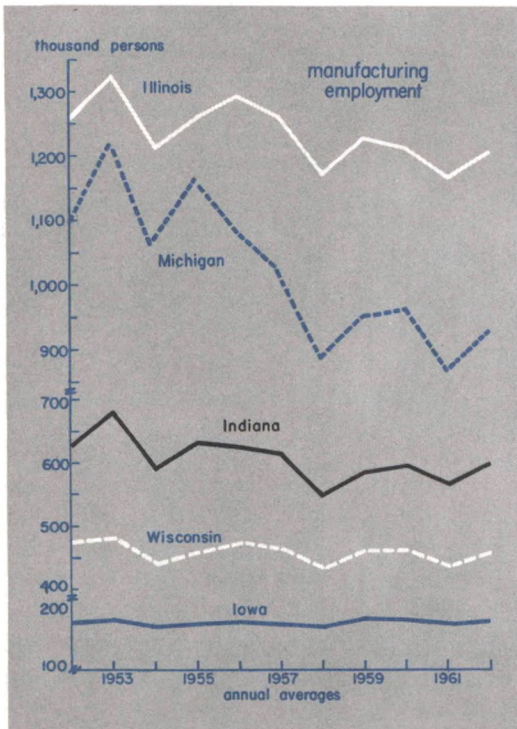
In retrospect it appears that the concern over the slow increase in output per man-hour was most widespread at the very time when it was beginning to rise sharply. The large volume of capital expenditures in 1955-57 helped push the economy to boom levels during these years. Temporarily this had the effect of reducing production per man-hour because the less efficient plants were in use. The absence of “full employment” conditions in 1958 and later years coincided with the period when new equipment purchased in the

### Employment in the United States has increased despite a decline in manufacturing





## Manufacturing employment up in 1962 in all District states but below earlier peaks



1955-57 upswing became effectively integrated into the nation's economy.

From 1957 through 1962 production per man-hour rose at about the same high rate as from 1947 to 1955. During the past two years, the rise in output per man-hour in both manufacturing and nonmanufacturing has been even more rapid.

Physical output measured by the manufacturing component of the industrial production index was 18 per cent *higher* in 1962 than in 1957 while employment in manufacturing was 2.5 per cent *lower*. Employment gains have been held down not only by rising

output per man-hour but also by an increase in the average workweek from 39.8 hours in 1957 to 40.4 in 1962.

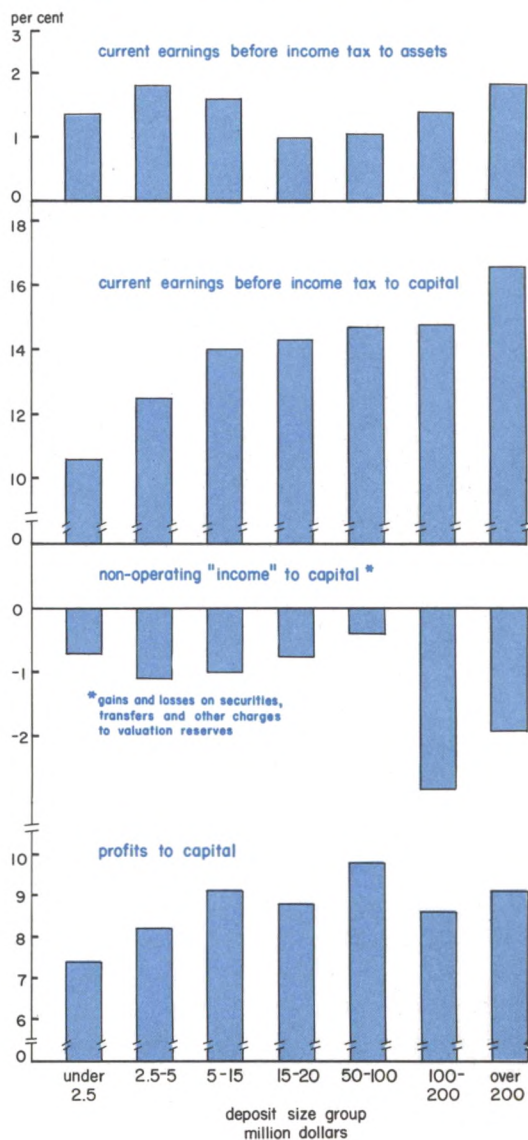
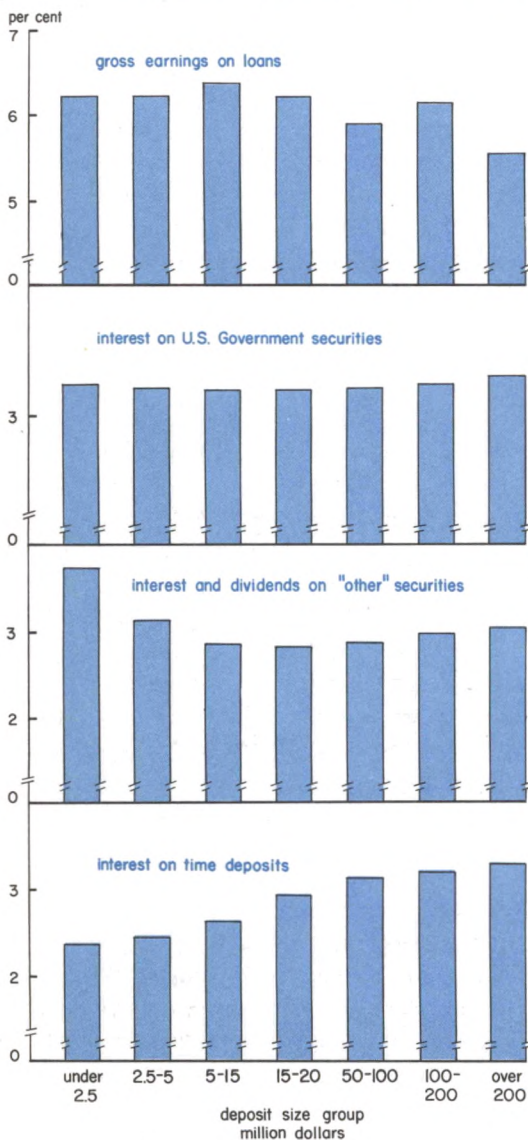
For the past few years employment in most areas of the Midwest has grown more slowly than in the nation. To a large degree this reflects the relatively greater importance of manufacturing in this region, particularly steel, machinery, automobiles, food processing—where productivity gains have been most significant. Outside the realm of manufacturing and heavily represented in the Midwest is the railroad industry. This industry has scored conspicuous gains in output per man-hour which have sharply curtailed total manpower requirements. The relative unimportance of such rapidly growing industries as aerospace and chemicals also has played a role in the slower-than-average growth in employment in the Midwest.

Will the trend of the past several years toward reduced employment in the producing industries and larger employment in the service industries continue? There is no sure answer. Changes in technology and product "mix" can lead to increases in employment rather than reductions, at least temporarily. Broad opportunities to reduce manpower through the use of modern equipment are being realized in such white collar activities as trade, finance and government.

Increases in output per man-hour must continue if inflationary pressures are to be contained and the capacity of the economy to produce goods and services is to rise more rapidly than population. However, if demand does not increase in step with potential output, improvements in technique will tend to cause unemployment to grow. Recent trends in output and employment suggest a mounting challenge to public policy in the years immediately ahead when growth of the labor force is certain to accelerate.

# Trends in banking and finance

## Selected operating ratios of Seventh District member banks, 1962





Earnings on loans and investments and interest paid on time deposits reached new highs for the "average" Seventh District member bank in 1962. However, as expenses rose quite sharply, net profits as a per cent of capital declined. Interest expense continued the upward trend evident throughout the postwar period and accounted for one-third of total expense, up from one-sixth 10 years earlier.

Profits averaged 8.6 per cent on bank capital, somewhat below both 1960 and 1961 and the average level for the postwar years.

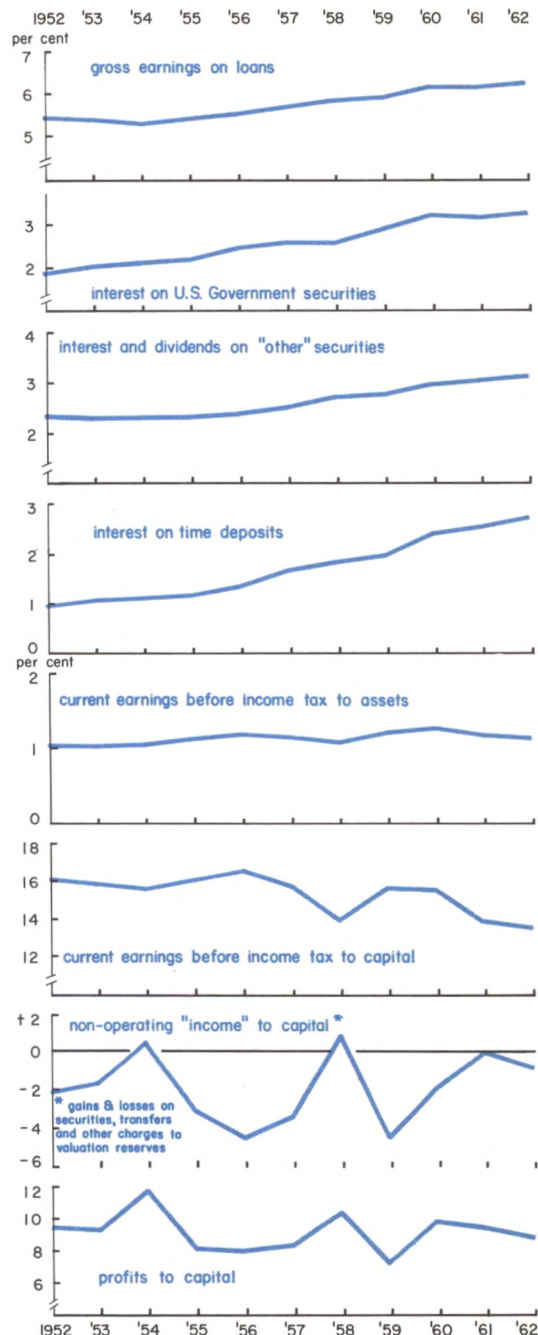
Gains or losses from the sales of securities in 1962 were small for most banks, reflecting the stability of long-term interest rates in recent years. In some years, capital gains or losses have had an important effect on profits. In 1962, transfers to valuation reserves affected profits more than did capital gains and losses.

Profits as a per cent of capital tended to be greater in 1962 for large than for small banks. This relation is even stronger for net current earnings before income taxes. The ratio of earnings before taxes to assets, however, shows no consistent relation to size of bank.

Interest rates paid on time deposits were higher at the large than at the small banks. In 1962, banks with deposits of 200 million dollars and over paid almost a full per cent more than banks with deposits of 2.5 million dollars or less. Gross earnings per dollar of loans, on the other hand, tended to be greater for small banks, reflecting lower interest rates on the larger loans made by large banks.

The much higher return on "other" securities for banks with deposits of under 2.5 million dollars reflects their relatively smaller holdings of the obligations of state and local governments. Interest on these securities is exempt from Federal income tax and therefore lower than on taxable investments.

## Trends in operating ratios



# Renewed strength seen in capital outlays

One of the most significant economic developments of the first quarter was the reversal of a modest downturn in business expenditures on new plant and equipment that developed late last year. In 1962, capital outlays were at a record high, 9 per cent above the previous year. Present plans—subject, of course, to future revisions—indicate a further rise of 5 per cent in 1963. This prospect is of particular interest in the Seventh Federal Reserve District, where about one-third of the machinery and equipment used by United States manufacturers is produced.

Several months ago the view was widespread that capital expenditures would decline or, at best, increase only slightly in 1963. New orders for many types of business equipment declined in the early autumn and production of these items, after rising vigorously through most of 1961 and 1962, leveled off late last year. Commercial and industrial construction declined somewhat during this period. As a result, total capital expenditures were slightly lower, on a seasonally adjusted basis, in the fourth quarter of 1962 than in the third quarter.

## **Investment and business prospects**

The disturbing aspect of this evidence of a falloff in capital outlays was not the magnitude of the development, but rather the likelihood, on the basis of past experience, that it marked the beginning of a trend. When capital expenditures peaked out in 1953, 1957 and 1960, the ensuing declines averaged well over 10 per cent and the movements continued for a year or more.

Business investment spending trends are important because these outlays provide the means of increasing productive efficiency and accelerating economic growth. But for the near term, interest is focused on the relationship between these outlays and the trend of general business activity. In the past, major fluctuations in total business activity always were accompanied by proportionately larger changes in capital outlays.

Frequently it is asserted that a vigorous uptrend in general business is brought about by a rise in business investment. There are many, however, who hold that the cause and effect relationship runs the other way, that a rise in total spending induces an increase in capital expenditures. A third view, perhaps the most reasonable, lies between these poles—that consumption and investment are mutually stimulating.

A decision to build and equip a new plant results in a flow of wage and other payments which are used, to a considerable degree, to purchase consumer goods and services. But such a decision may have been made in the first place because of a rise in sales to consumers that pointed to the need for expansion or modernization of facilities. Whatever the merits of these varying views it is clear that assuming the continued availability of funds—from savings, current income or lenders—increases in the level of both consumption and investment are dependent upon underlying confidence in over-all economic prospects.

Uncertainty inhibits spending decisions of all kinds, but particularly on capital goods,



many of which have a useful life of 10 to 20 years or longer. While clouds remain on the horizon, as always, the economic atmosphere is more conducive to investment than it was several months ago. More conclusive evidence of an advance in total business activity easily could increase capital expenditure in 1963 above the level now planned. This has happened several times previously in the postwar period.

### Steel, autos and railroads

Hard goods manufacturing is leading the rise in capital expenditures for 1963 with a prospective increase of 11 per cent compared with a 3 per cent rise expected for soft goods manufacturing. Among types of manufacturing the largest increases are planned for steel, autos, nonferrous metals, chemicals and textiles. Moderate declines are expected for pro-

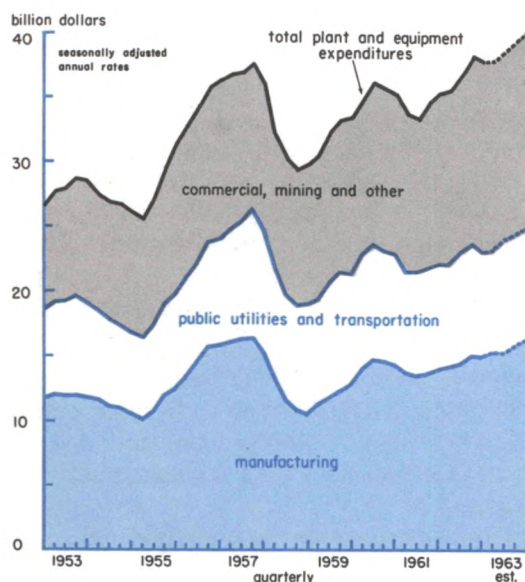
ducers of machinery, petroleum and rubber. In the nonmanufacturing sector, utilities, railroads and commercial enterprises plan increases in capital spending while declines are anticipated in mining and nonrail transportation.

Total planned capital outlays are expected to reach 39.1 billion dollars this year, well above any previous year. However, in most industries the expected level has been exceeded at some time in the past, in some cases by a substantial margin. For example, the projected 1963 outlay of 1.2 billion dollars for steel compares with a high of 1.7 billion in 1957. For autos, capital investment will be only 55 per cent of the 1956 total, and outlays in most other industries will fall short of previous peaks. Record highs will be set for capital outlays in the commercial sector, textile manufacturing and the remaining "all other" category as a whole if present plans are realized.

The pattern of expected increases and decreases in capital outlays by industry groups shows little relationship to estimates of the amount of "excess capacity" in these lines. For example, the steel and railroad industries, which are planning large increases in spending this year, are likely to operate far below peak rates of the past. Emphasis is upon new facilities that reduce costs and improve the quality of goods or services. For example, orders for railroad cars are expected by industry sources to reach 50,000-60,000 this year compared with last year's 37,000. A growing proportion of these are relatively expensive, specialized units for carrying dry bulk cargo, fluids, perishables, heavy machinery and truck trailers.

A marked contrast to the capital spending plans of the railroads is found in the case of the airlines. Procurement of jet aircraft is declining sharply now that a substantial por-

### Plant and equipment spending is expected to rise again in 1963



tion of the main routes have been changed over from piston models. The present jets are expected to remain in service for at least 12 to 14 years before new designs make existing craft obsolescent.

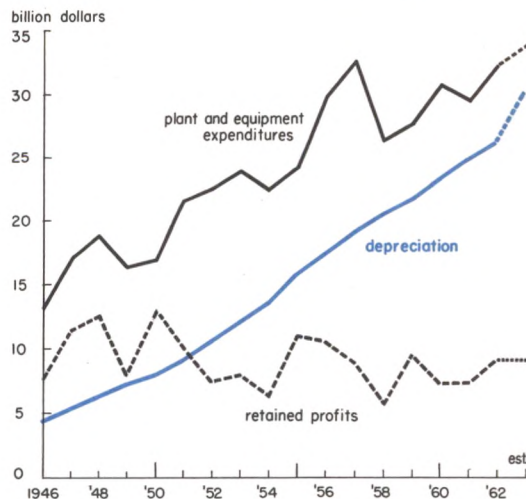
### Tax credits and depreciation

The prospective rise in capital outlays in 1963 is traceable in part to the tax credit now allowed on purchases of capital equipment and the Treasury's new guidelines which permit shorter "useful" lives to be assigned to equipment for depreciation purposes. The former has been estimated by the Treasury to reduce corporate tax liabilities for 1962 by 1 billion dollars and the latter by 1.5 billion. If these estimates prove to be accurate, the temporary effect of these two factors combined on corporate "cash flow," depreciation plus after-tax income, will be equal to a reduction in the corporate tax rate from 52 to 47 per cent. However, the benefits will not accrue to all corporations equally, but in proportion, more or less, to their use of machinery and equipment.

As enacted, the *tax credit* allows business firms to deduct a maximum of 7 per cent of the cost of new equipment from their tax liability for the year. For utilities the maximum credit is 3 per cent. The tax credit does not apply to assets with expected useful lives of less than four years, and the amount of the credit is scaled down for assets with expected lives of four to eight years. For tax purposes the depreciation base for newly acquired assets must be reduced by the amount of the credit. The credit may be applied only in the case of equipment purchased for use in the United States since the start of 1962. (Used equipment may be included up to \$50,000 purchase price.)

10 In its present form the investment tax credit is the equivalent of a price reduction of

### Rising proportion of capital outlays financed from depreciation



a like amount and should have the same tendency to increase spending on capital goods. The effect of the credit is the same as though the Treasury made a payment of 7 per cent of the price of new equipment to the purchaser, with the understanding that the payment need not be reported for tax purposes but with the requirement that the amount of depreciation to be taken on the new asset be limited to the cost price less the credit. (Of course, lowered equipment costs resulting from either price cuts or tax credits will tend to increase taxable income in future years.) However, since the payment is in the form of a tax credit, it is of value only to firms with sufficiently large tax liabilities—past, present or future, for there is a carry-back and carry-forward provision—against which the credit may be applied.

The *depreciation* changes apply to existing equipment as well as new purchases. (No change was made in the suggested schedules for buildings.) For many types of equipment



the useful lives now permitted for calculating depreciation are well below those previously used. For example, the major steel firms increased their depreciation charges by 24 per cent for 1962 over the amount they would have used if the new guidelines had not been authorized.

Like the tax credit, more rapid depreciation applied to existing assets may have a considerable impact upon capital expenditure decisions. Although the funds can be directed to other purposes such as dividends or debt reduction, a substantial portion of the additional cash made available may be used for new investment.

The case of the textile industry may foreshadow developments elsewhere. Textile firms had been given permission to use shorter useful lives late in 1961. Their capital expenditures rose by 22 per cent in 1962 and are expected to increase an additional 18 per cent in 1963.

### Internal funds rise

In 1962 internally generated funds of all nonfinancial corporations—retained earnings plus depreciation—amounted to 35 billion dollars or 10 per cent more than in 1961, which had marked the previous high. Although capital outlays of individual firms are not necessarily proportional to internally generated funds—other sources such as debt may be tapped—it is often useful to relate total depreciation and retained earnings to total plant and equipment outlays. Last year funds obtained internally by nonfinancial corporations were 9 per cent greater than the capital outlays of these firms. In the high investment year, 1957, internally generated funds were 14 per cent less than capital expenditures. The combination of the tax credit and more rapid depreciation will help to bring about a further substantial rise in internally generated

funds in 1963, thereby encouraging investment and reducing dependence upon outside sources of funds.

### Investment and GNP

Although capital expenditures rose substantially last year, the proportion of the gross national product represented by these outlays was only 6.7 per cent, the lowest in the postwar period except for 1961. Present prospects are that the share of total spending accounted for by plant and equipment will rise little, if at all, in the current year.

Since World War II four years—1947, 1948, 1956 and 1957—stand out in terms of the proportion of total spending accounted for by capital expenditures. In each of these years the proportion was close to 8.5 per cent. If this relationship were to prevail in 1963, capital expenditures would be about 25 per cent higher than the current estimate.

One reason for the higher proportion of business investment to total spending in the early postwar period was the large amount of replacement demand for capital goods which had been deferred during the depression of the Thirties and World War II. The sharp upswing in capital spending in the mid-Fifties was aided by the belated acceptance of the view that a serious depression was not imminent and that larger capacity in basic industries was needed.

It may be significant that the four postwar years of relatively high capital spending marked the culmination of inflationary booms which featured substantial increases in the prices of both consumer and producer goods. Moreover, in each case the boom was followed by a business recession in which capital outlays declined much more than other types of spending. Commonly these recessions were attributed, in part, to the excessive exuberance of the investment surge.

Perhaps continued increases in capital outlays, at a slightly faster pace than the rise in general business activity, will be more conducive to stable growth than a rapid return to the investment-total spending relationship of the peak postwar period. A number of factors point to strength in demand for capital goods in the years ahead. First, the initial postwar capital spending surge ended 15 years ago and the bulk of the equipment purchased at that time has reached, or soon will reach, the normal retirement age. Second, the massive research and development programs

of business and government, stressed particularly since 1957, have tended to accelerate obsolescence of producers' goods which are not actually "wearing out." Third, partly because of these factors, a number of studies have concluded that much of the currently unused capacity is substandard and therefore is not a barrier to new investment. Fourth, the anticipated rapid growth in the rate of family formation in the middle Sixties as the war and postwar babies begin to reach marriageable age will broaden markets for all types of goods and services.

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## Banks step up mortgage lending

Are commercial banks a growing factor in real estate financing? This question has attracted increasing interest in recent years as time deposits have risen rapidly and the powers of commercial banks to lend on real estate have been liberalized.

Growth of savings and other time deposits at commercial banks has been especially pronounced since about mid-1960. In 1961, for example, such deposits rose 15 per cent, and this was followed by a further gain of 18 per cent last year.

In the postwar period, time accounts have increased far more rapidly than checking or demand deposits. In 1947 deposits in the time category made up only 29 per cent of all commercial bank deposits owned by individuals and business firms, but by late last year the share had climbed to more than 43 per cent. This shift in bank liabilities has been accompanied by changes in bank investment policies.

Time deposits tend to be longer term than demand deposits—they "turn over" less rapidly. In general, the more stable a bank's deposits the larger the proportion of its funds that can be invested in long-term assets. And longer-term assets tend to provide higher interest yields than shorter-term, more "liquid" holdings.

Among the most important outlets for long-term funds is mortgage lending. The total of 250 billion dollars in mortgage debt outstanding at the end of 1962 amounted to one-fourth of all net debt—public and private—and well over one-third of total private debt.

Loans to finance real estate usually run for extended terms—seldom less than 10 years, often 20 or 25 years and sometimes longer—on credits providing the permanent financing for buyers of either existing properties or properties to be built. Shorter- or intermediate-term loans spanning the period of con-



struction only are also common. Individual transactions, moreover, are highly distinctive, with each loan specifically tailored to the nature and circumstances of the property securing it and the financial position and needs of the borrower. The result is that mortgage loans often are low in liquidity, but their comparatively generous yields—ordinarily above those of loans or investments more readily convertible into cash—frequently serve to make them attractive holdings.

The Federal mortgage insurance and guarantee programs, administered by the Federal Housing Administration (FHA) and Veterans Administration (VA), however, have served importantly to enhance the liquidity and marketability of loans receiving such protection. The secondary market for FHA-VA loans, under the Federal National Mortgage Association (Fannie Mae), further widens the market acceptability and the willingness of investors to hold the government-underwritten mortgages. Thus to a considerable extent the distinctiveness and illiquidity of individual mortgage loans has been lessened, with the market for them broadened, under the influence of these programs.

### Banks in the mortgage market

Since the early postwar years, the share of total mortgage debt held by commercial banks has declined. From 19 per cent of the

### Commercial bank mortgage holdings in sharp postwar rise, but banks' share of mortgage financing has narrowed

Year end	Total mortgage debt outstanding	Total amount	Commercial bank holdings						Bank share of total mortgage debt (per cent)
			Residential				Other non-farm	Farm	
			Total	FHA	VA	Conventional			
			billion dollars						
1948	56.2	10.9	8.1	..	..	...	1.9	0.9	19
1950	72.8	13.7	10.4	..	..	...	2.3	1.0	19
1952	91.2	15.9	12.2	3.7	3.0	5.5	2.6	1.1	17
1954	113.6	18.6	14.2	4.1	3.4	6.7	3.3	1.1	16
1956	144.5	22.7	17.0	4.8	3.9	8.3	4.4	1.3	16
1958	171.9	25.5	18.6	5.5	3.3	9.8	5.4	1.5	15
1960	207.1	28.8	20.4	5.9	2.9	11.6	6.8	1.6	14
1961	225.5	30.4	21.2	6.0	2.6	12.6	7.5	1.7	13½
1962*	249.9	34.0	...	..	..	...	..	..	14

\*Total preliminary; bank holdings estimated for aggregate only.

49 billion dollar total in 1947, the banks' proportion edged downward in the years following to about 14 per cent of the much greater volume outstanding, 207 billion, in 1960. At the end of 1961 the proportion held by banks remained practically unchanged. This was despite a substantial further gain in the dollar volume of bank holdings—a reflection of the very substantial climb that year in the total amount of outstanding mortgage debt. In 1962, also, it appears that the commercial bank proportion remained close to the 14 per cent level—again notwithstanding a sharp rise in bank holdings. The dollar increase in total mortgage debt last year, almost 25 billion dollars, was the largest in the postwar period.

### Mortgage loans as bank assets

The banking system is the supplier of roughly one-seventh of all mortgage credit and mortgage loans account for about the



same proportion as this of the banks' total earning assets. Real estate loans, of course, make up a substantially larger share of total loans, excluding investments.

For all banks in the United States belonging to the Federal Reserve System—banks holding about 85 per cent of all commercial bank deposits—credits secured by real estate have constituted between 22 and 23 per cent of total loans held during the years since World War II. Since 1960, the ratio has increased very slightly, moving from 22.5 per cent at the end of that year to 22.6 per cent a year later and 22.9 per cent on December 31, 1962.

In the Seventh Federal Reserve District experience has been generally similar, with the ratio of real estate loans to total loans little different recently from 15 years earlier. In this region, too, the last two years have seen a slight advance, from 24.1 per cent on December 31, 1960, to 24.7 and 25.1 per cent one and two years later. The 1960-62 period was marked by gains in both Illinois and Michigan, but steady or declining ratios in Indiana, Iowa and Wisconsin. The differing state-to-state results doubtless reflect wide variation in individual bank experience. In the case of the Indiana member banks, of course, the slight dip in the relative importance of real estate loans appears to have been associated with the comparatively slow growth of time deposits. This in turn reflects at least in part the 3 per cent limit on time deposit interest rates under Indiana law.

Measured against earning assets—the total of loans and investments—member bank holdings of real estate loans have risen substantially in the postwar period. Both for the United States and the Seventh District, the ratio of loans on real estate to this larger total has almost doubled in the last 15 years.

14 Thus real estate loans have gained ground

relative to investments—and specifically holdings of Treasury securities. Because lending to businesses, farmers and instalment borrowers in the aggregate has grown similarly, the ratio of real estate to all loans excluding investments has changed little.

### Scale of real estate lending

A host of factors determine commercial bank activity in real estate lending. Of crucial importance is the volume of funds becoming available for new commitment—additions to deposit balances, repayments of loans, proceeds of the sale of securities and loans and redemptions at maturity of investments held in portfolio. In apportioning funds among new uses, bank management will be influenced strongly by liquidity considerations as indicated earlier. These serve to set upper limits on allocations of funds to loans and investments in the different maturity ranges and different risk and marketability.

A critical influence on choices among alternatives will be relative yields. A bank, or any other investor, tends, of course, to prefer a higher-yielding asset to a lower-yielding one, other things the same—a preference serving the useful purpose of giving priority to the more urgent needs for credit over the less pressing ones.

During 1962, a period when the growth of time deposits at commercial banks was especially rapid, long-term interest rates were, in general, under downward pressure. Yields on short-term investments, on the other hand, rose somewhat.

The weakness in yields on long-term investments “competitive” with real estate loans stimulated interest among the banks in real estate lending. But returns in the mortgage market were also under downward pressure during the year. Thus, yields on 25-year FHA-guaranteed home loans with down



payments of 10 per cent or more averaged roughly 20 basis points—2/10 of one percentage point—lower in the fourth quarter of 1962 than they had been a year earlier (see chart). While no comprehensive national series is available on conventional mortgage rates, experience in the Chicago market—as revealed by the Reserve Bank's monthly survey of home mortgage loan characteristics for the area—may be taken as an indication. Effective interest rates on conventional, or nonguaranteed and noninsured loans secured by new homes declined by about 10 basis points between the fourth quarter of 1961 and the same quarter a year later. That this movement somewhat understates the extent of easing in the market is indicated by the fact that loan terms lengthened slightly, moving from an average of 21.7 years in late

1961 to 22.8 years in the fourth quarter of 1962, while the average ratio of loan amount to property value climbed from 70.3 to 72.1 per cent in the same interval.

It is obvious that the weakening of investment yields in 1962 in part reflects the policy of monetary ease and the impact on commercial bank lending and investment activity during the year. Certainly an important reason for the substantial fall in municipal bond yields was that the commercial banks—and other financial institutions as well—were aggressively acquiring such investments during the year. Similarly, the downward drift in mortgage loan yields may be ascribed in part to the expansion of commercial bank lending activity in this sector.

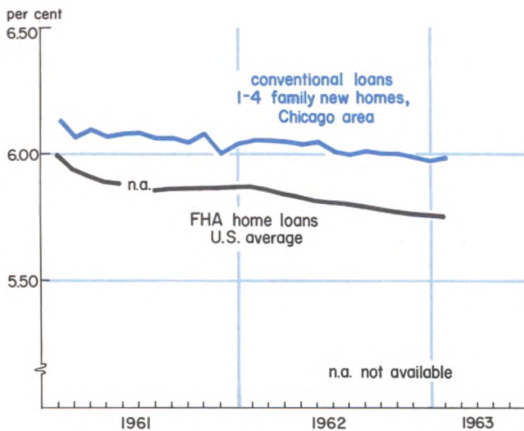
#### Legal limits on bank lending

All national banks as well as state-chartered banks in some states are subject to legal restrictions on the volume of real estate loans they may make and certain features of the credit contracts into which they may enter. No national bank is permitted to hold a volume of conventional real estate loans

... in excess of the amount of the capital stock ... paid in and unimpaired plus the amount of its unimpaired surplus fund, or in excess of 70 per centum [raised from 60 per cent in September 1962] of the amount of its time and savings deposits, whichever is the greater.

Of the five states served by the Seventh Federal Reserve District, Indiana and Michigan more or less follow the provision of the Federal statute in restricting the lending powers of banks chartered under their laws, although they do not exclude FHA and VA loans from the limitations. Neither Illinois nor Iowa imposes an over-all limit on the volume of mortgage loans that a state-chartered bank may hold, while Wisconsin

#### Residential mortgage rates under downward pressure in 1962



SOURCES: FHA series based on reports from field personnel on prevailing rates and discounts. Chicago series from individual loan information on contract rates and fees, submitted to the Bank by lenders.

restricts holdings to 50 per cent of capital, surplus and deposits, except that a larger proportion may be held if authorized by a two-thirds vote of the board of directors of the bank. Against the backdrop of recent growth in bank holdings, the question arises whether legal limits on mortgage loan volume have restricted bank lending on real estate, or promise to do so in the near term ahead.

An analysis of Seventh District member bank condition reports for December 31, 1961, and September 28, 1962, discloses that few of the banks, national or state, held real estate loans in such volume as to preclude further increases. On the September date, only nine of the 594 national banks in the District held conventional mortgage loans (that is, loans subject to the limitation on total holdings) exceeding 70 per cent of their time deposits, and all of these were within the other restricting factor—the relationship to capital and surplus accounts—used in specifying the loan limit. On the other hand, 466 of these banks, or more than three-fourths of the total, had outstanding mortgage loans in excess of their capital and surplus accounts—300 having ratios of more than two to one. Again, however, all were within the limit imposed by the ratio-to-time deposits factor; indeed, none showed a ratio exceeding 65 per cent and only seven were higher than 55 per cent.

It appears that the formal restrictions on the volume of real estate credit that national banks may supply have been of little practical significance lately as a limiting factor in the growth of conventional loan holdings by these banks. While the ratios of real estate loans to time deposits and to capital and surplus accounts for state-chartered member banks are somewhat higher than for national banks on an average, this appears to be related to the relatively smaller size of the state banks.

Thus, for District member banks as a whole—national as well as state-chartered—all but one of the 16 banks having real estate loans equal to more than 80 per cent of time deposits had *total* deposits of less than 10 million dollars. At the other end of the scale, no bank having total deposits of 200 million dollars or more had a mortgage loan-time deposit ratio exceeding 45 per cent. It deserves to be stressed that the banks' holdings of FHA and VA loans are not taken into account by the foregoing ratios.

Limitations on national bank lending on real estate that may have a more direct or restrictive effect than the ceiling on total holdings of conventional loans are the 75 per cent top loan-to-value ratio and 20-year maximum term to maturity applicable to residential loans. (These limits do not apply to Government-underwritten loans, and the banks are permitted to invest in loans bearing maturities and loan value ratios acceptable to the FHA and VA.) In general, state banks are not similarly restricted, and certain non-bank real estate lenders commonly are subject to less stringent limitations, or none at all. Federally chartered savings and loan associations ordinarily are subject to an 80 per cent, 25-year ceiling, but may go to a 90 per cent ratio and 30-year term on a limited proportion of their total loans.

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