

Business Conditions

1968 January



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Pound sterling devalued

Many small countries follow Britain's lead

Britain announced November 18 that the exchange rate of the pound sterling was being reduced from \$2.80 to \$2.40.

The announcement had immediate impact throughout the world. Within hours, governments of 13 countries announced reduction in the exchange rates of their currencies relative to the U. S. dollar. Eleven other countries announced reductions soon after.

In the days following, repercussions were felt in markets for foreign exchange and gold as individuals, businesses, and governments responded to the new conditions. International markets for goods and commodities will doubtlessly be adjusting for months as patterns of trade gradually respond to the new structures of exchange rates and associated shifts in competitive positions of suppliers. Directly or indirectly, the lives of millions of people throughout the world will be affected by the devaluation of the pound.

Why Britain devalued

The fundamental reason for the British action was a persistent balance of payments deficit that had plagued the country for years. The devaluation came as the most dramatic in a long series of moves undertaken to balance its international expenditures and receipts.¹

Previous measures, especially those last year, had been aimed essentially at limiting the growth of domestic demand for goods and

services. This had been done both to dampen demand for imported goods and to free up more domestically produced goods for export. It was also expected that such measures would help relax some of the structural rigidities of the British economy and arrest the wage-price spiral that had been undermining the competitiveness of British goods in world markets.

In the first months of 1967, the measures seemed to produce the desired results. Unemployment rose to 550,000—the highest level in 20 years—and industrial production and growth in consumer spending declined. There seemed reason to believe that Britain could not only balance her accounts but, hopefully, also repay international credits obtained over the previous two years.

But the improvement was short-lived. Partly because of such external developments as the crisis in the Middle East and the decline in economic activity in a number of other countries, which weakened demand for British exports, and partly because of such continued internal difficulties as strikes in the shipping docks, a large deficit in British trade accounts reappeared, causing renewed concern that the pound might not be viable at the current rate of exchange. This caused speculation against the pound—that is, the taking of positions by traders, investors, and speculators to minimize losses or maximize gains if the value of the pound were reduced. Faced with rapidly diminishing international reserves, the government chose to devalue the pound as a means of stemming the specu-

¹For a summary description of previous measures undertaken by the British government, see *Business Conditions*, October 1966.

lative outflow of funds in the short run and balancing trade accounts in the long run.

What is devaluation?

The current international monetary system is largely an outgrowth of the 1944 Bretton Woods Conference, which laid the groundwork for the establishment of the International Monetary Fund. Member countries of the fund have defined the values of their currencies in terms of the U. S. dollar and are expected to adopt domestic policies that will allow them to keep the relative values fixed. Only if a country suffers from a fundamental imbalance in its international accounts can it apply to the International Monetary Fund for permission to change the value of its currency relative to the dollar—to devalue.²

Devaluation, in effect, reduces the number of dollars or other dollar-defined currencies that can be bought with a given amount of domestic currency. Viewed from the foreign side, it increases the amount of domestic currency that can be bought with dollars or other foreign currencies. It has no direct effect on the domestic value of the currency as such. The impact on domestic prices is indirect, arising mainly from the effects of the devaluation on imported goods and services.

How does devaluation work?

The primary impact of currency devaluations is on the prices of goods and services exchanged between the devaluing country and its trading partners. It reduces the prices of domestically produced goods and services to foreigners and increases the prices of foreign goods and services to residents of the devaluing country.

On the morning after devaluation of the

pound, for example, an American in London would have found he could buy a sweater for which he paid, say £ 10 (\$28.00) the day before 14.3 percent cheaper—for only \$24.00 (£ 10). But, an Englishman in Chicago would have found that the steak for which he paid, say, \$2.80 (£ 1) the day before now cost him 16.7 percent more—1 pound, 3 shillings, and 24 pence (\$2.80). Similar price changes will be made in goods and services the British import and export, but there are several reasons why the prices of internationally traded goods will show smaller changes than these examples.

For one thing, retail prices of British goods sold abroad contain, in addition to the cost of the goods in Britain, such other charges as transportation, insurance, duties, and profits of the wholesalers and retailers abroad—all costs largely unaffected by the devaluation of the pound. Thus, a 14.3 percent reduction in the dollar-price of British goods in Britain would normally lead to a much smaller reduction in the price of those goods to customers abroad, possibly only 6 to 7 percent.

For another, many goods produced in Britain contain raw materials imported from abroad. As the prices of these materials to British importers are increased by the devaluation, British producers will have to increase the pound-prices of the products.

For still another, in some cases, producers may increase the pound-prices of their goods to the full extent of the devaluation, particularly if they think the demand for their goods abroad completely exhausts their ability to supply it.

And finally, increases in the prices of imported goods in Britain may create demands for wage and salary increases that, if granted, could increase the costs of production and be reflected in higher prices.

While the final effect of the devaluation on

²The charter provides that a member nation can change the par value of its currency up to 10 percent without seeking the fund's approval.

the price structure of traded goods is hard to predict at this point, British prices are expected to change enough to stimulate exports and retard imports—thus helping the country balance its international accounts.

But there is an important assumption underlying the expectation of such a favorable outcome. It is essential that the decrease in British prices to foreigners, and the increase in foreign prices to Britons, does not only increase foreign demand for British goods (and decrease British demand for foreign goods) but also that the shift will be sufficient in both cases to offset the initially unfavorable impact of devaluation on the country's total international earnings and expenditures.

The devaluation-induced reduction in the dollar-prices of British exports, and increase in the pound-prices of imports, reduce Britain's total receipts in dollars on a given volume of trade by the same percentage as the devaluation—and increase its total expenditures in pounds by approximately the same percentage. Thus, unless exports increase or imports decrease at least as much as the percentage change in international prices, Britain's trade balance would actually be worsened by devaluation. The government can aid such a development by rechanneling productive resources into export industries to accommodate increased demand abroad and by restricting domestic demand to set the stage for decreases in imports.

The effect on Britain

Devaluation in itself will not solve the economic problems that have plagued Britain for years. It can help restore the balance in Britain's international accounts and it can help restructure the British economy so that in the long run it can meet the requirements placed on it by changing patterns of world

trade. But the fundamental adjustments still have to be made internally. The economic forces unleashed by devaluation will have to be channeled toward such basic restructuring. Otherwise, the initial advantage gained by devaluation will be lost.

The British government, in announcing the devaluation, made it clear that it intends to do whatever is necessary to make sure that the devaluation not only re-establishes balance in the country's international accounts but that it also allows the country to earn enough surplus to repay the foreign credits it received during months preceding the devaluation. Additional restrictions have already been announced:

- To reduce domestic demand still further, the government increased downpayment requirements on instalment buying and shortened the maximum repayment period. It also proposed an increase in the tax on corporate income from 40 to 42.5 percent.
- To ensure that credit expansion does not provide support for inflationary pressures, the government asked British banks to restrict their lending, and the Bank of England increased the discount rate from 6.5 percent to 8 percent.
- To reduce the demands on the economy arising from government spending, the Chancellor of the Exchequer proposed a £ 400 million reduction in government expenditures.

The period ahead will doubtlessly mean an interruption in the rise in the standard of living for Britons. As the rise in import prices affects the cost of living, increases in wages and salaries will have to be held back to prevent cost-push inflation from boosting the prices of export products. The general level of demand will have to be held in check to guard against demand-pull inflation. Employment policies will have to be aimed at weed-

ing out structural rigidities that have hampered Britain's progress, and that could mean unemployment would have to remain uncomfortably high.

The response of the British people and the British economy to current policies will largely determine whether the once greatest economic power in the world will successfully resolve its balance of payments problem and continue to play an important role in international trade and finance.

The effect on the U. S.

Devaluation of currencies abroad has affected the United States in two ways—by changing its competitive position in world trade and by influencing the position of the dollar in world finance. As dollar-prices of imports from the United States increase in countries that devalued their currencies, U. S. exports of goods to those areas can be expected to taper off. Also as dollar-prices of U. S. imports from devaluing countries drop,

imports of goods from those areas can be expected to increase. The interplay of these two forces—one tending to decrease U. S. exports, the other tending to increase U. S. imports—will act to reduce the U. S. surplus in international trade accounts. But the impact will probably be small. Only about 11 percent of U. S. exports and 13 percent of U. S. imports will be affected—and these by relatively small price changes.

With the devaluation of the pound, additional attention is focused on the position of the dollar in its role as a reserve currency. The Secretary of the Treasury has observed that the dollar now stands in "the front line" against possible future speculation. To maintain confidence in the dollar as a viable reserve currency and thereby enable it to continue serving effectively in helping finance a growing volume of the world's trade and investment, the United States must intensify efforts to reduce the outflow of dollars—to balance its own international accounts.

Seventh District developments

Business in the Seventh Federal Reserve District was in a strong upswing at year-end. With the settlement of labor disputes in important Midwest industries, manufacturing production rose sharply and employment was on the rise. Preliminary reports indicate that the sluggishness in retail sales earlier in 1967 had been overcome. Orders for steel had strengthened, and moderate increases in orders for machinery, equipment, and components were reported. Construction contracts, at record levels in the second and third

quarters, continued strong in the fourth. While earlier predictions of a vigorous rise in business activity in the fall failed to materialize, the rise underway at year-end gives indication of continuing and even strengthening further in the early months of 1968.

Employment rising

Total nonfarm employment in states of the Seventh District—Illinois, Indiana, Iowa, Michigan, and Wisconsin—has risen every year since 1961, but the increase has not kept

pace with the growth of employment nationally. While the district's average annual rate of growth was 3 percent between 1961 and 1967, the average rise nationwide was a little higher—3.3 percent. Indiana and Iowa led the advance in the district, and Wisconsin matched the U. S. average gain. The district's slower rate of increase is partly explained by its population growing slower than the nation.

The smaller district gain in nonfarm employment also reflected a leveling off in Midwest manufacturing employment between 1966 and 1967. Although year-end employment in district manufacturing was apparently about the same as at the end of 1966, average monthly employment in manufacturing through the third quarter of 1967 was below the 1966 average in all district

states except Iowa. Production in many areas was curtailed by the generally slow growth of the economy in the first half of 1967, unusually severe weather last winter, and strikes in a number of manufacturing industries in the summer and fall. But with these disruptive influences largely out of the way, expansion was widespread at year-end.

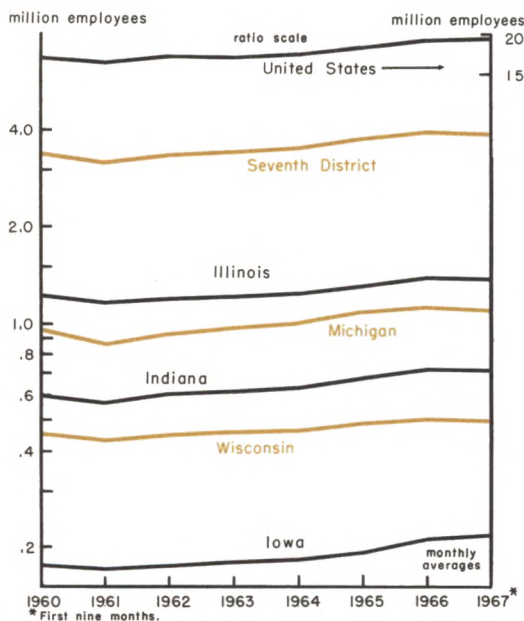
Personal income lags

Personal income in the first half of the year also rose less in the district than the nation. Between the fourth quarter of 1966 and the second quarter of 1967, the rise for the district was less than 1 percent, compared with 1.3 percent for the nation. Preliminary data for the third quarter indicate a continuation of this difference—personal income for the district rising 4.3 percent over the same period a year before, compared with 6.5 percent for the nation. Seventh District states, which have large proportions of personal income derived from manufacturing, were affected more than other states.

Personal income actually declined between the first and second quarters in Indiana, Illinois, and Wisconsin. But preliminary information indicates that solid gains were made between the second and third quarters in all states of the district but Iowa, where the change was negligible.

In Indiana, a production slowdown in the electronic industry and a rash of strikes in the trucking, electrical machinery, and furniture industries accounted for much of the decline between the first and second quarters. In Wisconsin, a decline in the average work-week and in weekly earnings, offset the increase associated with rising employment. And in Illinois, the trucking strike, which severely curtailed production in some industries, was largely responsible for a small (less than 1-percent) decline. A gain in Michigan

Growth in District manufacturing employment slows



was due largely to increases in automobile production schedules and a spring surge in nonmanufacturing, especially retailing.

Although district growth in personal income lagged in the first half of 1967, the increase in per capita income since 1961 has exceeded that for the nation. Illinois, with a 35-percent increase, almost matched the national advance of 36 percent over this period. All other district states surpassed the U. S. increase. Iowa's growth in per capita income was fastest—more than 50 percent.

Production slowdown early in 1967

Manufacturing activity in Chicago slipped in 1967. Buffeted by a decline in demand, a severe winter, and strikes, manufacturing in the district's largest metropolitan area dropped slightly more than 5 percent from the second half of 1966 to the first half of 1967. However, measured by an index based on the electric power used in various industries, two-

thirds of the decline had been recovered by the third quarter, and preliminary reports indicate further recovery to year-end.

A first-half decline in manufacturing in Detroit was moderated in June by a spurt in automobile production. As a result, manufacturing activity in the district's second largest metropolitan area declined less than 2 percent in the first half. With output in automobile and related plants limited first by downtime for model changeovers and then by work stoppages, the performance of Detroit manufacturing continued sluggish into the second half but rose sharply at year-end.

Spending gains moderate

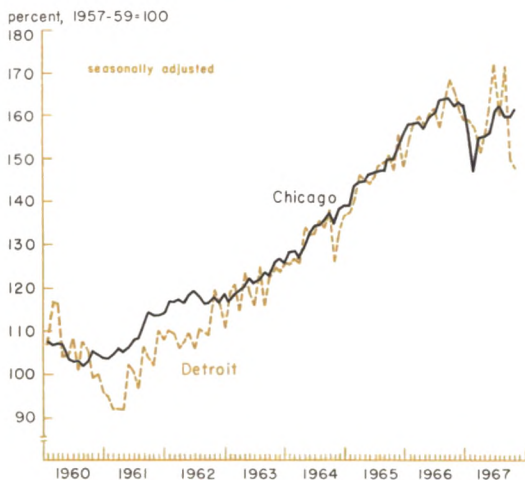
Retail sales for the district in 1966 ran about 8 percent above levels for the year before—slightly more than the year-to-year increase for the nation. But the rate of increase slackened in the first half of 1967, and retail sales in the district slipped below year-ago levels in three of the first six months. Sales weakened more for the district than for the nation, reflecting the severe weather in the spring. While gains in retail sales in the Midwest have largely paralleled those of the nation since midyear, they are still small compared with the rise in personal income.

Bank debits, a measure of local spending, showed less evidence of a district decline in the first half and sluggishness in the second than did other measures. While district debits dipped in January, the 1966 level was exceeded by April and a new high was set in August. Debits in district centers tend to fluctuate more widely than those for the nation, but short-term changes have been similar for the district and the nation.

Construction strong

Construction contracts were at record highs in the second and third quarters. Con-

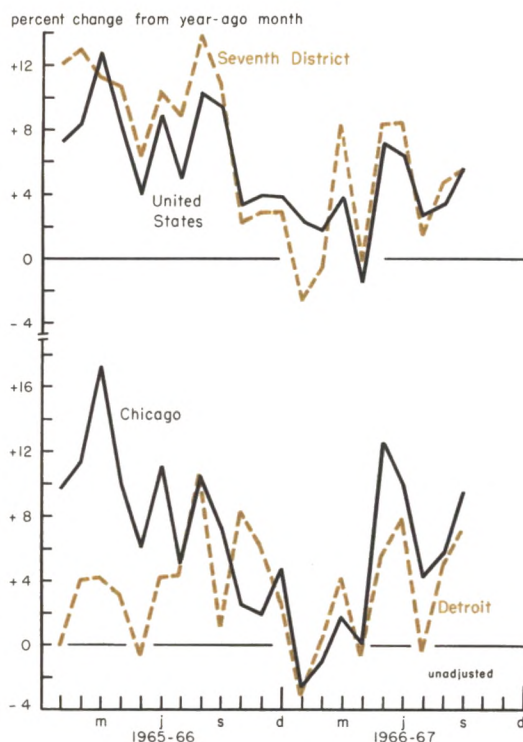
Recent rise in electric power consumption indicates recovery from first-half slowdown



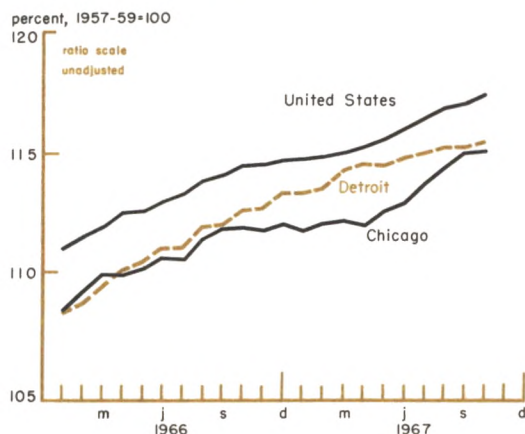
tract awards for residential, commercial, and public construction have been large, especially for apartment buildings.

Rates on new mortgages have increased to the highs seen in the fall of 1966—6.5 to 7 percent. Money remains available, with savings inflows to savings and loan associations continuing large. With the associations having heavy mortgage commitments to builders,

District retail sales slipped below year-ago levels in three of the first six months



Consumer prices in Chicago accelerate, while increases in Detroit are moderate



expansion of residential construction is likely to continue.

Price pressures continue

Price pressures were stronger in Chicago than in the United States as a whole. The consumer price index showed only moderate increases in Chicago in the first quarter as prices of food and housing remained stable, tending to restrain the overall rise. But the index rose 2.5 percent between April and September—or at an annual rate close to 6 percent. The increase reflected sharp rises in nearly all categories of consumer goods and services—food, housing, transportation, and health care.

The consumer price index for Detroit has shown more moderate increases. Although

there was a sharp rise between February and April, the increase through September was less rapid than for the nation.

Near-term prospects

Business in the district is expected to continue improving. Some production increases will accrue from efforts to regain time lost to strikes, and if the predicted general ebullience of the U. S. economy materializes in the first half of 1968, the picture in the Midwest will be even better.

State and local spending appears to be

rising in the district undeterred by the costs of financing. Steel orders are improving, and inventories of steel in the hands of manufacturers, now generally low, will probably increase as manufacturing activity gains momentum and, in view of a possible strike in the fall, companies undertake protective inventory buildups. Although production of defense materials is not generally important in this district, increased demand for other products stimulated by continued defense spending will add strength to measures of district activity.

Fewer farmers, and their average age rising

The average age of farmers is rising. This has caused some concern for the future of agriculture. But the trend, which is of long standing, has had no significant adverse effects thus far. Nor are there any in the offing, even though the trend is almost certain to continue for many years to come.

The average age of the nation's farmers in 1964, the year of the most recent Census of Agriculture, was 49. That was an increase of 4 years in the average age since 1950. Workers in manufacturing average 39 years—10 years less than farm operators. Nearly two-fifths of the farmers in the Seventh Federal Reserve District are over age 55. This is up from one-third in 1950.

The tendency for older groups to account for an increasing proportion of farmers reflects the rapidly rising productivity of American agriculture and the accompanying

decline in the number of farmers needed to supply the nation with farm commodities. As total requirements increase or decrease, in any occupational group, it is the younger elements that make most of the adjustment. In agriculture, production per manhour has increased rapidly as farmers have found new technologies (such as larger machines, improved seeds and fertilizers, new chemicals, and even computers) profitable and put them increasingly to use. As a result, the number of people participating directly in the production of agricultural commodities has declined for more than 30 years. And since new technology is most effective on fairly large farms, the number of farms—and, therefore, farmers—has declined.

The efficiencies obtained through enlarging farm size are only one aspect of the migration from farms to urban centers and the increased

average age of farmers. Equally important are the other, often more attractive, opportunities available to young workers in other employment. As young men growing up on farms survey the alternatives open to them, more and more have been attracted to other work. Many that started farming have lacked the necessary capital or management skill to expand their operations into efficient sizes and, therefore, have seen little prospect for satisfactory incomes as farmers. With employment available in urban areas, many have turned to nonfarming employment.

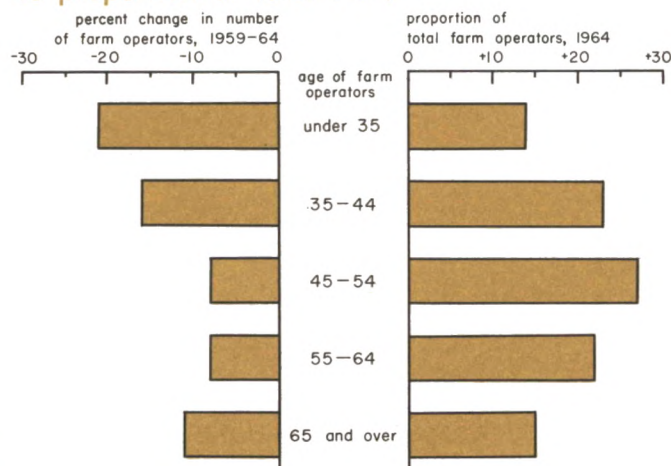
Older workers, on the other hand, are more likely to be established in their occupation and are generally more reluctant, or less able, to shift to other types of work. This is especially important in farming, which requires large amounts of capital that typically must be provided primarily by the farmer. Older established farmers are in a strong position to compete for land and resources. Thus, the average age rises as fewer young men become farmers and older men remain.

Many observers have suggested that, if this trend continues, there will not be enough farmers to provide adequate supplies of farm commodities. But such concern does not seem warranted. Although the number of young men entering agriculture has declined, those taking it up appear to be operating generally larger and more efficient farms than older farmers and to be expanding their operations faster.

In the Seventh Federal Reserve District, the number of farmers under age 34 declined more than 21 percent between 1959 and 1964. The decline, however, was confined to those operators of relatively small farms. The number of farmers in that age group operating farms with product sales of \$20,000 or more increased nearly 26 percent. Moreover, a recent study by the Department of Agriculture states, "One-third of the new entrants into the \$10,000 or over gross sales class during recent years were under 36 years of age." Yet, in the five states of the Seventh District, this age group accounted for only about 15 percent of all operators in 1964.

With modern technology, farmers have greatly increased their production efficiency by merging small farms into larger ones. Although the number of farms in the Seventh District declined about 13 percent between 1959 and 1964, farms with product sales totaling \$20,000 or more increased about 53 percent. Similarly, the number of farms of more than 260 acres rose about 12 percent between census years, while those with fewer than 260 acres declined about 19 percent. As indicated above, younger farmers, although a small and de-

Young farmers decline as proportion of total . . .

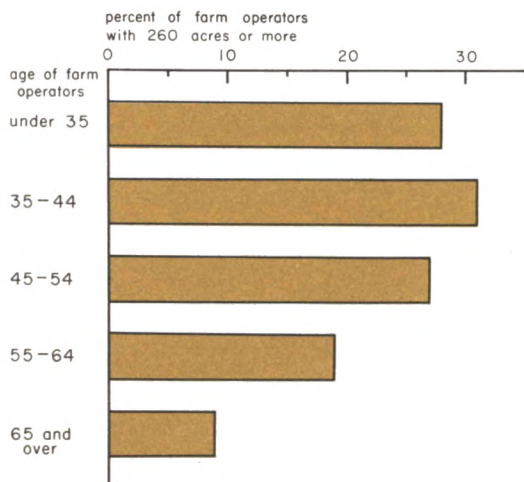


clining proportion of all farmers, played an important role in these shifts.

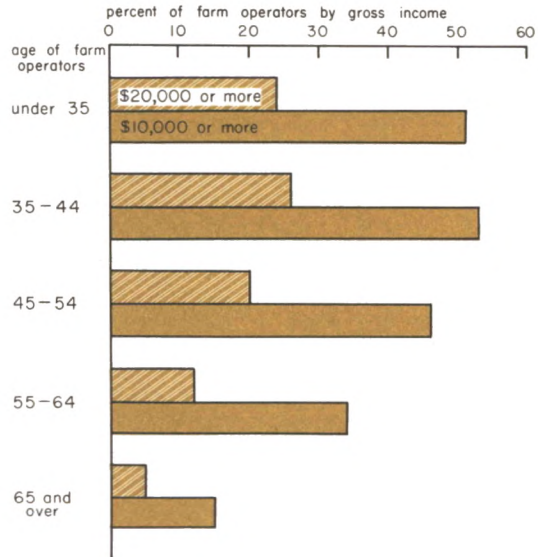
Although the amount of resources devoted to agriculture has remained fairly stable over the past several years, production has risen nearly 16 percent since 1959. Production per acre in the Corn Belt has increased about 26 percent since then, and output per manhour has increased about 64 percent.

The increases in production were probably even greater on farms making the greatest investment in new technology. And younger operators may well have adopted improved methods faster than older farmers, especially young farmers with access to additional capital. Studies of the characteristics of farmers readily adopting new technology indicate that innovators are venturesome, more willing to take risks, and more educated than late adopters. Older age tends to be associated with more conservative attitudes, stable or declining production, and a greater emphasis on stability and security.

... but operate larger acreages ...



... and produce greater quantities of agricultural commodities



Older farmers also have less formal education than young farmers. These studies generally found the average age of late adopters older than that of innovators.

Younger farmers are probably more willing to risk investments in new production methods and technology—if only because they can expect to realize more return over their working years. New technology often requires increased investment, and often the use of borrowed capital, especially for young farmers. According to the Federal Reserve System's 1966 farm loan survey and data from the Census of Agriculture, young farmers in the Seventh District used more bank credit than their proportion in the number of all farmers. Moreover, the average outstanding amount of bank loans was largest for

borrowers 35 to 44 years of age—more than \$6,500 per borrower—and the average bank debt outstanding to that age group increased faster in 1956-66 than to any other group. Other studies also indicate that young borrowers are more likely to be indebted to more than one lender, further increasing the total debt to young farmers.

Census data reveal further evidence of other characteristics associated with young farmers. More than half the younger farmers (those under 45) operated farms with gross sales of \$10,000 or more in 1964, while only a third of the older farmers (those 55 to 64) reached that level. A fourth of the younger farmers operated farms with gross sales of \$20,000 or more, compared with a mere eighth of the older farmers. Similarly, about a third of the younger farmers operated 260 acres or more, compared with a fifth of the older farmers between 55 and 64. In Illinois, the Seventh District state with the largest average farm size, farmers from 35 to 44 operated farms averaging 268 acres, while farmers 55 to 64 operated farms averaging 204 acres.

Even though the number of young farmers is relatively small, they produce a large proportion of total farm commodities. Farmers less than 45 years old made up only 36 percent of the farmers in the district in 1964, but they produced 45 percent of the farm commodities. They also operated more than half of the farms in the district with gross sales of \$20,000 or more. By contrast, farmers at least 45 years old operated more than two-thirds of the farms with sales between \$5,000 and \$9,999 and nearly three-fourths of those with sales under \$5,000.

A large proportion of farmers are found on small, noncommercial farms. Many are semi-retired or hold part-time jobs. Income from such nonfarm jobs to farmers with less than \$5,000 in sales of agricultural commodities average about \$3,400 per farm in 1966. About a fourth of the farms of that size were operated by farmers at least 65 years old.

Some of these older farmers may have transferred parts of their farm businesses to younger men. That would partly explain their lower production and sales. A retiring farmer might, for example, rent some of his land to a son but continue to live on the farm and operate part of it to supplement his retirement income.

The kinds of structural changes in agriculture that have been associated with the decline in the number of farms and farmers can be expected to continue. By 1980, further improvements in technology and additional investment in agriculture are likely to reduce labor requirements still further—probably by as much as a third. About half the men farming in 1968 will have reached retirement age by 1980, but the number of younger farmers needed to provide ever increasing amounts of agricultural commodities for both domestic consumption and exports to other nations will be considerably smaller than the number reaching retirement age.

While farm population can be expected to decline further and in turn result in a further increase in the average age of farm operators, the flow of income to those remaining in agriculture is nevertheless likely to rise. The farmers will be larger operators, producing a substantially larger volume of agricultural commodities, and a larger income per farm.

Recent time deposit growth

Inflows of savings to thrift institutions rose sharply in the first three quarters of 1967. Personal savings-type deposits at commercial and mutual savings banks were up substantially from last year. And additions to share accounts at savings and loan associations were more than six times as great as in the same period in 1966 when funds were flowing largely to other uses.

The question of where this money came from takes on special significance in view of the instability in time deposits and share accounts in 1966 and fears that a new round of turbulence might develop if market interest rates were to continue to rise.

Inflows into time accounts at banks and share accounts at S&Ls may come from a variety of sources—savings from current income, sales of physical assets, shifts of funds from checking accounts or other financial institutions, and sales of securities. How much comes from each is, of course, unknown. But some indication can be had from looking at recent changes in the time-deposit mix, recognizing that inflows into one type of account are apt to be more related to one source than another.

Liquidity preferred by some

Savings accounts at commercial banks yield less return than can usually be had elsewhere. Federal regulations allow banks to pay no more than 4 percent on savings accounts, compared with 5 percent on time certificates under \$100,000 and 5.5 percent on larger certificates. The latter are of little practical importance as a savings medium for individuals, however, because the minimum denom-

ination is far too large for most people.

Unlike funds held in certificate form, savings accounts can usually be converted to cash immediately. Because time certificates have specified maturities, holders must usually wait until the maturity date to convert their certificates into cash.

The prevalence of savings deposits over certificates probably reflects the immediate availability they offer depositors and the size of most savings balances, which are typically too small to make transfers to certificates worthwhile. About half the banks require at least \$500 for investment in a certificate.

Because savings accounts provide a safe, convenient means of holding assets in liquid form, they are among the first types of savings to show the effects of changes in income and spending. Most funds deposited in bank savings accounts come directly from customers' current income or transfers from their checking accounts. Some banks provide a service of transferring funds from checking accounts to savings accounts at regular intervals. Savings deposits at commercial banks tend to increase rapidly when aggregate personal saving is rising relative to income, as it was last spring and summer.

Banks in more than half the metropolitan areas of the Seventh Federal Reserve District reported net inflows into savings accounts in the first three quarters of 1967. This was in sharp contrast to the net outflow common in the same period in 1966.

The sharp increase in inflows can be attributed largely to sustained high levels of personal income, coupled with strong motivations to build up liquidity. The emphasis on

quick accessibility of savings was probably fostered by uncertainties regarding future income, and especially by spring and summer forecasts of strong possibilities of layoffs resulting from strikes in the automobile and other industries. Increases in savings balances during January-September were most common in areas of the Seventh District where workers in manufacturing make up a large part of the work force.

Five of the district's 33 metropolitan areas—Rockford, Muskegon, Kenosha, Milwaukee,

and Racine—had greater growth in savings deposits in 1967 than in 1965 or 1966. All five areas have high concentrations of workers in manufacturing.

There were large inflows into savings accounts in some areas where the rate paid on such deposits was relatively low. Banks in the Gary-Hammond area, for example, had sizable increases in savings deposits in 1967, even though some paid only 2 percent. Because of state regulations, no Indiana bank could pay more than 3.5 percent on savings accounts. Yet, gains in savings deposits in Indiana were as large as those of other areas; people seldom go outside their own communities to obtain savings deposit service.

For banks in most areas, certificates of deposit were a more important source of funds than savings deposits. In about a third of the areas, savings deposits decreased in the first three-quarters of 1967, but this was offset by a rise in certificates. In other areas, savings deposits rose, but the gains were smaller than gains in certificates. Insofar as the increase in certificates represented funds diverted from savings accounts, the composition of deposits in commercial banks changed, but with no net inflow of funds from outside the banking system.

Savings have varied more in district centers where manufacturing is important

Centers by percent of employment in manufacturing	First nine months balances compared with year earlier			Balance, September
	1965	1966	1967	1967
	(percent change)			(millions)
Commercial banks				
Savings deposits				
15 centers with more than 40%	14	— 11	2	\$ 5,365
18 centers with less than 40%	8	— 6	— 1	7,586
Total, 33 centers	10	— 7	*	12,951
Total savings-type deposits†				
15 centers with more than 40%	14	4	9	\$ 7,435
18 centers with less than 40%	9	2	10	10,179
Total, 33 centers	11	3	9	17,614
Insured savings and loan associations				
Share balances				
15 centers with more than 40%	5	— 1	9	\$ 5,013
18 centers with less than 40%	4	2	6	10,592
Total, 33 centers	4	2	7	15,605

*Less than ± 0.5 percent.

†Includes, in addition to savings deposits, individuals' holdings of time certificates of deposit.

Banks versus S&Ls

Since 1966, savings and loan associations have had a regulated differential rate advantage over commercial banks. In most of the country, most S&Ls can pay as much as 4.75 percent on regular passbook share accounts, compared with a maximum of 4 percent on savings deposits at banks. Savings and loan associations can usually pay as much as 5.25 percent on certificates, compared with 5 percent at banks.

Many banks pay the maximum authorized rates. Figures for July 31 (the latest avail-

able) show nearly nine-tenths of all banks in the United States with total deposits of \$100 million or more, and almost two-thirds of the smaller banks, paying 4 percent on savings deposits. On certificates of less than \$100,000—those issued predominately to individuals—about half the banks—those accounting for four-fifths of the small-denomination certificate deposits outstanding—paid the 5 percent ceiling.

Information available on S&Ls indicates that in January 1967 about four-fifths of all share accounts were of the regular passbook type. A third of the associations, holding nearly half the share capital, paid the maximum authorized dividend—4.75 percent in most states but 5 percent in the Far West and certain eastern states. Nearly all paid more than the 4 percent maximum authorized for banks. By contrast, a third of the associations had paid only 4 percent on regular share accounts in December 1965 and another third 4.25 percent. Very few had paid more than 4.5 percent.

The differential between savings and loan dividend rates and bank interest rates on passbook savings had therefore widened noticeably by early 1967. Rate ceilings kept most banks from following the lead of S&Ls in increasing rates on savings. The result was a growing attractiveness of passbook accounts at S&Ls for savers wanting their funds to be readily available. The widening gap apparently slowed bank gains in savings deposits.

Information for the Seventh District provides an indication of the extent of the impact. In the first nine months of 1967, banks in three-fifths of the centers reported greater growth in personal savings-type deposits (savings deposits and certificates) than was registered in share accounts at local S&Ls. This was a smaller proportion of areas than in 1965 and 1966 when banks in nearly all

areas improved their relative positions.

Thrift institutions versus the market

Thrift institutions have also attracted a good deal of money that is held for investment purposes. These funds tend to be mainly in certificate form at commercial banks but in regular share accounts at S&Ls. A survey conducted by the U. S. Savings and Loan League at the end of 1965 indicates that savings and loan accounts contain a sizable amount of "investment-type" money. The survey showed that 31 percent of all savings at associations was in accounts with balances of more than \$10,000. At commercial banks, around 35 percent of all savings deposits were in accounts exceeding \$10,000. Holders of these funds included individuals and non-profit organizations such as pension funds, churches, and credit unions. The large sums involved suggest that such accounts are sensitive to developments in the security markets.

There are indications that the funds acquired by banks and S&Ls in the first three quarters of 1967 resulted partly from a decline in direct investment in marketable securities. Data on flows of funds indicate a *decline* in direct financial investment by individuals in the first three quarters at a seasonally adjusted annual rate of \$8.7 billion. This contrasts with the \$10.8 billion average *increase* in 1966. Net gains at the thrift institutions averaged a \$36.4 billion annual rate in the first three quarters of 1967—far more than the 1966 gain of only \$18.9 billion.

The shift of funds to thrift institutions was related to the fall in interest rates on government bonds and high-grade corporate securities from the 5.5 to 6 percent range in the summer of 1966, when a substantial amount of money was attracted to such instruments. Although yields available in the long-term

bond market remained generally higher than maximum rates at thrift institutions in the first nine months of 1967, the smaller yield differential was apparently enough to curtail investment in marketable securities. The average size of savings and loan shares, which had been \$2,770 in December 1965, dropped to a low of \$2,670 in October 1966, but had climbed to \$2,800 by September 1967.

The role of corporate deposits

Negotiable time certificates of deposit in denominations of \$100,000 and more—certificates held primarily by businesses—rose about \$1 billion in the first half of 1967 and accounted for about 13 percent of the rise in aggregate time deposits of individuals and businesses. Moreover, growth in certificates of large denominations was widespread, with banks in almost all parts of the country reporting increases.

The sharp rise in these deposits resulted largely from a buildup in corporate liquidity and, at least in early 1967, from the increased attractiveness of bank interest rates compared with rates on Treasury bills and other money-market instruments. Corporations, even more than individuals, responded to the change in the rate structure. Yields on short-term government securities—which, to corporations and other large holders of liquid assets,

are the closest investment alternatives to time certificates issued by banks—were considerably lower in early 1967 than in 1966. In September 1966, for example, the market yield on six-month Treasury bills was 5.8 percent, compared with 3.8 percent in May 1967. With the fall in yields, banks—operating under a regulatory maximum of 5.5 percent for certificates of deposit of \$100,000 or more—were able to attract larger amounts of such deposits.

While corporations sometimes place funds in savings and loan shares, their interest in these establishments is small. Commercial banks, with their greater liquidity and greater flexibility in the kinds of time deposits and loan services they can offer, are the primary outlet for deposits of business. Reflecting the buildup of time deposits of corporations, total time and savings deposits at commercial banks grew faster in the first three quarters of 1967 than at other financial institutions. The source of the recent gains in time deposits, therefore, appears largely to have been current income and reduced flows of funds into market securities, not transfers of funds from other financial institutions. However, this probably provides no substantial assurance that flows of funds would not shift again in favor of market securities if interest rates make such a shift attractive to investors.

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