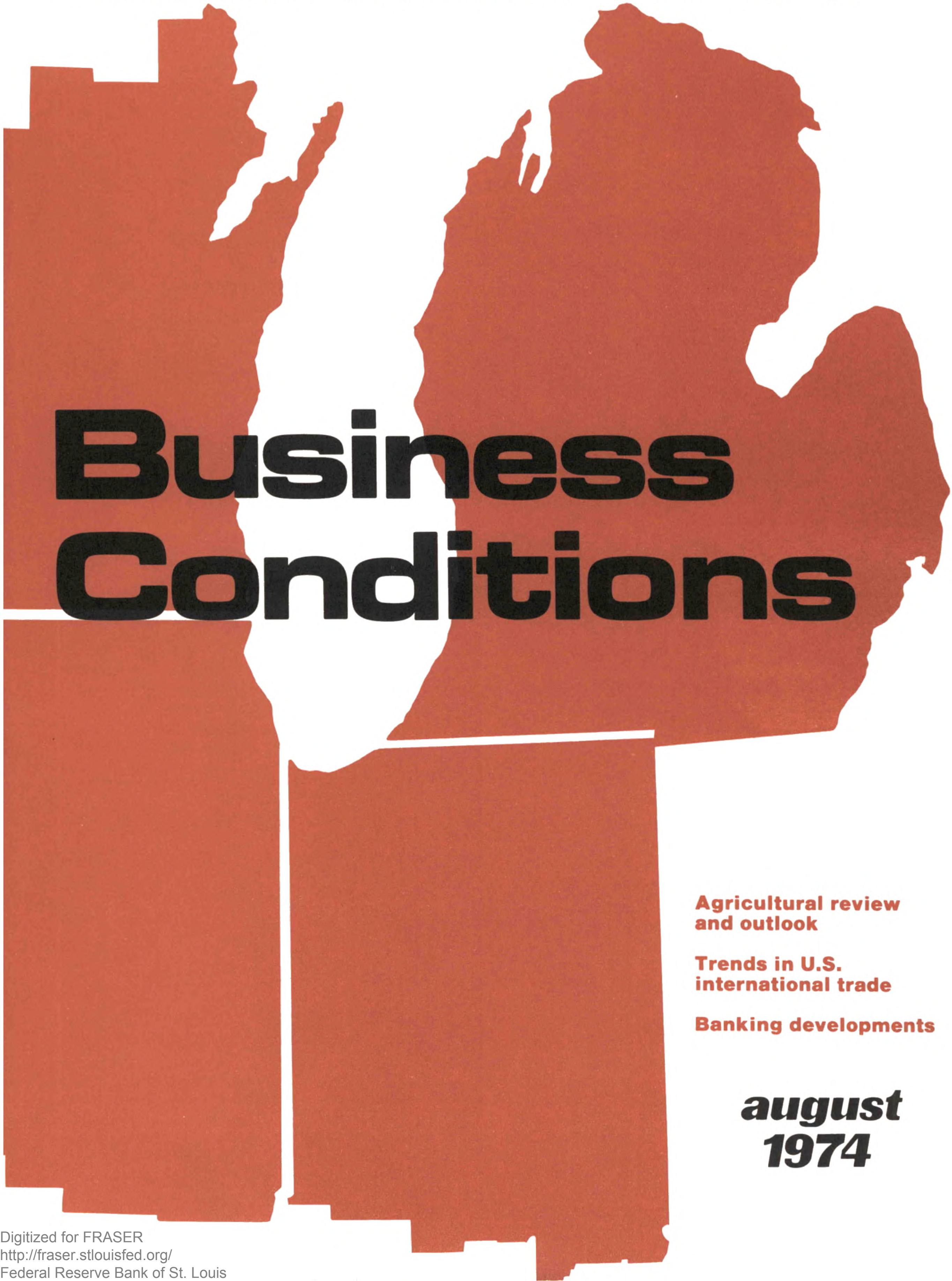
an economic review by the Federal Reserve Bank of Chicago



Business Conditions

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Agricultural review and outlook

Widely fluctuating prices continued to highlight agricultural developments in the first half of this year. Prices of farm commodities rose sharply in January, and by mid-February the composite index of prices received by farmers was up close to the August 1973 peak. But a long and steep downtrend followed as livestock marketings rose and as concerns for a virtual depletion of grain stocks were alleviated by prospects for a large 1974 harvest. By mid-June, the index of farm prices had fallen below the year-earlier level—the first year-to-year decline since July 1971—and was 19 percent below the 1974 high recorded in February.

The downtrend reversed abruptly late in the first half. Prices of agricultural commodities started zooming in late June as the mounting financial losses suffered by livestock producers became evident in reduced feedlot inventories, and as the adverse weather conditions drained the optimism for record crop harvests. By mid-August, it was apparent that the crop damage would severely curtail production and leave livestock producers with little prospect of breaking out of their financial squeeze. As a result, prices of several major crops had reached new 1974 highs, while livestock prices had recovered most of their earlier declines.

Food prices remained high

Food prices reacted sluggishly to the extended first-half declines in farm prices. Retail prices of food consumed at home accelerated during the first quarter and by March exceeded the previous peak of December 1973 by 6 percent. Although food prices declined in April, increases in May and June were more than offsetting. By midyear, the index of grocery store food prices was slightly above the March peak, and exceeded the rapidly rising year-earlier level by 15 percent.

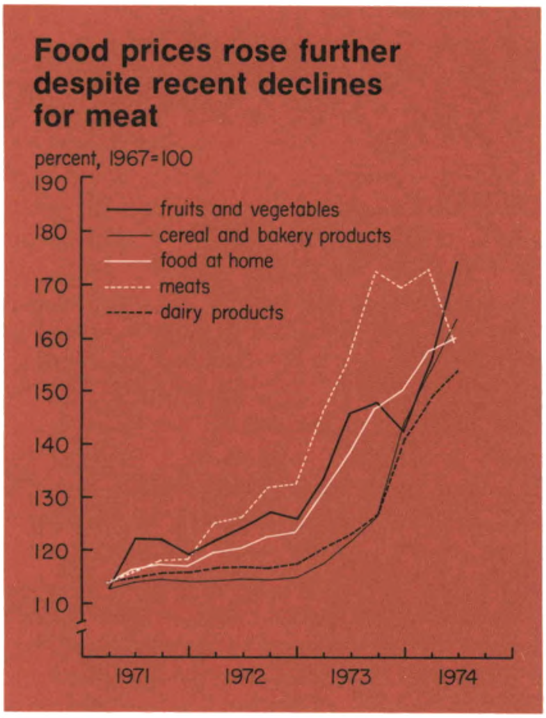
The divergent trends between retail food prices and farm prices resulted in further increases in the already wide farm-to-retail price spreads. The index of the farm-to-retail price spread for the market basket of food* narrowed briefly in January but rose steadily thereafter. By June, the index exceeded the ending 1973 level by 14 percent and the year-earlier level by 28 percent. Major factors contributing to the wider spread were higher costs of labor, transportation, and packaging materials. But higher profits for firms involved in manufacturing, processing, and distributing food also contributed to the widening farm-to-retail price spreads.

Foreign demand remained strong

Foreign purchases of U. S. agricultural goods continued to accelerate during the first half of this year. Paced by higher prices, agricultural exports rose 48 percent above the year-ago mark during the January-June period. For all of fiscal 1974, agricultural exports were valued in excess of $21 billion, compared to less than $13 billion in fiscal 1973. The increase more than offset a large gain in imports and provided an agricultural trade surplus of nearly $12 billion, up from $5.6 billion in fiscal 1973.

Shipments of feedgrains and soybeans dominated the export picture in the first

*The market basket contains the average quantities of domestically produced farm foods purchased annually per household in 1960 and 1961 by wage-earners and clerical worker families and workers living alone.



half. The volume of corn shipments rose 12 percent ahead of the corresponding year-earlier level during the first half, while total feedgrain shipments rose 12.5 percent. Soybean shipments were up 12 percent, while shipments of soybean oil and meal were up 37 and 6 percent, respectively. The volume of wheat exports fell 41 percent behind the record year-earlier level during the first half as sharply higher prices rationed the dwindling supplies.

Commodity review and outlook

Cattle and hog prices registered extreme fluctuations during the first half. Both rose about $10 per hundredweight early in the year and peaked at around $48 and $40 per hundredweight, respectively, in the second week of February. The downtrend that followed, however, ultimately pushed cattle prices down to $36 per hundredweight and plunged hog prices to a two-year low of less than $23 per hundredweight. Following these lows in mid-June, cattle and hog prices climbed rapidly and reached the high $40s and high $30s, respectively, by early August.

The cycling livestock prices largely reflected slaughter patterns. Cattle and hog slaughter fell slightly short of the year-earlier pace during the first quarter, in part reflecting the disrupted marketings caused by the truck strike in February. But marketings picked up in the second quarter, and cattle and hog slaughter rose 8 percent above the low year-earlier levels. The increased slaughter coupled with heavier average slaughter weights boosted total commercial red meat production to a near-record high for the first half, 6 percent above the same period a year earlier. The increase in production more than offset a rise in consumption and boosted cold storage of red meat markedly.

The outlook for livestock prices remains highly uncertain since drought and high feed prices may cause second-half marketings to vary from the traditionally reliable indications provided in inventory estimates. Placements of cattle into feedlots continued to fall during the first half in response to mounting losses experienced by cattle feeders since September of 1973. As a result, the number of cattle on feed in the major cattle-feeding states on July 1 was at the lowest level since 1968 and down 21 percent from the record set in 1973. Nevertheless, the inventory is sufficient to hold fed cattle slaughter substantially above year-earlier levels throughout most of the second half, if the relationship between inventories and slaughter—which has been widely distorted for the past six quarters—returns to the more normal level. In addition, the rapid buildup in the total cattle inventory during the past few years—up 6 percent from a year ago on July 1—plus the lagging movement of cattle into feedlots for the past 15 months implies there is a large supply of heavyweight cattle currently grazing on pasture. The combination of drought and tight supplies of forage and feedgrains suggests that during the next several months a proportionately large number of these cattle may move directly to slaughter markets or, if profit incentives exist, into feedlots for a brief period. Either course of marketing, however, will result in a lower quality grade of meat than traditional grain-fed beef.

Hog marketings are also expected to be substantially above year-earlier levels throughout the second half of 1974. Although the inventory of hogs intended for market is slightly below a year ago, the level is sufficient to hold second-half slaughter 6 to 10 percent above a year ago. The increase could be even larger if farmers respond to the high feed prices by liquidating hogs held for breeding purposes.

The uncertainty over slaughter has lowered the degree of certainty in forecasts of livestock prices. Nevertheless, many observers expect hog prices will average in the low to mid-$30s during the second half, while cattle prices may average in the low to mid-$40s. The typical pattern of high prices in the third quarter followed by lower prices in the fourth quarter is expected to prevail, although seasonal fluctuations are not likely to be as great as a year ago.

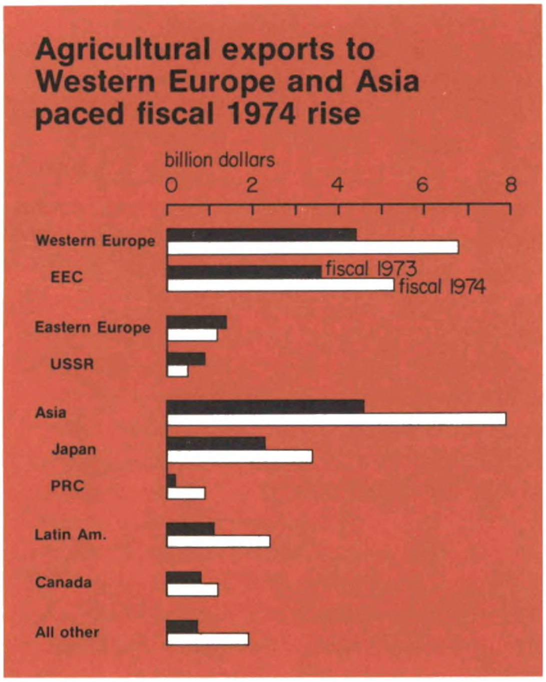
Milk prices held fairly stable during the first quarter after rising sharply during the last half of 1973. But in the second quarter, the seasonal decline tripled the normal 30 cent reduction per hundredweight. Nevertheless, milk prices received by farmers remained nearly one-fourth above the year-earlier level in June.

The extraordinary seasonal decline in milk prices occurred despite lower production as consumer resistance to high retail prices resulted in a larger cutback in consumption. Total milk production for the first half of this year was down about 2.5 percent from the year-earlier level. But it appears that fluid milk sales were down 5 percent. This produced an increased flow of milk into manufactured dairy products where production proved more than the market could bear. The resulting decline in prices of manufactured dairy products, in turn, activated government purchases in order to maintain price support levels.

Although sharply higher milk prices boosted cash receipts, dairy farmers continued to operate under extremely tight margins. For the entire first half, the milk-feed price ratio—pounds of concentrate feed ration equal in value to 1 pound of milk—averaged close to the low year-earlier level and 15 percent below that of the same period in 1972. There appears to be little hope for improved operating margins in the second half. Feed prices will remain high, and while milk prices will recover seasonally during the last half, lagging consumer demand will likely limit the increase. These developments suggest milk production will remain below year-earlier levels throughout the second half.

Crop prices rose sharply early in the year and then trended downward for several weeks. The upward pressures partially reflected the normal post-harvest seasonal rise. But other factors—such as fertilizer shortages, prospects for the smallest carryover of grain stocks in a quarter of a century, and the rumor that bread would cost $1 a loaf—were also important. These concerns subsided in late February, however, when preliminary indications suggested that this year's wheat harvest would exceed the 1973 record by 20 percent, that farmers intended to boost spring plantings substantially above year-earlier levels, and that domestic feed demand would be reduced by the financial problems of livestock producers. The downward pressures were intensified by reports of large grain harvests in Argentina and South Africa, expanded soybean production in Brazil, a return to fishing in Peru, and weather conditions that permitted an early start in spring plantings.

From early May to early June, crop



prices stabilized as prospects for larger harvests were being weakened by an awareness that drought and disease were affecting wheat and that heavy rainfalls would substantially delay spring plantings throughout the Corn Belt. The resulting upward pressures on crop prices were intensified in July when drought conditions settled over much of the Midwest. By mid-August, it was apparent that the 1974 feedgrain and soybean harvest would fall far short of year-earlier levels and that the increase in wheat harvest would be disappointingly small. As a result, corn and soybeans were well above earlier highs, while wheat prices were up considerably despite the record harvest.

The outlook for crop prices is extremely uncertain. The estimated 8 percent increase in this year's wheat crop is fairly assured since the harvest is nearly completed. However, since the increased production will not offset the reduction in carryover stocks, total wheat supplies for the 1974-75 wheat marketing year will be slightly lower than in the year ended June 30, 1974. And although many observers feel a reduction in exports will ease the tight supply/demand balance for wheat, high feedgrain prices will likely provide additional support for wheat prices.

Based on conditions as of August 1, the U. S. Department of Agriculture estimates this year's corn harvest will fall below 5 billion bushels, down from 5.6 billion in each of the past three years. The lower corn crop plus smaller harvests of oats, barley, and sorghum, would drop feedgrain supplies for the 1974-75 marketing year to the lowest level since 1957-58. The sharply lower supplies will necessitate major adjustments in both exports and domestic utilization. As a result, corn prices will continue to fluctuate widely at historically high levels.

Much the same outlook holds for soybeans. According to the latest estimates, the 1974 soybean harvest is expected to total 1.3 billion bushels, down from 1.6 billion in 1973. While carryover stocks this fall will be larger than a year ago, total supplies may be down 9 percent. And with the increased U. S. crushing capacity and the strong foreign demand, the supply/demand balance for soybeans will be appreciably tighter in the 1974-75 marketing year that starts in September.

Financial review and outlook

Financial developments in the agricultural sector this year could be termed disastrous if compared strictly with those of 1973. Alternatively, the financial developments could be characterized as extremely favorable if compared to 1972 and most earlier years. Unfortunately, neither comparison provides an accurate appraisal of conditions. For the record, however, the U. S. Department of Agriculture recently estimated that net realized farm income would approach $25 billion this year, down from $32 billion in 1973 but well above the previous record of

$17.5 billion in 1972. During the first half of this year, net farm income averaged $28 billion on a seasonally adjusted annual basis. Farmland values are expected to rise 15 percent during the year ending March 1, 1975, down from a record increase of 25 percent the previous year but up from the then comparatively high 14 percent advance two years ago.

The problem of using overall averages as a measure of the current financial condition of the agricultural sector is that the averages mask the problems of the entire livestock sector. The losses experienced to date by cattle feeders, hog producers, and dairy farmers, as well as the continued losses that are almost certain in the second half can only be described as tremendous. Although figures vary widely, the U. S. Department of Agriculture estimates that losses on cattle placed into feedlots during the last half of 1973 amounted to $1 billion, or nearly three-fifths of the equity capital employed to fatten those cattle. For cattle placed into feedlots during the first half of this year, the estimates suggest equity losses of $0.3 billion out of the total $1.1 billion in equity capital involved. The combined loss of $1.3 billion is indicative of both a bleak financial picture for livestock producers and the probable structural shifts that will occur in cattle feeding in order to find new equity sources.

Farm debt continued to accelerate during the first half of this year, extending a trend that started in 1971. New money loaned by Federal Land Banks (FLBs)—the mortgage lending arm of the borrower-owned Farm Credit System—exceeded the rapid year-earlier pace by 27 percent during the first half. The increase exceeded loan repayments and boosted FLB outstandings of 23 percent above a year ago July 1. Loans made by Production Credit Associations (PCAs)—the short- and intermediate-term credit counterpart of FLBs—rose 15 percent during the same period which combined with slow repayments pushed midyear outstandings upward by 21 percent. The available evidence suggests that banks also have provided a substantially larger volume of farm loans during the first half.

The continued large increases in farm borrowings are a reflection of several factors. Much of the growth reflects increased operating expenses resulting from both larger purchases and sharply higher prices paid. As of mid-July, the index of prices paid by farmers for production items was 15 percent above the year-earlier level. A large portion of the increase reflected higher fertilizer and seed prices.

A sizable portion of the increased borrowing, no doubt, is attributable to the financial losses of livestock producers. In some cases, these losses have necessitated renewals and extensions of existing loans and, in others, a refinancing of farm real estate to pay off operating loans. Finally, much of the growth in short-term farm loans represents the tightening credit practices of merchants and dealers who no longer need to promote sales by offering credit to customers.

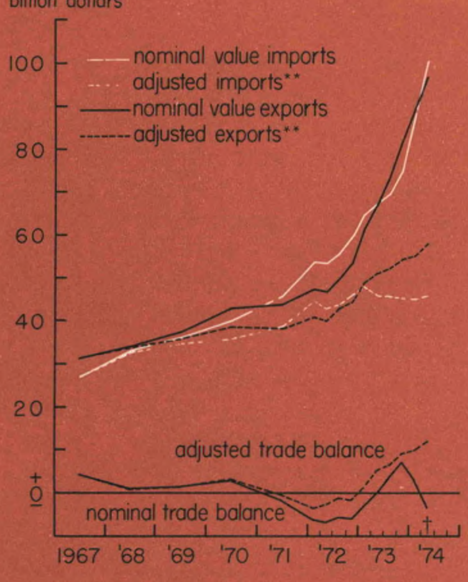
An overall summary of the agricultural outlook would have to acknowledge the possibility that farmers may experience some of the most rapid and financially painful adjustments experienced in years during the next several months. High prices of grains and soybeans will provide those farmers who are able to harvest a reasonable portion of their crop with high incomes and encourage expanded production next year. Returns to farmers that lost the bulk of this year's crops may not cover the costs of plantings. Livestock producers will continue to be buffeted financially as high grain prices ration reduced feed supplies while the possibility of a partial liquidation of livestock inventories will scale livestock prices downward.

Gary L. Benjamin

Trends in U.S. international trade

International trade, long considered a minor factor in the formulation of the economic policy of the United States, is becoming increasingly important to the nation's economy. U.S. international trade has increased more rapidly than domestic goods production in recent years. As a result there has been a steady and substantial increase in the share of U.S. output and consumption that goes into or is derived from the foreign market. In the first quarter of 1974, for example, nearly 14 percent of U.S. production entered the export market, and over 13 percent of the goods available for sale in the United States were of foreign origin. In 1967, these percentages were 7.6 and 6.7 percent, respectively. The interdependence inherent in an increasingly open U.S. economy will undoubtedly require some rethinking of national economic policies as well as of industrial and labor policies.

U.S. exports and imports—nominal and adjusted for price increase*



*Quarterly data—adjusted to 1967 unit values.
**Nominal value adjusted to 1967 unit values.
†Estimate based on partial price data for second-quarter adjusted figures.

The role played by rising import and export prices has been the most dramatic characteristic of the nation's expanding international trade over the past 18 months. Upward pressures on prices came from several directions in 1973. Shifts in both foreign and domestic demand strained the productive capacity of some U.S. industries. Crop shortfalls cut available world supplies of agricultural products. Government actions restricted supplies of basic raw materials, i.e., Arab cutbacks in oil production and U.S. restrictions on oilseed exports.

Higher prices were a more important factor in the increased value of imports than in the increased value of exports. About 80 percent of the increased value of imports, but less than half of the increased value of exports, was accounted for by higher prices in 1973.* Price-quantity relationships for U.S. exports and imports exhibited somewhat different patterns. While the volume of imports increased less than 5 percent in 1973 over 1972, the volume of exports rose 23 percent—with the trend moving

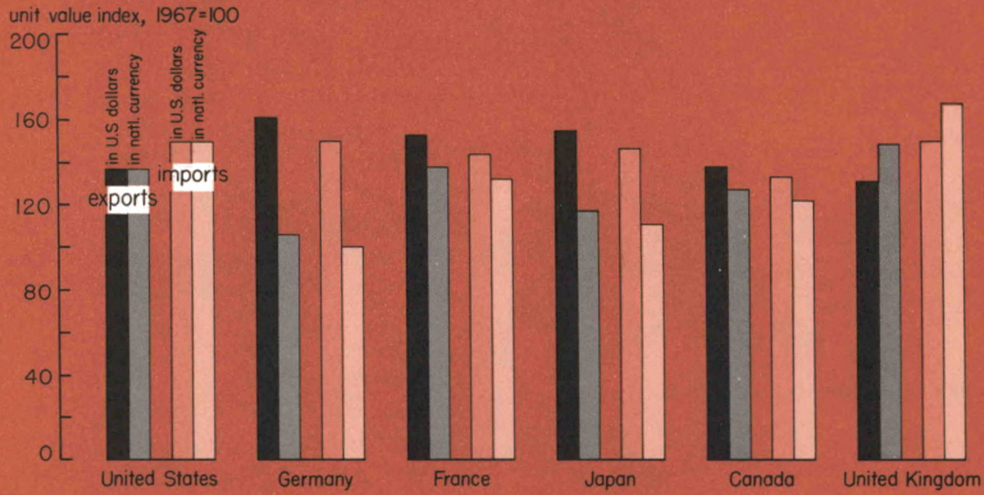
*U. S. export values quoted in this article are f.a.s. (free alongside ship) port of export. U. S. import values quoted are "customs import value."

irregularly higher throughout the period. As was the case for imports, export prices increased during 1973 and early 1974, though less sharply than imports. Preliminary estimates of second-quarter 1974 export prices stood about 27 percent above second-quarter 1973 prices. This compares with a 12 percent increase in prices from second-quarter 1972 to second-quarter 1973. Increases in import prices were 49 percent and 17 percent, respectively, for the comparable periods.

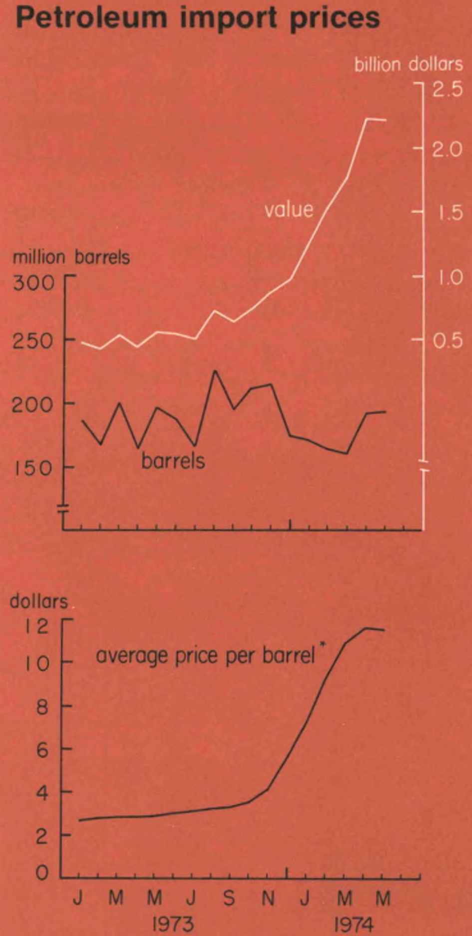
Export/import figures adjusted to reflect constant or "real" dollars provide an indication of the effect of price increases on the value of U.S. trade. From 1967 through the second quarter of 1974, at an annual rate, the nominal value of U. S. exports increased $66 billion, and the nominal value of U.S. imports increased $74 billion. A surge in prices of imported oil pushed the trade balance into deficit in the second quarter of 1974.

Adjusting 1974 dollar values to account for price increases since 1967 reduces the export/import values to "real"increases of $27 billion and $19 billion, respectively. The net export of "real" resources (export surplus) continued to increase during the first half of 1974.

Unit value indexes in dollars and national currencies, 1973



Unit value indexes provide particularly striking comparisons of changes in prices attributable to the devaluation of the dollar vis-a-vis the currencies of the major trading partners of the United States. In terms of dollars, for example, the unit value index of German exports in 1973 was 61 percent greater than in 1967; when measured in marks, however, the unit value of German exports was only 6 percent greater in 1973 than in 1967. Similar though less dramatic comparisons can be made for Canada, France, or Japan. In Britain, where in 1973 the pound had depreciated relative to the dollar, unit value increases measured in pounds show larger gains than unit value increases measured in dollars.



*Includes refined petroleum products.

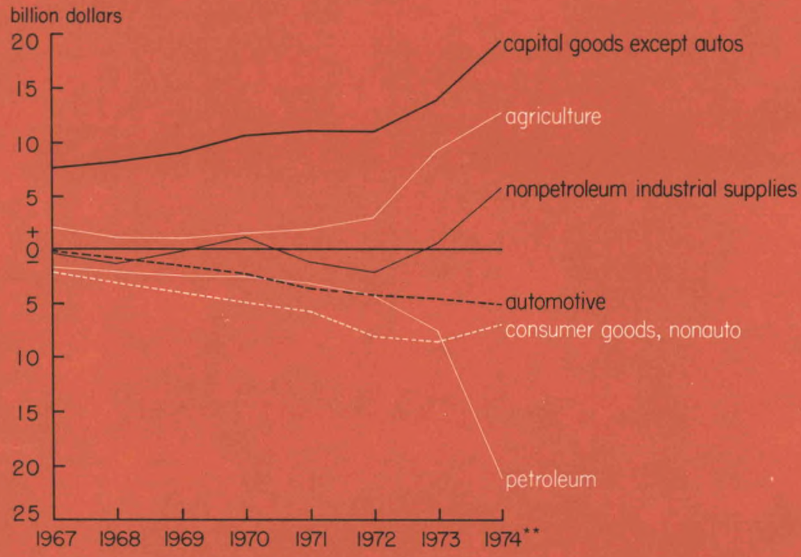
Petroleum and petroleum product imports as a share of total U.S. imports increased from less than 10 percent during January-May 1973 to nearly 24 percent during the same period in 1974. Although the volume of petroleum imports actually decreased slightly in early 1974 from the 1973 period, the total value increased from about \$2.6 billion in 1973 to over \$9 billion in 1974. Higher prices accounted for the increase.

The average price of imported petroleum and petroleum products was about \$2.70 per barrel in January 1973. By the end of September, the price had increased to about \$3.40 per barrel. In October, the Organization of Petroleum Exporting Countries (OPEC) increased the "posted price" of petroleum by 70 percent. (The posted price is a base on which royalties and taxes are determined—it is not to be equated with the market price.) On January 1, 1974, the posted price was increased again by nearly 130 percent. Over the period September through December 1973, the average price of petroleum and petroleum product imports increased from \$3.40 per barrel to \$5.65 per barrel—by May 1974 the average price stood at more than \$11.50 per barrel.

While there has been no increase in posted prices in 1974, there has been a continuing movement by some OPEC members toward increasing their share of ownership in petroleum-producing operations. These OPEC members in particular have resisted recent downward market pressure on oil prices by refusing to sell their share of petroleum production at less than their asking price. Regardless of whether petroleum prices ease or increase from current levels during the remainder of the year, there is no expectation that potential short-term price changes will approach the magnitude of the price changes observed since early 1973.

The impact of the petroleum situation on the U.S. trade picture in 1974 will be awesome. If petroleum imports and prices in the second half match the levels of the first half, the U.S. trade deficit in petroleum alone will exceed \$20 billion, an increase of more than \$13 billion from 1973. This would more than wipe out expected surpluses in the agricultural, capital goods, and non-petroleum industrial supplies sectors.

Trade balance by category*



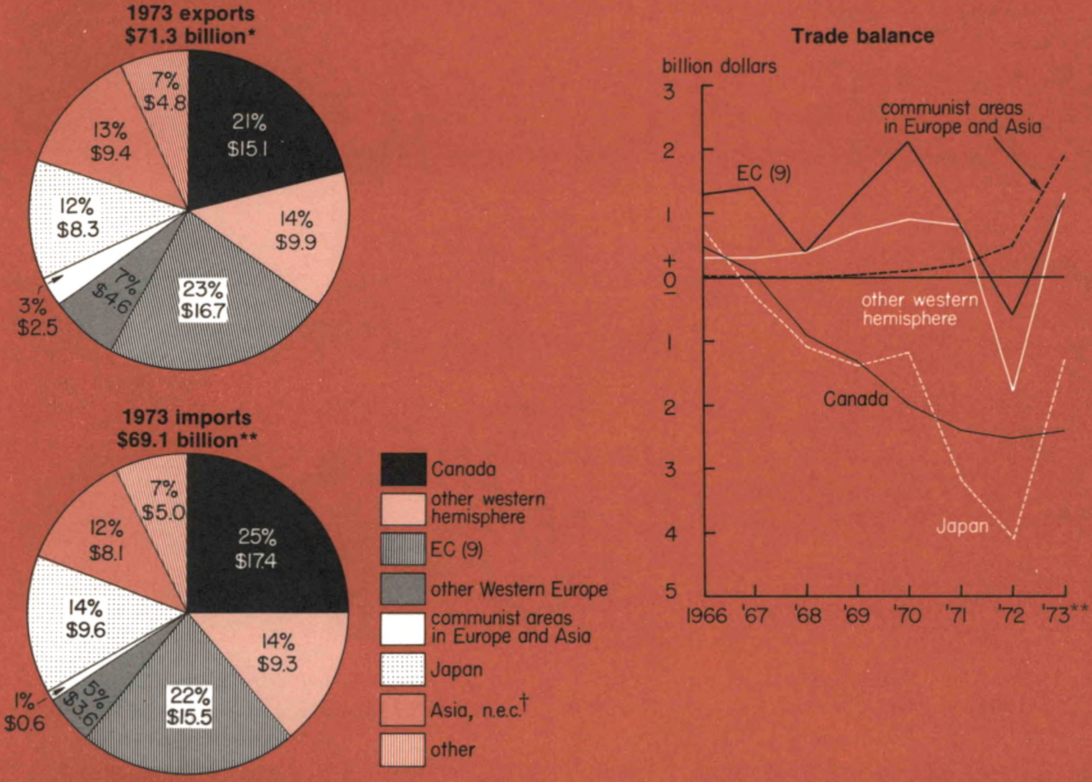
*Categories do not sum to total.
**Annual rate based on January-May data.

Marked acceleration in the growth of U.S. exports of agricultural products and imports of industrial supplies dominated the changes in the U.S. trade balance in recent months. Agricultural exports accounted for 25 percent of total exports in 1973, up 6 percentage points from 1972. As recently as 1969, agricultural exports accounted for only 16 percent of the total. Imports of industrial products—which include petroleum and which had been gradually declining in relative importance—increased nearly 2 percentage points in 1973 from 1972, reaching more than 38 percent of the total. Moreover, the full impact of higher petroleum prices was not felt until 1974 when, during the first five months, the import share of industrial supplies surged to 48 percent of the total value of U.S. imports.

The level of U.S. agricultural exports in calendar 1973 was great enough to push this category's trade surplus to more than $9 billion—an increase of over $6 billion. On the other hand, the U.S. trade deficit in industrial supplies imports created by price increases in petroleum products reached $7 billion—up $3 billion. But this deficit was offset by a $3 billion increase in the surplus for capital equipment exports. This historically strong export category posted a total surplus of $14 billion in 1973.

If the trends observed during the first five months of 1974 continue through the year, the trade surplus for agricultural goods could expand another $3 billion over the 1973 level, and the surplus for capital goods could grow by about $5 billion. In a comparatively recent development, nonpetroleum industrial supplies have recorded export surpluses and could expand as much as $5 billion in 1974 over a marginal surplus in 1973.

U. S. trade by geographic area



*Includes military aid.
**Crude petroleum imports for November-December not included in country totals.
†n.e.c. not elsewhere counted.

The worldwide pattern of U.S. trade remained relatively stable during the late 1960s and early 1970s, with one notable exception. The majority of U.S. trade, exports and imports, is with other western hemisphere countries, with Western Europe, and with Japan. About 78 percent of all U.S. trade in 1973 followed this pattern, a decline of about 3 percentage points since 1967. Within this group, Japan's share increased somewhat while the share accounted for by the others declined.

The one principal exception to the stability in U.S. trade patterns has been with communist bloc countries. Political initiatives since 1972 that thawed trade relationships between the two areas resulted in the United States exporting 13 times more goods to these countries in 1973 than in 1967. U.S. imports from the communist countries increased more slowly and were three times greater in 1973 than in 1967. Still, the value of U.S. trade with the communist areas remains relatively small—$2.5 billion in exports and $0.6 billion in imports during 1973.

Jack L. Hervey

Banking developments

Bank credit in the first half

Despite a sluggish economy and increasing costs of loanable funds, commercial banks increased both their loans and holdings of investment securities in the first half of 1974. Holdings of U.S. Treasury issues declined seasonally, but this decline was more than offset by the acquisition of other securities—mainly obligations of states and political subdivisions and U.S. agencies.

At Seventh District member banks, total loans excluding sales of federal funds rose $4.6 billion, or 8.1 percent, through midyear—less than the record $5.9 billion (12 percent) increase registered in the comparable period of 1973. At all commercial banks in the nation, loans increased 6.4 percent during the first six months of this year, compared with a 10 percent gain a year earlier.

While the amount of bank credit extended to businesses was about the same as the record expansion a year ago, most other types of loans, including real estate and consumer loans, rose much less. Moreover, loan growth at smaller banks was much slower than last year. Heavy business loan demands this year, especially at the large money center banks, reflect the need for increased working capital stemming from price inflation as well as shifts to bank credit by firms that were unwilling or unable to tap the money and bond markets directly as interest rates rose and investors increased their preference for top-quality paper.

Treasuries at new low

After rising in the first two months of the year, holdings of U.S. Government securities at district member banks resumed their downward trend for a net first-half decline of $552 million. While this decline was only about half the decrease registered in the first six months of 1973, there was less available for liquidation. All commercial banks in the nation reduced their portfolios of government securities by $5.5 billion. However, these investments normally decline in the first half as the Treasury pays down temporary borrowings in the months of its heaviest tax receipts. Seasonally adjusted national data indicate an increase in these holdings in the January to June period but a decline in the year ended June 30.

At the end of June, district member banks held only $6.6 billion of U.S. Government securities—below the previous low reached in mid-1970. Treasuries as a proportion of earning assets slipped from 9.6 percent to 7.8 percent over the past year.

Both cyclical and trend factors explain the shrinkage in portfolios of Treasury securities. Banks usually acquire Treasuries when they expect loan demand to weaken and interest rates to decline. When these expectations are reversed, banks tend to liquidate their holdings of these securities in order to make higher-yielding loans. Early this year, many banks bought Governments in anticipation of the price appreciation that would accompany an expected decline in market interest rates—an expectation that was not fulfilled. As loan demand again accelerated, some of these issues were sold or allowed to run-off at maturity. Part of the overall decline can be attributed to the paring down of inventories in trading accounts in view of the negative cost of carry (excess of the cost of money over the earnings of securities in inventories).

Treasuries down most at large banks

	Loans[1]	Securities		Total loans and investments[1]
		U. S. Govt.	Other[2]	
	(percent change–first-half 1974)			
United States (all commercial banks)	6.4	– 9.4	4.5	4.6
Seventh District (member banks)	8.1	– 7.7	7.4	6.5
City[3]	11.4	–14.2	7.1	8.9
Other	3.5	– 3.0	7.6	3.7
	(percent of total loans and investments, end of June 1974)			
United States (all commercial banks)	72.0	7.8	20.2	100.0
Seventh District (member banks	72.8	7.8	19.3	100.0
City[3]	79.6	5.5	14.9	100.0
Other	64.4	10.7	24.8	100.0

[1] Excludes federal funds sold.

[2] Primarily obligations of states and political subdivisions, U. S. agency, and U. S.-sponsored agency securities.

[3] Reserve city banks as defined prior to November 9, 1972.

With the rapid rise in market interest rates, however, prices of outstanding securities dropped sharply, discouraging banks from selling, especially issues with longer maturities. The composition of Treasury portfolios by maturity categories is not yet available for smaller member banks, but data reported by 55 large banks in major district cities show that U.S. notes and bonds with more than five years to maturity rose 40 percent over the six-month period. Total Treasuries held by these banks were down about 12 percent in this period with all of the decline attributable to issues maturing within a year.

In addition to the short-run cyclical forces, there are a number of long-run factors that continue to shrink the importance of U.S. Government issues in bank portfolios. One, which dates back to the Tax Reform Act of 1969, requires banks to treat capital gains as ordinary income for tax purposes. This increased banks' incentives to reach out for higher-yielding assets. At the end of June 1974, five-year Treasury securities were yielding about 8.20 percent, in contrast to 8.70 percent on federal agency issues of a comparable maturity and a taxable-equivalent return on prime five-year municipals of almost 10.40 percent to banks and other corporations in a 48 percent tax bracket. FFrom the standpoint of yield, therefore, there has been an incentive for banks to switch out of Treasuries and into other securities.

Another reason for the declining importance of U.S. Government securities in bank portfolios is the recent greater emphasis on liability management; that is, the ability to acquire loanable funds by issuing bank obligations to investors. This has reduced banks' reliance on government securities as a source of liquidity. Since the suspension of interest rate ceilings on all maturities of large certificates of deposit in 1973 and the lifting of ceilings on smaller denominations, most liability growth has been in the form of time deposits. During the first half of 1974, time deposits at district member banks increased by almost $5 billion, compared with $4.3 billion in the comparable 1973 period.

Securities other than Governments rose $1.1 billion, or 7 percent, in the first half of 1974. A major factor explaining banks' shifts out of Governments into other securities is undoubtedly the rapid growth in the volume of agency issues sold and increased activity in the secondary market for these securities. Outstanding issues of federal agencies and federal-sponsored agencies now total more than $80 billion, of which all except $5 billion are privately held. Agencies are being substituted for Trreasuries to a greater degree as collateral against government deposits. Banks can also rely more on agencies as secondary reserves due to the increased ease with which they can be sold in the open market.

Agency issues, however, are still a less important component of "other" securities than state and local obligations. At the end of last year, district member bank investment in these latter obligations was more than three times the size of their agency portfolios. To a large extent financing of local governments is a vital service to a bank's community. A large portion of such investments resembles the loan portfolio in that municipal demands for funds tend to move in the same direction as private loan demand. Thus, these investments absorb funds rather than provide a source of liquidity when loans are rising.

The composition of investment portfolios is related, of course, to the amount of various kinds of debt instruments offered. This is particularly true of the banks that perform underwriting and distribution functions. During the first half of 1974, the Treasury paid down (largely because of the seasonal pattern of tax receipts) a net of more than $2 billion of debt; net federal agency offerings amounted to about $4 billion and state and local governments issued more than $12 billion of long-term bonds plus substantial amounts of short-term notes.

City versus "country" banks

District and national aggregates conceal significant differences between major city banks and the vast majority of smaller banking institutions in both total credit growth and in the composition of earning assets. Total loans and investments of reserve city banks (defined to be consistent with historical statistics) increased 9 percent, compared with a gain of less than 4 percent at other member banks. This difference reflects not only differences in loan demand but also the greater capacity of the large banks to compete for funds, especially through the issue of negotiable certificates of deposit. These obligations were up $3 billion in the six-month period. Total time deposits rose 15 percent at the city banks but only 6 percent elsewhere.

As would be expected at a time when the strongest credit demands are coming from the business sector, loans grew more rapidly at the big city institutions, increasing the already heavier concentration of the assets of these banks in loans. At midyear, almost 80 percent of city bank earning assets were in loans, compared with 64 percent for smaller banks.

Despite their greater access to money market funds, city banks reduced their holdings of Treasuries much more than did other banks, probably reflecting greater liquidity pressures as well as pared-down trading accounts. It is not clear, however, whether the slower loan growth at smaller banks was a result of slower credit demands on the part of their customers or the inability on the part of the banks to accommodate these demands.

Although the relative importance of U.S. Government securities in portfolios has been falling at both reserve city and country banks, these securities still constitute a much larger share of earning assets at the smaller banks. At midyear, Treasuries represented 10.7 percent of loans and investments at country banks, compared with 5.5 percent at city banks.

On the other hand, the pace of acquisition of non-Treasury securities was about the same for both groups of banks—roughly 7½ percent—in the first half. But the "other securities" category accounted for 24.8 percent of country banks' loans and investments, a share gain of 4.4 percentage points over the past four years, largely at the expense of holdings of U.S. Government securities. ■