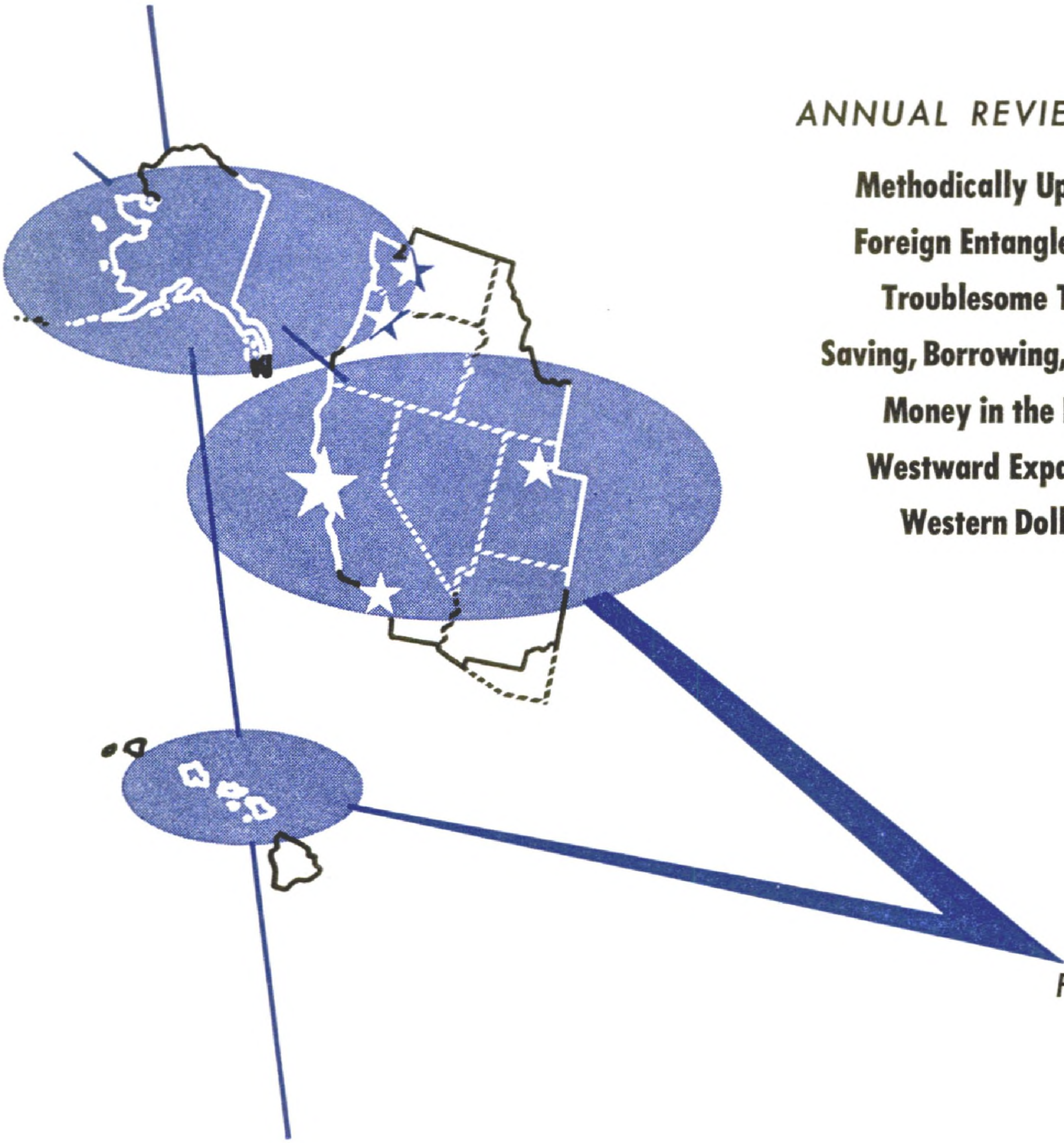
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



ANNUAL REVIEW ISSUE

FEBRUARY
1964

1914 FIFTIETH ANNIVERSARY 1964

1963 . . . . Annual Review

Methodically Upwards

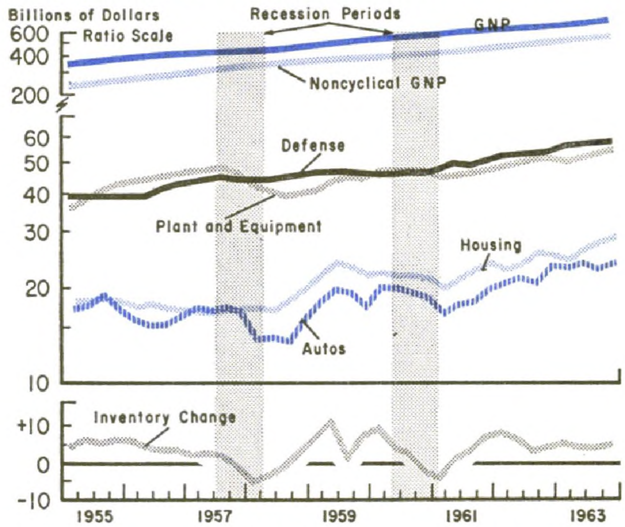
THE PROLONGED business expansion has now absorbed the shock of a President's death as well as many far smaller jolts, and thus it is gaining respect as a far more substantial phenomenon than its chroniclers previously had given it credit for being. In the words of the Council of Economic Advisers, the nation in recent years has experienced "an unprecedented gain in gross national product accompanied by a record of price stability unsurpassed in any expansionary period since World War II." As a consequence of this "unprecedented gain," the economy is now twice as large as it was at the beginning of World War II; in fact, by the yardstick of current rather than constant dollars, it is twice as large as it was just a little over a decade ago.

Growth, not drama

Nonetheless, the general impression which 1963 created was not of an upsurge but rather of a methodical—sometimes even sluggish—upward movement. Besides, during the year an aftertaste persisted from 1962's recession scares—the spring '62 steel price imbroglio, the mid-year stock-market break, and the summer's abortive tax-cut discussions. But, perhaps because 1963 lacked these hallmarks of economic drama, it recorded a better than 5-percent gain in GNP, to a $585 billion average, and it witnessed even greater gains as the year progressed.

The methodical upward movement was the product of expansion in all major sectors of the economy. Substantial strength was exhibited by the massive two-thirds of the nation's economy which expands throughout the booms and recessions of every business cycle—that is, consumer spending for food and other nondurable goods and services, and state and local government spending for community needs. The greatest increases were recorded, however, by the more volatile sectors—defense spending, business investment

All systems go in 1963 . . .
expansion centers in durable sectors



Source: Department of Commerce.

in plant and equipment, and, in particular, consumer "investment" in residential construction and automobiles.

Defense spending, which rose 6 percent to a total of about $57 billion, reflected the growth which had originated with the crises in Berlin, Vietnam, and Cuba. By year-end the Pentagon was spending about one-fourth more than at the beginning of the current business expansion, in order to bring its strategic-war capabilities to maturity and to fill out its conventional-war capabilities.

Another volatile sector, business plant and equipment spending, expanded sluggishly in the first half of the year and rapidly in the second half; for the year as a whole it wound up with a 5-percent gain to about $52.5 billion. This sector, hampered frequently during earlier years by over capacity in certain industries, has been encouraged recently both by improved business prospects and by an increase in its cash flow (retained earnings plus depreciation). Cash flow has risen about twice as rapidly as plant-equipment spending during the current expansion, at least partly because of tax changes which permit businesses to charge off equipment costs over a reduced time period and to deduct from current profit-tax liability as much as 7 percent of the cost of many types of capital equipment. These changes, together with the resultant increase in cash flow, have encouraged businesses to expand to meet growing markets and to modernize to achieve increased market penetration.

Cliff dwellers and hot-rods

The growth in these volatile sectors was outpaced in 1963 by the increase in consumer investment for housing and automobiles. With increased cash in their pockets and, obviously, increased incentive to buy, consumers not only scored their usual spending gains in nondurables and services, but they also recorded 10-percent year-to-year gains in housing purchases and auto-buying. Residential construction grew to $25 billion for the year; purchases of autos and parts expanded to more than $22 billion.

Consumer disposable income, at almost $403 billion, actually expanded less rapidly than it did in 1962, but the consumer spent 93.7 percent of that take-home pay, or slightly more than he did in most of the other years of the past decade. Moreover, the consumer exhibited great willingness to go into debt to finance added purchases. Thus, nonfarm individual debt increased 12 percent during the year, to almost $350 billion.

Debt and demography were two of the major keys to the housing boom. Longer mortgage loans at lower rates helped support housing activity at a high level, since this liberalization of credit (on both conventional and government - supported mortgages) made more potential homebuyers eligible to enter the home market. But apartment construction, which now accounts for 36 percent of total starts as opposed to about 13 percent a decade ago, provided equal support to the boom.

Under the influence of demographic trends, multi-family housing starts have doubled during this business expansion, while single-family starts have increased hardly at all. The phenomenon is explained by the fact that the age groups which typically buy rather than rent (the 25-44 brackets) are now declining in number, while the age group that initially rents (the 20-24 bracket) is now rising and will soon burgeon in size. Rising incomes have also contributed to the trend, by encouraging the young (and also the old) to set up separate households and by stimulating a long-overdue replacement of older apartment houses.

In the auto sector, demography—and debt, to a lesser extent — sustained the 10-percent year-to-year gain. Although maximum credit terms on new autos generally were not liberalized, more buyers took advantage of those maximum terms and thus helped to push up the ratio of outstanding instalment credit to disposable income; the ratio increased from less than 12 to more than 13 percent between late-1961 and late-1963.

The expanding crop of eager new drivers and the rapidly expanding stock of scrappable old cars both contributed to a substantial market expansion. These and other factors made the recent auto boom appear much more stable than the famous boom of 1955; in fact, autos and parts in 1963 accounted for just 5.5 percent of consumer income, close to the average of the past decade, as opposed to an unsustainable 6.5 percent in 1955.

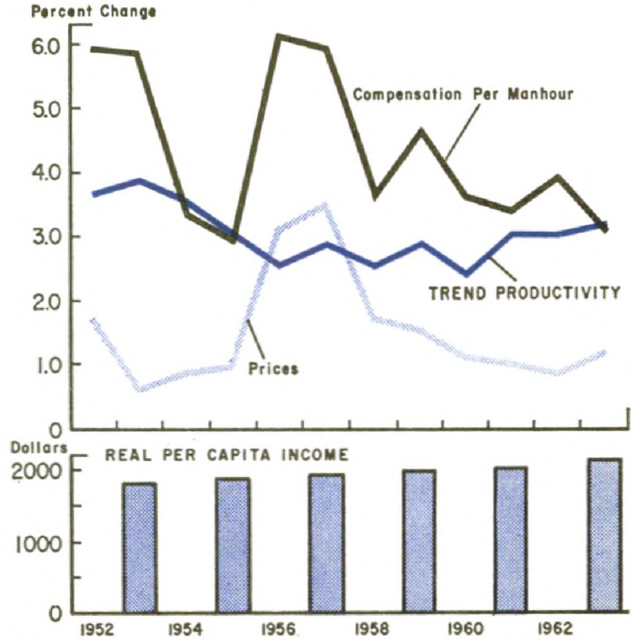
Business inventory spending, a sector which almost always is closely involved in cyclical movements, turned in a somewhat neutral performance in 1963. The increase in stocks was below $5 billion for the year, slightly less than in 1962, although the economy in both years recorded almost identical increases in final sales. This performance lends support to the argument that the postwar development of computers and computer-minded management permits a rising sales volume to be attained with smaller and smaller stocks of inventories. The relatively small gain in stocks, however, may have been more a consequence of the businessman's knowledge that quick delivery was easily obtainable and of his confidence that price stability made speculative stockbuilding unnecessary.

Production outpaces producers

On the basis of all the substantial increases cited above, the nation's total output rose from $555 billion in 1962 to $585 billion in 1963. The outlines of the methodical upward movement described by the GNP figures were evident, moreover, in other measures of aggregate activity. The industrial production index rose from 118 to 124 percent of the 1957-59 average, as a result of strong production gains in most durable and nondurable manufacturing industries. But the 6 percent gain in industrial production was achieved with only a 1.5 percent gain in employment (to 68.8 million persons). Since the number of jobseekers increased more rapidly than the number of jobs, unemployment also grew (to 4.2 million), or from 5.6 to 5.7 percent of the labor force.

Unemployment was an important 1963 phenomenon, but rapidly rising productivity was the other side of the coin. The trend-value of productivity—a 3.2-percent annual increase in output per manhour for the past half-decade—contrasted strongly with the 2.5-percent productivity figure attained in the mid-Fifties. Last year's average price increase (1 percent, according to the GNP price index), also provided a strong contrast to the 3-percent annual price gain of that earlier period. At the same time, the average annual gain in pay per manhour declined from 6 percent in 1956 to 3 percent in 1963, and this, coupled with rising productivity, helped bring about the near-stability in prices.

Rising productivity, stable prices stimulate rapid growth in income



Sources: Department of Commerce; Department of Labor; Council of Economic Advisers.

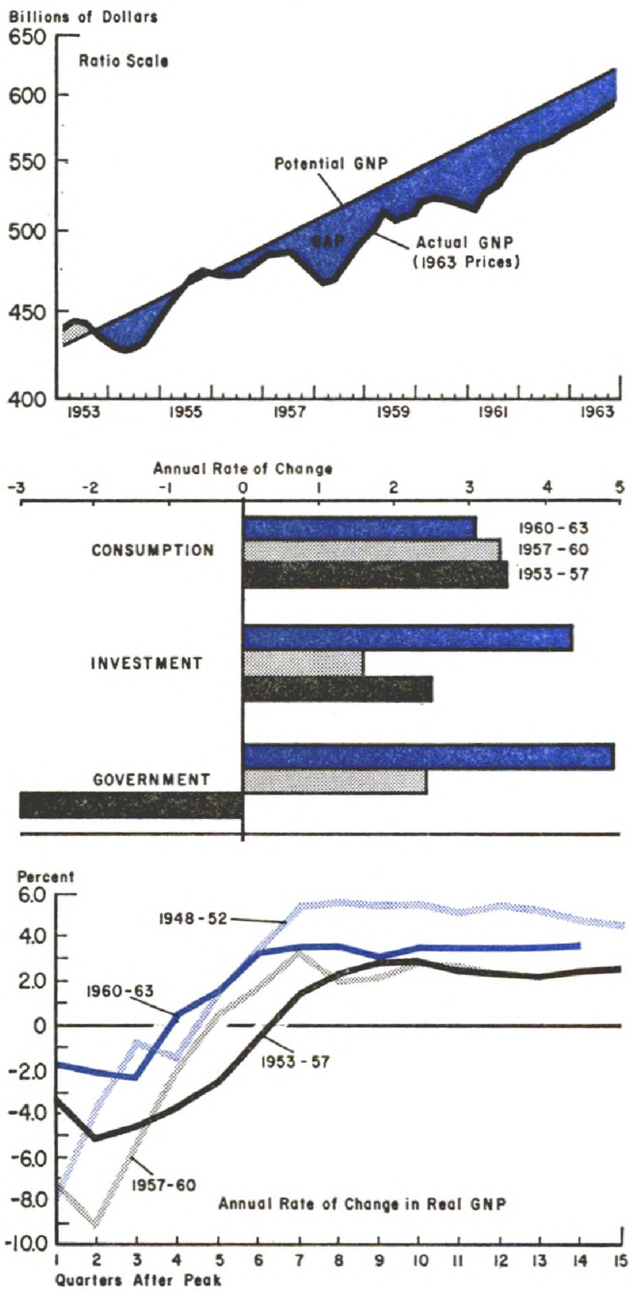
Promise and performance

Rising productivity, generally stable prices, and rising (but not soaring) average wages brought about a striking increase in real disposable personal income in 1963. Put another way, the continuing expansion caused per capita income (even after adjustment for price changes) to rise 6 percent within two years—a gain equivalent to the entire advance in the preceding five-year period.

In view of this striking rise in "welfare" and the methodical gains recorded during the long, long business expansion, why is there so much dissatisfaction with the state of the economy? The answer, according to the Council of Economic Advisers, is that "the nation's performance must be measured against its potential levels of output and employment and not simply against its past records."

To measure the discrepancy between promise and performance, the Council has introduced into the growthmanship debate the concept of potential GNP—the output that would be produced if unemployment were at the interim-target level of 4 percent. On this basis, actual GNP fell short of potential GNP by $50 billion (in 1963 prices) at the bottom of the last recession in early 1961, and it still remains $30 billion short despite the strength of the prolonged expansion.

Rising GNP lags behind potential as other sectors outpace consumption —yet cycle is strongest in decade.



Sources: Department of Commerce; Council of Economic Advisers; National Industrial Conference Board.

Is growth decelerating?

The Council's proposed fiscal solution for the GNP gap, and even the existence of the gap, have been prime subjects of controversy throughout the last several years. But criticism has also been leveled at the Council's argument—emphasized far more in its 1963 Annual Report than in its latest report—that the nation has been experiencing a slowdown in its rate of growth. The Council contended last year that the annual rate of growth of real GNP had dropped from 4 percent in the 1947-57 decade to only 3 percent in the succeeding half decade, but its critics retorted that just the opposite result would have been obtained from a different manipulation of the GNP statistics. Thus, when GNP growth is measured between successive cyclical peaks (based on quarterly data rather than the less-precise annual averages), the statistical record shows an unusually rapid growth during the early Fifties (the Korean War period), followed by very slow growth during the mid-Fifties, and a steady acceleration thereafter.

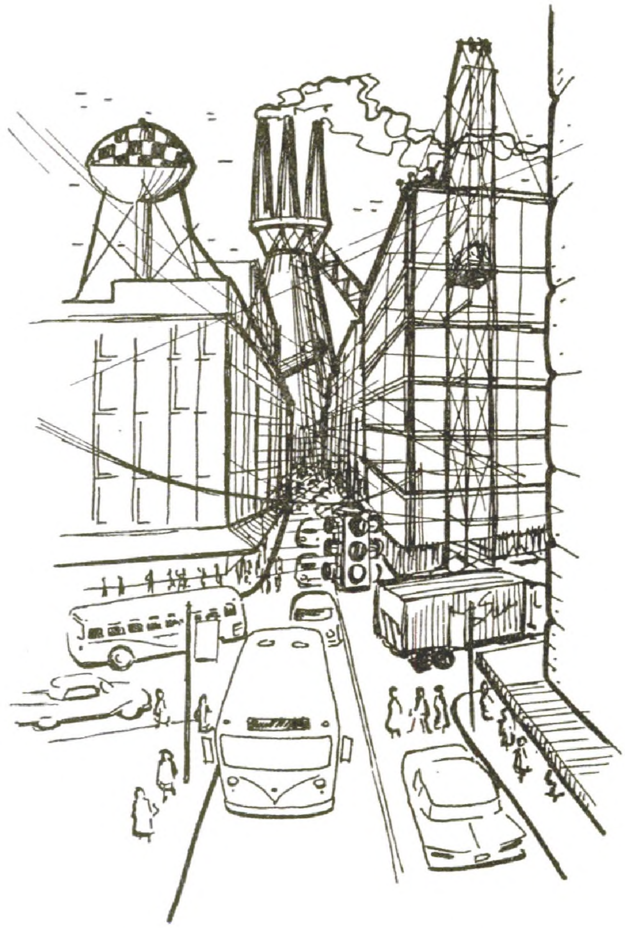
The peak-to-peak annual growth rate of real GNP was 5.2 percent during the Korean War boom, but the rate slumped to 2.3 percent in the 1953-57 cycle, rose to 2.7 percent between the 1957-60 peaks, and then jumped to 3.7 percent in the current prolonged expansion. Of the three business cycles of the past decade, only the current one has been strong enough to beget a growth rate greater than the 3-percent average rate which the nation experienced during the preceding half-century.

On the other hand, the record of growth in individual sectors has been somewhat spotty. During the past decade's cyclical movements, government purchases have assumed increased importance, business performance has been mixed, and consumption spending has grown at a decreasing rate. Government spending, primarily Federal spending, has increased at a 5-percent annual rate in this cycle to date. Business spending, with a 4-percent annual growth rate, has been stronger than in either of the two preceding cycles, but only because of the burst of investment in the second half of 1963. Consumption spending, despite the recent strength in durable goods, has grown only at a 3-percent annual rate during this cycle, in contrast to a 3.5-percent rate in the 1953-57 and 1957-60 cycles.

Growth plus gap equals paradox

Despite this changing structure of output growth, the fact remains that real growth (as measured from the last cyclical peak in GNP) has been notably strong in the current expansion. But most observers agree that a significant and persistent decline in degree of resource utilization has occurred since 1953; this decline has almost been checked by now, but it has left the economy with a large backlog of unused resources. Whether measured in terms of a $30-billion shortfall in potential GNP or simply in terms of a 6-percent average unemployment rate during a strong business expansion, a gap admittedly exists.

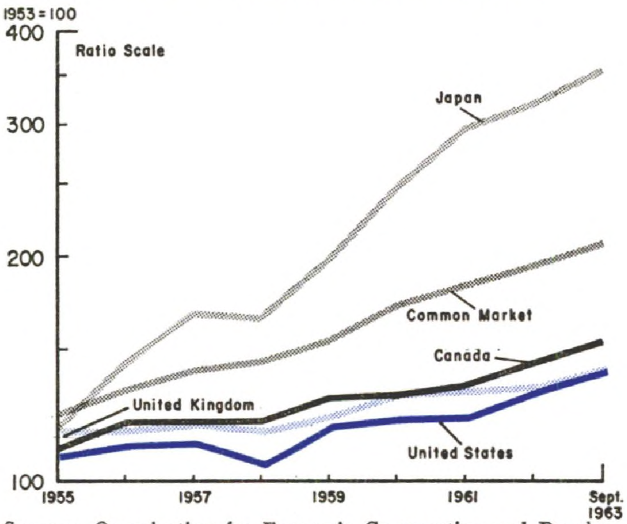
The history of the past decade can be read in this paradoxical record of an increasing rate of growth and a bothersome overhang of unemployed resources. The history of the next decade probably will depend on the success achieved by the pending tax cut (and other



policy measures) in overcoming the paradox —in maintaining a rapid growth rate and employing all the nation's resources, all within a framework of stable prices. The paradox was not overcome during 1963, but signs of its demise hopefully may become visible by close of business in 1964.

Foreign Entanglements

U. S. production matches competitors' rapid pace during year



Sources: Organization for Economic Co-operation and Development; The Oriental Economist.

INTERNATIONALLY as well as domestically, the American economy experienced both uncommon growth and unfulfilled promises during the year just ended. As a producer, trader, and investor, this nation affected and was affected by business developments throughout the world—even the world on the other side of the ideological frontier.

The international economic scene in 1963 was dominated by the continued rapid growth of some leading industrial nations and the catching-up by the United States and some other countries that previously had tended to lag in the growth race. For example, the European Economic Community (Common Market) recorded a 5-percent gain in industrial production on the basis of strong consumer and construction demand, but this was no better than the record achieved by the American economy during the year. (Individual countries such as France and Belgium did better, however.) Japanese production continued its sharp upward climb, but late-year overheating of the expansion brought about the imposition of credit restraints. Canada meanwhile sustained its relatively vigorous 1962 pace, and the United Kingdom began to revive by midyear as reflationary measures which had been adopted earlier began to take effect.

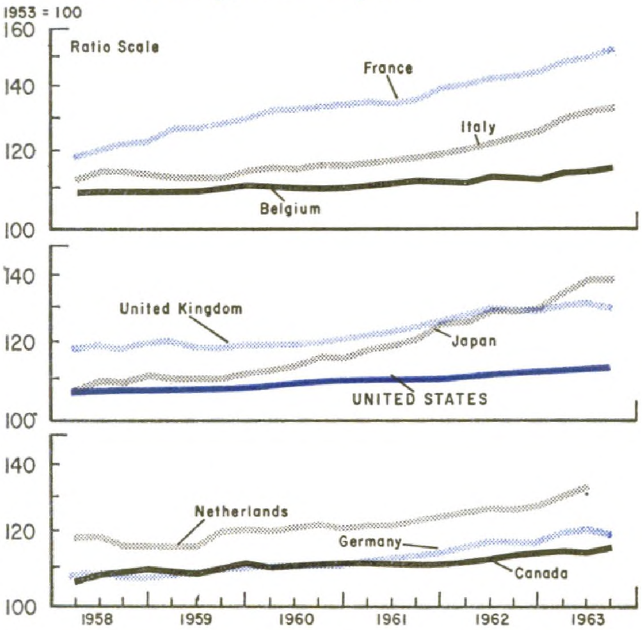
Better-balanced growth

On balance, then, the past year witnessed rising levels of international economic activity as the slower growing industrial nations accelerated their expansion and the faster growing nations held their own. The repercussions on the primary-producing countries were generally favorable, since foreign demand for their internationally traded primary products increased during the year. Production and price developments combined also to produce a better international payments balance, since the Common Market countries (except Germany) experienced reductions in their export and payment surpluses as well as smaller increases in their gold and foreign exchange reserves.

Unlike the United States, where a long-continuing expansion created relatively little pressure on domestic costs and prices, substantial inflationary pressures were evident in several major industrial nations. Under the influence of high levels of demand and strong labor market pressures, prices and wages moved up quite sharply in some countries (notably France and Italy) throughout the entire year, and in other countries (such as Belgium and the Netherlands) just in the latter part of 1963. Inflation also became an object of serious concern in Japan; consumer prices there, as in France and Italy, advanced quite rapidly. Only Germany remained relatively untouched by the inflationary pressures endemic elsewhere.

Anti-inflationary programs were adopted by the affected countries, with varying degrees of success, and inflation remained a major problem at year-end. In particular, the

Consumer prices rise most rapidly in France, Italy, and Japan



Sources: Organisation for Economic Co-operation and Development; International Monetary Fund.

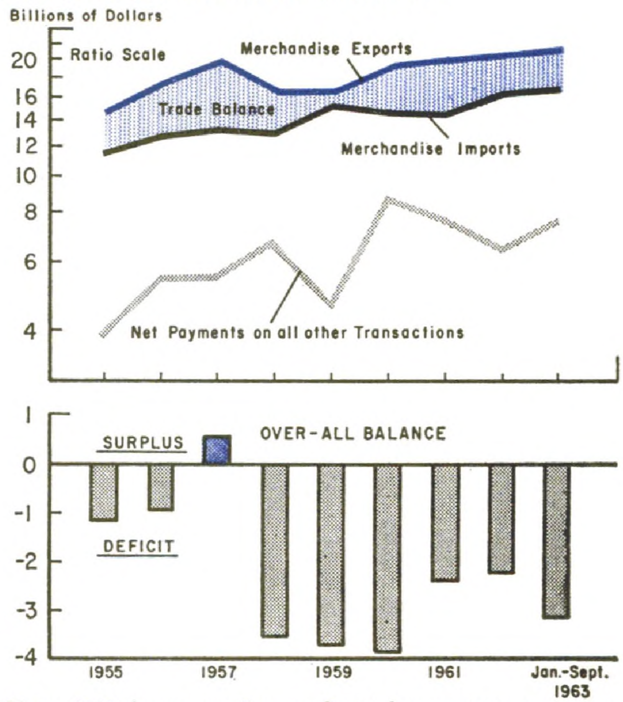
incomes policies being tested in several major countries (such as France, the United Kingdom, and the Netherlands) as a means of keeping income and wage increases in line with productivity growth were set back during the year by the failure of key wage settlements to hold the line. The American competitive advantage consequently was enhanced by these developments, even though little measurable change was evident on the basis of export prices alone.

High-level activity in the major industrial countries affected the American economy favorably in other ways as well. The expansion of U. S. exports to Europe, Canada, and Japan offset to some extent the rise in imports resulting from the quickening pace of domestic economic activity, and production for export markets also contributed to fuller utilization of U. S. plant capacity and manpower. Overseas developments—a steady rate of expansion, shrinking profits, and upward price pressures—thus combined with the American expansion to strengthen the competitive position of the United States and to make investment opportunities relatively more attractive here. Consequently, the narrowing of the gap between foreign and U. S. growth curves increased the likelihood of further reductions in our payments deficit.

But the problem remains

Nonetheless, the 1963 record gave little cause for complacency, in view of the year's $2.6 billion balance-of-payments deficit (versus $2.2 billion in 1962). The trade surplus was slightly larger but the balance on commercially financed goods and services was somewhat smaller than in the previous year. Direct investments remained at the high rate of recent years, while other long-term investments rose sharply; short-term capital outflows, although below the high levels of 1960-61, were about unchanged from 1962. Unrecorded transactions meanwhile continued to show a net outflow of funds from the United States, although in smaller volume than in the preceding three years. But with all this, the U. S.

Trade balance increases slightly but overall balance worsens



Note: 1963 figures are January-September averages, at seasonally adjusted annual rates.
Source: Department of Commerce.

gold loss, at $461 million, was only about half that of 1962.

The nation's international accounts became front-page news around midyear, when a sharp worsening was revealed by the second-quarter statistics. But the sudden shifts—from a $3.5 billion annual rate in the first quarter to $5 billion in the second quarter and then to $0.9 billion in the second half—largely reflected some temporary factors as well as a coincidental bunching of transactions. The second-half improvement probably also reflected a monetary policy shift towards "somewhat less ease"—characterized by a mid-July increase in the Federal Reserve discount rate and a decline in the level of free reserves—as well as an amendment to Regulation Q permitting higher maximum rates on time deposits of 3 to 12 months' maturity.

Stimulus to growth overseas

Although many observers worried about the continuation of the payments deficit, few questioned the fact that the nation's international transactions were continuing to serve as a stimulus to growth overseas through the provision of goods, services, and capital and through U. S. purchases of goods and services abroad. American imports of goods and services have constituted a major source of foreign exchange earnings for both the industrialized and the less developed nations of the world, and American exports in turn have served to dampen inflationary pressures in a number of European countries where demand exceeds domestic supplies.

The proponents of unimpeded foreign investment have argued that both government and private capital exports support economic growth abroad without detriment to our domestic economy. In addition to the balance-of-payments benefits in the form of larger exports and dividend and interest income, the United States derives a broader benefit in the form of a stronger international community of nations, fostered both by our private capital exports and by our foreign economic and military aid programs.

Most observers have recognized, of course, that our balance of payments may be affected unfavorably by increased imports to the United States from subsidiaries abroad, by larger imports of industrial raw materials from American-developed foreign sources of supply, or by displacement of direct exports from this country in third markets. In some cases, moreover, direct investment may result in a significant immediate net drain of dollars; this happens when dollars invested overseas are converted into foreign currencies primarily for expenditures within those countries and the dollars are added to official reserves, rather than used to pay for additional imports from the United States.

In toto, the proportion of U. S. private direct investments to total investments in individual foreign countries is very small, but the share can be significant in particular industries or sectors. Perhaps only 2 out of every 100 workers in Germany are employed by an American company, but two of the four largest auto firms in that country are American subsidiaries; moreover, in France, the third largest industrial company is a subsidiary of a major American oil company. At the margin, consequently, U. S. investments may be crucial. They may be especially important for some of the less-developed countries because income, savings, investment, production, and employment in such countries often are heavily dependent on foreign capital. Even in countries that are more advanced industrially, American capital supplements domestic capital and releases domestic capital for other uses, thus helping to maintain economic growth. Japan's rapid economic growth, for example, is based heavily on foreign long-term capital, 70 to 80 percent of which has been supplied by the United States.

How to fight a deficit

To the nation's monetary authorities, many of these points were somewhat academic last year—and moreover were not particularly amenable to monetary policy. While fully cognizant of both the favorable and unfavorable implications of the transactions contributing to a payments deficit, they were faced during 1963 with the continuing necessity to tilt the scales in favor of a payments equilibrium. Accordingly, they acted to strengthen the defenses against the emergence of massive disturbances affecting the international payments mechanism, in order to prevent recurrence of crises such as those which weakened the dollar in late 1960 and the pound sterling in early 1961.

New swap agreements were signed by the Federal Reserve System with Sweden and Japan, and existing agreements were enlarged, bringing total swap facilities to $2,050 million by the end of 1963. In addition, the Treasury began sales of convertible, medium-term foreign currency bonds and notes to foreign official institutions. The foreign currency proceeds were used by the Treasury to absorb foreign official dollar holdings, thereby reducing potential gold losses, and in one instance, the foreign currency bonds were used to refund a Federal Reserve swap drawing. By year-end, convertible and nonconvertible special Treasury obligations issued to foreign countries (denominated both in dollars and in foreign currencies) totaled almost $900 million. Additional foreign exchange resources were made available in July when the United States arranged a standby credit with the International Monetary Fund for the equivalent of $500 million in foreign currencies. However, this line of credit was not drawn upon until early 1964. The effectiveness of this network of international financial arrangements was demonstrated in the tragic period immediately following President Kennedy's assassination, when the Federal Reserve Bank of New York (acting on behalf of the System) intervened in the exchange markets with sizable offerings of five major foreign currencies at existing market rates.

The monetary authorities also were faced in 1963 (as in earlier years) with the necessity to shift tactics in order to deal with threats to the nation's balance of payments from new quarters. The major threat last year was a sharp second-quarter deterioration in our payments position resulting from the concentration of a large volume of foreign long-term borrowing within a relatively short period of time. Foreign demand for long-term funds had been stimulated by the relaxation of Canadian restraints on borrowing abroad by residents, by the high rate of expansion in countries such as Japan which rely heavily on foreign capital, and by relatively low long-term interest rates as well as ready availability of long-term capital in this country.

President Kennedy's announcement in mid-July of the proposed tax on American purchases of foreign stocks and bonds placed an effective but temporary damper on foreign security activity in U. S. markets. Despite the discouragement to foreign borrowing created by uncertainties about the final form of the proposed tax, some increase in new foreign security issues from recent very low levels might well occur. Once the new tax is approved, there may be a return to the market by exempted countries and by countries that—despite the tax—can still find lower costs or more accessible capital-market facilities in this country. Nonetheless, the scale of such reliance on our capital market should be diminished. Activity in foreign capital markets has increased since the interest equalization tax proposal was originally made; some foreign issues originally intended for the United States have been diverted abroad, and some countries have acted to broaden their money and capital markets.

Short-term capital outflows declined in 1963, particularly after mid-July ushered in a period of rising interest rates and somewhat less easy credit. Treasury debt management operations, along with Federal Reserve activities, provided support for short-term rates for balance-of-payments reasons. But some funds continued to move abroad into various types of short-term foreign assets, such as Canadian commercial and finance company paper and British hire-purchase deposits.

A number of foreign central banks lowered their discount rates in the first half of the year in attempts to stimulate their domestic economy or to bring their domestic interest rates into better alignment with rates abroad. After June, however, increases became more common as inflationary (and balance-of-payments) pressures appeared in various countries. Canada boosted her discount rate in August, in the aftermath of the U. S. interest-equalization tax proposal, as a "technical adjustment" to developments in Canadian interest rates and security markets. The Bank of England, on the other hand, left the bank rate unchanged after the January reductions; however, it maintained flexible pressure on the discount houses in order to keep short-term U.K. rates at levels designed to discourage the movement of funds either in or out.

Sowing the dragon's teeth

Foreign restrictions on American trade cropped up in several places during the year. Canada's international reserve position improved enough in early 1963 to permit removal of the last of the temporary import surcharges imposed during the June 1962 crisis; yet, on the other hand, the Canadian policy of developing domestic industrial capacity caused the introduction in November of a system of tariff rebates designed to stimulate exports, and to discourage imports, of automobiles and parts from abroad—primarily from across the border. Meanwhile, across the Atlantic, the Common Market countries showed protectionist signs, beginning with the exclusion of the United Kingdom from membership in January and continuing thereafter in several agricultural policy decisions. In addition, the Six reduced Common Market internal duties by another 10 percent, and thereby widened the disparity between tariffs levied on imports from member countries and tariffs on goods from nonmembers. (A similar 10-percent reduction in the internal tariffs of the European Free Trade Area countries, which took place around year-end, should have a similar restrictive effect.)

On the plus side, a number of countries managed to remove restrictions on their trade during the year, to the benefit of the United States and other trading nations. Preliminary negotiations under the authority of the Trade Expansion Act made some progress, and the "Kennedy Round" of trade and tariff discussions scheduled for the spring of 1964 was heralded as a harbinger of a further easing of trade. While waiting for progress in that line, meanwhile, U. S. farm exporters could happily anticipate an increase in wheat sales to several countries not hitherto noted for their devotion to free trade—the Soviet bloc countries.

Troublesome Twins

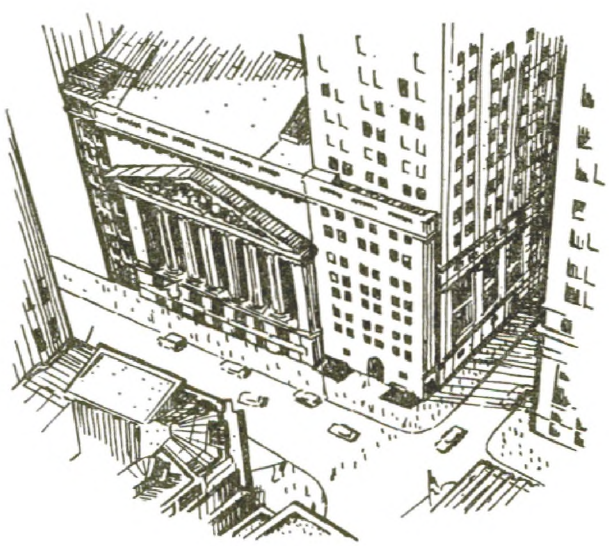
PUBLIC POLICY in 1963 had to confront the same troublesome twins that have bedevilled policymakers for much of the past decade. The nation's monetary and fiscal authorities achieved some success in handling these twins —a still-inadequate rate of growth in the domestic economy and a chronic deficit in our international accounts—but the authorities still found it necessary to devise new measures to get the twin problems under control. Their task was made no easier by the knowledge that these problems (like most troublesome children) cannot be controlled by a single common policy. Thus, measures designed to improve the balance of payments position without regard to the state of the domestic economy could have restrictive effects upon the domestic economy; conversely, measures designed solely to speed up the rate of growth in the domestic economy could have unwelcome side-effects on the international payments situation.

Policymakers agree that monetary and fiscal policy are designed to achieve the same final results but generally through different avenues of approach and with a certain amount of overlapping. Monetary measures are directed to the cost and availability of bank credit, while fiscal policy actions are focused on the general level of spending as influenced by Federal tax and expenditure programs. With this in mind, most observers believe that the problem of inadequate growth in the domestic economy is more amenable to fiscal policy actions than to a purely monetary policy program; at the same time, they favor the monetary-policy approach to the balance of payments problem, especially to the extent that interest-rate differentials are considered to figure in that situation.

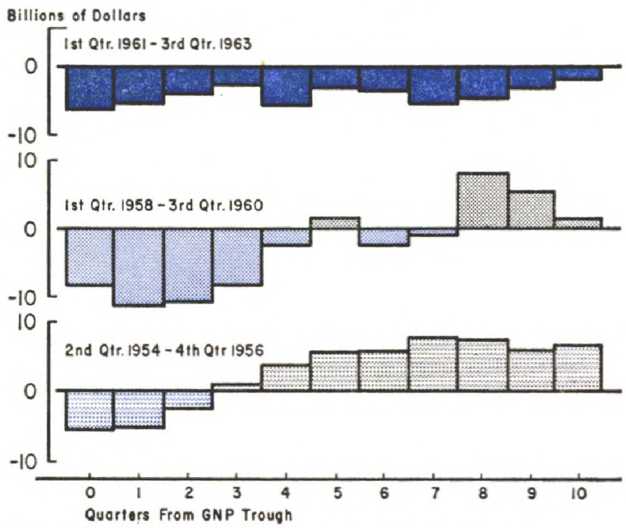
What has fiscal policy done to spur the cyclical recovery and what can it do now to sustain the prolonged expansion as it enters its fourth year of life? Undoubtedly, fiscal policy has played a consistently expansive role through the medium of Treasury deficits. Throughout the expansion, the Federal government has made a net addition to the aggregate level of spending in the economy, as funds fed into the income stream in the form of Government purchases of goods and services have more than counterbalanced the volume of funds drained from the private sector of the economy through taxation. The Treasury, in fact, has run a deficit in every quarter since late 1960. But over the past year, the amount of the deficit has narrowed steadily, from $5.3 billion in the fourth quarter of 1962 to $1.9 billion in the third quarter of 1963. In this interval, Federal government receipts increased by $7.1 billion while expenditures increased by $3.7 billion. (All figures are seasonally adjusted annual rates.)

Fiscal policy expansive?

Over half of the rise in tax receipts came from higher revenues from income and excise taxes, as a consequence of rising levels of personal income, corporate profits, and consumer



Expansion sustained by deficit, unlike previous cyclical pattern



Note: Federal budget data, on national-income basis.
Source: Department of Commerce.

spending. However, social-insurance contributions accounted for $3 billion of the 1963 increase, primarily because of a hike in the contributions rate, which took effect January 1. The resultant increase placed social-insurance contributions second only to the personal income tax as a source of Federal revenues.

Fiscal policy was less expansive in calendar 1963 than in the two preceding years, because of the faster rise of receipts than of expenditures. The only change in the rate structure was the increase in the social-insurance contributions rate. Yet, since that increase took effect at the very beginning of the year, and since rising levels of business activity caused an expansion in revenues across the board, the quarterly *increase* in revenues consistently out-paced the quarterly *increase* in expenditures — even though total expenditures continued to exceed total revenues.

Treasury debt-management operations also played a part in moderating the expansionary force of the Federal deficit. During 1963, the Treasury placed nearly $8 billion in maturities of ten years and beyond through its regular refunding and advance refunding operations. By lengthening the average maturity of the public debt in this manner, the debt managers reduced the relative liquidity of holders of the debt and thus partly offset the stimulus resulting from an increase in the outstanding debt.

Fiscal solution: a tax cut

In 1963 and again this year, a reduction in the rate schedules for personal income taxes and corporate profits taxes has had a high priority in the Administration's legislative program. The now firmly expected tax cut has been designed to stimulate consumer spending and business plant-equipment spending, and thereby to put more people and resources to work to keep the expansion moving forward.

Since public policy offers two means of attack upon problems of instability, why should Washington emphasize fiscal rather than monetary means to accelerate the rate of economic growth—especially when such a program would result in a larger Federal deficit? In answering this question, tax-cut supporters have had to face up to the criticism that a monetary policy of aggressive ease would encourage an expansion without the necessity of increasing the public debt. In reply, they have argued that such a monetary policy would adversely affect the nation's balance-of-payments position, for by making bank credit more readily available and by lowering borrowing costs, it could widen the differential between domestic and foreign interest rates and thereby increase the outflow of funds.

The tax-cut supporters have also been able to present a more positive argument. They have contended that the effect of the proposed fiscal policy remedy—the tax cut—would be a direct and immediate expansion of the aggregate demand for goods and services. The income stream in the private sector of the economy would be increased by the amount of the tax cut, and this would be reflected in the larger disposable income available to consumers and businessmen. Federal spending would not decline in the amount of the tax cut, and therefore the total amount of potential spending would be enhanced by the amount of the tax reduction.

Continuing, the fiscal proponents have pointed out that monetary policy is less direct in its action. By increasing the access to bank credit and by reducing its cost, easy money could provide the means to finance an expansion. But this alone would not guarantee an increase in the volume of spending, that is, an increase in the total demand for goods and services. It would provide a favorable environment for such an increase, but it would not itself give force and direction to a rise in the total volume of spending.

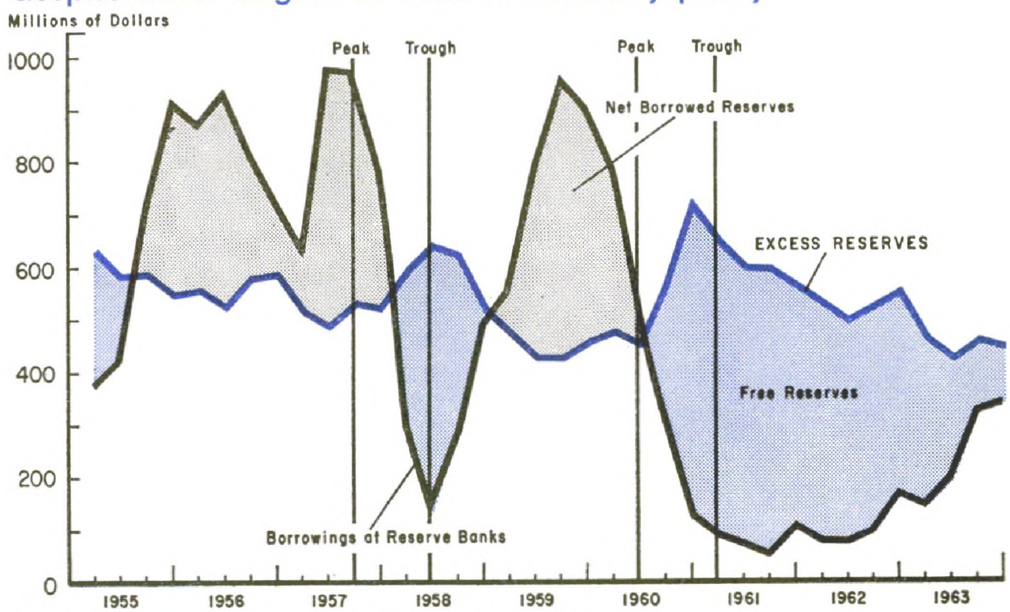
Monetary policy expansive?

None of these arguments could detract, however, from the fact that monetary policy has made an impressive contribution to the strength of the extended expansion. Member-bank free reserves (excess reserves minus borrowings from the Federal Reserve Banks) have been positive for the longest period since the Treasury - Federal Reserve Accord of 1951. The level of free reserves ranged around $400 - 500 million throughout 1961 and 1962. But in 1963, as a reflection of the strengthening domestic expansion and the worsening capital outflow, the monetary authorities permitted the gap to narrow between excess reserves and member bank borrowings, and the level of free reserves thus declined to the neighborhood of $100 million in the latter part of the year.

Two specific policy actions taken during 1963 also affected interest rates and credit markets. The first of these was the July increase in the discount rate—the rate at which member banks borrow from the Reserve Banks—from 3 percent to 3½ percent. (At the same time, the Federal Reserve Board also eased the restrictions on interest payments to holders of time deposits.) The other action was the November increase in the margin requirement, from 50 to 70 percent, on loans for the purpose of purchasing and carrying securities. This action was taken against the backdrop of a sharp run up in stock prices and an even sharper rise in stock market credit.

The increase in the margin requirement was not unexpected, since this instrument could be directed toward the solution of a specific problem arising in one particular credit

Expansion sustained by continued reserve availability despite lesser degree of ease in monetary policy



Source: Board of Governors of the Federal Reserve System.

market. The increase in the discount rate was part of a program to stiffen short-term interest rates domestically and to narrow the differential between short-term rates here and abroad. Short-term balances are rather volatile and are highly responsive to rate differentials in some circumstances. Such balances could be expected to remain closer to home in response to higher rates—for example, higher market yields on 3-month Treasury bills, which after July rose practically in concert with the discount rate.

Monetary solution: a dual role

Growing foreign entanglements consequently have forced monetary policy to perform a dual role in recent years, whereas in earlier cyclical expansions the principal emphasis was upon the domestic scene to the virtual exclusion of foreign considerations. As detailed in the preceding article, monetary measures designed to improve the balance-of-payments situation have centered around swap arrangements with foreign central banks, along with those domestic arrangements concerned with avoiding downward pressure upon the short-term structure of interest rates. Monetary policy has received a powerful assist in this area from certain fiscal and debt-management measures. Thus, the announcement of a proposal to impose a tax upon foreign security flotations in this country was instrumental in reducing the outflow of long-term funds in the second half of the year. Debt-management officials also, in recognition of their effect on the short-term interest rate, increased the supply of short-term debt to sustain this rate. In November, however, the Treasury cut back the tender of 3-month bills for two issues because it felt that the then-current level of short-term rates was in equilibrium with similar rates abroad.

Despite the difficulties involved in fulfilling its double assignment, most observers credit monetary policy with high marks in supplying the expanding economy's credit needs. Total bank credit outstanding increased by nearly $52 billion in the three years ended December 1963. The $18.2 billion gain posted in 1963 was slightly below the 1962 gain but well above the $15.1 billion increase of 1961. However, the change in the composition of total bank credit during this period was even more striking; for example, in 1961 total loans accounted for less than one-half of the total rise in bank credit outstanding, while in the next two years they accounted for three-fourths and nine-tenths, respectively, of the annual gains in bank credit. While the increase in total bank credit rose by 20 percent from 1961 to 1963, the annual increase in loans more than doubled.

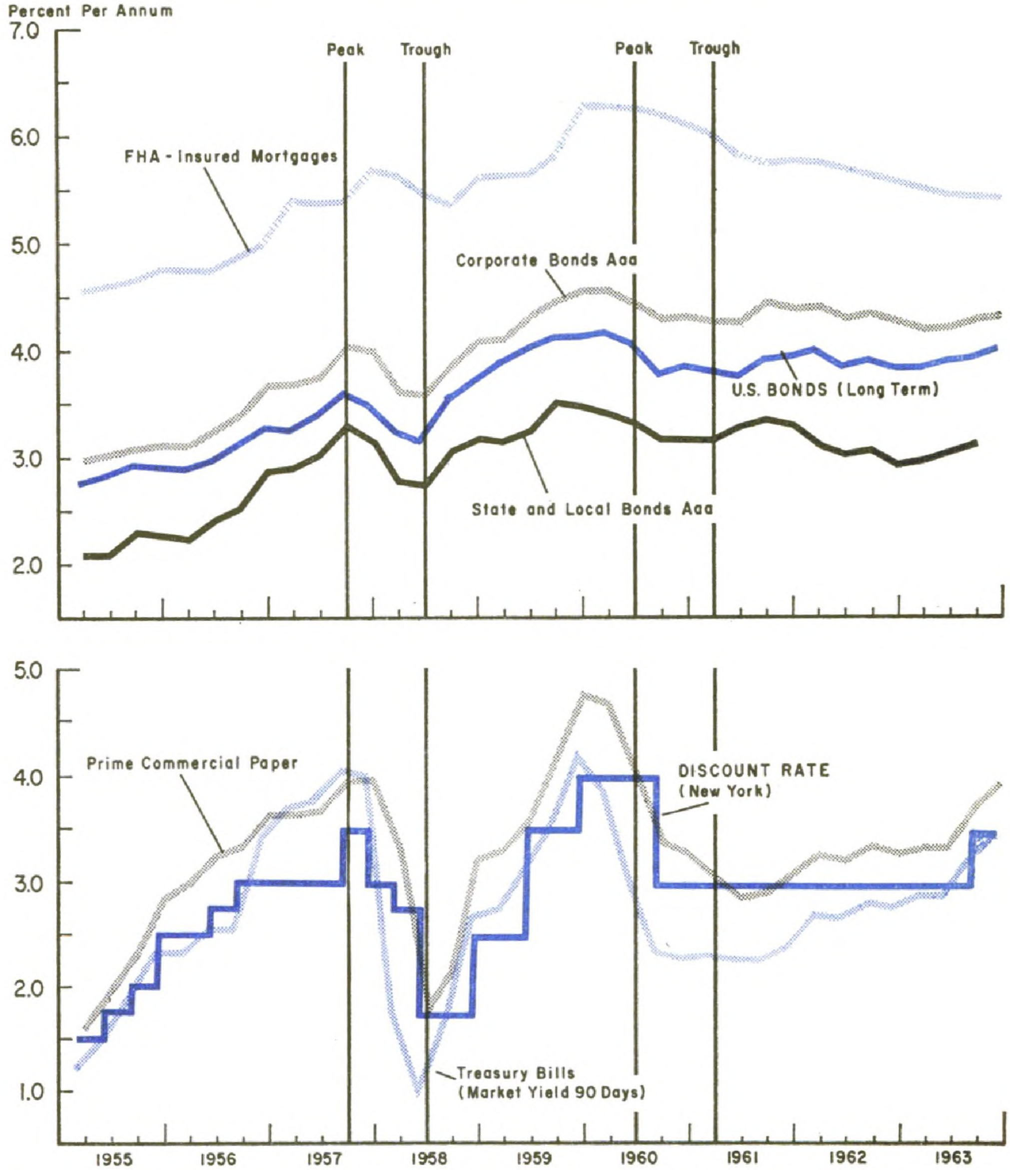
Although the term "availability of credit" is not capable of precise measurement, banks traditionally look to loans as their most desirable form of earning assets and acquire securities only when loan demand is weak. Thus, if the availability of credit is interpreted in terms of an increase in loans without a decrease in bank investments, there is no question that bank credit has been freely available to the private sector of the economy throughout the expansion.

Two sides of the coin

The availability of credit is only one side of the coin: what of the obverse, the cost of credit? Here the data present a curious picture in terms of the usual pattern of interest rates in a cyclical upturn. Unlike the experience in both the 1954-57 and the 1958-60 expansions, a general upward shift in the entire structure of interest rates has not been evident in the present expansion. The trend of long-term rates has been downward over the course of the current expansion — despite some increases in 1963—while short-term rates have been trending upward since late in 1961.

The unusual shift reflects the fact that long-term and short-term interest rates have been subject recently to different sets of influences.

Cost of money rises, sharply in short-term area, but much more slowly at long-term end of spectrum



Sources: Board of Governors of the Federal Reserve System; Federal Housing Administration.

The easing in long-term rates stems in part from the economy's high degree of liquidity and in part from the competition of banks and other institutions for means of investing the heavy influx of savings funds. The rise in short-term rates has been a matter of deliberate policy in connection with the balance of payments, rather than solely a reflection of market forces. But since interest rates are a fairly sensitive barometer of relative demand-supply conditions in the capital and money markets, the late-1963 experience suggests a strengthening demand for funds, paralleling the expansion in business activity. However, the increase in rates recorded at that time was not enough to warrant any conclusions about reduced credit availability.

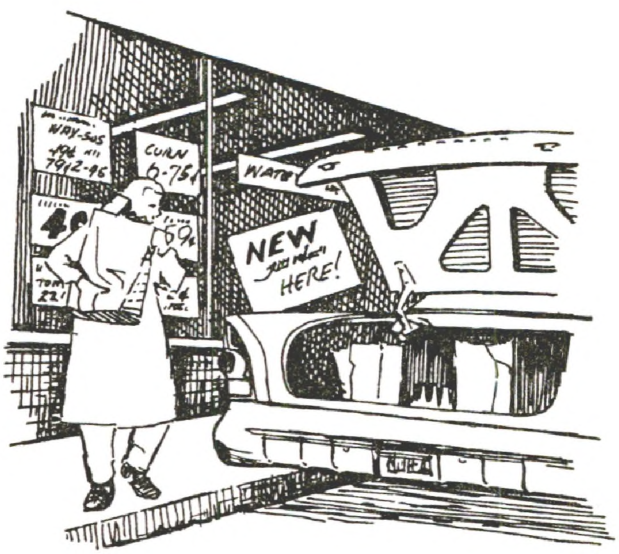
All this, and liquid too

Continuing credit availability was only part of 1963's happy story; of equal importance was the continuing build-up in the public's liquid asset holdings. Over the three-year-long expansion, the total increased by $90 billion (22 percent), and consequently the liquid asset-GNP ratio rose by late 1963 to 81.7—the highest figure since the early 1958 recession.

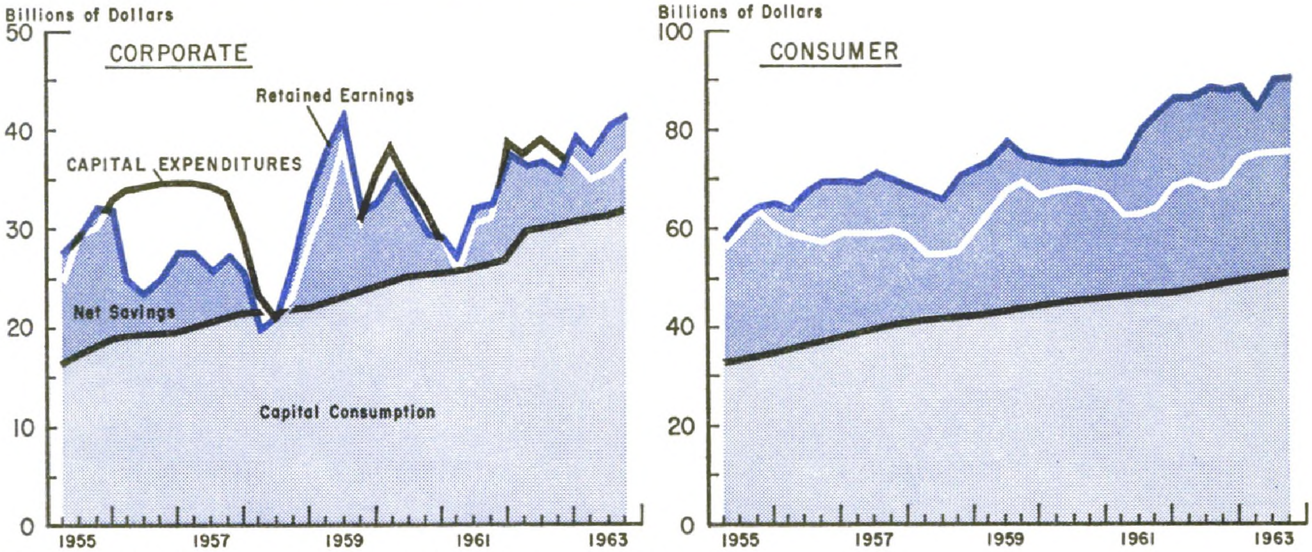
Over four-fifths of the 1963 increase in liquid assets was concentrated in the time deposits at commercial and mutual savings banks and in shares of savings and loan associations. The money supply (defined as demand deposits and currency) grew substantially in 1963 but still declined in relation to GNP. This ratio has fallen steadily since World War II, but it has declined by 3 percentage points in the present expansion alone.

The drop in the money-GNP ratio was not at all unusual for this stage of a cyclical expansion. Normally, after the public builds up its cash balances to the level that it wishes to hold, it will then use those funds to acquire other liquid assets which earn a return—for example, by transferring balances from checking accounts into savings deposits or savings and loan shares. Accordingly, in 1963, the money supply increased by less than $5 billion, while time deposits and savings and loan shares rose by about $27 billion.

On the other hand, the recent increase in the liquid asset-GNP ratio was quite unusual for such a sustained period of rising business activity. The public normally builds up its liquid balances in relation to GNP during times of uncertainty—during recessions and early recovery periods. But as an expansion gets underway and confidence increases, the public generally elects to spend for goods and services rather than to add further to liquid balances. Past experience therefore suggests that the right mixture of liquidity and consumer confidence can spark a substantial increase in sales throughout the economy. Thus, a highly liquid public now has the means to ensure the sharp increase in total spending that the tax cut is designed to elicit.



Businessmen and consumers record upsurge in capital spending, but their retained earnings rise even more rapidly



Source: Board of Governors of the Federal Reserve System (flow-of-funds data).

Saving, Borrowing, Spending

Consumers, businesses, and governments all succeeded in finding ample funds to finance 1963's 5-percent increase in GNP. All sectors benefited from increased revenues during the year, but they also augmented their expenditures with substantial infusions of credit. These developments, moreover, went hand-in-hand with a striking buildup in liquid assets.

During 1963 the disposable income of consumers rose about $18 billion, and corporate net earnings about $2.5 billion, above the levels of 1962. In the government sector, receipts of the Federal government increased almost $8 billion and state-local receipts more than $5 billion. Taken all together, these four items expanded by some $34 billion, or almost 6 percent, during the year.

At the same time, all sectors of the economy turned increasingly to credit facilities to help finance their growing activities. Consumers added approximately $6.7 billion to their short- and intermediate-term debt outstanding, mostly in the form of instalment debt. Mortgage debt rose about $30 billion, half of the increase going to finance 1- to 4-family housing. Total corporate debt rose $25 billion. The Federal government and its agencies increased their indebtedness by $5 billion, and state and local governments increased theirs by substantially more—nearly $8.5 billion. All in all, total debt rose about 7.7 percent during the year, and thus outpaced the 5-percent gain in the nation's total output.

Business means profits

Burgeoning business activity during 1963 was clearly reflected in the trend of corporate profits. Actually, profits have been rising since the inception of the three-year-long expansion, but since the rate of increase was relatively slow during most of 1962, widespread fears were expressed at that time about narrowing profit margins.

As 1963 progressed, however, it became evident that those fears were groundless. The nation's leading manufacturing companies reported a 13-percent increase in profits between the first three quarters of 1962 and the comparable 1963 period. Among major industries, the steel industry registered the greatest average increase—42 percent—but automotive, oil, drug, machinery, and aerospace industries all scored substantial gains.

Although final data are not yet available for 1963, total pre-tax profits almost certainly surpassed (for the first time) the record of nearly $48 billion set in 1959. After-tax profits had already matched their 1959 record in 1962 but proceeded to climb another 10 percent in 1963. (The increase in profits was less impressive in relation to the increase in national income, however; the profits-income ratio was about 11 percent in 1963, as opposed to 13 percent in 1955 and 12 percent in 1959.)

Out of the swelling flow of earnings, corporations paid their stockholders close to $18 billion in dividends, and so continued for the fifth year in a row an uninterrupted rise in payouts. After the payment of taxes and dividends, about $9.5 billion remained in company coffers in the form of retained earnings —by no means a record figure, but the highest since 1959.

Corporations manufacture money

In addition to these undistributed profits, business firms were able to set aside greater-than-ever allowances for depreciation and amortization. Aided by the 1962 tax revisions, which permitted faster write-offs of machinery and equipment as well as deductions of up to 7 percent of the cost of some kinds of capital equipment, corporations raised their allowances to about $29 billion in 1963. This 6-percent gain was far below the 16-percent gain stimulated by the tax changes in the preceding year, but it was still sufficient to lift allowances to a figure two-and-a-half times above the level of a decade ago.

Record-breaking sums for depreciation and amortization, together with sizable undistributed profits, gave corporations roughly $38 billion from internal sources in 1963. They found uses for those funds in financing a record level of plant-equipment expenditures, but corporate spending for such purposes ($33.5 billion) still fell far short of the flow of internally generated funds.

Business firms made only moderate demands on the capital markets, since they were able to generate such a large flow of funds from their own operations. During 1963, corporations obtained from outside sources about $10.5 billion in net proceeds for new capital—7 percent more than 1962 and about the same as the average of the 1960-62 period. To an even greater extent than in previous years, the bulk of the new money was raised by bond issues; new corporate stock issues, totalling less than $1.5 billion, were at their lowest level since 1949. Moreover, for the first time on record, more corporate stocks and bonds were placed privately than were offered to the public.

In sum, corporations generated substantially more money from internal sources than they got from all external sources, including bank loans and mortgage loans as well as new capital issues. But with all that, corporate indebtedness rose by $25 billion during 1963, or slightly more than in the preceding year.

Money for cars and houses

Consumers, although not at all reluctant to go into debt, increased their asset holdings almost as much as their debt during 1963. Consumers added almost $7 billion to their short- and intermediate-term debt and a record $16 billion to their mortgage debt. Meanwhile, they recorded net financial saving (over and above increases in debt) of approximately $19 billion—just a little below the record high of 1962 but well above the level of other postwar years.

The record increase in mortgage debt naturally reflected the record amount of new construction spending, but other factors were also involved, since mortgage debt has increased more than proportionately during this expansion. The difference can be explained partly by the postwar inflation in real estate prices, which causes a rise in mortgage debt when old houses change hands, but it must also be attributed in some part to the increasing use of housing funds for nonhousing purposes—for example, the financing of cars, college expenses, and tourism.

Consumer instalment credit during 1963 was dominated, not unexpectedly, by the auto-credit field. With record-breaking new car sales reflected in a rising volume of instalment purchases, the amount of automobile credit outstanding expanded by nearly $2.7 billion, or approximately 14 percent. A high level of appliance sales also produced a record volume of new credit for financing consumer goods, and the increase in personal loans set a new mark as well. For every category of instalment credit, the increase was greater than in 1962, and for instalment credit in the aggregate, early estimates indicate a record growth, clearly exceeding that of 1955 and probably exceeding the $5.6 billion increase of 1959 also.

Money for governments

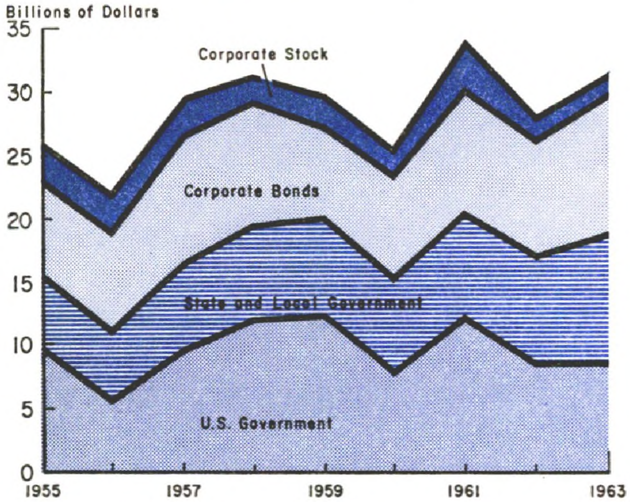
In the government sector, the multitude of state and local units increased their debt more, in the aggregate, than did the Federal government. Nonetheless, current receipts of the Federal government were nearly double those of the state and local units. Federal revenues increased 7.5 percent to $113 billion; state-local revenues rose 9 percent, to $64 billion.

In terms of the demand upon the capital and money markets, the Treasury's increase of about $4.3 billion in net cash borrowing was small relative to the demands of corporations and state and local governments. However, with the Treasury it is not always the size but rather the style of the needs for funds that counts. As evidenced in 1963, the Treasury's refunding operations can be competitive with other borrowing operations when long-term securities are offered in exchange for maturing issues which could be redeemed for cash. In such a situation, the Treasury effectively taps the long-term market for the amount of debt that has been refunded into longer issues, even when the level of outstanding public debt remains unchanged.

In 1963, the Treasury placed about $15 billion into issues maturing in more than five years. (Almost $8 billion went into maturities of 9-years, 11-months or longer.) Most of this extension of the public debt was accomplished in two massive advance refundings undertaken in February and September. On the other hand, there were no basic innovations in debt-management techniques during the year, although there were some changes in the form of offerings. The Treasury auctioned long-term bonds on two occasions during the year, thus reviving a technique used in the mid-thirties, though the recent offering differed in some respects from the earlier experience. The tender of one-year bills was shifted from a quarterly to a monthly cycle; moreover, greater emphasis was given to the use of bills and bonds, as the amounts of certificates and notes outstanding declined.

In terms of the structure of the public debt, a net decrease occurred in outstanding issues of less than five years' maturity. The relative drop in shorter maturities reflected the issues taken out of this area by advance and regular refundings, which on balance more than offset the increase in bills outstanding. A "two-way stretch" in the structure of the outstanding public debt, towards the short and long ends of the maturity spectrum, was carried out under the influence of two sets of circumstances. At the short end, the Treasury systematically increased the supply of public-debt issues, in order to firm up short-term rates as part of the program to remedy the balance-of-payments deficit. At the long end, the Treasury extended the maturity of the debt whenever possible in order to take advantage of the gen-

Moderate gain in new capital issues based on rising state-local activity



Source: Securities and Exchange Commission.

eral easiness of long-term interest rates and the strong investor demand for long-term issues.

Tax-exempt milestone

In the same realm of debt financing, state and local governments passed a milestone in 1963. For the first time, sales of municipal bonds in the United States exceeded the $10 billion mark. Market prices for municipal issues drifted irregularly downward during the year, from the high levels reached in 1962. But even at the low point reached in November, prices were higher than they had been most of the time since 1958.

The strong market performance reflected the sustained demand for this type of investment on the part of commercial banks, which make up the largest single buying group for tax-exempts. Abetted by the July revision of Regulation Q, the banks' time and savings deposits continued to expand throughout the year and thereby provided resources for a substantial expansion of earning assets. For the United States as a whole, the increase in bank holdings of municipal and other non-Federal securities amounted to $5.4 billion, or 15 percent.

The year also witnessed a marked rise in the volume of municipal refundings. Many state and local governments apparently took advantage of the relatively high prices being paid for new offerings, to refund ahead of schedule issues carrying higher interest costs. In some cases, the refunding was done several years in advance of the redemption date or the first call date of the bonds being refunded, and the receipts were invested in United States Treasury bonds which will be held until the refunded issues are eligible for redemption. All told, more than $1,250 million of outstanding municipal issues were refunded in 1963, compared with only $261 million in 1962.

Money in the Bank

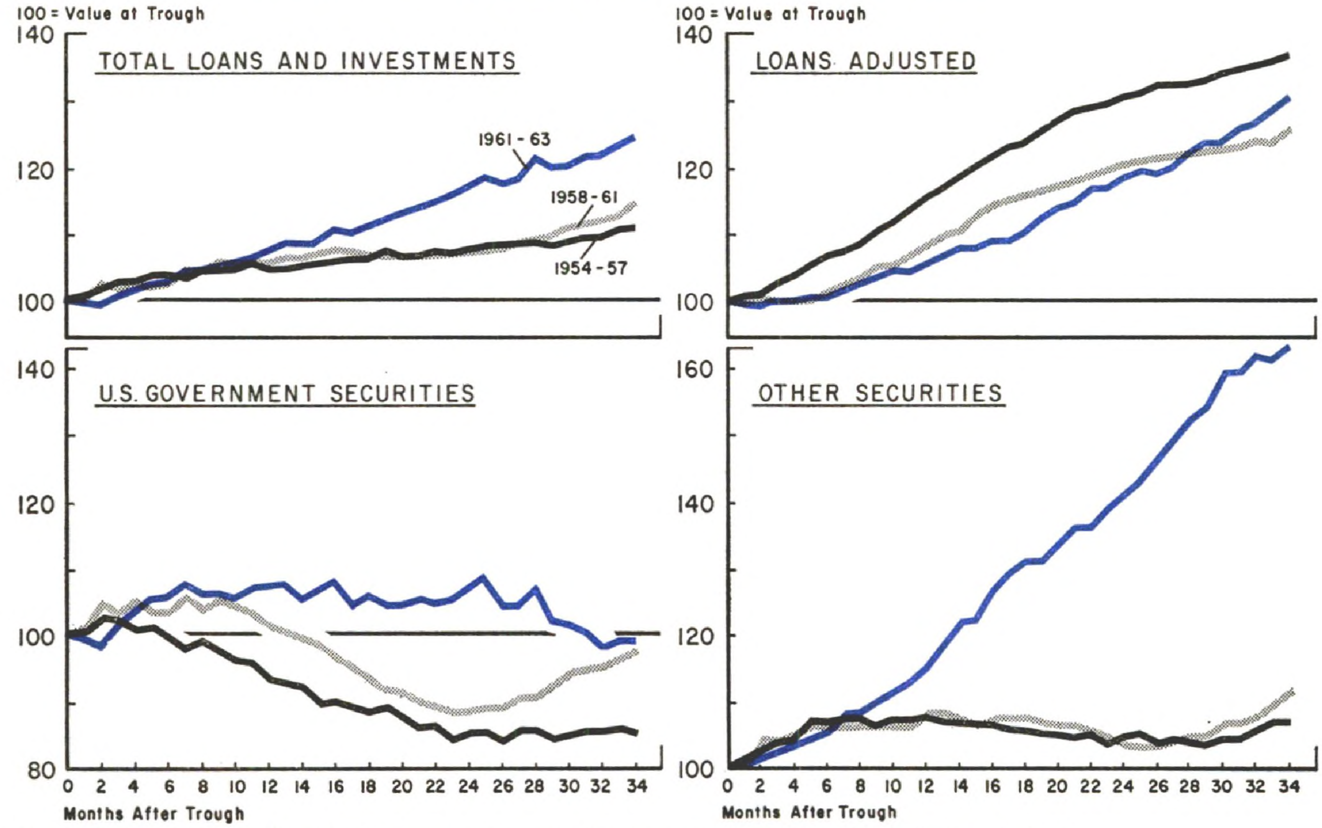
THE PERFORMANCE of the nation's commercial banks in 1963 reflected the year's somewhat expansive pace of economic activity as well as a generally smooth adjustment to reduced ease in monetary policy. Total bank credit increased at a slightly more leisurely pace than in 1962, but total loan demand strengthened with a higher rate of expansion in business, real estate, and consumer loans. However, the channeling of additional funds into loans (and into tax-exempt securities) was accompanied by a reduction in U. S. Government security holdings. The deposit flow into banks meanwhile continued at a high rate but, as in 1962, was heavily weighted toward time and savings deposits. Some tautening of liquidity positions became evident, with a rise in the loan-deposit ratio and a drop in the security-deposit ratio, but banks at year-end still had ample funds available for financing a further expansion of economic activity.

Within an intensely competitive atmosphere, the commercial banking system was eminently successful in 1963 in obtaining ample deposits. The growth in supply was somewhat unbalanced, since the banks secured only a 2-percent gain in demand deposits as opposed to almost a 15-percent increase in time and savings deposits. The latter figure stands out, however, as a striking in-

Ample raw material

In order to obtain individuals' savings, banks faced increasingly aggressive competition from other institutions, many of whom offered higher rates of return than banks advertised. Weekly reporting member banks gained over $3 billion in passbook savings deposits in 1963, but the rate of increase fell below the 1962 gain and also below the net increase in savings capital of savings and dication of the banks' continuing success in the competition for the excess funds of individuals, businesses, and governments.

Bank credit grows faster than in earlier expansions, as non-Federal security holdings zoom and loans continue to rise



Note: All data are seasonally adjusted; loans are less valuation reserves and adjusted to exclude loans to banks.
Source: Board of Governors of the Federal Reserve System

loan associations. (Data on all banks are not yet available.)

Conversely, time deposits—other than savings deposits—of individuals, partnerships, and corporations expanded at a faster pace than in 1962; weekly reporting member banks recorded almost a 50-percent gain in this category. The striking gain reflected the July revision of Regulation Q, which permitted banks to make adjustments in rates on time certificates of deposit—and thereby allowed those certificates to remain competitive with Treasury bills and other short-term instruments within the general environment of rising yields. Payment of competitive rates on time deposits also served to attract additional funds from foreign banks, foreign official organizations, and state and local governments. Not surprisingly, then, negotiable time certificates accounted for a substantial part of the year's entire increase in time deposits.

Demand deposit growth continued to lag far behind that of time deposits in 1963. Total demand deposits (less cash items in process of collection) rose 2 percent; demand deposits adjusted[1] rose 2.3 percent, compared with a 1.5 percent growth rate in 1962. As a result, only 57 percent of total deposits at year-end were demand deposits, compared with 63 percent at the beginning of the cyclical expansion.

Problem: shifting structure

The shift in deposit structure has had a pronounced effect on bank performance in the current cycle. Since early 1962, the banks have adjusted their loan and investment port-

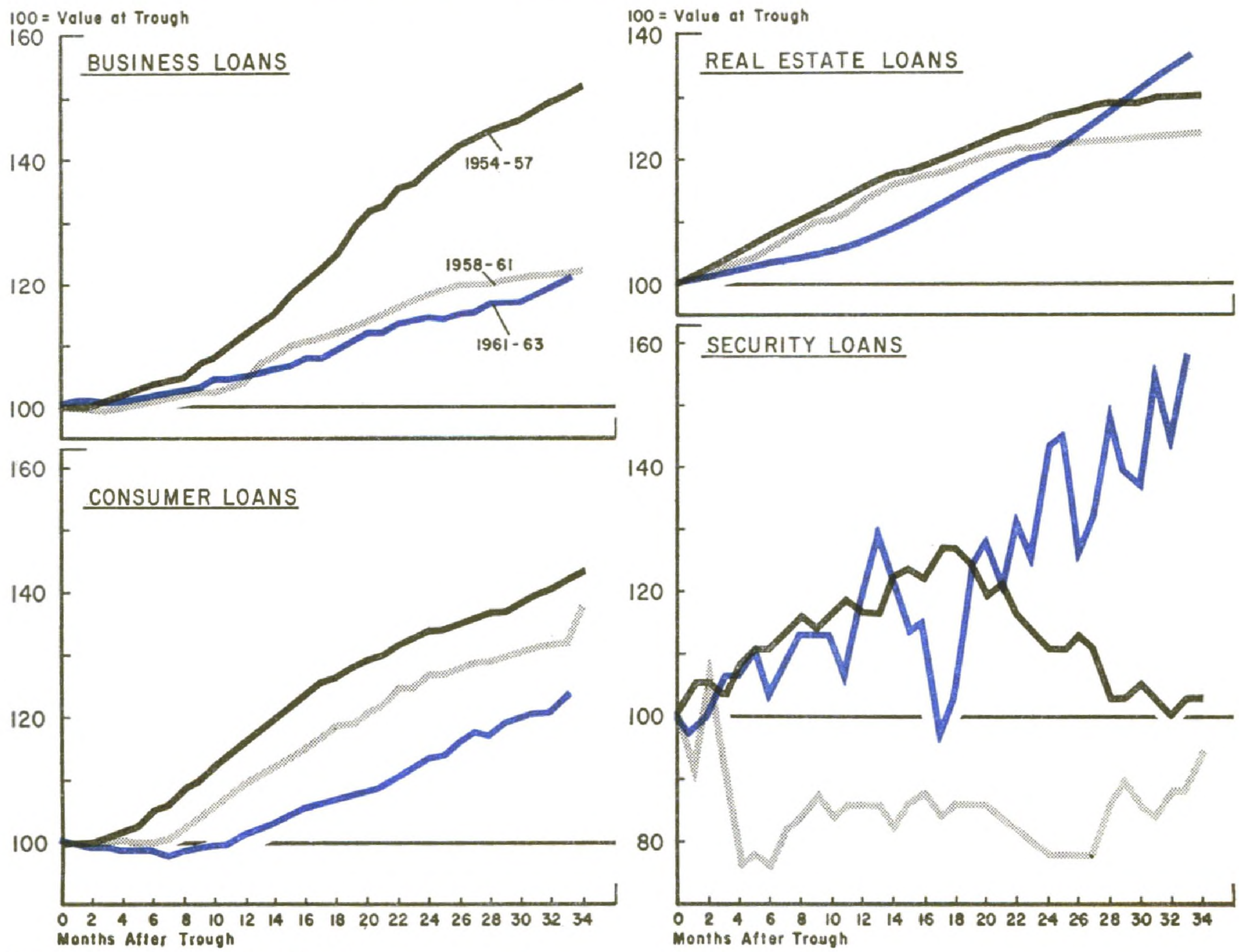
[1] Total demand deposits excluding U. S. Government and interbank deposits and less cash items in process of collection.

folios so as to obtain higher-earning assets and thereby cover increased costs on the rapidly expanding interest-bearing sector of their deposit structure. At the same time, the banks have taken advantage of the generally less volatile characteristic of time deposits to lengthen maturities on their loans and security purchases. Yet, in evaluating their liquidity positions, banks have had to remember that these deposits could become more volatile, since a sizable proportion of time certificates are in large denominations and in negotiable form. After all, the highly rate-sensitive investors who hold these certificates are in a position to take advantage of alternate short-term investment outlets in the event of significant movements in money-market rates.

Ample availability of credit, a hallmark of the prolonged cyclical expansion, remained much in evidence during 1963. Commercial bank total loans (exclusive of interbank loans) increased by $15.9 billion—as compared with $13.6 billion in 1962—but the distribution among the various loan categories remained much the same as before. (All loan and investment data are on a seasonally adjusted basis.)

In 1963 as in the earlier stages of the long expansion, business loan demand failed to

All loan categories expand, but business and consumer loans grow at slower pace than mortgages and security credit



Note: All data are seasonally adjusted.
Source: Board of Governors of the Federal Reserve System

assume the pacesetting role that it evidenced in other post war cycles—at least partly because many businesses had ample ability to pay their bills out of their substantial accumulation of internally-generated funds. Business borrowings rose $4.5 billion (9.4 percent) during the year, but the increase was little better than the 1962 gain, and it was accomplished only by virtue of a second-half upsurge in loan demand.

Buying mortgages

The banks meanwhile continued to favor mortgages as an investment outlet for the heavy inflow of time and savings deposits. The gain for the year—$5.3 billion, or 15.5 percent—was the highest recorded since early in the postwar period. The near-record expansion did not, however, result in higher mortgage rates; in fact, there was some downward pressure on rates because of the ample supply of long-term funds available from most lending institutions.

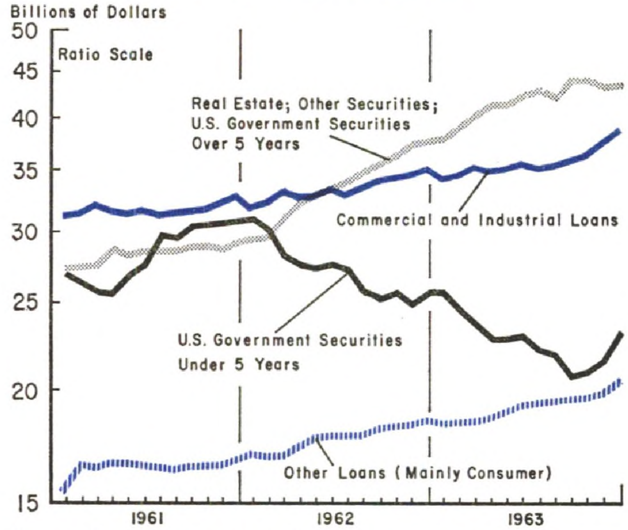
Record sales of consumer goods—mostly autos— stimulated a 13-percent increase in consumer borrowings from commercial banks in 1963. This was the highest annual rate recorded in the expansion to date. Consumers apparently still preferred the savings window to the loan officer's desk, however, since they increased their loans far less in the 1961-63 expansion than in either of the two preceding cyclical expansions. Activity in other lending categories meanwhile continued to increase; security credit remained consistently above the 1962 level, and loans to nonbank financial institutions increased much more rapidly than in the preceding year.

Selling governments

The composition of banks' investment portfolios shifted during 1963; holdings of U. S. Government securities declined by 5 percent while other security holdings jumped 20 percent. Reduced investments in U. S. Governments reflected changes in monetary policy, although changing maturity preferences were also involved. The decline in total holdings of Treasury obligations occurred for the most part in the second half of the year as banks' reserve positions came under increasing pressure. On the other hand, the decline in short-term maturities (under 5 years) began in early 1962 and continued at an accelerated pace through August 1963; then, towards year-end, a reverse movement brought an increase in holdings of these extremely liquid market instruments.

The phenomenal recent growth in bank holdings of non-Federal securities continued, meanwhile, as banks attempted to offset rising costs with rising earnings from attractive tax-exempt issues. Net acquisitions slowed down in the last quarter of 1963; even with that, however, the $5.8-billion (20 percent) increase for the year was roughly comparable with 1962's outstanding performance.

Commercial-bank portfolio shifts feature long-term asset growth



Source: Board of Governors of the Federal Reserve System.

Westward Expansion

NINETEEN SIXTY-THREE was a re-telling of a long-familiar Western story. According to the major measures of economic growth—employment in particular—Twelfth District business again grew faster than business elsewhere in the nation. Yet the story's plot contained some tangled threads as well; unemployment grew more rapidly here than elsewhere, and consumer spending grew more slowly — surprisingly, even in the auto sales field. And despite a strong second half, towards year-end some of the factors that had marred the first-half performance began to reappear, particularly in the field of defense-related employment.

The magnitude of Western growth in 1963 can be gauged by a 2.4-percent (225,000) gain in employment — a gain which far exceeded the 1.3-percent increase recorded for the rest of the nation. The bulk of the increase occurred in California, which recorded a 3-percent year-to-year gain. By industry, the increase centered in the service and distributive industries rather than in the commodity-producing industries, although each of these sectors recorded gains greater than those recorded elsewhere.

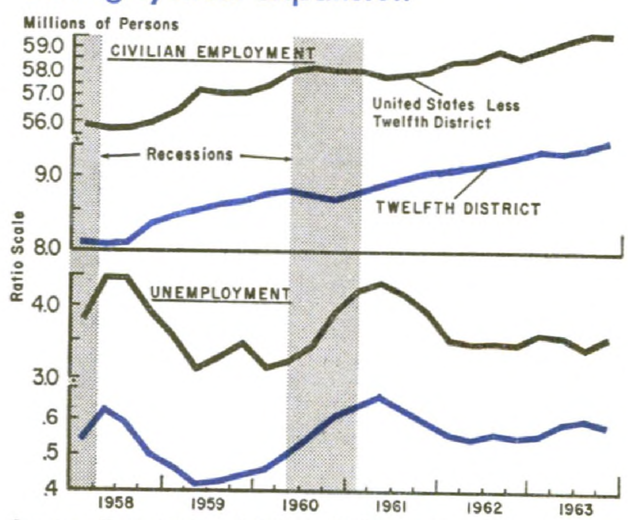
Growth and growing problems

One-fourth of the almost quarter-million increase in jobs came from state-local government employment—the fastest growing sector in most District states. (The number of workers on the Federal government payroll remained practically unchanged, here as elsewhere in the nation.) Another one-fourth of the increase in jobs developed from finance and service activities, and yet another fourth came from trade and other distributive industries. Employment in the commodity-producing industries (manufacturing, mining, and construction) increased by almost as much, but the agricultural sector suffered a slight (2-percent) decrease in jobs.

The over-all employment figures paint a picture of a broad, even expansion, but that picture hides the blemishes which cropped up in the crucial manufacturing sector. Factory employment increased one percent in 1963 — only one-fourth as rapidly as in the preceding year. A random cause was involved, in the guise of a labor conflict which idled 28,000 Northwest lumber workers for several months in midsummer. A structural factor was also involved, because of the relative unimportance in the District of two industries, steel and autos, which strongly stimulated factory employment elsewhere in the nation. But a completely different structural problem also accounted for the employment slowdown; that is, the disproportionate importance in Western manufacturing of defense-related activities, which in 1963 suffered from contract cancellations and cutbacks.

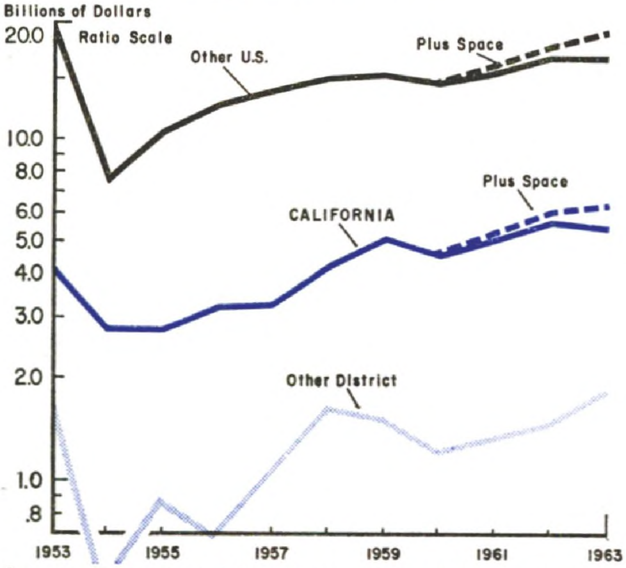
The defense-space complex of industries—ordnance, aircraft, electrical equipment, and shipbuilding — normally accounts for about one-third of District manufacturing jobs. Employment in these industries grew about 10 percent in 1962, and the job total finally

More jobs, more jobless appear during cyclical expansion



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

Space spending takes up slack as defense begins to level off



Sources: Department of Defense; National Aeronautics and Space Administration (prime-contract awards data).

reached a record 631,000 towards year-end. But major layoffs then took place through the first half of 1963, principally in the California electrical equipment industry and the Washington and California aircraft industries. Then, after stabilizing for several months, employment declined again in the latter part of the year to about 600,000 — which meant an average employment for the year no higher than the 1962 average.

Paradoxically, however, the defense-space complex received a record volume of new business from the Federal government in 1963, judging from a still-incomplete tally of contract data. The previous year's totals were impressive in themselves; in 1962 Department of Defense prime contract awards in the District exceeded $8 billion (32 percent of the national total), and direct procurement awards of the National Aeronautics and Space Administration reached $726 million (48 percent of the national total). In the same year, moreover, the 631,000 personnel staffing military installations in the District received about $3 billion in pay. Presently available data indicate substantial increases in all those dollar figures for 1963, but the data on employment trends in the defense-space complex suggest even more strongly that — partly because of technological changes — the DOD-NASA dollar inflow cannot always be counted on as a source of new job opportunities.

Rising construction, falling trees

What of that other major support of the Western economy — the construction industry? Here, the 1963 data present a picture of the rosiest hue. Admittedly, construction contracts for nonresidential building showed a smaller year-to-year gain than elsewhere in the nation (8 percent), but the housing boom — stimulated by a vigorous pace of apartment building — continued unabated, with a 19 percent year-to-year gain. Single-family housing maintained a fairly stable pace of activity, but multi-family construction continued rising even in the face of increasing vacancy rates. As a result, about two out of five construction permits were issued for large multi-family structures in 1963, as opposed to only one out of four in 1960.

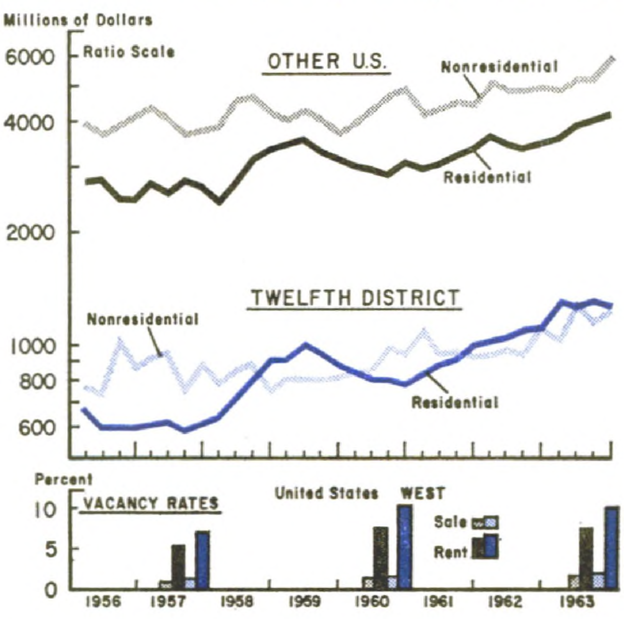
The building boom has been stimulated not only by the continuing influx of migrants but also by a major injection of mortgage funds. In 1963, savings and loan associations in District states added $4.4 billion to their mortgage loan holdings, and commercial banks added almost $1.0 billion more. In both cases, of course, the heavy inflow of mortgage money reflected the continued heavy inflow of savings into lending institutions.

The nationwide boom, not only in construction but in most other sectors as well, was reflected also in heavy demand for Western products throughout the year. The District's steel industry recovered sharply from its previous year's decline to attain a production record of 5.7 million tons in 1963. This 17-percent increase, however, was accompanied by a 28-percent rise in imports of foreign steel; consequently, imports into the District now amount to one-fifth of total local production.

The District's lumber industry also benefited from the vigorous pace of building activity. Lumber output increased 4 percent and plywood production jumped 13 percent during the year, despite the strike and lockout which idled a large proportion of the industry throughout the summer. Average lumber prices increased appreciably during the strike, but they dropped abruptly after the August settlement and ended the year not far above the year-ago level. But although production and prices seemed unaffected in the aftermath of the labor conflict, market penetration was a different story. Canadian mills, which had accounted for about two-thirds of the waterborne trade to the key Atlantic Coast market in early 1962, obtained a four-fifths share during the midsummer work-stoppage at the American mills, and they lost little of that advantage in succeeding months.

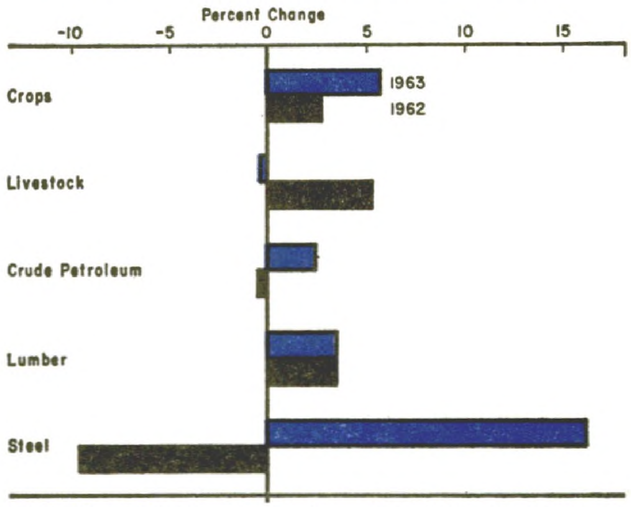
District producers of lead, zinc, and aluminum also increased their production and prices in 1963, on the basis of the strong demand for nonferrous metals created by the boom in durables and construction. District petroleum refineries meanwhile expanded their processing activities for the fifth straight year; the increase was accompanied by a slight rise in District crude production, and hopes for further production gains were bolstered by the first lease-sale of Federal land off the California coast.

Western building boom matches boom elsewhere, despite high vacancies



Note: Contract-award data for District exclude Alaska and Hawaii; vacancy data for West include 13-state data.
Sources: F. W. Dodge; Bureau of the Census.

Crop sales expand, but not livestock . . . steel dominates industrial boom



Note: Farm data based on cash receipts; industrial data based on physical production.
Sources: Department of Agriculture; Federal Reserve Bank of San Francisco.

In the agricultural sector, crop marketing receipts went up, but livestock receipts declined in response to sagging prices. Nonetheless, the marketing record of $5.5 billion recorded in 1962 was surpassed by about 3 percent — twice the rate of gain recorded nationally. But the District's favorable performance stemmed to some extent from several special factors which are not likely to be repeated — higher prices for citrus crops resulting from a freeze in two major producing states (Florida and Texas), and expanded acreage and exceptionally high yields of wheat. Moreover, reduced government payments and increased production costs tended to offset the advance in cash receipts, so that farm net income in the District remained practically unchanged from 1962.

INDEXES OF INDUSTRIAL PRODUCTION—TWELFTH DISTRICT

(1957-59 = 100)

INDUSTRIAL PRODUCTION	1958	1959	1960	1961	1962	1963p
Copper	101	86	112	119	127r	127
Lead	92	93	76	99	105	101
Zinc	94	96	86	97	101r	98
Silver	102	94	91	105	105r	102
Gold	104	90	99	92	86r	70
Steel Ingots	94	92	102	111	100	117
Aluminum	87	101	101	97	107	115
Crude Petroleum	98	96	95	96	96	97
Refined Petroleum	96	101	104	108	111	112
Natural Gas	96	104	112	121	126r	137
Cement	99	108	101	105	111	116
Lumber	98	109	98	95	98r	102
Wood Pulp	98	103	106	109	114	N.A.
Douglas Fir Plywood	97	120	119	132r	142r	160
Canned Fruit	91	112	111	114	119	105
Canned Vegetables	107	95	101	89	106	97
Meat	95	101	107	111	112r	117
Sugar	91	108	105	107	113r	120
Flour	102	102	102	99	101	94
Creamery Butter	96	102	112	120	119	N.A.
American Cheese	97	103	112	111	111	N.A.
Ice Cream	101	103	102	106	105	N.A.

p—Preliminary.
N.A.—Not available.
r - Revised.
Source: Federal Reserve Bank of San Francisco.

Where the jobless come from

What, then, was the effect on producers and consumers of the District's impressive yet sometimes-mixed 1963 performance? As already noted, employment grew far more rapidly here than elsewhere; in fact, employment in every major industry rose at a more rapid pace. But unemployment increased to about 585,000 — roughly a 6-percent gain or close to double the rate of increase recorded outside the District. Thus, the jobless rate rose from 5.6 to 5.8 percent between late-1962 and late-1963, and the rate increased to 6.2 percent in the major industrial states of California and Washington.

As in the past, however, the District's relatively high jobless rate reflected not so much a weakness in employment trends as a vigorous growth in the labor force — attributable mostly to a continuing heavy population inflow and a rapid entry of young people into the job market. The District's population increased at roughly twice the national growth rate in 1963, and migration, as usual, was the basic cause of the difference in growth rates. But past Census data indicate that migration tends to maintain District unemployment at a relatively high level in every major occupational category — professionals as well as laborers, and skilled as well as unskilled. The District jobless rate, moreover, also tends to be nudged upward because of the relatively heavy concentration in the Western population of the age-group that now suffers most from unemployment—the 14-19 age bracket.

Mixed labor force trends yielded mixed results during the year. Total personal income, like total employment, increased more rapidly in the District than it did in the rest of the nation. The national total increased 5 percent to $463 billion; the District total probably increased 6 percent or more, to the neighborhood of $75 billion. But that substantial income gain still had to be judged against the West's rapid rate of population growth; on that basis, the year's gain in *per capita* income, as in 1962, probably fell somewhat below the percentage gain recorded elsewhere.

Where will sales come from?

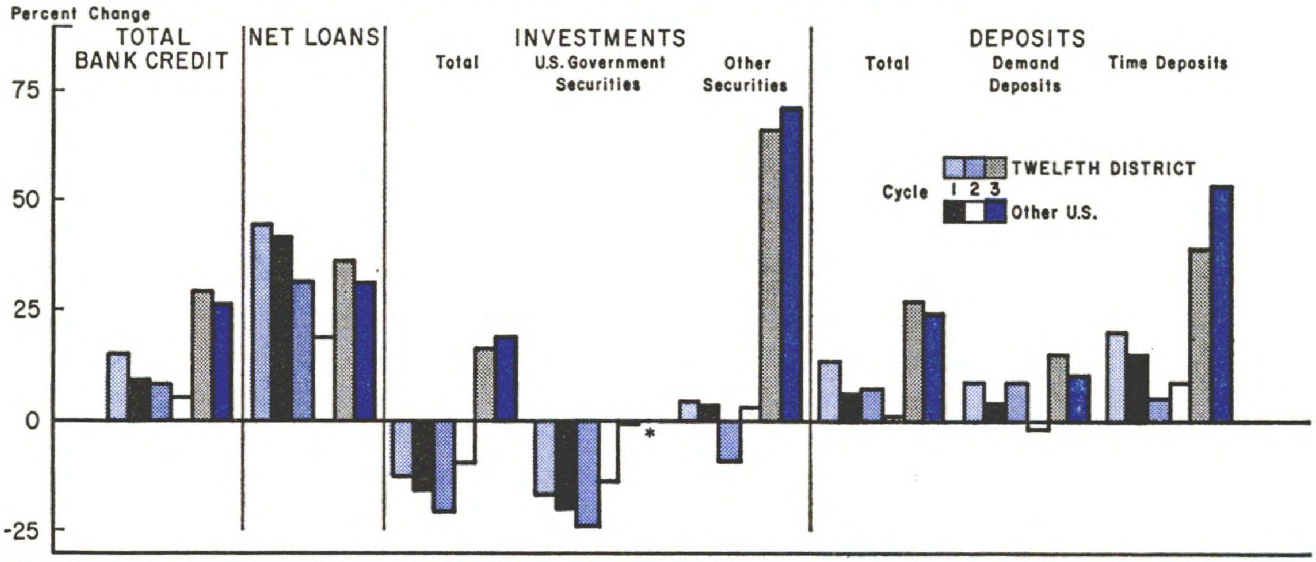
Aggregate consumer spending, although rising, also seemed to lag behind the rapid pace maintained in the rest of the nation. Retail store sales (exclusive of those at the largest multi-unit chains) increased by roughly 2 percent as opposed to 5 percent nationally; new-car registrations increased roughly 6 percent as opposed to 9 percent elsewhere in the nation. (In fact, total auto and truck sales rose only about 2 percent, versus an 8 percent gain elsewhere.)

This picture of relatively slow consumer spending must be evaluated in terms of the base used for comparison — the very high sales level reached in the preceding year, not only in the auto sector but throughout the retail sales field. Some of the increased activity in 1962 developed in connection with the Seattle World's Fair, so that the absence of that stimulus in 1963 resulted in rather weak comparative sales performances in the Pacific Northwest and the District as a whole.

Even so, the strong 1963 expansion of employment and income normally would have created far more cash-register activity for District merchants than actually developed during the year. Some consumers may have postponed purchases of big-ticket items because of timidity induced by a reading of the unemployment figures — current or anticipated. Others may simply have preferred saving to spending, not because of caution but rather because of the savings fever generated by a reading of the interest-rate figures in the ads of savings institutions. Whatever the reason, the result was a 7 percent increase in commercial bank savings accounts, and a 27-percent increase in savings and loan shares, during the year.

The dollars generated by the District's basic economic strength, the dollars available in ample consumer savings, and the dollars promised through Federal tax reductions, all presage a continued high level of incomes and sales in 1964. Whether the incomes will be translated into sales will depend, of course, on the enticements offered by Western merchants. And to whet the public's sometimes-jaded taste, many new enticements may be expected to hit the market in 1964; for example, consider just the simple utilitarian item now being marketed at $18.95 by an imaginative California firm—a pair of Hollywood-style sunglasses with a 3-transistor radio built into the frames.

District continues to outpace rest of nation
in loan and demand deposit categories, but not in other sectors



Note: Cycles dated August 1954-July 1957 (I), April 1958-May 1960 (II), and February 1961-December 1963 (III); time-deposit data include savings deposits.
Sources: Board of Governors of the Federal Reserve System; Federal Reserve Bank of San Francisco.

Western Dollars

WESTERN growth spelled increased strength for Twelfth District member banks in 1963, just as it did in the earlier part of the three-year long expansion. Moreover, as a consequence of the sustained relative ease in monetary policy, District banks continued to record—as did banks elsewhere—a more rapid rate of growth in bank credit than in either of the two preceding cyclical expansions.

In some respects, however, 1963 was not quite so strong for District banks as it was for banks elsewhere. Because of a decline from the extraordinarily high rate of growth recorded previously in time deposits, the $2-billion (6 percent) gain in total deposits failed to match either the District's 1962 gain or the 1963 deposit growth of all other member banks. On the other hand, District banks continued to boast a higher rate of growth in demand deposits adjusted—that is, total demand deposits excluding United States Government and inter-bank deposits and less cash items in process of collection.

Nonetheless, time and savings deposits continued to grow far more rapidly than demand deposits, both here and elsewhere in the nation. Moreover, time and savings deposits continued to account for more than half of total deposits at District banks, as opposed to less than two-fifths of total deposits at banks elsewhere.

Competition for savings

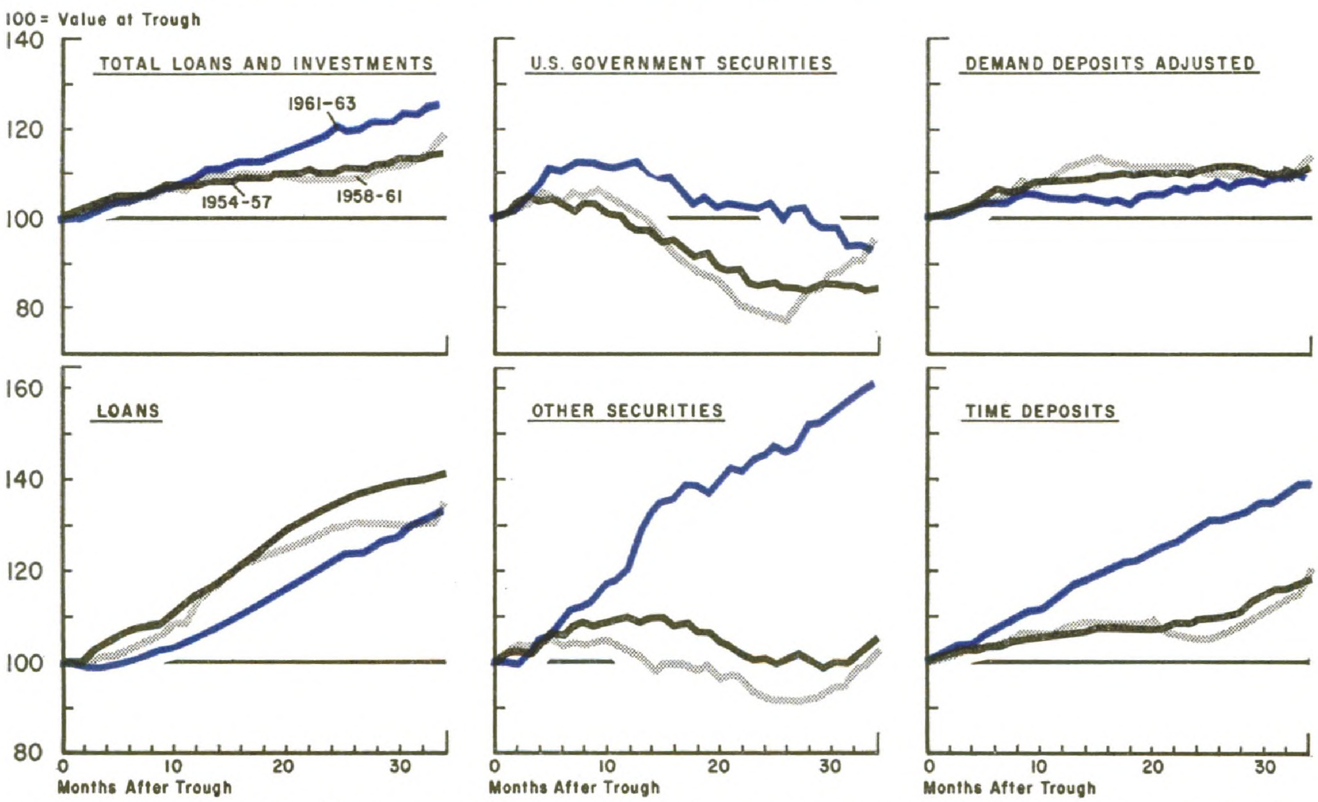
The decline in District banks' total time-deposit growth—from the remarkable 13-percent growth of 1962 to the still very respectable 9-percent gain of 1963—could be traced to a first-half slowdown in the inflow of personal savings deposits, and this could be explained, in turn, by the aggressive competition for personal savings that banks faced from savings and loan associations. Many of the associations paid dividends on savings shares at rates well above the 3½ and 4 percent ceilings imposed on commercial banks by Regulation Q; California associations, for example, offered average rates of 4.8-4.85 percent, and a few even paid 5 percent.

Savings and loan associations located in Twelfth District states have registered gains in savings capital of at least 20 percent in every year since 1959. The 1963 increase in savings shares—$3.9 billion, or 23 percent—was nearly four times the gain in savings deposits at District member banks. Moreover, outstanding shares at year-end exceeded total time and savings deposits of all District member banks by over $1.5 billion. Yet, in the second half of the year, when some associations began to make slight downward adjustments in dividend rates, the associations' rate of growth declined—and the banks' savings inflow picked up.

Although scoring smaller gains in time deposits than banks elsewhere, District banks throughout the three-year-long expansion have recorded both a steady uptrend in savings deposits and a sharp rise in other time deposits of individuals, partnerships, and corporations. Foreign deposits at District banks have risen consistently at a more rapid pace than at banks elsewhere in the nation. State and local government deposits, on the other hand, have tended to stabilize for the past two years, rather than continue upwards, as they have done elsewhere. Moreover, large-denomination negotiable time certificates, although growing much more slowly in the District than in New York City banks, amounted to an impressive $851 million outstanding at the end of 1963—roughly the same amount as for banks in the Chicago Federal Reserve District.

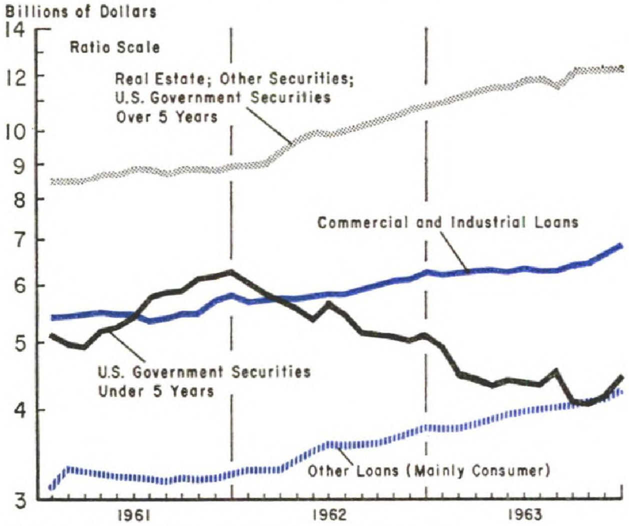
In 1963, District banks adjusted to the gradual shift toward less ease in monetary policy in the same manner as other banks—by increasing borrowings as well as by reducing holdings of U. S. Government securities.

Rapid cyclical growth in District bank credit related to rise in security holdings . . . time-deposit boom dwarfs demand-deposit growth.



Note: All data are seasonally adjusted; time-deposit data include savings deposits; loans are less valuation reserves and adjusted to exclude loans to banks.
Source: Federal Reserve Bank of San Francisco.

District, like nation, experiences shift toward long-term assets



Source: Federal Reserve Bank of San Francisco.

Average daily borrowings from the Federal Reserve Bank rose from $5 million in 1962 to $16 million in 1963; free reserves (excess reserves minus borrowings) declined in the same period from a daily average of $17 million to $6 million. The shift became most pronounced in the final quarter of 1963, when District member-bank recourse to the discount window resulted in borrowings of $24 million and net *borrowed* reserves of $3 million (both on a daily average basis). The increased pressure on reserves and the slowing rate of deposit growth combined to hold the rate of credit expansion in 1963 to 8 percent, as opposed to 9 percent in the preceding year. This gain in bank credit matched the rate of increase of other member banks in the nation.

Competition for mortgages

District banks increased their loans by $2.7 billion in 1963—more in dollar terms, but less in percentage terms, than in 1962. Just as before, loan portfolio managers directed their funds into higher earning assets in order to cover the ever-increasing interest cost on time deposits. The major result was a $943 million increase in real estate loans—roughly the same dollar increase, with roughly the same half-and-half distribution between construction loans and other mortgages, as in 1962. (Heavy construction activity in District metropolitan areas, both for high-rise apartments and for commercial-industrial buildings, was primarily responsible for the gains in those two categories.) Banks elsewhere expanded their mortgage portfolios at an even faster pace, but the District in 1962 still accounted for one-fifth of both the total dollar gain and the outstanding mortgages of all member banks.

Competition for mortgages, as for savings, intensified in 1963. Savings and loan associations in District states increased their mortgage holdings by about $4.4 billion; this increase substantially exceeded the net flow of savings capital into these associations, and dwarfed by comparison the annual gain in District-bank mortgage holdings. Yet, despite the competition, District banks managed to increase their mortgage holdings in tandem with time deposits and thereby maintained a fairly stable (42 percent) ratio between those two balance-sheet items.

Business loans vs. consumer loans

District business-loan demand in 1963 was characterized by a very shallow seasonal decline in the early months of the year and unusually strong demand in December; on a year-to-year basis, however, commercial-industrial loans increased less than in 1962. The ready availability of credit was reflected in a downward trend of business borrowing costs during the year. The average rate on short-term loans dropped 10 basis points to 5.28 percent, and the proportion of the dollar volume of business loans made at the prime rate—the rate charged to borrowers with the highest credit rating—rose from 28 to 34 percent.

Consumers contributed notably to expanding loan portfolios in 1963. With a 15 percent gain—slightly more than that for banks out-

SELECTED ASSET AND LIABILITY ITEMS OF ALL MEMBER BANKS IN THE TWELFTH FEDERAL RESERVE DISTRICT

(dollar amounts in millions)

	As of Dec. 20, 1963	Change from Dec. 28, 1962 to Dec. 20, 1963		Change from Dec. 30, 1961 to Dec. 28, 1962	
		Dollar Amount	Percent	Dollar Amount	Percent
Total loans and investments	35,058.5	+2,546.0	+ 7.8	+2,758.3	+ 9.3
Net loans and investments	34,699.5	+2,505.3	+ 7.8	+2,734.2	+ 9.3
Loans and discounts — net[1]	23,716.4	+2,733.6	+ 13.0	+2,634.5	+14.4
Commercial and industrial	7,447.4	+ 461.7	+ 6.6	+ 665.3	+10.5
Real Estate	8,169.1	+ 942.5	+ 13.0	+ 939.6	+15.0
Agricultural	1,139.2	+ 109.7	+ 10.7	+ 117.7	+12.9
Domestic commercial and foreign banks	580.8	+ 165.4	+ 39.8	+ 171.3	+70.2
Nonbank financial institutions	1,437.9	+ 305.6	+ 27.0	+ 224.4	+24.7
For purchasing and carrying securities					
To brokers and dealers	336.5	+ 179.6	+114.5	— 4.3	— 2.7
To others	133.9	+ 13.2	+ 10.9	+ 18.8	+18.5
Consumer	4,505.5	+ 554.7	+ 14.0	+ 424.4	+12.0
All other loans	355.2	+ 42.0	+ 13.4	+ 101.4	+47.9
Total investments	10,953.1	— 228.3	— 2.1	+ 99.7	+ 0.9
U. S. Government securities	6,928.4	— 724.7	— 9.5	— 548.6	— 6.7
Treasury bills	808.4	— 236.8	— 22.7	— 220.8	—17.4
Certificates	176.8	— 232.5	— 56.8	+ 101.1	+32.8
Notes and bonds maturing:					
Within 1 year	726.0	— 261.3	— 26.5	— 55.5	—53.2
1 to 5 years	3,599.3	+ 5.1	+ 0.1	— 924.6	—20.5
After 5 years[2]	1,617.9	+ 0.8	+ 0.04	+ 551.2	+51.7
Other securities	4,024.7	+ 496.4	+ 14.1	+ 648.3	+22.5
Total deposits	38,017.3	+2,023.8	+ 5.6	+2,300.3	+ 6.8
Demand	19,174.5	+ 433.8	+ 2.3	+ 285.5	+ 1.4
Time and savings	18,842.8	+1,590.0	+ 9.2	+2,041.8	+13.4
Capital accounts	2,862.1	+ 199.2	+ 7.5	+ 141.1	+ 5.6
Total assets/liabilities and capital accounts	42,646.5	+2,586.5	+ 6.5	+2,959.3	+ 8.0

[1] Individual loan items are gross and do not add to total.
[2] All guaranteed obligations included in this category.
Source: Reports of condition of member banks.

side the District—District banks accounted for nearly one-fifth of the year's total expansion in bank-held consumer instalment credit. The major part of the increase, not unexpectedly, came in the wake of the steady stream of new cars which drove onto the already congested Western freeways. But the increase in District bank holdings of auto paper, substantial as it was, lagged behind the 1962 gain in that category. On the other hand, instalment borrowing for other consumer goods, for repair and modernization loans, and for personal expenses all showed greater gains than in 1962.

A sharp rise in credit extensions to nonbank financial institutions was another significant District development in 1963. Outstandings in this category rose over $300 million (27 percent), and a sizable proportion of this amount went to mortgage companies —indicating a further, although indirect, participation by banks in mortgage financing. In addition, the 1963 stock-market boom was amply reflected in a substantial year-to-year gain in borrowing by brokers and others for carrying non-Federal securities. Moreover, in late February and again in September, around the dates of the Treasury's advance refunding operations, District banks sharply increased their loans to brokers and dealers for purchasing and carrying U. S. Government securities.

A somewhat different story developed in the investment sector, since 1963 was the first year of the current expansion in which District banks experienced a net decline in total investments. The banks increased their holdings of non-Federal securities—mainly tax-exempt municipals — by a substantial $496 million (14 percent), but at the same time they lightened their portfolio of U. S. Governments by $725 million. All of the decrease was in short-term maturities.

Less liquid, more profitable

Throughout the long expansion, District banks have experienced a greater weakening of liquidity positions than banks elsewhere—not surprisingly, in view of their more rapid pace of loan expansion during this period. During 1963, the loan-deposit ratio for District member banks rose from about 62 to 66 percent, and the ratio of short-term Government securities to total deposits fell from 7.1 to 4.7 percent. By either measure, District banks are far less liquid than their counterparts elsewhere—but of course neither measure takes into account differences in deposit structure. In other words, by maintaining a higher proportion of time and savings deposits—over one-half of total deposits, as opposed to less than two-fifths of the total at other banks—District banks have had somewhat more leeway than others in protecting against deposit fluctuations.

The same concentration on interest-bearing deposits, which made 1962 an active but not-too-profitable year, was offset sufficiently as time went on to make 1963 a very pleasant year for District bank managers. Net earnings in 1962 dropped 6 percent below the preceding year's level, because of the initial impact of higher interest rates on time and savings deposits. By early 1963, however, District banks had realigned their asset structure sufficiently to increase operating revenues and thereby offset higher interest costs. This realignment paid off so well that many District banks reported record earnings for 1963.