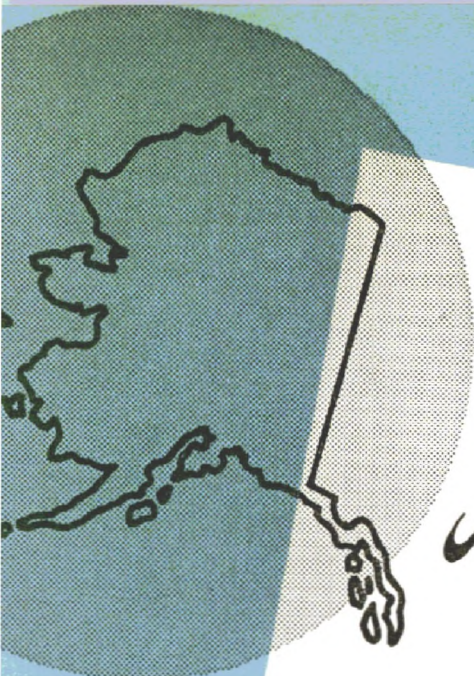


# Monthly Review



ALASKA



IDAHO

FEDERAL RESERVE BANK OF SAN FRANCISCO  
TWELFTH FEDERAL RESERVE DISTRICT



WASHINGTON

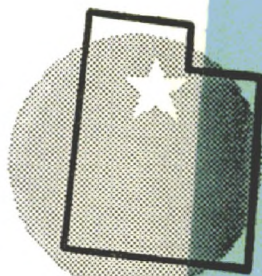
*September 1963*

*In This Issue*

**The Longest Expansion? . . . . . page 128**

**Three Years Back-to-Back? . . . . . page 133**

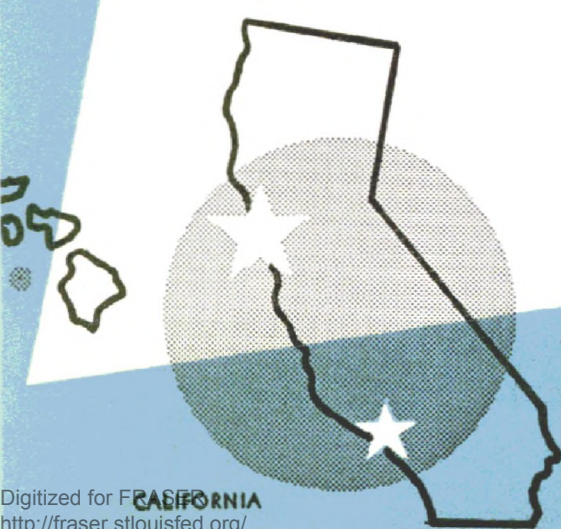
**Federal Agency Securities:  
The Market . . . . . page 138**



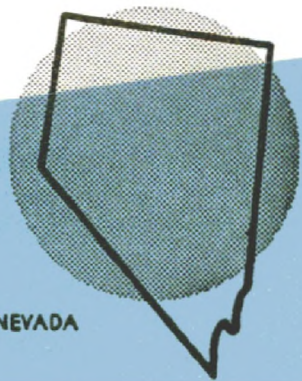
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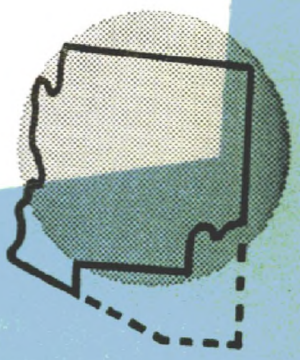
OREGON



CALIFORNIA



NEVADA



ARIZONA



# The Longest Expansion?

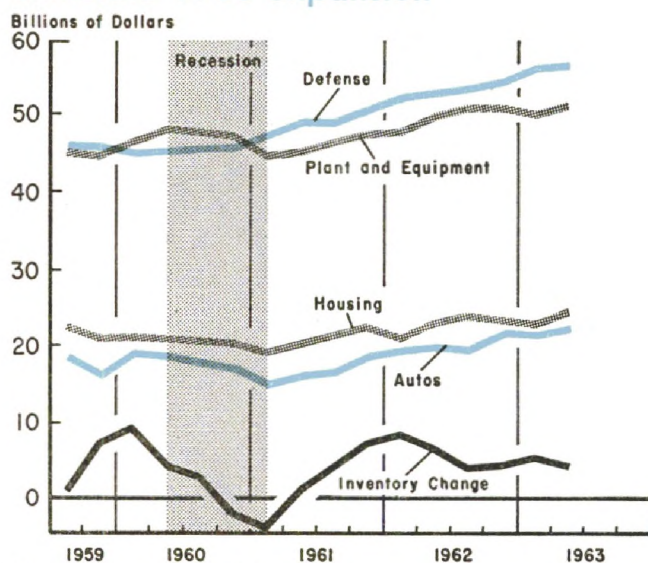
**B**USINESS cycle analysts are keeping their fingers crossed; they are increasingly confident that the current expansion will last longer than any since the massive Korean War expansion, but they still cannot point with certainty to the forces that will propel the economy to higher ground in 1964. Some portents have developed in this, the thirty-first month of the expansion, to suggest that business investment may provide the driving force that was earlier supplied by consumer and government spending. There is still much uncertainty, however, regarding the underlying strength of the factors that will determine the shape of the 1964 economy—primarily such factors as business investment decisions, the consumer's appetite for new cars and new apartment space, and government tax and expenditure decisions.

## The changing mix

Detailed analysis of the second-quarter advance in gross national product may suggest a possible line of development. The \$7.8 billion increase, which raised GNP to \$579.6 billion at a seasonally-adjusted annual rate, occurred in response to a considerable shift in the pattern of expenditures. In contrast to the pattern prevailing during the preceding three quarters, when the gains in GNP were due entirely to increases in consumer and public-sector outlays, the primary factor contributing to the most recent gain was a \$4 billion rise in private fixed investment. At an annual rate of \$80.7 billion, total investment outlays reversed a succession of three quarterly declines to attain a new record high.

The rise reflected both a \$1.7 billion gain in producers' durable equipment and a gain of over \$2 billion in construction. (The latter, however, partly reflected a rebound from the more-than-seasonal declines which occurred in each of the two preceding quarters.) Inventory accumulation, which had been a moderately expansive factor in the two preceding

## Cyclical components of GNP stimulate 1963 expansion



Source: Department of Commerce

quarters, meanwhile receded somewhat to an annual rate of \$4.3 billion.

Notwithstanding a \$6.0 billion rise in personal income and a \$5.5 billion gain in disposable (after tax) income, personal consumption expenditures increased by only \$3.0 billion during the second quarter, to an annual rate of \$370 billion. This was the smallest quarter-to-quarter increase since the third quarter of 1961. But in spite of the small rise in total consumer spending relative to the gain in personal income—which, incidentally, permitted personal saving to rise to 7.5 percent of disposable income from a figure of 6.9 percent—consumers financed a much larger proportion of their expenditures through the accumulation of debt. At \$1.4 billion (seasonally adjusted), the rise in consumer instalment debt outstanding was equal to about one-half of the second-quarter increase in consumer spending; this proportion was twice as large as the corresponding debt-spending ratio in 1962.

With a net increase of \$800 million, government purchases of goods and services constituted much less of an expansionary factor than at any other time in the past year. State



and local expenditures actually showed a slight decline, for the first time in the past four years. Net exports of goods and services, on the other hand, increased by slightly over \$1 billion during the second quarter, because of a substantial recovery in export trade occurring in the wake of a major dock strike.

### How much staying power?

Business cycle analysts are now watching the various leading indicators with particular interest, to see if they can provide any clues concerning the staying power of the current expansion. The optimists among them can take some cheer from the 6 percent year-to-year gain (first-half 1962 – first-half 1963) in building contract awards. But although this indicator presages a continuing high level of construction activity in the months ahead, construction spending at its recent July peak exceeded the rate attained during the last quarter of 1962 by no more than 3 percent. Optimists can find further support in the July improvement in new orders received by manufacturers of durable goods — but the July figure, while 8 percent above mid-1962 levels, was still somewhat below the level attained in March-May of the current year.

Plant and equipment spending appears to be holding fairly close to the levels contemplated in surveys earlier this year. If the envisioned rise in expenditures materializes (from a second-quarter rate of \$38.0 billion to a fourth-quarter rate of about \$41.1 billion), the present period would provide a striking contrast to the declines which occurred in the comparable periods of the two preceding cyclical expansions. The total gain would still be smaller than that of other postwar recoveries, but this can be understood in the light of the relatively modest dimension of the preceding cyclical decline.

Inventory-sales ratios recently have remained at levels below those which prevailed during the comparable period of the two preceding postwar recoveries. Since the third

quarter of 1962, total business inventories have exhibited a maximum quarter-to-quarter change of slightly more than \$1 billion, a stability which reflects such factors as business efforts to effect closer control over costs, generally shortened delivery schedules, and the absence of price pressures sufficient to induce speculative inventory accumulation. In view of the relatively low level of stocks, therefore, any substantial increase in final demand should lead to increased inventory spending as well.

The consumer played a smaller than usual role in 1963's first-half expansion. Because of this, but also because of the crucial importance of the one sector on which he has recently lavished attention—automobile spending—the consumer's intentions will be closely watched in the months ahead. During the first seven months of this year, his enthusiasm for the automobile imparted considerable buoyancy to an otherwise restrained demand for durable goods, and, directly and indirectly, the demand for automobiles in turn accounted for a significant part of the rise in industrial production and in employment and income. Consumer reception of the 1964 auto models thus promises to be a significant factor in determining the duration, as well as the strength, of the current economic expansion.

### Weakness in the West?

Twelfth District observers are particularly interested in the forces making for further expansion, since the pace of District business activity during the second quarter generally fell short of the nation's performance. By the end of the quarter, employment fell more—and unemployment rose more—in the District than in the nation. In relation to the District's past cyclical performance, meanwhile, employment showed substantial gains, but so too did the unemployment rate.

In the important defense and space sector, the volume and proportion of District defense and space procurement awards showed some



weakness, as did employment in these industries. In the construction sector, employment in almost every District state<sup>1</sup> was lower in June than in March (seasonally-adjusted basis), but otherwise construction activity was maintained at a high level. Leading indicators, in fact, point to continuing high levels of construction activity in most District states in the months ahead.

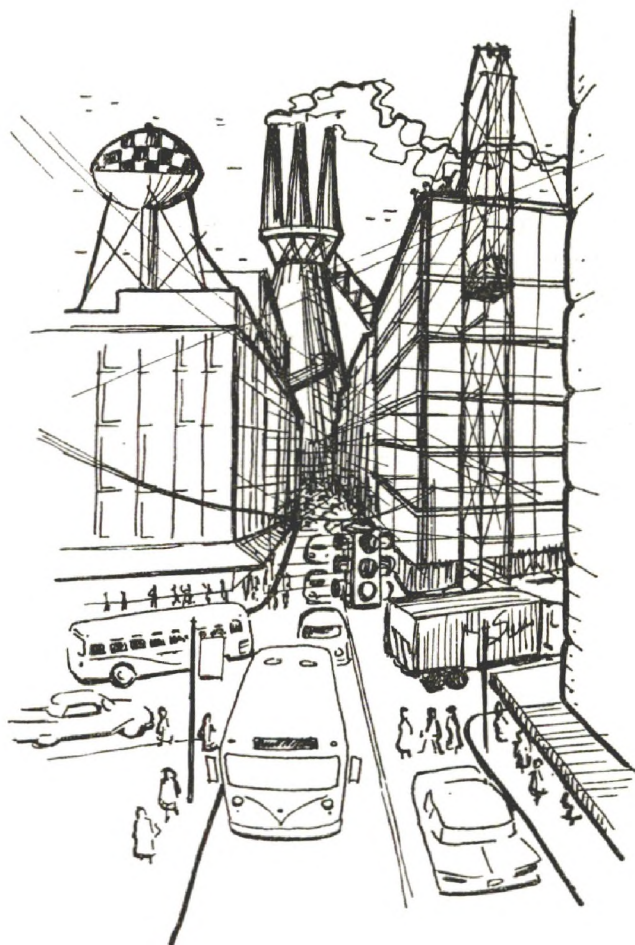
Consumer spending, as reflected in retail store sales and auto registrations, exhibited less buoyancy in the District than in the nation. Among other developments, District farm receipts posted a good gain over the year-ago level, in contrast to a decline in farm receipts nationally, and agricultural employment increased during the quarter while registering a fairly sharp drop in the nation as a whole. Employment in the crucial manufacturing sector meanwhile declined—partly because of a lumber strike but also because of cutbacks in most of the major manufacturing sectors.

### How much for defense?

The dollar volume of prime contracts awarded by the Department of Defense to District firms in the second quarter of 1963 appears, on the basis of partial data, to have amounted to less than half of the \$2 billion total of the preceding quarter. Consequently, the District share of Defense Department awards, which had recently been over 30 percent of the national total, dropped far below that figure and was not offset by any increase in procurement contracts let by the National Aeronautics and Space Administration.

The NASA budget is only about one-third as large as the DOD procurement budget, but its past—and projected—growth trend has been much steeper. District firms have shared heavily in NASA business, receiving about 50 percent of direct procurement awards of \$25,000 and over during calendar 1962.

<sup>1</sup>Not including Alaska and Hawaii, for which comparable data are not available.



However, preliminary estimates indicate that District firms are receiving a much smaller share of new business in this area also.

Other question marks in the outlook include the second-quarter employment decline in defense-oriented industries and a reduction in major firms' order backlogs. On the other hand, Western electronics manufacturers anticipate a rising level of activity in coming months and a 1963 sales total of \$4 billion—8 percent above the 1962 figure.

### High building, speedy autos

Construction activity in the District generally remained at a high level during the second quarter, despite a slight decline in industry employment. Private housing starts in the 13-State West posted a 20 percent year-to-year gain during the first half of 1963, substantially exceeding the 7 percent gain in starts nationally. More important, various



indicators now point to a continuing high level of construction activity in most District states in the months ahead. For example, construction awards rose 22 percent (on a cumulative basis) during the first half of the year, far surpassing the 6 percent gain nationally. Performance was not uniform among individual states, however. The cumulative gain in construction awards ranged from a low of 3 percent or less in Arizona, Washington, and Idaho to gains of 17 percent in Oregon, about 26 percent in California and Utah, and 47 percent in Nevada (F. W. Dodge data).

Consumer spending in the District has risen in recent months, but more slowly than in the nation as a whole. In the second quarter, large retail stores selling soft goods posted an increase of about 3 percent over the year-ago level, but those trading in hard goods (particularly automotive products) experienced a decline in sales. For the entire first half, however, new car registrations recorded a 7 percent year-to-year gain, as compared with an 11 percent gain for the nation as a whole (*Automotive News* data). Within individual District states, the auto registration gains ranged from a low of 5 percent in Idaho to a high of 13 percent in Arizona.

### **Farm, factory activity**

Marketing receipts of District farmers increased by 2 percent between the second quarter of 1962 and the comparable period of 1963. The District bettered the national performance, primarily because of a 5 percent year-to-year gain in crop marketings; nationally, crop receipts declined. The bulk of the rise in District crop returns occurred in the wheat-growing states of the Pacific Northwest and California. Inasmuch as average prices for both crops and livestock were below year-ago levels, the rise in farm receipts in the District reflected a heavier volume of marketings. The relative buoyancy of agricultural activities in the District also was reflected in a **better than seasonal gain in agricultural em-**

ployment, in contrast to a decline nationally.

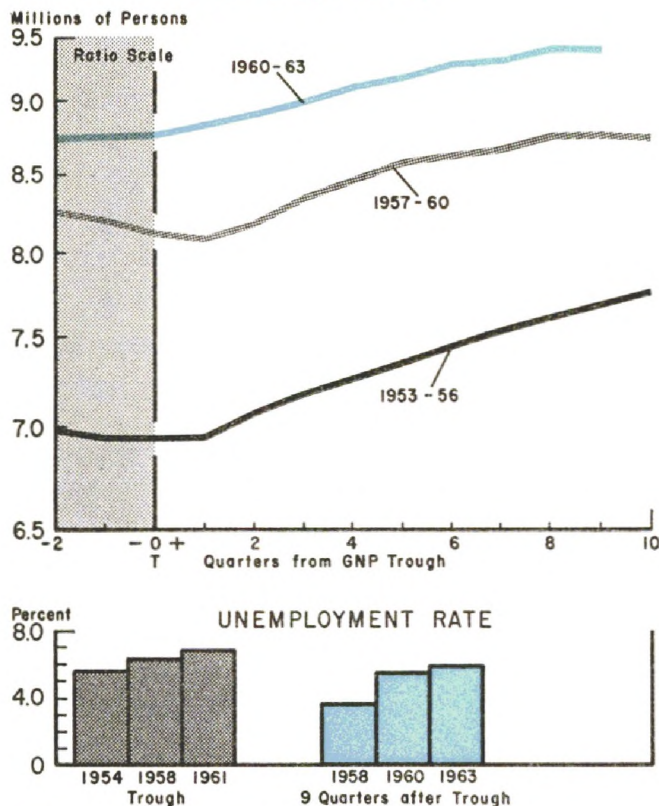
District petroleum processing facilities operated at 82 percent of capacity during the second quarter of the year, compared with an estimated operating rate of 86 percent of capacity in the rest of the country. Oil refineries in both areas were operating at a higher level than a year ago, but the gain was relatively greater for District facilities. To support the expanded level of refining activity, increased supplies of crude oil were obtained from domestic sources outside the District and from foreign sources, as well as from within the District.

The upswing in steel production which began in the fourth quarter of 1962 continued into the second quarter of this year, as output in the District and the nation attained levels 34 and 39 percent, respectively, above the output levels of a year ago. (The comparison is inflated, however, by the fact that an inventory build-up dominated the recent period, in contrast to the severe cutbacks of the year-ago period.) Following the labor contract agreement of June 20, production began to decline as steel consumers, in an effort to liquidate stocks, canceled and deferred orders placed prior to the settlement. At their mid-August levels, Twelfth District and national steel production still exceeded year-ago output by approximately 19 and 8 percent, respectively. The declines in production this year have been less sharp than those which followed the labor settlement in March of 1962, partly due to the high level of steel consumption by the automobile and construction industries.

A lumber strike and lockout in the District dominated market developments in that industry and imparted further strength to an already rising price structure for lumber and wood products. The dispute was settled on August 15 with contract agreements providing for an increase of 30.5 cents an hour in wage and fringe benefits over a three-year term. As production resumed, lumber prices



**District employment rises slowly, jobless rate rises cyclically**



Source: Federal Reserve Bank of San Francisco

lost part of their strike-induced gains and fell from a peak of \$82.21 to \$77.35 per thousand board feet; this quotation, however, represented a 2.6 percent gain over the year-ago figure.

**Jobs and the jobless**

The slowdown in the District's growth rate has been reflected in the employment statistics. California, Arizona and Nevada each registered a small gain in employment during the second quarter; the gains were not sufficient to offset declines in Utah and the Northwest States, however, and total employment in the District<sup>1</sup> declined between the end of March and the end of June. A concomitant rise in the labor force meanwhile resulted in an increase, from 5.4 to 5.8 percent, in the District unemployment rate. This rate was only slightly above the June figure for the nation, but the gap tended to widen in July,

since the District then recorded a 6.0 percent rate as opposed to a 5.6 percent rate for the nation.

The rise in unemployment during the second quarter primarily stemmed from a decline in employment in manufacturing, and, to a lesser extent, in construction. While manufacturing employment, which accounts for about 20 percent of total employment in the District, declined in every District state except Arizona, and by slightly over 2 percent in the District as a whole, the drop was particularly sharp in the Northwest, where losses ranged from about 7 percent in Idaho to 9 percent in Oregon and Washington. In part, these declines stemmed from cutbacks in defense-related industries, but for the most part they were attributable to the lumber strike and lockout which reduced employment in the Pacific Coast lumber and wood products industries by almost 30,000 (or somewhat over 17 percent).

Between mid-1962 and mid-1963, however, the District labor market exhibited somewhat more buoyancy than the national labor market; area employment increased by 2.7 percent, twice the rate of gain nationally, and the rise in unemployment was less than that in the nation as a whole. California, which accounted for almost 91 percent of the net increase in District employment between mid-1962 and mid-1963, sustained over 60 percent of the rise in unemployment in the District and made no progress in reducing its unemployment rate (6.1 percent in July). Utah, Washington, and Idaho all recorded higher rates of unemployment than a year ago, ranging from 5.1 percent in Utah to 6.0 percent in Washington and Idaho. While an absolute decline in manufacturing employment accounted for the weakened performance of some of these areas, the problem developed in most District states simply because the number of job seekers grew at a faster pace than the labor market could absorb.

<sup>1</sup>Not including Alaska and Hawaii, for which comparable data are not available.



The jobless data suggest why businessmen in the Twelfth District are particularly interested in the strength of the forces that will determine the future size and shape of this cyclical expansion. If danger signals continue

to appear in the fields of consumer and government spending, future strength must be sought elsewhere. In the District as in the nation, therefore, business investment decisions may provide the missing clue.

## Three Years Back-to-Back?

SEVERAL times during the current expansion, the economy has developed a threatening knock in its motor, but Detroit's "insolent chariots" came along on each occasion to give the economy a push and help keep it moving forward. In the process, the automakers effectively demolished the myth that a poor sales year must inevitably follow a good one, since they sold \$19.5 billion of autos and parts in the 1962 model year and then sold about \$22 billion in the model year just ending.

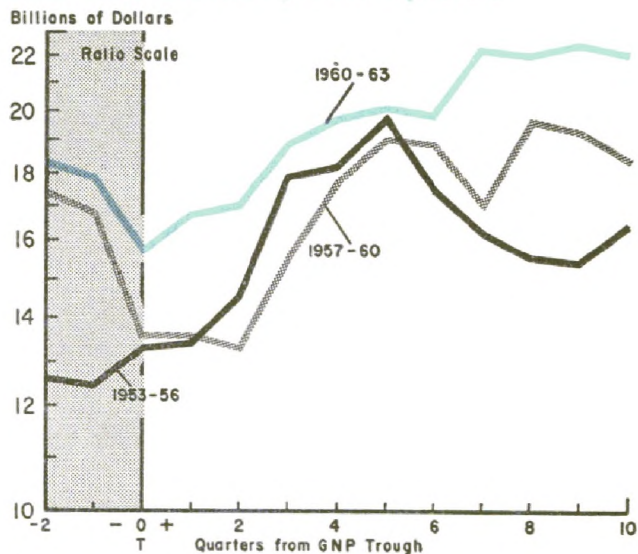
Now, having proved its ability to put two strong sales years back-to-back, can the industry confound the skeptics and post its third straight record? The industry claims that it can and the steel-rubber-glass complex of supplying industries fervently hopes so, but outside observers are prone to withhold judgment until the underpinnings of the boom can be examined under the pressures of a new model year.

### Bumper-to-bumper crops

The answer is important because the fate of the current business expansion will depend—at least partly—on Detroit's ability to repeat its success with its bumper-to-bumper crops of '62 and '63 models. General business activity has been able to advance in the face of some poor auto years—for example, 1956—but changes in auto sales have contributed to every recession and every full-blown business expansion of the past decade.

Autos, on the other hand, have not contributed substantially to the secular growth of

### Auto sales expand more evenly than in previous cyclical upturns



Source: Department of Commerce

gross national product since the middle of the last decade. The trend of auto sales in the first half of the postwar period hewed fairly close to the GNP trend, but passenger-car output since then has failed to approach the 5 percent share of total output recorded in 1955. This fact reinforces the optimism of the automakers, who feel that the 7-million-plus unit-sales records of 1955 and 1963 represent a norm that will be maintained throughout the mid-1960's. But the same fact fails to impress many skeptics, who argue that the consumer today does not need to restock as he did in the early postwar period, and that he has a wide choice of alternatives on which he can—and will—spend his discretionary dollars.

### Do-it-yourself transportation

There may be disagreement about the slope of the growth trend for auto spending, but



riod the industry had permitted value per car to rise faster than consumer income; moreover, it had made its cars almost indistinguishable — in size, power, appearance, and price. Because cars looked so much alike, the consumer had difficulty in deciding which ones were the real status symbols; because they were all increasingly expensive, he had difficulty in purchasing the different types of transportation needed for suburban living.

Around the end of the decade, Detroit (reacting to the success of its foreign competitors) devised a new strategy. To meet the consumer's needs for basic transportation, the small foreign cars and domestic compacts entered the market in force; only about 100,000 of these cars were sold in 1956, but the market zoomed to 600,000 in 1958 and to about one million a year later. To meet the still lively demand for status symbols, meanwhile, the automakers offered a new variety of ego-stirring expensive cars.

### Resurgence of negative thinking

Both 1959 and 1960 were good sales years because of the industry's rejection of the "more car per car" concept and its acceptance of the necessity to provide a car for every purse and purpose. But the poor sales record of the 1961 models brought a resurgence of the negative thinking of the late-Fifties. Marketing men generally agreed that auto making had become only a replacement industry; even the most bullish trend projectors could not visualize another 7-million sales year until 1965. Psychologists insisted that the public had finally decided to allocate a lower status to do-it-yourself transportation than to boating, foreign travel, and higher education. Engineering men argued that the motoring public would pay for lighter cars, smaller engines, and lower maintenance costs but not a cent for frills.

The automakers listened to their experts and resignedly began to look abroad for the growth markets of the future. Before they had

an opportunity to revise their basic strategy, however, the old strategy paid off handsomely in the 1962-63 model years. Buyers increased their purchases in every price category, put two record years back-to-back — in dollar terms if not in unit sales — and forced market forecasters to re-examine the (heretofore optimistic) 7-million unit figure originally projected for the middle of this decade.

But what caused the resounding recovery of the past two years? What caused the market to outdistance so rapidly the most optimistic forecasts of the normally ebullient automakers? In retrospect, the market analysts can find nothing wrong with their basic equations; their only fault was in underestimating the substantial impact which these factors were capable of exerting in the marketplace.

### The power of money

Rising consumer income, the basic factor underlying a healthy auto market, was of course closely involved in the 1962-63 boom. The unexpected dimensions of the boom must also be attributed, however, to the strength of a number of other market factors — in particular, the easy availability of auto credit, the slow growth of auto prices in relation to other prices, the large number of cars headed for the scrapheap, and the increasingly large number of young drivers headed for the auto showrooms.

The average income per consumer spending unit (\$6400 in 1962) increased 2 percent (in constant-dollar terms) between 1961 and 1962. This increase, the largest of the past decade (with the exception of 1959), will apparently be followed by another substantial increase this year. Consequently, enough cash has been available to support the market for medium- and high-priced cars, and to expand the numbers of two-car and three-car families.

The rapid growth of the young-driver class has perhaps been a more crucial factor in upsetting the notion that the market had a future



only in the replacement field. The 15-24 age category, which increased about 3 percent in each of the years around the turn of the decade after growing hardly at all in the mid-Fifties, has now grown by about 6 percent in each of the last two years. These millions of postwar babies, while unable to afford the top of the price line, have been heavy buyers of used cars; in other words, they have been a tremendous factor in supporting a market which in turn provides a powerful stimulus to new-car buying.

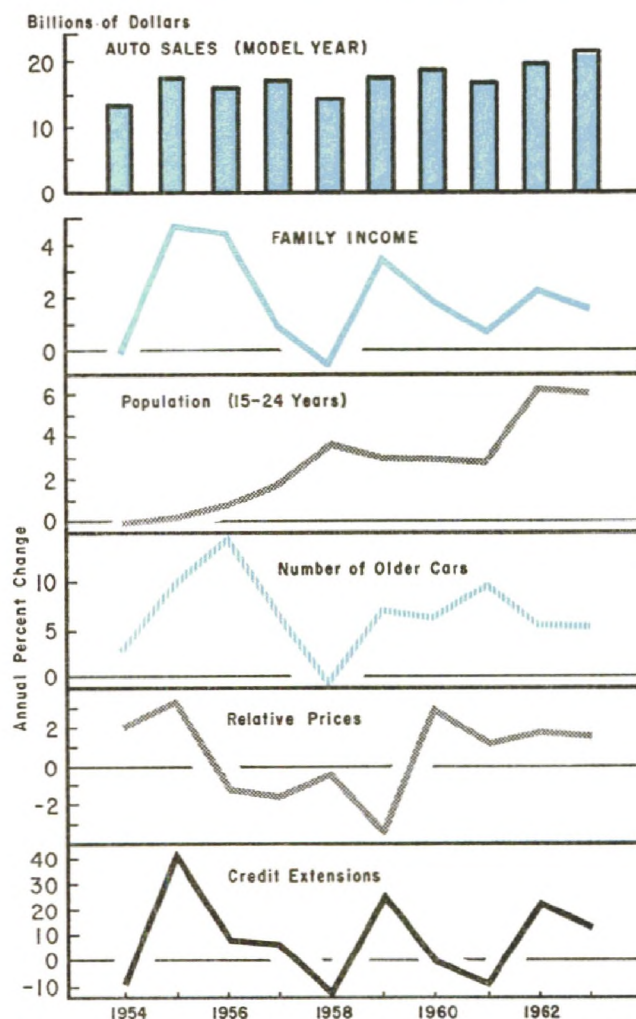
### Birth in the auto graveyard

The steadily growing number of older cars, meanwhile, has provided a solid underpinning to the replacement market. Since the 1958 model year, the number of cars over five years old has increased at least 5 percent annually; there were more than 34 million cars of this vintage on the road at the beginning of the 1963 model year. In particular, a big bulge in replacement sales was almost inevitable during the past several years, because it was during this period that the cars purchased in the 1954-55-56 heavy-volume years approached their eighth birthday — the age of heavy scrappage. The demise of these cars, whether from the violent death on the freeways or from the degenerative diseases of old age, has created the potential for the birth of a major replacement market.

Another favorable factor has been the relative price attractiveness of the industry's product in recent years. The "more car per car" strategy of the late-Fifties caused new-car prices at that time to rise even more rapidly than the consumer price index. Because of the introduction of the compact car and other features, however, the new-car price index has actually declined since 1959. In comparison with the total price level and with the industry's own product of several years ago, the auto today is something of a bargain.

Finally, the market has been stimulated by a large infusion of new credit during the past

### New sales records created as income and other factors expand



Note: Bar chart shows dollar sales of autos and parts in each model year (beginning one quarter before calendar year). Line chart shows annual percentage change in factors affecting auto sales—family income in 1962 dollars, population aged 15-24, number of cars 5 years or older (at beginning of model year), difference between changes in consumer price index and new-car price index, and amount of auto credit extended. All 1963 figures are estimates.

Source: Department of Commerce, *Automotive News*, Bureau of Labor Statistics, Board of Governors of Federal Reserve System.

several years; extensions increased by 22 percent in 1962 and by 12 percent more between the first half of 1962 and the corresponding period this year. But in contrast to the 1955 boom year, when credit terms were eased so strikingly by the widespread adoption of the 36-month sales contract, recent sales records have been set without any significant lengthening of terms. Some instances have been reported of 42-month and even 48-month contracts, but these have been isolated cases. Basically, credit terms have not shifted very



significantly since 1955, which means that available credit has been used to support a wider and higher-priced market, rather than to entice those would-be buyers who cannot afford normal contract terms.

The commercial banking system, incidentally, is playing an increasingly important role in this credit picture. In 1962 it accounted for \$9.6 billion of new auto credit—about one-half of total extensions—and it may exceed that dollar figure substantially this year. (By way of contrast, commercial bank extensions of \$6.7 billion accounted for only 40 percent of the total in 1955.) Twelfth District banks have consistently accounted for almost one-fifth of the commercial bank total.

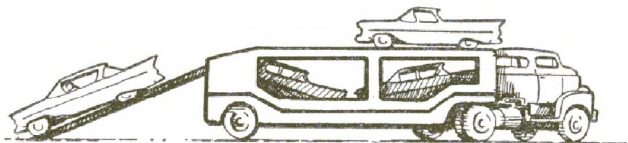
### Where on the S-curve?

Rising consumer income, to permit greater multiple-car ownership; growing numbers of young drivers, to support the crucial used-car market; growing numbers of aged cars, to expand the replacement market; relatively stable prices, to enhance the attractiveness of autos in relation to other consumer purchases; easily available credit, to permit the immediate enjoyment of this postponable big-ticket item—all these factors have combined explosively to generate two successive sales records and to create a spirit of euphoria reminiscent only of the heady days of 1955. But are these fac-

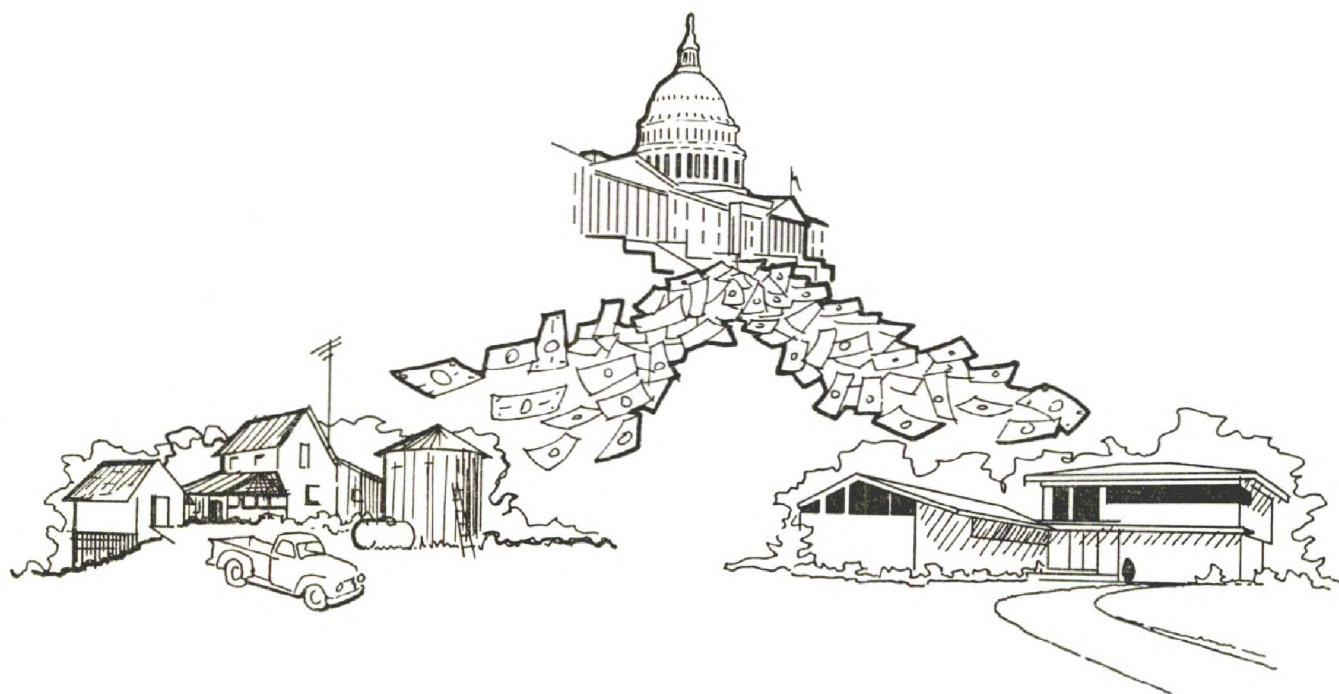
tors now capable of creating a third back-to-back year? The industry, hedging its bets only slightly, suggests that they can.

One industry leader, who had predicted in the midst of a six-million-unit year (1961) that the market was nearing the top of its S-shaped growth curve, recently declared that the industry has reached a seven-million-unit plateau and was “setting its sights on eight million.” Others pointed with relish to a recent Census Bureau survey which indicates that 8.4 percent of all consumers plan to buy a new car within the next 12 months, as compared with 7.4 percent prior to the 1963 record model year. The only factor left out of the industry’s optimistic equation was the crucial one—the psychology of the American consumer.

That crucial factor may soon be tested. In practically every year of the past decade, public acceptance or rejection of new models has tended to jell soon after model-introduction time. For instance, total expenditures for autos and parts jumped from a \$17.0 billion annual rate to an \$18.9 rate in the first quarter of the 1962 model year, and jumped again, from \$19.8 billion to \$22.2 billion, in the first quarter of the 1963 model year. But all that is past history; whether the consumer will render his decision so early and so resoundingly in this model year, he alone knows.







## Federal Agency Securities: The Market

**F**EDERALLY sponsored credit agencies have been selling their securities to the public for decades, but they have generally received little attention in the literature on debt instruments and financial markets. This situation may now be changing, however, since the market for such securities has recently broadened far beyond its previous range.

The supply of this unique class of securities, which as late as 1954 totaled only about \$2 billion outstanding, has grown substantially in recent years, reaching \$10 billion by the end of 1962. Compared with many other types of investments, Agency securities now represent a sizable market. For example, more than \$5 billion, or about half of the amount outstanding at the end of 1962, fell in the short-term maturity range; this was almost twice as large as the volume of bankers' acceptances, and was nearly equivalent in size to the market for commercial and finance company paper or the market for negotiable certificates of deposit.

This article examines the basic characteristics of the comparatively little known but

expanding market for Agency securities. Future articles will describe the participants in the Agency securities market, and will analyze the major factors shaping the supply and demand for this special class of investments.

### Little risk but no guarantee

The securities issued by five instrumentalities of the Federal Government comprise what is commonly referred to as the "Federal Agency" market. These instrumentalities—Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, Federal Home Loan Banks, and the Federal National Mortgage Association—finance most of their credit activities by selling their own obligations to the public through regular market channels. The unique feature of Agency issues, which sets them apart as a special class of investments, is the fact that they are not guaranteed by the Federal Government, even though they are issued by instrumentalities of the Government. Legally, they are the responsibility of the issuing agency. They occupy an anomalous position; strictly speaking, they



are neither Government nor private debt instruments. Only in the most formal sense, however, would there appear to be any greater degree of risk attached to these securities than to Governments; in fact, regulations on investments of national banks classify all the securities of these Agencies as "minimum risk" assets.

Most Agency securities bear a fixed rate of interest and are bought and sold in terms of a price rather than a discount. (One agency, the Federal National Mortgage Association, also sells obligations on a discount basis.) Short-term Agency securities of the fixed-interest variety, although more directly comparable with short-term Treasury coupon issues than with issues such as Treasury bills, compete with bills for short-term money. Longer term Agency obligations, which are marketed with maturities of up to 15 years, compete principally with Treasury and corporate obligations.

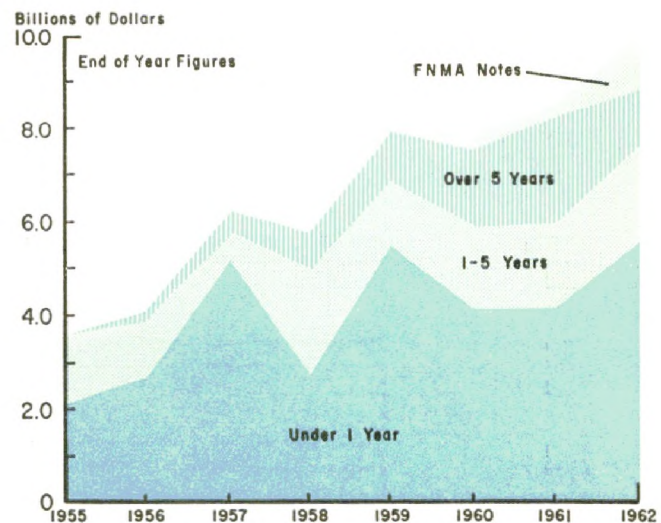
The tax status of Agency securities is somewhat different from that of United States Government or corporate securities. The interest on Agency securities is subject to all Federal taxes and some state taxes. Interest on the securities of each Agency except the Federal National Mortgage Association, however, is exempt from state income taxes.

A typical new Agency issue is about \$100 million, which is small only in comparison with flotations of Treasury securities; it is sizeable in relation to the average corporate or municipal bond flotation. In the past, new Agency issues rarely exceeded \$300 million, but several issues in the \$300-\$500 million range were sold in 1963.

### The narrowing spread (1)

Agency issues traditionally carry higher yields than Treasury issues of comparable maturity. Their nonguaranteed status is often cited as the principal reason for this relationship, but changed supply and demand relationships affecting market behavior since the

## Agency securities expand at all maturity levels



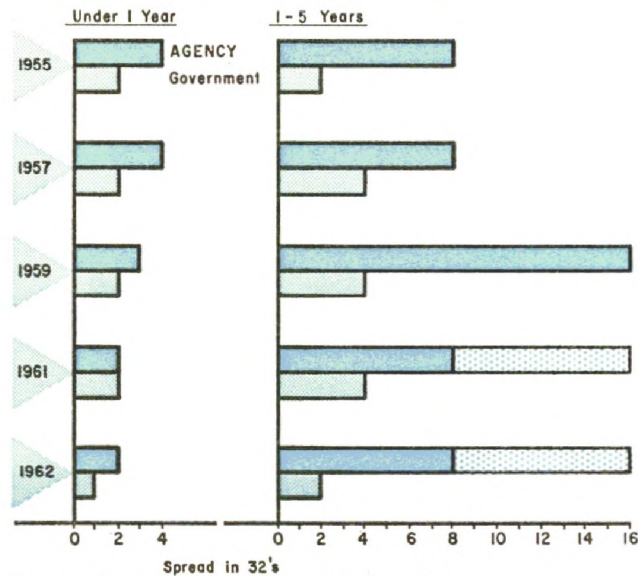
Source: Department of the Treasury

1960-61 recession suggest that the absence of a Government guarantee should be viewed as only one among many factors bearing on the position of Agency issues in the structure of interest rates. The differential has always fluctuated with changes in market conditions, and at times has disappeared. For example, a greatly narrowed spread between comparable Agency and Treasury maturities was one of the most conspicuous developments in the Agency market during 1961 and 1962.

Until 1961, the yield spread between Agency and Treasury issues of similar maturity usually ranged between  $\frac{1}{4}$ - $\frac{3}{4}$  percent throughout the maturity range. The spread tended to be greater in the earlier years. In 1961 and 1962, this differential shrank, and by the end of 1962 even the long-term issues carried a yield only 10 to 20 basis points above comparable Treasury issues. Moreover, yields on the shortest maturities declined to the level of those on short-term Governments toward the end of 1962. This unusual relationship developed partly as a result of Treasury operations in the bill market. The financial authorities, as part of their defense against the gold outflow, pursued a course of bolstering short-term rates on Government securities, specifically by increasing the supply of



**Narrowing spread for securities concentrated in shorter maturities**



Source: *Commercial and Financial Chronicle*.

Treasury bills by almost \$9 billion during the 1961-62 period. The resulting upward pressure on short-term rates tended to reduce the differentials among them. Commercial banks and other investors looking for higher yields took a renewed interest in short-term Agency issues, and thereby tended to reduce the spread between them and Governments.

**The narrowing spread (2)**

Historically, the market for Agency securities has exhibited a wider spread between bid and asked prices than has the Government securities market. In the past two or three years, however, short-term Agency securities have traded at spreads almost as narrow as those prevailing on short-term Treasury securities, and only the maturities beyond one year have continued to show appreciably wider spreads. This situation reflects an increased supply and variety of maturities in the market. The degree of tradeability possessed by a debt instrument depends to a large extent on the difference between the price at which an investor can buy and sell in the market. The wider the price spread is, the greater the cost involved when it is sold. The volume of trading influences the price spread, but the price spread also may affect

the volume of trading; both are determined by the characteristics of the supply. For short-term Treasury securities, the huge supply and wide range of available maturities are reflected in very thin spreads of 1/32-2/32.<sup>1</sup> For short-term Agency securities, which during the 1950's typically showed a 4/32 spread, the increased supply and variety of maturities in recent years have also resulted in a spread as narrow as 2/32. But for maturities beyond one year, which are available in smaller quantities, spreads are much wider—both in relation to short-term Agency securities and in relation to Treasury issues. The quoted spread usually has been a full point on Agency issues maturing beyond five years, whereas for Treasury securities it generally is only 1/8 point on intermediate, about 1/4 point on long-term maturities.

Government securities dealers have played a prominent role in bringing about the narrowed spread between the bid and ask price on Agency issues. By making an active market—carrying inventories of Agency securities and standing ready to buy or sell quickly—dealers have been instrumental in promoting wider public acceptance of Agency issues.

**How to market an Agency issue**

The quasi-governmental character of Agency securities carries over into the manner by which they are sold. Each Agency has a fiscal agent in New York who handles all the details of each sale. (The fiscal agents' functions do not extend to servicing Agency debt, however; the Treasurer of the United States handles payments of principal and interest on Agency securities.) In practice, one fiscal agent handles the sales of the three agricultural credit agencies, while the Federal National Mortgage Association and the Federal Home Loan Bank Board each has its own agent.

<sup>1</sup>Treasury and Agency fixed-interest securities are usually quoted in fractions of 32nds of a dollar. For example, a dealer may offer to buy (bid for) a certain short-term coupon issue at a price 100 5/32 and sell (ask) at a price of 100 6/32. The spread is 1/32, or \$0.031250 per \$100 of the security.



The fiscal agents are responsible for assembling selling groups for the purpose of distributing securities to retail investors. A selling group—composed of government bond dealers, dealer banks in securities, stock houses, and similar nationally-recognized organizations—differs in several important respects from the type of syndicate that markets corporate and municipal bonds. First, a selling group is set up on a continuing basis, although individual members do enter and leave the group; the typical syndicate, on the other hand, is formed anew to bid on each particular corporate or municipal issue.

Secondly, only one selling group deals with each Agency issue, whereas several syndicates generally bid against each other for each corporate or municipal issue.

Prior to each sale, the fiscal agent consults with officials of the Agency concerned and with representatives of the selling group regarding the amount, coupon, price, and date of sale. The individual Agency is responsible for the final determination of terms. On the sale date, the agent telegraphs the price to the members of the selling group. The members then telegraph or telephone their subscriptions to the fiscal agent's office in New York, where allotments are made. The new securities are delivered at the Federal Reserve Bank of New York, and payment is in Federal funds<sup>1</sup> at the offering price less the stated commission.

### **Bridging the credit gap**

Many Federal credit programs were developed for the purpose of bridging credit gaps in the private economy. In particular, the five Agencies under discussion were set up to facilitate credit flows in one or more of the following ways: to supplement the sources of financing already available to certain types of

borrowers; to reallocate locally available funds geographically, moving them from areas of surplus to areas of deficit; and to create and maintain orderly credit markets of national scope in place of isolated local markets. The agencies were designed to carry out these functions in the two areas of agricultural credit and residential mortgage credit.

All five Agencies are intermediaries—they deal directly with other financial institutions when they perform the lending, discounting, or buying and selling functions appropriate to their programs. The financial institutions, in turn, extend credit to the ultimate borrower, who might be a farmer, a farm cooperative, or a city dweller purchasing a new home. The capital stock of these Federal Agencies, which originally was provided by the United States Treasury, now is owned almost entirely by the retail financial institutions or by the ultimate borrowers. In each instance, however, private ownership and control is subject to Federal supervision of general policies and operations.

Operations of Federal credit agencies have expanded rapidly in recent years. In the late 1940's and early 1950's, these agencies had obligations outstanding of about \$1.5-2.0 billion. In 1955, credit activities expanded further as a result of the housing boom and increased demands for mortgage credit. The Federal Home Loan Banks, which had been selling notes since 1937, experienced a sizeable increase in the scale of their operations in 1955. The Federal National Mortgage Association, moreover, following its 1954 reorganization, entered the market for the first time in 1955 in order to finance the liquidation of its predecessor's mortgage portfolio, and in the following year began to borrow to finance its secondary market operations.<sup>1</sup> In the ensuing period, the credit functions of all five Agencies have increased, and their borrowings in the financial markets have risen correspondingly, albeit with substantial cyclical fluctuations in mortgage-associated programs.

<sup>1</sup> All transactions involving new issues of United States Government securities and most transactions in outstanding Government obligations are settled by payment in Federal funds. Federal funds are the member-bank deposit balances which are maintained at the Federal Reserve Banks.



FEDERAL RESERVE BANK OF SAN FRANCISCO

BANKING AND CREDIT STATISTICS AND BUSINESS INDEXES—TWELFTH DISTRICT<sup>1</sup>

(Indexes: 1957-1959=100. Dollar amounts in millions of dollars)

Year and Month	Condition items of all member banks <sup>2, 7</sup>				Bank debits index 31 cities <sup>4, 5</sup>	Bank rates on short-term business loans <sup>6, 7</sup>	Total nonagricultural employment	Total mf'g employment	Car-loadings (number) <sup>5</sup>	Dep't store sales (value) <sup>5</sup>	Retail food prices <sup>7, 8</sup>
	Loans and discounts	U.S. Gov't securities	Demand deposits adjusted <sup>3</sup>	Total time deposits							
1929	2,239	495	1,234	1,790	19	....	...	...	110	18	53
1933	1,486	720	951	1,609	8	....	...	...	56	11	34
1939	1,967	1,450	1,983	2,267	14	....	...	...	83	19	38
1953	9,220	6,639	10,515	7,997	69	4.14	86	86	108	74	93
1954	9,418	7,942	11,196	8,699	71	4.09	85	81	103	74	93
1955	11,124	7,239	11,864	9,120	80	4.10	90	90	112	82	92
1956	12,613	6,452	12,169	9,424	88	4.50	95	96	112	91	94
1957	13,178	6,619	11,870	10,679	94	4.97	98	101	103	93	97
1958	13,812	8,003	12,729	12,077	96	4.88	98	96	96	98	101
1959	16,537	6,673	13,375	12,452	109	5.36	104	103	101	109	101
1960	17,139	6,964	13,060	13,034	117	5.62	106	103	95	110	103
1961	18,499	8,278	14,163	15,116	125	5.46	108	103	94	115	104
1962	....	....	....	....	141	....	113	109	104	123	...
1962 August	20,017	7,309	13,255	16,655	144r	....	113	109	105	124	105
1962 September	20,165	7,471	13,446	16,772	143	5.49	114	110	107	122	106
1962 October	20,460	7,471	13,969	16,934	142r	....	114	111	104	121	106
1962 November	20,589	7,501	14,012	16,827	144r	....	114	110	102	128	105
1962 December	21,102	7,608	14,431	17,093	146	5.50	115	111	101	127	106
1963 January	21,035	7,454	13,917	17,390	146	....	116	111	90	127	107
1963 February	21,403	7,130	13,527	17,532	149	....	116	111	105	128	107
1963 March	21,480	7,130	13,646	17,760	152	5.46	116	111	105	130	107
1963 April	21,714	7,103	14,175	17,868	147	....	116	110	99	118	107
1963 May	21,894	7,069	13,427	18,111	152	....	116	110	103	129	106
1963 June	22,140	7,153	13,610	18,264	152	5.53	116	108	...	127	106
1963 July	22,277	7,002	14,030	18,363	159	....	116p	108p	...	128	108
1963 August	....	....	....	....	164	....	....	...	...	...	...

Year and month	Industrial production (physical volume) <sup>5</sup>							Waterborne Foreign Trade Index <sup>7, 9, 10</sup>					
	Lumber	Petroleum <sup>7</sup>		Cement	Steel <sup>7</sup>	Copper <sup>7</sup>	Electric power	Exports			Imports		
		Crude	Refined					Total	Dry Cargo	Tanker	Total	Dry Cargo	Tanker
1929	84	91	61	34	...	89	13	96	61	193	20	55	*
1933	35	54	39	17	...	15	11	55	...	...	12	...	...
1939	62	70	49	35	16	70	17	82	43	190	16	41	1
1952	101	112	90	77	92	100	61	86	81	101r	33	61	18
1953	102	114	95	82	105	98	69	71	56	113	51	70	41
1954	101	111	92	83	85	90	73	67	57	96	44	71	28
1955	107	111	96	90	102	104	82	84	72	117	52	80	35
1956	104	109	100	97	108	114	89	101	105	91	75	86	69
1957	93	106	103	93	114	113	95	117	124	96	95	93	97
1958	98	98	96	99	94	101	97	89	86	96	92	95	91
1959	109	96	101	108	92	86	107	95	90	108	112	113	112
1960	98	95	104	101	102	112	115	122	123	120r	133	117	142
1961	95	96	108	105	111	119	124	126	134	104	134	116	145
1962	97	96	111	111	100	128	...	...	...	...	...	...	...
1962 July	98	96	115	115	84	112	128	82	85	74	154	122	172
1962 August	95	97	114	117	89	115	134	116	130	76	168	136	186
1962 September	98	96	113	115	90	119	134	105	121	61	153r	122	171r
1962 October	98	97	112	120	88	127	132	96	105	72	158	154	161
1962 November	104	97	113	115	91	127	135	93	91	99	163	127	183
1962 December	103	97	113	121	100	127	...	154	157	144r	134	124	140
1963 January	101	96	113	122	100p	125	...	127	139	94	123	128	120
1963 February	94	96	111	118	114p	130	...	132	145	96	111	119	107
1963 March	104	97	110	122	127p	134	...	...	...	...	...	...	...
1963 April	91	98	108	105	138p	135	...	...	...	...	...	...	...
1963 May	93	98	112	111	145p	127	...	...	...	...	...	...	...
1963 June	94	98	116	111	131p	...	...	...	...	...	...	...	...
1963 July	...	...	...	127	109p	...	...	...	...	...	...	...	...

<sup>1</sup> Adjusted for seasonal variation, except where indicated. Except for banking and credit and department store statistics, all indexes are based upon data from outside sources, as follows: lumber, National Lumber Manufacturers' Association, West Coast Lumberman's Association, and Western Pine Association; petroleum, cement, and copper, U.S. Bureau of Mines; steel, U.S. Department of Commerce and American Iron and Steel Institute; electric power, Federal Power Commission; nonagricultural and manufacturing employment, U.S. Bureau of Labor Statistics and cooperating state agencies; retail food prices, U.S. Bureau of Labor Statistics; carloadings, various railroads and railroad associations; and foreign trade, U.S. Department of Commerce. <sup>2</sup> Annual figures are as of end of year, monthly figures as of last Wednesday in month. <sup>3</sup> Demand deposits, excluding interbank and U.S. Government deposits, less cash items in process of collection. Monthly data partly estimated. <sup>4</sup> Debits to total deposits except interbank prior to 1942. Debits to demand deposits except U.S. Government and interbank deposits from 1942. <sup>5</sup> Daily average. <sup>6</sup> Average rates on loans made in five major cities, weighted by loan size category. <sup>7</sup> Not adjusted for seasonal variation. <sup>8</sup> A new index now combining not only Los Angeles, San Francisco, and Seattle food indexes but also Portland. Reweighted by 1960 Census figures on population of standard metropolitan areas. <sup>9</sup> Commercial cargo only, in physical volume, for the Pacific Coast customs districts plus Alaska and Hawaii; starting with July 1950, "special category" exports are excluded because of security reasons. <sup>10</sup> Alaska and Hawaii are included in indexes beginning in 1950. p—Preliminary. r—Revised. \* Less than 0.5 percent.