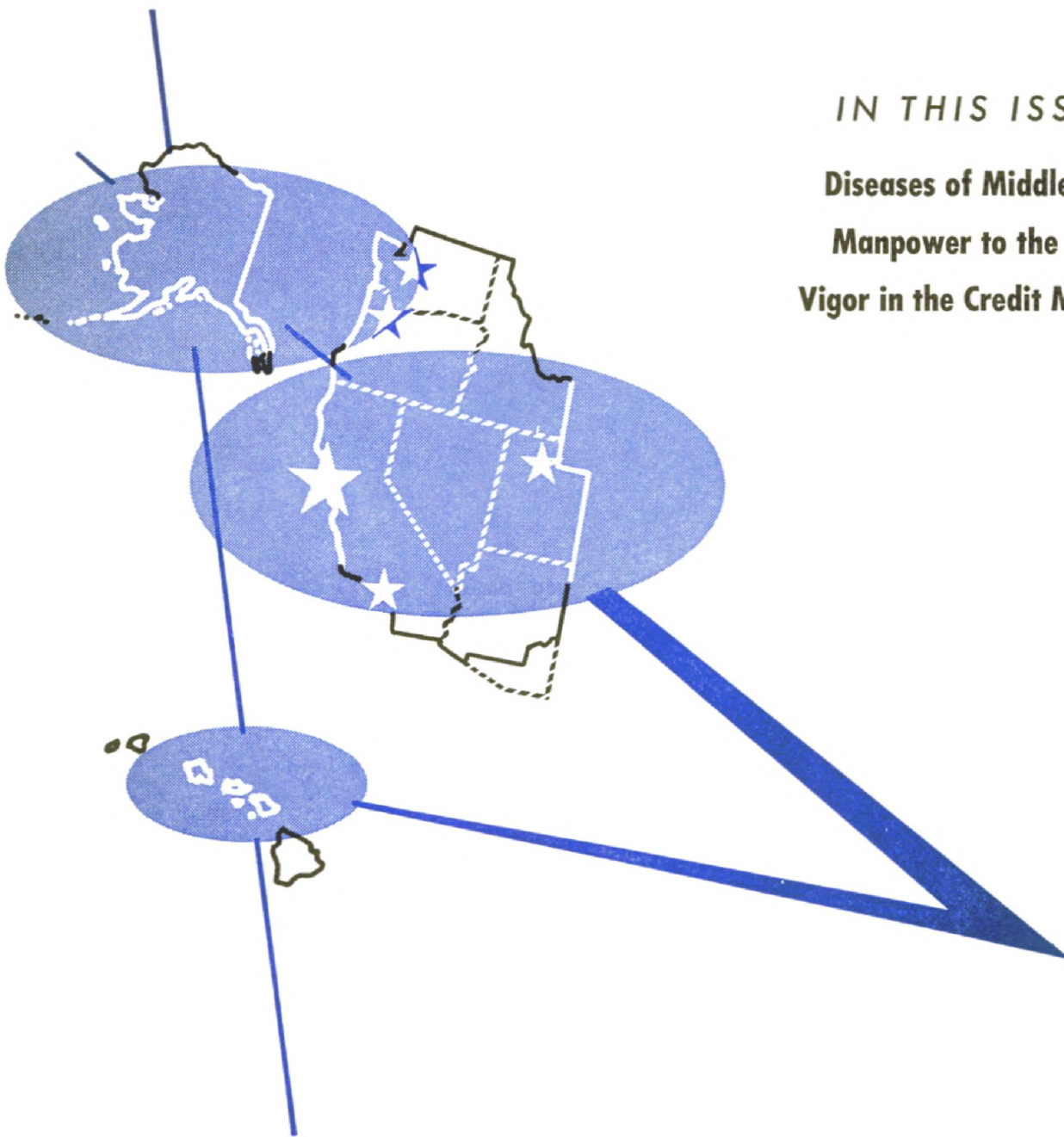


FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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MAY
1965

Diseases of Middle-Age

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Editor: William Burke

Diseases of Middle-Age

THE learned doctors who watch over the health of the business cycle are now looking rather quizzically at their ostensibly healthy middle-aged patient. One diagnosis is that the four-year-old expansion is showing signs of hypertension as a result of too many middle-aged excesses. A conflicting diagnosis is that the patient is slowing down with age. But a detailed examination may show that the patient—with the help of the modern economist's pharmacopoeia—is still bursting with good health.

The symptoms of hypertension, according to some diagnosticians, include the torrid pace of activity in industries such as autos and steel. Other symptoms include manpower pressures—for example, a continued decline in the unemployment rate (although it is still too high) and the lowest rate of insured unemployment in almost a decade. Then, again, there are price pressures—for example, an upward drift in the wholesale price index, amounting to about 1½ percent since last

summer, and a rise in the brokers' loan rate from 4½ to 4¾ percent.

But some observers claim that the economy in future months will be plagued, not by hypertension, but rather by middle-aged sluggishness. They point, for instance, to the fact that new orders for durable goods leveled off during the first quarter of the year, and that sales during that period were somewhat artificially inflated—auto sales by makeup purchases and steel sales by strike-hedge buying. Developments of this type thus led the Council of Economic Advisers to warn against “assuming that continuing gains at the recent rate are assured.”

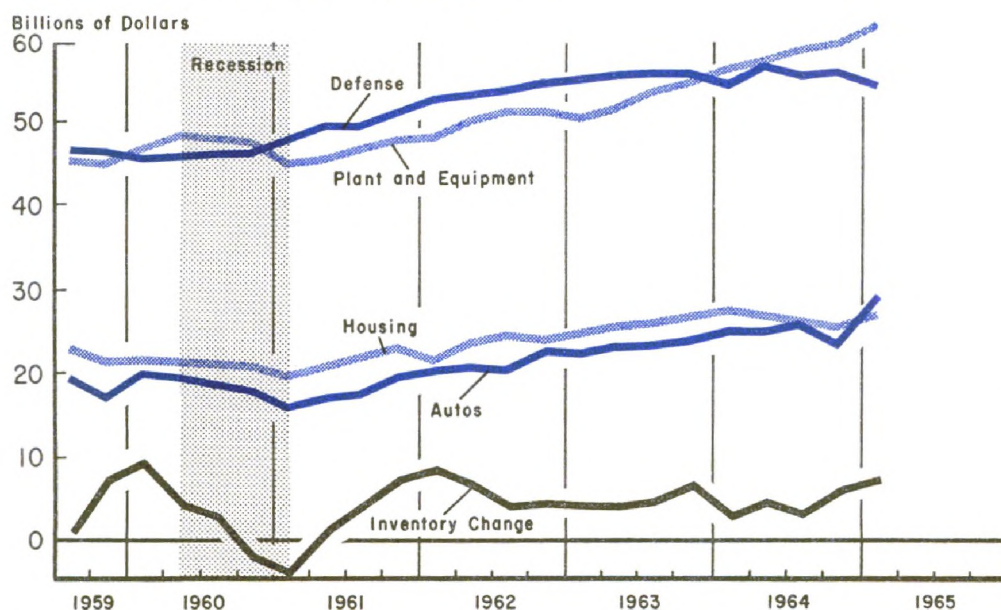
Robust good health

The conflicting diagnoses were made against a backdrop of an extremely strong first-quarter performance. In that period, gross national product rose to \$649 billion, at a seasonally adjusted annual rate. The quarterly rate of increase was \$14½ billion

—almost equal to the entire gain of the preceding two quarters and the strongest gain since early in the 1961-64 expansion.

Over the past half year or so, the strength of this middle-aged expansion has been concentrated in consumer durables buying and business fixed investment — both of which increased about 5 percent over the period — and in a sharp buildup in business inventories. During the same period, oth-

Hyperactive expansion stimulated by autos, inventories, capital goods



Source: Department of Commerce.

er consumer buying continued rising (as always), while residential construction rose about 2 percent from its 1964 low point. In the government sector, meanwhile, a drop of about 2 percent in Federal defense spending was offset by a comparable rise in state and local government expenditures.

The major questions about the continuing strength of this expansion center around those sectors that have recently shown the most ebullience. In the next several months, will the inventory buildup reach an unsustainable level, as auto dealers and steel manufacturers attempt to respond to their customers' exaggerated demands? In the next several quarters, will manufacturers' fixed investment continue rising in the event that their orderbooks lose some of their recent thickness?

Volatile once again

Consider, first, the short-term situation in inventories. This sector obviously will be much in the limelight in coming months. Until recently, this normally volatile component of the national economy has shown more moderate fluctuations and less perverse timing than in any other postwar expansion. More recently, however, there have been signs of the most rapid inventory buildup since the period following the 1959 steel strike.

In comparison with January-September 1964, when business inventories increased at a \$3 billion annual rate, the buildup in the two succeeding quarters was at a \$6 billion rate—and currently it may be even higher. The buildup has been based mostly upon three factors: strike-hedge buying by steel consumers, restocking of auto dealers in the aftermath of the late-1964 auto strike, and catch-up buying by other retailers in the aftermath of the post-taxcut consumer-spending boom.

The present inventory situation has led business analysts to look again at the record of earlier postwar expansions. In those pe-

riods, unlike 1961-64, inventories began to outmatch final sales fairly early in the cycle's expansion phase. In each case, after about the sixth quarter of expansion, inventories increased even after the sales trend warranted little further growth. Mounting imbalances between inventories and sales then brought about higher costs and risks of inventory holding, and thus set the stage for a sharp liquidation when final sales eventually turned down.

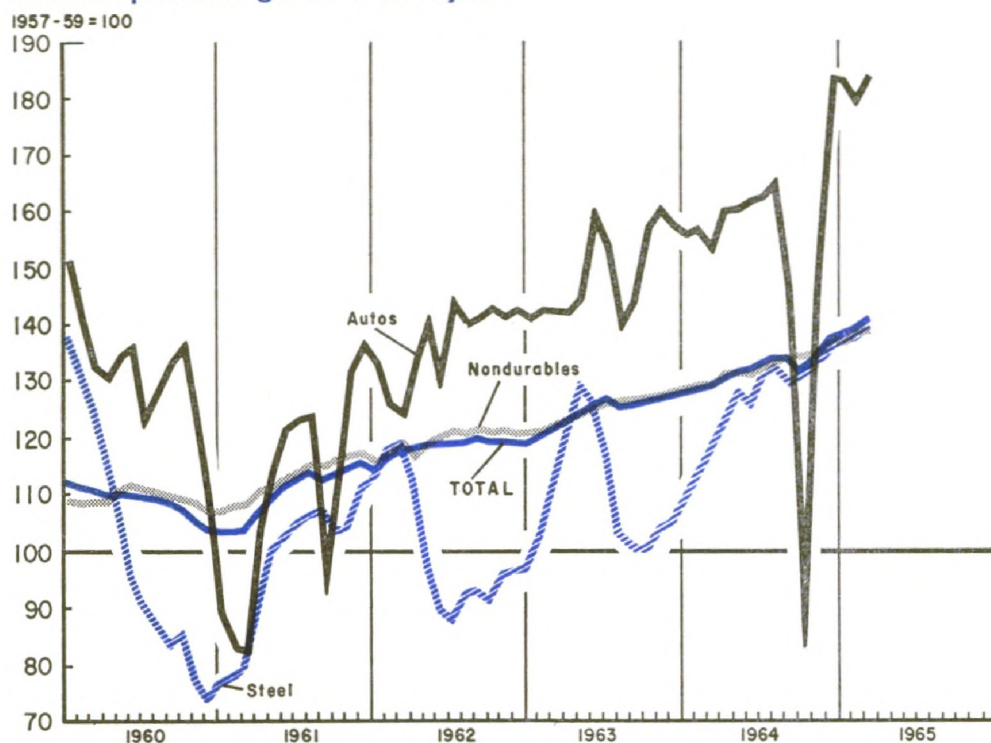
By way of contrast, the generally stable inventory situation of the 1961-64 period was based not only upon a steady rise in final sales but upon several other important factors as well. Improvements in inventory control—for example, the use of computers—became widespread enough to dampen the usual volatility of inventories. Moreover, expansion beyond current needs seemed unwarranted: speculative buying was unnecessary because of price stability, and reasonably prompt delivery was assured because of ample manufacturing capacity. Are those conditions still present? The next several months should tell.

Hard-driving sectors

The inventory picture will depend primarily upon developments in autos, steel, and other hard-driving sectors. In autos, the testing time may be near at hand, as dealers begin to confront their basic market instead of simply catching up with last fall's hungry market. In steel, the testing time may be postponed several months, in view of the extension of the steel labor contract from May 1 to September 1.

The recent strength of auto sales has confounded even the normally optimistic sales managers of Detroit. In the early months of 1965, domestically produced cars were selling at a 9½-million annual rate, although February seemed to mark a temporary peak. This performance eventually persuaded the industry's leaders to up their 1965 sales forecast to about 9 million cars—or perhaps even

Autos, steel boost production index with 20-percent gains within year



Source: Federal Reserve Board.

more if the excise tax on passenger cars should be reduced at midyear. So, while sales managers cheer, production lines hum along at a very busy pace as manufacturers attempt to keep abreast of dealers' inventory needs as well as consumers' clamoring demands.

In steel, an inventory buildup may well continue for several months longer, since many steel users had smaller stocks than desired when the strike deadline was set back four months. The contract extension, incidentally, involves placing 11½ cents an hour in an informal escrow fund for each hour worked by the steel union's 425,000 members. The agreement amounts to a labor-cost increase of roughly 2.7 percent per year—as compared with the 3.2-percent figure recommended in the Administration's guidelines, the 3.5-percent figure achieved recently in the steel union's contract with can manufacturers, and the even greater increase achieved last fall by the auto workers' union.

At the time of the contract extension, steel output was running about 50 percent above the 1957-59 average and about 20 percent above the year-ago level. Much of the strength, however, was simply due to the ebullience of final consumer demand, and so inventory building has been not much more significant than in the similar contract-negotiation periods of 1962 and 1963. Even so, steel consumers have added about 4 million tons to their stocks of steel within

the past half-year. Thus, if an early settlement is reached in contract negotiations and if output should slow in autos and other overheated fields, the next half-year may witness substantial cutbacks in steel inventories.

Bricks, mortar, machinery

Consider, also, the longer-term situation in business plant-equipment spending. This sector now appears quite strong, on the basis of the 12-percent year-to-year increase projected in the Commerce-S.E.C. survey, and the even stronger gain shown in the more recent McGraw-Hill survey. According to the Commerce-S.E.C. survey, this sector will show an increase for the fifth straight year and (unlike earlier years) the gain will outpace the rise in GNP for the second consecutive year.

The survey highlights several factors favorable to the continuation of the boom. For one thing, expenditures on new plant are scheduled to rise faster than expenditures on equipment; in other words, the emphasis will be

on the expansion of capacity rather than simply the modernization and replacement of facilities. Moreover, manufacturers' carry-over of uncompleted investment projects was about 40 percent higher at the beginning of this year than a year before, while new orders for machinery and equipment have been somewhat stronger than in the big investment boom of the mid-1950s.

The anticipated expansion of plant-equipment spending comes on top of an almost 50-percent increase over the earlier course of the four-year long expansion. Investment spending has responded to a gradual rise in operating rates; capacity utilization has increased from about 82 percent to 87 percent during this expansion. Spending has also risen in response to the growth in demand for final products; total sales in manufacturing and trade have risen from \$61 billion to \$73 billion over the last several years. Again, spending has responded to improved rates of profits and cash flow, augmented by the new depreciation guidelines, the investment tax credit, and the reduction of tax rates; internally generated funds have risen from \$30 billion to \$41 billion between 1961 and 1964. In addition, this sector has expanded in response to the continued availability of credit at relatively stable rates of interest; last year, corporate issues for new capital approached the 1957 peak, while the corporate bond yield has held stable at about 4.3-4.4 percent for several years now.

Watch the laggards

In the present testing period, diagnosticians searching for clues as to the future health of this business cycle may find some answers by examining inventory behavior and fixed-investment spending plans, and perhaps by examining other "lagging" cyclical indicators as well. In the terminology of the National Bureau of Economic Research, manufacturers' inventories and plant and equipment spending—along with such indicators

as unit labor costs, bank rates on business loans, and consumer instalment debt—tend to lag somewhat behind the movements in the broad aggregates of economic activity, and to lag even further behind the "leading" cyclical indicators. Nonetheless, these indicators are valuable for cyclical analysis in that they warn of excesses that frequently develop in a mature cyclical expansion.

Several of the lagging indicators measure costs—that is, the cost of money or the labor cost per unit of output. Others measure costs along with business risks—that is, inventories and consumer debt. And, since excessive costs generally tend to bring an expansion to an end, the pre-condition for a business decline is a significant rise in lagging indicators.

In the typical case, rising costs and slower increases in volume lead to shaved profit margins, and the financing of burdensome inventories creates additional problems. Expectations diminish, commercial failures rise, and stock prices and new incorporations fall. Attempts to reduce inventories are soon reflected in declines in new orders and in sensitive commodity prices. In addition, hiring slows down, layoffs rise, and the average workweek declines as overtime is eliminated and short-time is instituted. Moreover, if confidence becomes sufficiently impaired, major business decisions to invest may be postponed.

Until recently, this dire sequence of events was only a dim possibility, since the striking feature of this business expansion to date has been the slow response of lagging indicators. The excesses which were common during the advanced stages of previous expansions simply were not visible. But the laggards will be watched closely in coming months, however, as the doctors now hovering over the incredibly long-lived business expansion continue to probe for signs of excesses which could bring on a decline.

—William Burke

Manpower to the Fore

MANPOWER developments dominated the Western business scene as the fifth year of a prolonged cyclical expansion got underway. During early 1965, employment expanded strongly in most Twelfth District industries and unemployment correspondingly declined. But the most newsworthy items were the following:

Unemployment declined more rapidly in the District than in the rest of the country, even though the District's first quarter jobless rate of 5.5 percent remained high above the national figure of 4.8 percent;

Employment in defense-related manufacturing kept declining, but at a lower rate than heretofore;

The farm labor controversy remained unsettled, as growers received some—but far from all—the foreign contract laborers they requested.

Overall, the Western employment picture improved significantly during the first quarter of the year. Nonfarm employment increased 1 percent in the District—the same as in the rest of the nation—although the pattern of employment growth varied from industry to industry. The distribution, service, and government categories all expanded more rapidly in the District than elsewhere. Construction also expanded substantially, although more slowly than in the rest of the nation. The level of employment in Western manufacturing firms, however, increased only slightly above the late 1964 level. (All data seasonally adjusted.)

On the factory floor

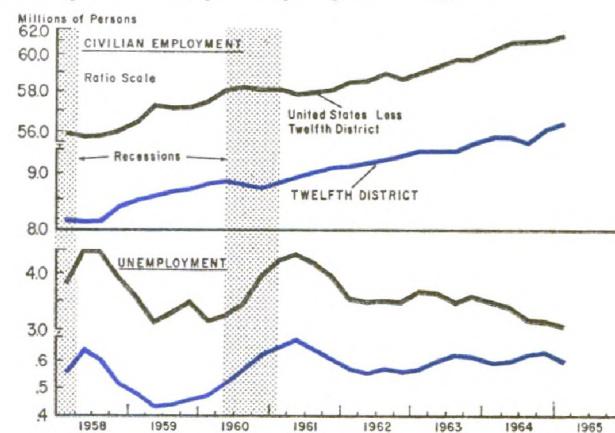
District states, which have a relatively minor automotive sector, did not receive as much benefit as other regions did from the first-quarter recovery in auto production-line employment. These states, moreover, were affected by the drag imposed by the continu-

ing decline in defense-related manufacturing. Consequently, the region's total manufacturing employment remained below the early-1964 level, in contrast to a 4-percent year-to-year increase elsewhere.

The first-quarter drop of 5,000 in defense employment was comparable to the fourth-quarter decline, but was far smaller than the declines recorded earlier in 1964. Western aircraft, missile, electronic, and shipbuilding firms thus now employ 563,000 workers, or almost 15 percent less than at the December-1962 peak. This drop has reflected a number of worrisome factors—principally a sharp 25-percent decline in District defense contracts between 1963 and 1964, in contrast to a slight increase in contract placements elsewhere.

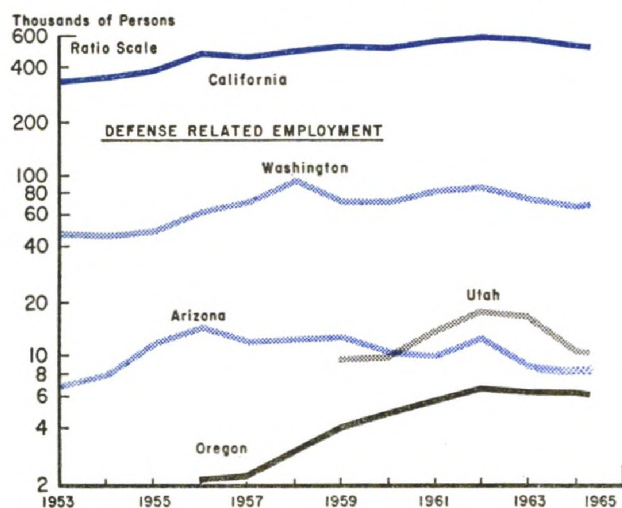
The defense decline in the first quarter centered in California, where 1,000 shipyard workers and 5,000 other defense employees were laid off. Washington, on the other hand, recorded a 1,000 gain in employment. This gain reflected an increase in study contracts involved in competitions for major production contracts, and it also reflected a substantial increase in new orders for commercial

District jobless problem continues despite sharp employment gain



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

Two-year decline in defense employment shows signs of easing



Sources: State employment reporting agencies.

short-range jet aircraft. (Defense-related employment includes employees manufacturing commercial aircraft.)

In the fields

On the farm front, there was no question of the need for additional workers, but there was strong disagreement about where the necessary workers would be procured. Despite the ending of the "bracero" program at the end of 1964, many District growers argued that foreign contract workers would still be needed for the hard work of planting and harvesting the region's 1965 crops. (About 17,000 were employed in California and Arizona in March 1964—and considerably more at the harvest peak.)

A partial solution to the problem was reached in late April, when Labor Secretary Wirtz accepted the report of a special study panel which recommended the importation of some foreign workers under existing immigration legislation. The panel's award recommended the use of 1,500 Mexicans and 1,000 other foreign workers in California asparagus, strawberry, and lettuce fields. (Growers had requested 6,700 such workers.) In making its award, the panel acted on the understanding that the transition now underway to exclusive

use of domestic workers "will produce a minimum amount of economic and job dislocations." Even at that, however, the implementation of the panel's award was hampered by delays in obtaining Mexican government exit permits for farm laborers.

But what of the needs for workers (domestic or foreign) later in the planting and harvesting season? Weather will be a major factor in this situation. The early-1965 rainy and cold weather in Southern California and Arizona alleviated somewhat the lack of bracero labor at that time. In coming months, however, the demand for farm labor may intensify as harvesting needs for crops such as strawberries overlap the labor requirements for other crops. Weather may be important in another way also. Although tomato acreage in California has been considerably reduced, according to Department of Agriculture forecasts, abundant supplies of moisture have improved prospects for a number of other labor-intensive crops, such as tree fruits.

Coming months, therefore, may bring about an increased, and not a smaller, demand for agricultural workers. To date, however, there has been little evidence of strong upward pressures on farm wages. California farm wages, for example, have increased only about as fast as the national average over the past year. (On the other hand, average farm wages in California have already reached \$1.36 an hour—considerably above the average for most other states.)

With the bulldozers

Western construction activity has exhibited considerable strength in recent months, despite continued weakness in housing. Construction awards in early 1965 reached a \$9.3-billion annual rate—7 percent above the fourth-quarter average and equal to the record year-ago figure.

The year-long housing decline continued into the first quarter of 1965. In relation to the early-1964 peak, the number of contract

awards was down about 25 percent for single-family housing and about 40 percent for multi-family structures. The continued decline partly reflected recent increases in vacancy rates; during 1964, for example, rental vacancies in the West rose from 9 to 11 percent.

A hopeful construction indicator was the first-quarter stability in new housing starts; in fact, new residential starts advanced in March to their highest level of the last eight months. Another hopeful indicator was the recent strength in heavy construction awards, which increased 60 percent in value in the first quarter of the year. Electric-utility construction awards doubled during that period. In addition, street and highway awards (the largest single heavy-construction category) also increased significantly, so that 1965 spending plans for this category are now up in almost every state of the District.

With shovels and saws

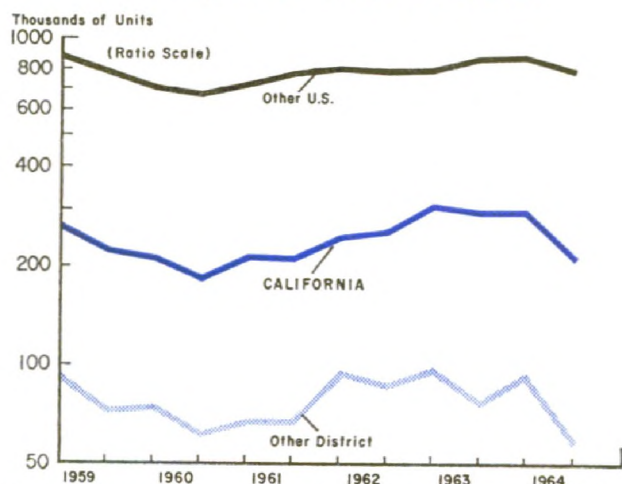
Heavy construction provided the underpinning for a record-breaking first-quarter performance by the Western steel industry. Unlike manufacturers elsewhere, the District industry derived little benefit from the rapid

first-quarter pace of auto manufacturing and inventory building. But the District industry derived substantial support from the construction of major power projects, industrial plants, and office buildings, as well as from repair work resulting from the year-end floods in the Northwest and the year-ago earthquake in Alaska. Meanwhile, the domestic supply situation remained tight, and foreign steel imports thus found ready markets throughout the West.

Nonferrous-metals production was also strained during this period, as producers attempted to keep up with a record pace of orders arising from the heavy-construction and durable-goods booms. Copper shortages were aggravated at U.S. and foreign refineries by the East Coast dock strike. Yet, despite the shortages, producers of copper and other nonferrous metals resolutely attempted to hold their prices constant in order to restrain consumers from shifting to substitute materials. In early May, however, when Chilean government pressure brought about an increase in the world-market price of copper, producers in this country were forced to boost their price from 34 to 36 cents a pound. On the other hand, the stability of metals markets in the near future should be assisted by the scheduled release of 100,000 tons of copper and 150,000 tons each of lead and zinc from government stockpiles.

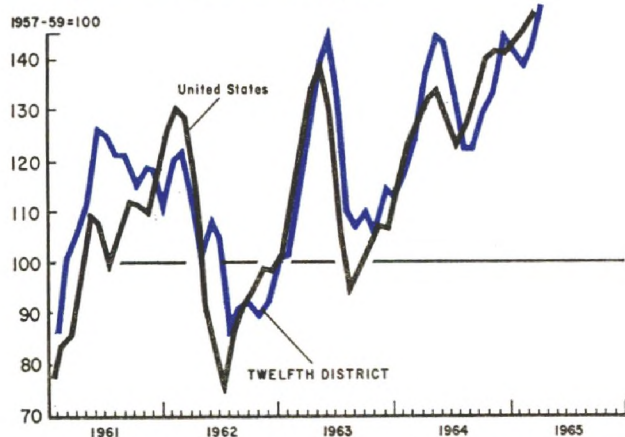
The Western lumber industry in recent months presented a different picture from the metals industry. Prices had increased rapidly in January because of production cutbacks resulting from year-end flood damage and a subsequent wave of speculative buying. Since early February, however, lumber prices have trended downward, partly because of a rapid recovery of production from mills in the flood areas and partly because of a slowdown in consumer demand related to a declining housing market. In fact, lumber prices recently have fallen below the low levels prevailing a year ago.

Nation's housing slump centered in California, other Western states



Note: Chart shows semi-annual average of residential building permits, at annual rates (unadjusted).
Source: Department of Commerce.

West, like nation, pushes steel output to record heights



Sources: Federal Reserve Board; Federal Reserve Bank of San Francisco.

In the countinghouse

On balance, Western business was just as strong as business elsewhere at the outset of a fifth year of a prolonged cyclical expansion. Despite problems of too few jobs in defense manufacturing and perhaps too few workers in agriculture, first-quarter production gains throughout the District were quite substantial. Employment, as already indicated, matched the nation's 1-percent employment gain during the first quarter, and personal in-

come grew in step with the national rate. (District personal income in early 1965 was roughly 7 percent above the year-ago level.)

Substantial gains in income supported substantial gains in consumer spending. Retail sales in early 1965 were more than 6 percent above the year-ago level — in line with the national trend — despite weakness in several sectors, such as apparel, furniture, and appliances. The West also participated in the nation's auto-buying spree, as new car registrations in District states increased 10 percent above the year-ago level.

As the spring progressed, then, there was little doubt of the continued ebullience of consumer spending. The major questions confronting Western businessmen rather concerned the strength of activity in certain specific industries. In other words, how many jobs and how much income will be generated in coming months by the recent limited inflow of defense contracts? At the same time, will enough farm workers be available to bring the District's crops to market? When these and related questions are answered, a better fix will be available on the shape of the Western business situation for the remainder of the year.

Foreign Investment

Copies are again available of the article, "Can We Afford to Invest Abroad?", which appeared in the September 1964 *Monthly Review*.

The article provides a background analysis of the role of private capital flows in the U.S. payments picture. The discussion includes definitions of different types of private capital investments, the location of our investments abroad, the short- and long-run impact of private capital outflows on the balance of payments deficit, and the implications of private capital exports.

Copies of the article are available on request from the Administrative Service Department, Federal Reserve Bank of San Francisco, 400 Sansome Street, San Francisco, California 94120.

Vigor in the Credit Markets

VIGOROUS business activity continued to be accompanied by vigorous financial activity in early 1965. Business concerns in particular, but consumers and state-local governments as well, increased their credit demands in order to finance higher levels of expenditures. The Federal Government, meanwhile—notwithstanding a slight reduction in outlays—also increased its borrowings in order to finance a cash deficit and to maintain its operating balances.

During the January - March quarter, the supply of loanable funds remained adequate to accommodate the higher level of expenditures at a level of interest rates only slightly above the late-1964 level. But some rate increases occurred in the short-term end of the maturity spectrum, and the yield spread thus continued to narrow.

The market yield on 90-day Treasury bills rose by about 16 basis points (almost to 4 percent) between the beginning of the year and late February — partly because of attempts to maintain short-term rates at a level that would discourage substantial outflows of short-term funds, and partly because of expectations of reduced credit availability in the context of a continued vigorous expansion. But the rate then declined to the neighborhood of 3.89-3.94 percent in April and early May, as a reflection of the more confident tone which developed in the money market after the announcement of the Administration's balance-of-payments program.

Yields on other short- and intermediate-term market instruments also moved upward during the first quarter, but yields on most long-term debt instruments remained relatively stable during this period. Rates on mortgages, corporate bonds and long-term Treasury issues all moved sideways, as a continuing heavy flow of savings was directed

into these investment outlets by financial intermediaries.

Strongest development

A strong and widespread expansion in business borrowing undoubtedly was the most significant financial development of the January-March period. In particular, business loans at the nation's commercial banks jumped by a record \$4 billion — well over double the average quarterly gain of 1964 (seasonally adjusted data).

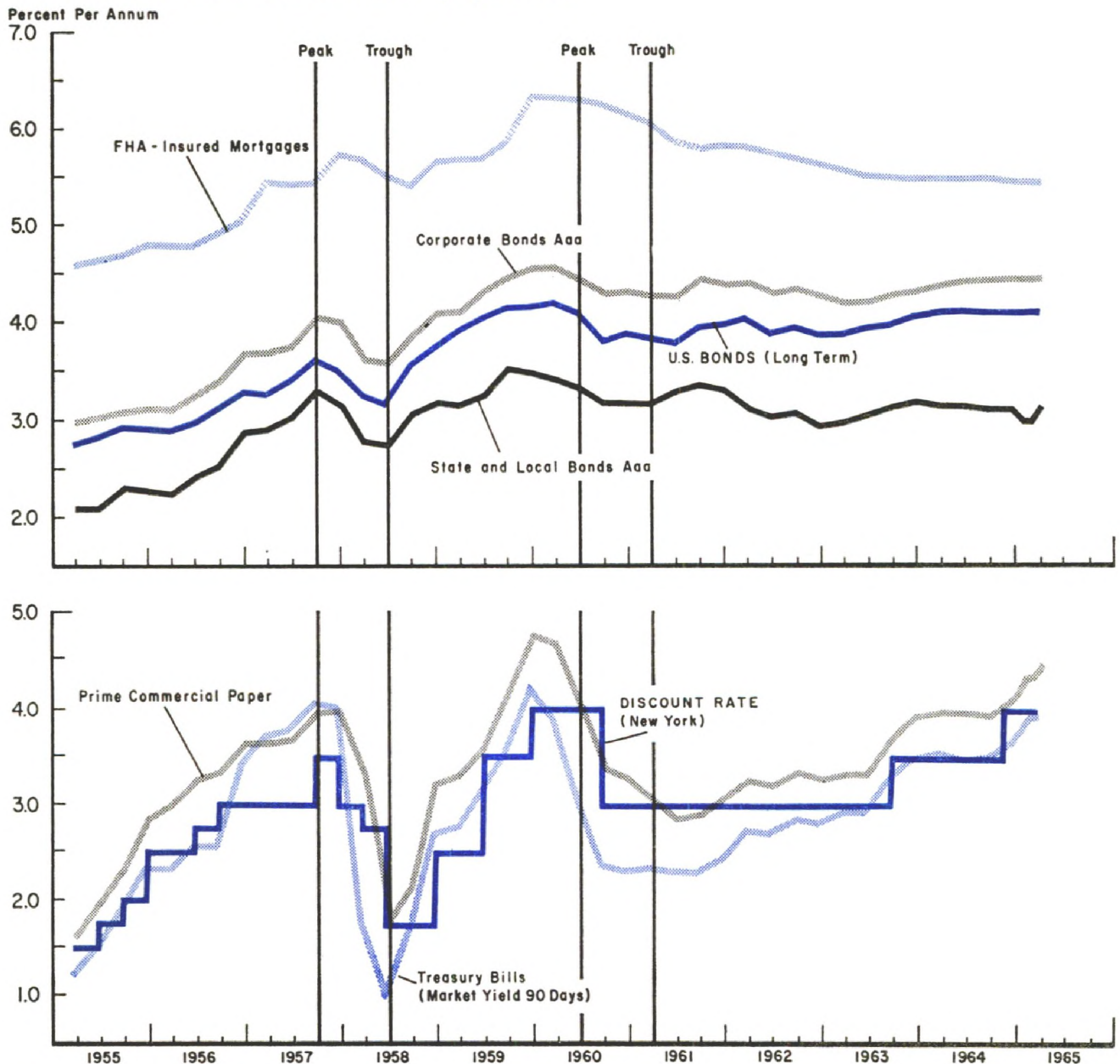
The sharp rise in business borrowing suggests at first glance a decline in corporate liquidity margins, in the face of continued gains in business sales and profits. But other indicators suggest almost the reverse. For example, total holdings of negotiable certificates of deposit at weekly reporting member banks rose \$1.3 billion during the January-March period—substantially more than the average 1964 gain—and a large part of these were held by corporations. This increase no doubt reflected the increased yields obtainable on such investments, but businesses also boosted their holdings of other liquid assets, such as tax-anticipation bills.

Other signs also pointed to the continued adequacy of internally generated corporate funds. While turning increasingly toward bank loans, businesses approached the capital market with some restraint; the first-quarter volume of debt and equity offerings was less than the quarterly average of each of the three preceding years. Perhaps more significant, the ratio of funds raised externally to business investment outlays was lower in the first quarter than during most of 1964.

Other signs of vigor

Consumers also stepped up their borrowing to finance sharply increased expenditures

Yield spread continues to narrow as rate increases
 occur at short-term end of maturity spectrum



Source: Federal Reserve Board.

during the quarter. But they also reduced sharply their savings out of disposable income; the quarterly savings rate (6.8 percent) was the lowest of the past year and a half. On the other hand, public holdings of liquid assets increased substantially, with most of the gain showing up in interest-bearing claims on commercial banks and other financial intermediaries.

Both extensions and repayments of con-

sumer instalment credit rose significantly in the January-March period. Consumer borrowing increased in all categories, but the active auto market generated about 37 percent of all new extensions, on a seasonally adjusted basis.

The Federal Government's net cash demands on the market were fairly small during the first quarter, considering the fact that that period typically is a deficit period for the

Treasury. In a highly successful advance re-funding in January, the Treasury swept \$9.7 billion of 1965-67 issues further out into the maturity spectrum. Notes falling due on February 15 which were not exchanged in the January operation were refunded into an 18-month note in a combined cash-exchange offering. Moreover, the Treasury raised \$2.9 billion in new cash through the sale of June tax-anticipation bills in January and through an increase in the weekly bill tender. So, in view of the redemption of \$2.5 billion of March tax-anticipation bills, the Treasury raised net new cash of only \$0.4 billion during the quarter.

Several other indicators also attested to the favorable state of Federal finances. Throughout the quarter the Treasury balance ran consistently ahead of year-ago levels. Then, an April recheck of budget figures revealed that the fiscal 1965 deficit will be about \$1 billion less than anticipated in January, because of higher-than-expected revenues as well as lower-than-expected Federal expenditures.

In the state and local government sector, higher spending levels during the quarter were accompanied by a \$2.5-billion rise in debt offerings. This was slightly above that of

the preceding three months but was less than the 1964 quarterly average volume of tax-exempt issues. The major part of the new issues went for the financing of highway construction.

Commercial-bank role

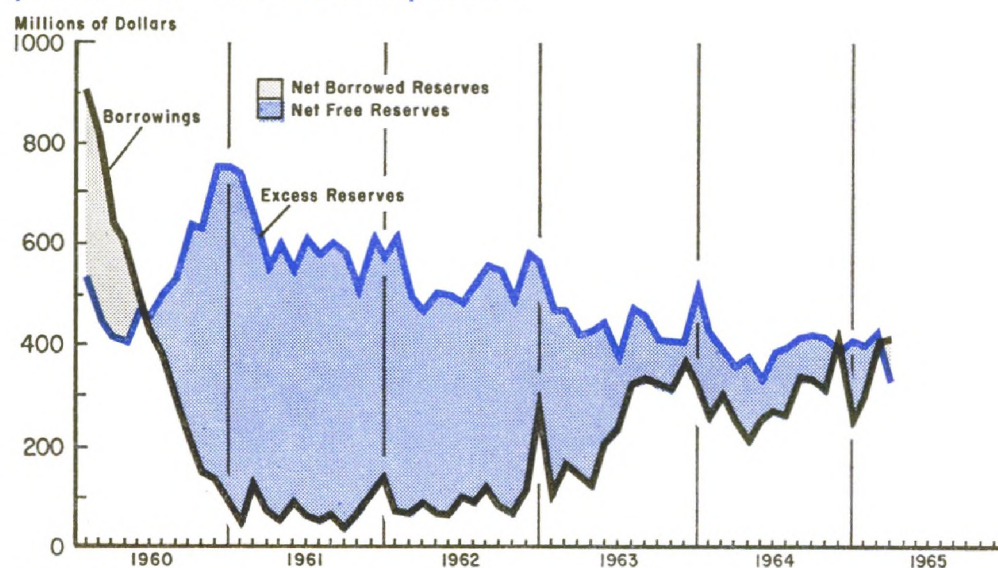
Commercial banks played a leading role in the nation's active credit markets during early 1965. Commercial-bank credit rose \$8.5 billion (seasonally adjusted basis), and thus substantially exceeded 1964's average quarterly gain. Loans increased even faster—\$8.8 billion, or twice the 1964 pace. The increase was financed partly by a drop of almost \$2 billion in Treasury security holdings—a drop, however, that was largely offset by a substantial gain in other security holdings.

Business borrowing, as already indicated, was the principal cause of the increased activity in bank lending departments. The business-loan gain reflected the need for larger working balances attendant to the financing of higher levels of output. But other factors were also important—for example, commodity dealers' financing of goods held up in transit during the early-1965 dock strike, steel customers' financing of strike-hedge buying

of inventories, and (especially) foreigners' sharply increased borrowing prior to the February action by banks limiting their annual increases in such lending to 5 percent. Meanwhile, real-estate loans increased at a rate comparable to the average 1964 gain, and consumer loans out-matched their average 1964 gain.

On the other side of the ledger, bank deposits rose by about

Banks show net borrowed reserve position for first time in expansion



Source: Federal Reserve Board.

FEDERAL RESERVE BANK OF SAN FRANCISCO

\$8.3 billion, including a \$2.6-billion net increase in U.S. Government deposits. Deposit growth failed to match the growth in outstanding credit, however. During the first quarter, bank borrowings from the Federal Reserve System tended to increase, while excess reserves tended to decline. Consequently, average free reserves declined from their fourth-quarter level, until in March the banks recorded net borrowed reserves of \$76 million.

First-quarter money supply statistics showed a slight decline in demand deposits and a slight increase in currency, but a sharp \$5.7-billion increase in commercial-bank time and savings deposits. This development clearly reflected the attractiveness of the increased rates on time and savings deposits which many banks have paid since the beginning of this year.

The higher rates, which were permitted under last November's amendment of Federal Reserve Regulation Q, have helped improve the competitive position of commercial banks vis-a-vis other depository institutions. Commercial banks accounted for 66 percent of the total first-quarter savings gain at savings institutions, as compared with only 45

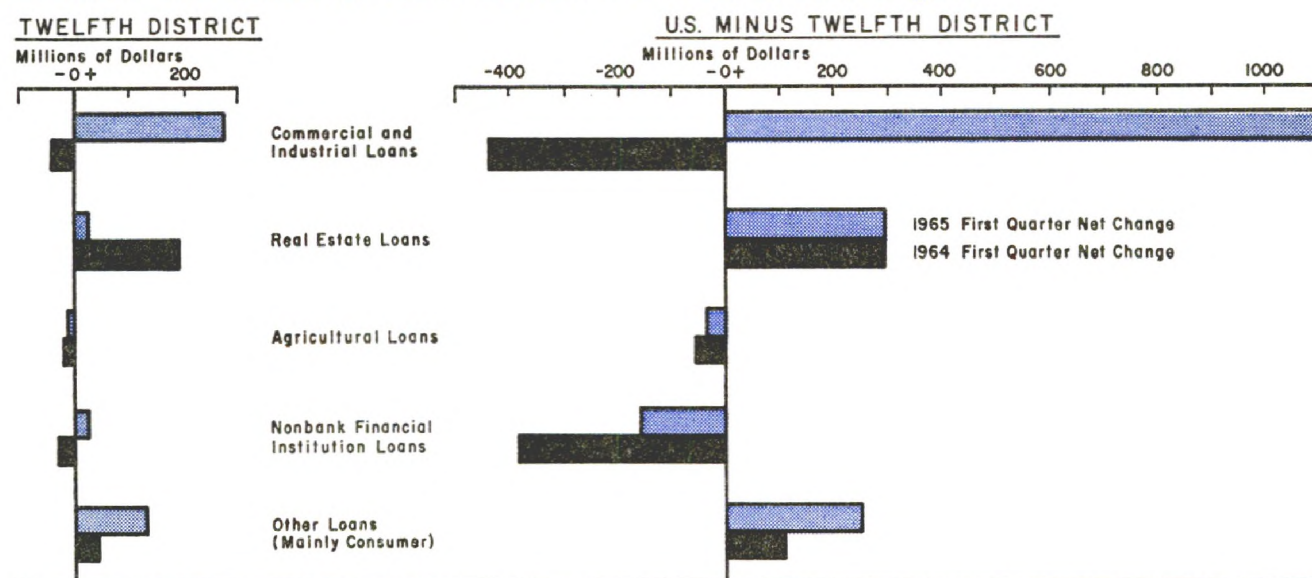
percent of the gain in the year-ago quarter. Moreover, savings growth at savings and loan institutions was smaller during the first quarter than during the comparable periods of the last several years.

Contra-seasonal District rise

In the Twelfth District credit demands also increased vigorously in the first quarter of 1965. Total credit at District weekly reporting member banks rose \$336 million, or one percent, during this period. Loans increased more than \$500 million—double the gain in the year-ago quarter. (But even this gain was relatively less than at banks elsewhere, which overcame their normal pattern of a sharp first-quarter loan decline.) Meanwhile, in the securities category, banks increased their holdings of "other" securities at twice the national rate of increase, and thus offset a large part of their net reduction in holdings of U.S. Government securities.

Business-loan demand accounted for over one-half of the total first-quarter loan expansion at District weekly reporting banks. Business borrowing declined slightly in January, but then increased fairly constantly through-

District banks' loan expansion falls short of national pace . . . business and consumer loans account for most of District gain



Sources: Federal Reserve Board; Federal Reserve Bank of San Francisco.

SELECTED BALANCE SHEET ITEMS OF WEEKLY REPORTING MEMBER BANKS IN LEADING CITIES

(dollar amounts in millions)

	Twelfth District				U. S. Minus Twelfth District		
	Outstanding 3/31/65	Net change First Quarter 1965		1st Qtr. 1964 Percent	Outstanding 3/31/65	Net change 1st Qtr. 1965	
		Dollars	Percent			Percent	1st Qtr. 1964 Percent
ASSETS							
Loans adjusted and investments ¹	\$32,650	+ 336	+ 1.0	— 0.3	\$119,317	+ 0.5	— 2.6
Loans adjusted ¹	23,413	+ 507	+ 2.2	+ 1.2	81,404	+ 2.6	— 1.6
Commercial and industrial loans	7,854	+ 273	+ 3.6	— 0.6	36,766	+ 6.5	— 1.4
Real estate loans	7,569	+ 24	+ 0.3	+ 2.7	12,757	+ 2.4	+ 2.7
Agricultural loans	1,000	— 13	— 1.3	— 2.0	542	— 6.2	— 8.6
Loans to nonbank financial institutions	1,551	+ 26	+ 1.7	— 2.3	7,346	— 2.1	— 5.3
Loans for purchasing and carrying securities	511	+ 55	+ 12.1	+ 27.0	5,938	— 4.6	— 10.6
Loans to foreign banks	330	+ 24	+ 7.8	+ 10.5	1,244	— 0.8	+ 6.7
Other loans (mainly consumer)	4,988	+ 131	+ 2.7	+ 0.9	18,716	+ 1.4	+ 0.7
Total securities	9,237	— 171	— 1.8	— 3.5	37,913	— 3.7	— 4.4
U. S. Government securities	5,176	— 520	— 9.1	— 5.9	19,789	— 10.0	— 7.8
Other securities	4,061	+ 349	+ 9.4	+ 0.5	18,124	+ 4.2	+ 0.6
LIABILITIES							
Demand deposits adjusted	12,343	— 507	— 4.0	— 4.3	51,062	— 7.5	— 8.6
Total time and savings deposits	19,396	+ 818	+ 4.4	+ 3.3	51,744	+ 7.1	+ 3.9
Savings accounts	14,321	+ 418	+ 3.0	+ 1.9	28,002	+ 4.5	+ 1.5
Other time deposits IPC	2,530	+ 464	+ 22.5	+ 20.7	15,926	+ 11.1	+ 6.8

¹ Exclusive of loans to domestic commercial banks and after deduction of valuation reserves; individual loan items are shown gross.

Note: Quarterly changes are computed from the December 30, 1964-March 31, 1965 and from December 31, 1963-April 1, 1964.

Source: Board of Governors of the Federal Reserve System; Federal Reserve Bank of San Francisco.

out February; in fact, the February gain exceeded the large March increase, even though the latter was inflated by heavy credit demands over the March 15 corporate-tax date. Some of the special factors which influenced national credit developments—for example, heavy foreign borrowing prior to the voluntary restraint program initiated in February, along with financing needs associated with the dock strike and steel inventory buildup—also appear to have influenced the pattern of District lending.

All major categories of business borrowers, except public utilities, increased their bank-held debt at metropolitan offices of major banks. Loans to durable goods manufacturers increased \$61 million, largely due to credit needs of machinery manufacturers. Loans to nondurable goods producers rose by \$38 million—in sharp contrast to a \$91-million decline in the year-ago period. The petroleum industry recorded heavy credit

needs for oilfield operations and other purposes. The dock strike, meanwhile, contributed to a less-than-seasonal reduction in bank-held debt of food, liquor, and tobacco manufacturers. But in contrast to these plus factors, the downturn in District construction activity contributed to a smaller net increase in construction loans than in the comparable year-ago period.

Contrary to assumptions, the cost of business borrowing did not increase as bank-credit demands strengthened. According to the Federal Reserve quarterly interest-rate survey, rates paid on short-term business loans made in the first half of March declined from the December level, both in the Twelfth District and nationally. The decline in the average District rate for all-size loans, from 5.25 percent in December to 5.11 percent in March, was due mainly to a very substantial increase in the proportion of the total loan volume extended to borrowers who qualify

for the prime rate (currently $4\frac{1}{2}$ percent). But average rates on loans in the smaller loan-size groups were somewhat higher than reported in the December survey. Moreover, bank policies tended to be firmer on nonprice terms of lending, particularly in regard to compensating balances.

Mortgages, consumers, dealers

While business lending increased at District banks, mortgage lending weakened. The net expansion in real estate loans for the first quarter was only \$24 million; the gain in the corresponding period of 1964 was \$192 million. Weekly reporting banks outside the District, on the other hand, matched their year-ago mortgage performance even while recording a very large increase in business loans.

Since last fall, District weekly reporting banks have slowed down their acquisitions of mortgages and have stepped up their sales of mortgages out of bank portfolios. District banks normally maintain a fairly constant ratio of real-estate loans to savings deposits, but the accelerated inflow of savings since December so far has not been reflected in mortgage lending. Other factors—particularly the relative weakness of mortgage demand and the ample availability of funds for real-estate investment by competing institutions—have tended to limit bank participation in the mortgage market. But even so, District banks still hold a far higher proportion of their total loan portfolios in real estate loans than do banks elsewhere in the nation.

Consumer demand for bank credit helped push up loan totals in the first three months of 1965. The rise of \$131 million in the “other loan” category, where these loans are reported, was three times as great as in the comparable year-ago period. The rate of gain at District banks was nearly double the rate recorded at other weekly reporting banks. As in early 1964, the net increase in this loan category exceeded the gain in real-estate

loans. Obviously, the higher interest costs that banks must meet in 1965 has enhanced the attractiveness of consumer instalment loans, with their relatively high effective rate of return.

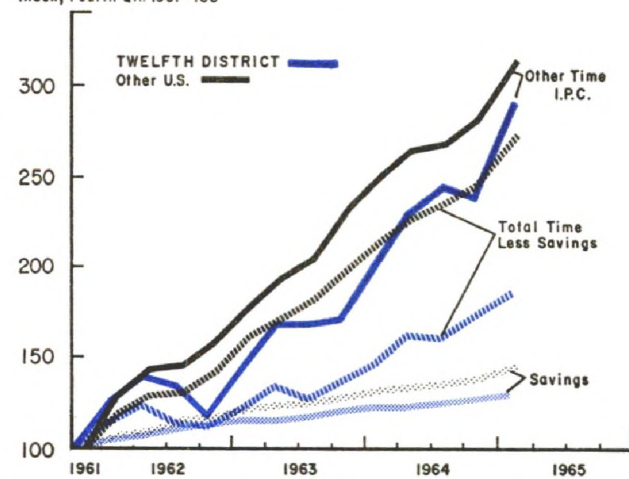
During the January-March period, District banks provided a large volume of credit to brokers and dealers for financing and carrying securities. In this, as in the preceding quarter, some banks frequently took advantage of the arbitrage in rates on Federal funds (excess reserves on deposit with a Federal Reserve Bank)—buying funds from other banks and reselling at higher rates to Government securities dealers.

Record deposit inflows

Total time deposits chalked up a record first-quarter gain of \$8.8 million at District weekly reporting banks, in response to the higher rates authorized by last November’s revision of Regulation Q. (Some District banks immediately increased rates paid on time certificates of deposit, but most waited until January to increase rates paid on savings deposits.) The total dollar increase was greater in early 1965 than in the first quarter of 1962, when District banks also raised in-

Higher rates induce sharp gains in time and savings deposits

Index, Fourth Qtr. 1961 = 100



Sources: Federal Reserve Board; Federal Reserve Bank of San Francisco.

terest rates by $\frac{1}{2}$ percent following a revision in Regulation Q, but the percentage gain was somewhat smaller—4.4 percent vs. 5.6 percent.

A number of major banks that had formerly issued savings certificates with 12-month maturities at 4 percent recently offered time certificates to individuals at rates above 4 percent, and thereby improved their competitive situation vis-a-vis savings and loan associations. In response to these rate developments and to a deceleration of growth in their own savings inflow, a number of District savings and loan associations outside of California increased dividend rates at the beginning of the year, and a few more moved upward at the end of the first quarter. But California associations, which were already paying a prevailing rate of 4.85 percent, held their ground at the first of the year. Then, at the end of the quarter, several Southern California associations announced increases to around 5 percent. But the Federal Home Loan Bank Board immediately ruled that associations increasing rates above locally prevailing rates (if over 4.25 percent) would not be eligible for advances for loan expansion. Since this ruling, no further increases have been announced.

District weekly reporting banks took advantage of the unusually large first-quarter increase in total time and savings deposits to decrease their dependence on large-denomination negotiable CD's. The \$90-million first-quarter increase in outstanding CD's was less than a third as large as the increase in the comparable year-ago period. District banks, unlike New York City banks, apparently did not seek to offset the large volume of CD's maturing on the March 15 corporate-tax date, and consequently they recorded a net reduc-

tion in this category in March. But the growth in this type of deposit instrument exceeded that at Chicago District banks and the San Francisco District continued to hold third place among the Districts in the volume of outstanding CD's.

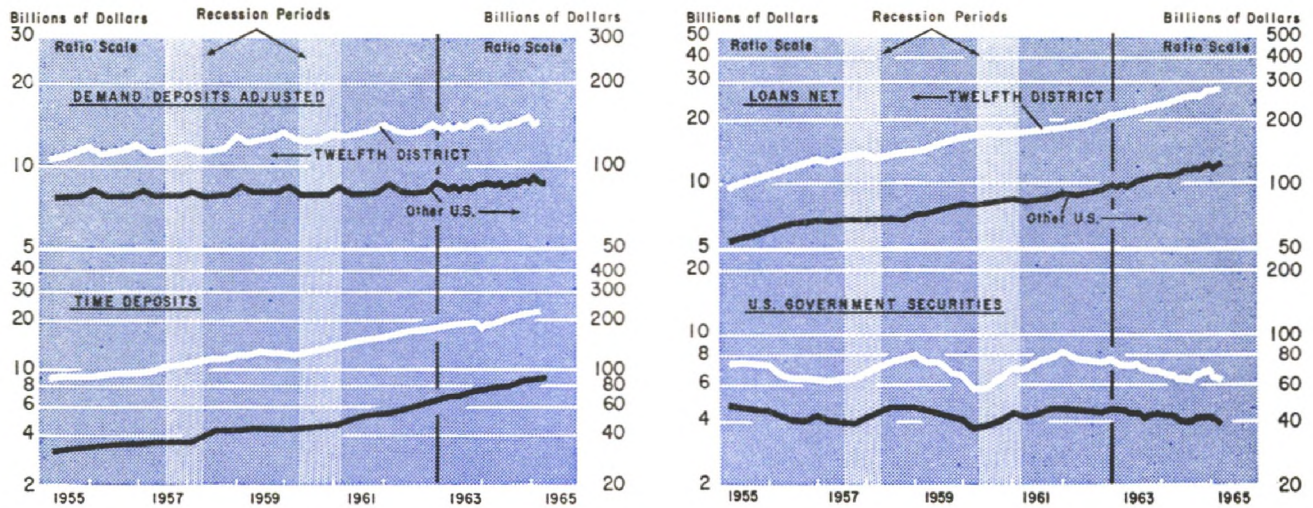
Less reserve pressure

The record net inflow of time and savings deposits exceeded the seasonal first-quarter decline in demand deposits by about \$300 million, and the supply of lendable funds available to District banks consequently increased. Because of this favorable expansion in deposits, District banks were under somewhat less reserve pressure than were banks elsewhere. Required reserves of District member banks during the January-March period were \$134 million higher, on a daily average basis, than in the corresponding period in 1964. But excess reserves were also greater, and daily average discounting at the Federal Reserve Bank of \$16 million was only half the volume of borrowing in the first quarter of 1964. Thus, excess reserves exceeded borrowings by a daily average of \$4 million, in contrast to average net borrowed reserves of \$18 million in the comparable year-ago period. In April, however, District bank reserve positions tightened, and their net borrowed reserves were larger than in April 1964.

In spite of favorable loan and deposit performances in the first quarter of 1965, the substantial increase in interest costs on savings and time deposits tended to depress District bank earnings. The impact of the interest rate adjustment was intensified for District banks because they hold a relatively high proportion of their total deposits in time and savings deposits.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Condition Items of All Member Banks — Twelfth District and Other U. S.



Source: Federal Reserve Bank of San Francisco. (End-of-quarter data shown through 1962, and end-of-month data thereafter; data not adjusted for seasonal variation.)

BANKING AND CREDIT STATISTICS AND BUSINESS INDEXES—TWELFTH DISTRICT^{1*}

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

Year and Month	Condition items of all member banks ² Seasonally Adjusted				Bank debits Index 31 cities ^{5, 6}	Bank rates on short-term business loans ^{7, 8}	Total nonagri- cultural employ- ment	Dep't. store sales (value) ⁶	Industrial production (physical volume) ⁶		
	Loans and discounts ³	U.S. Gov't. securities	Demand deposits adjusted ⁴	Total time deposits					Lumber	Refined ⁵ Petroleum	Steel ⁵
1952	8,712	6,477	10,052	7,513	59	3.95	84	73	101	90	92
1953	9,090	6,584	10,110	7,994	69	4.14	86	74	102	95	105
1954	9,264	7,827	10,174	8,689	71	4.09	85	74	101	92	85
1955	10,816	7,181	11,386	9,093	80	4.10	90	82	107	96	102
1956	12,307	6,269	11,580	9,356	88	4.50	95	91	104	100	109
1957	12,845	6,475	11,384	10,530	94	4.97	98	93	93	103	114
1958	13,441	7,872	12,472	12,087	96	4.88	98	98	98	96	94
1959	15,908	6,514	12,799	12,502	109	5.36	104	109	109	101	92
1960	16,612	6,755	12,498	13,113	117	5.62	106	110	98	104	102
1961	17,839	7,997	13,527	15,207	125	5.46	108	115	95	108	111
1962	20,344	7,299	13,783	17,248	141	5.50	113	123	98	111	100
1963	22,915	6,622	14,125	19,057	157	5.48	117	129	103	112	117
1964	25,561	6,492	14,450	21,300	169	5.48	120	139	109	115	132p
1964											
March	23,691	6,961	14,272	19,566	167r	5.47	119	133	114	113	149
April	23,929	6,563	14,215	19,773	170r	...	119	134	102	111	140
May	24,126	6,493	14,199	19,813	168r	...	119	139	106	112	139
June	24,443	6,380	14,376	19,896	169r	5.46	119	137	105	114	131p
July	24,912	6,161	14,369	20,152	168r	...	119	141	113	115	121p
August	24,965	6,212	14,377	20,235	172r	...	120	143	107	118	121p
September	25,282	6,480	14,689	20,473	167r	5.51	120	137	108	121	129p
October	25,165	6,519	14,587	20,602	170r	...	121	139	111	117	132p
November	25,339	6,685	14,503	20,792	172r	...	121	150	106	113	149p
December	25,561	6,492	14,450	21,300	168r	5.48	122	142	106	115	140p
1965											
January	25,853	6,337	14,430	21,669	179	...	122	152	110	116	137p
February	26,120	6,659	14,453	21,878	176	...	123	146	109	117	142p
March	26,539	6,538	14,714	21,996	181	5.44	123	140	150p

¹ 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, U.S. Bureau of Mines; steel, U.S. Department of Commerce and American Iron and Steel Institute; nonagricultural employment, U.S. Bureau of Labor Statistics and cooperating state agencies.

² Figures as of last Wednesday in year or month. ³ Total loans, less valuation reserves, and adjusted to exclude interbank loans.

⁴ Total demand deposits less U.S. Government deposits and interbank deposits, and less cash items in process of collections. ⁵ Debits to demand deposits of individuals, partnerships, and corporations and states and political subdivisions. Debits to total deposits except interbank prior 1942.

⁶ Daily average. ⁷ Average rates on loans made in five major cities, weighted by loan size category. ⁸ Not adjusted for seasonal variation. ^{*} Banking data have been revised using updated seasonal factors. Monthly data from 1948 available on request from the Research Department of this Bank.

p—Preliminary. r—Revised.

