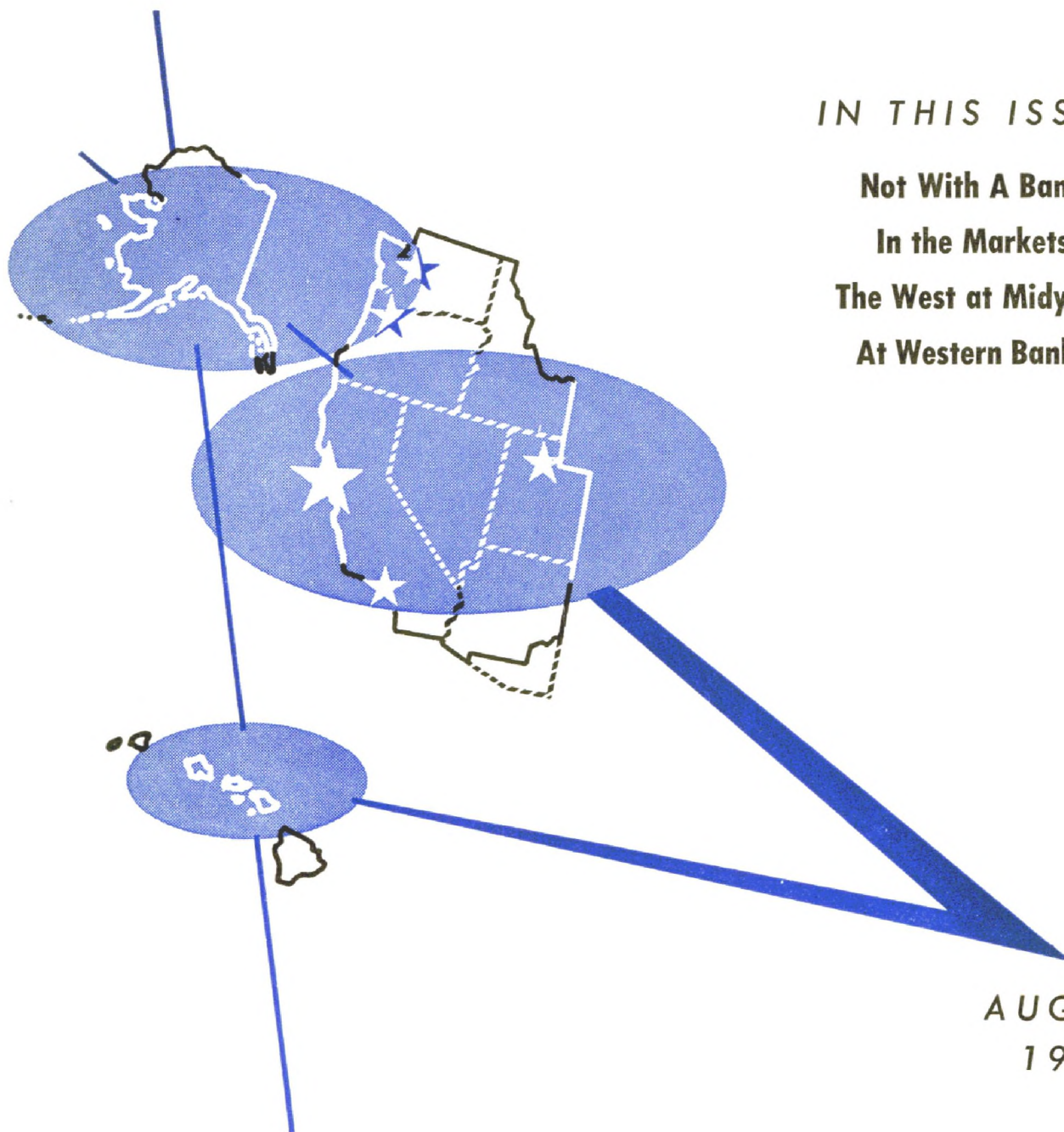


FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW

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**AUGUST
1965**

Not With A Bang . . .

. . . Despite escalation in Vietnam, some observers still foresee a possibility of the boom running out of steam.

In the Markets

. . . The spring quarter is featured by a turn of the screw of monetary policy and an ebullient business demand for credit.

The West at Midyear

. . . The region's key export industry, aerospace manufacturing, shows improvement, but unemployment still nags.

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Editor: William Burke

Not With a Bang . . .

YALE Professor James Tobin surveyed the business scene at midyear and, waxing somewhat poetic, concluded that the expansion might very well end “not with a bang but a whimper.” In line with the thinking of his former colleagues on the Council of Economic Advisers, Professor Tobin was here raising the possibility that the prolonged boom, instead of building up too much steam under pressures of excess demand, might rather be endangered by running out of steam. This thesis received some support during the second quarter, as the nation’s growth rate slowed somewhat, and it was given greater weight for many tape-watchers by the late-spring decline in the stock market. (After midyear, on the other hand, the escalating situation in Vietnam raised possibilities of another kind.)

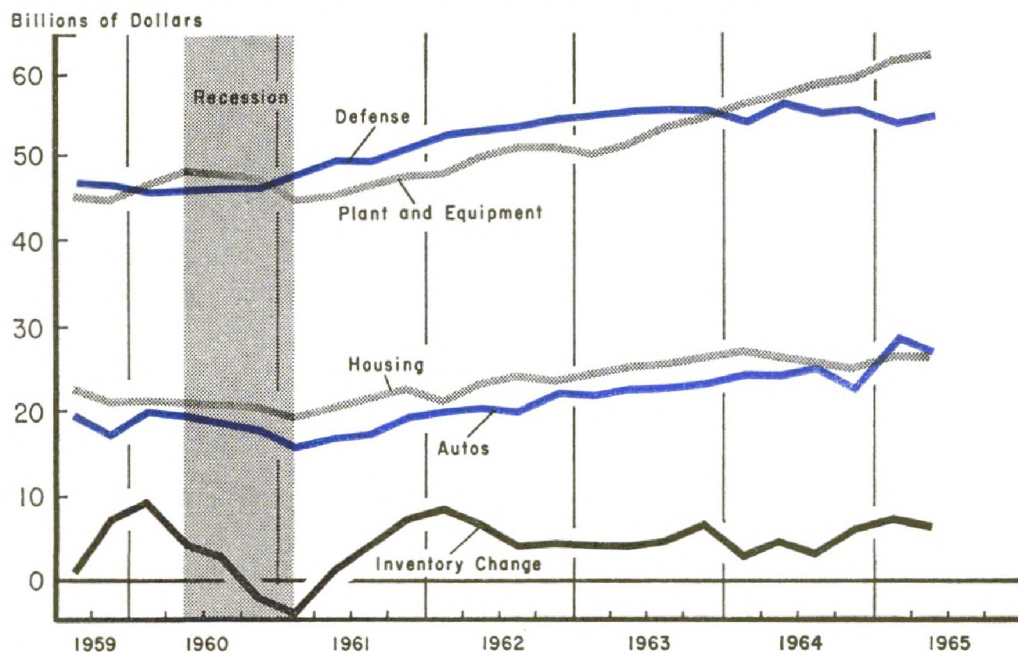
Strong growth, but . . .

The growth rate of the national economy admittedly did lag somewhat during the sec-

ond quarter, but the quarterly gain in GNP was admirable by all standards except those of the unsustainably fast-paced first quarter of 1965. The nation’s total output increased \$9 billion, to a \$658-billion annual rate, in the April-June period. This gain, although falling below the \$14-billion gain of the first quarter, approximated the average quarterly gain of prosperous 1964. Moreover, the second-quarter expansion was broadly based; consumption spending, business investment, net export spending, and expenditures at every level of government, all contributed to the increase.

The gain in personal consumption spending would have been greater except for a decline in auto purchases below the phenomenal first-quarter pace. During the spring quarter, unit sales of new domestic cars approximated 8½ million, at a seasonally adjusted annual rate. This rate fell about 10 percent below the first-quarter pace, but it exceeded the

Expansion stimulated by fixed-investment boom, plus continuing strength in autos and inventories



Source: Department of Commerce

strong 1964 sales rate by about the same margin. Again, business spending for inventories, substantial as it was during the spring quarter, would probably have been greater had the strike-hedge stockpiling of steel consumers and the post-strike rebuilding of auto dealers’ inventories not been concentrated so heavily in earlier months.

With develop-

ments of this type, the lagging growth rate showed up not only in the GNP statistics but in the production indexes as well. Industrial production by midyear was running about 3 percent above the late-1964 level, mainly on the basis of the first-half strength in electrical and non-electrical machinery. Production of consumer goods, however, declined slightly after reaching a peak in March. By way of contrast, the index rose about 5 percent in the second half of 1964, as production for all markets increased in tandem at a relatively rapid rate.

The question at midyear, then, was whether the economy's slower second-quarter pace foreshadowed a dying away of the boom or whether it simply represented a temporary readjustment of forces which would later provide the foundation for a further substantial advance. To answer the question, most analysts are now closely examining each of the several sectors which at one time or another have provided the main stimulus to the 4½-year-old expansion. These include defense spending and residential construction, which dominated the scene in the early stages of the boom, and auto spending and business fixed investment and inventory spending, which kept the expansion moving during the last several years.

Defense, business spending up?

Defense spending, which strongly supported the early stages of this business expansion but later tapered off, may again be a rising sector. (Spending in this area increased roughly 20 percent between late 1960 and mid-1962, at the time of the Berlin buildup.) Although no one knows how much might eventually be required because of the Vietnamese crisis, the \$1.7-billion supplemental appropriation request recently sent to Congress effectively removes the \$55-billion ceiling maintained on defense spending the last several years. But the projected buildup comes at a time when total Federal spend-

ing (at 10 percent of GNP) is at its lowest relative level of the past fifteen years.

Business fixed-investment spending, one of the mainstays of the more recent stages of the current expansion, is expected to exceed even the \$62-billion annual rate recorded in the second quarter of this year. This spring's survey of business spending intentions indicated a 5-percent second-half increase in new plant-equipment spending, on top of the 4-percent gain registered in the first half of 1965. The optimism revealed in the May spending survey was based partly on strong business-sales expectations for the next several years and partly on the growing belief that present capacity is inadequate to meet forthcoming demands. The continuing fixed-investment boom is also receiving support from a rising carryover of spending plans; expenditures intended for projects already underway rose to almost \$15 billion in the spring quarter, or to about double the level of two years ago.

Inventories, autos down?

Another strong support of the recent expansion, inventory spending, appears more of a questionmark for the second half of the year. Stockpiling, which began rising rapidly in late 1964 on the basis of steel and auto demand, may actually have reached its peak during the January-March quarter. (The increase in business inventories shifted from \$6.8 billion in that period to \$5.7 billion in the April-June quarter.) Inventories of steel consumers increased roughly 50 percent in the winter and spring months, or about as much as they did in the strike-anticipation periods of 1962 and 1963. Thus, with stockpiling needs essentially fulfilled, steel production dropped from about 87 percent of capacity in late April to about 81 percent of capacity in late July. At the same time, inventories of auto retailers rose to an estimated 1½ million cars by August 1.

The residential-construction sector continued as a questionmark at midyear, although spending for new housing (at a \$26-billion annual rate) was somewhat higher in the first half of the year than in late 1964. New starts and building permits stayed near dead center throughout early 1965; permits for new single-family housing held at about 700,000 annually, and multi-family permits tended to fall off from the 550,000 average of 1964. The housing market thus showed few signs of an early response to the demographic factors which are expected to support the market in the late 1960's. Moreover, it showed little indication of any further response to the relatively stable cost and ready availability of mortgage financing—a major bulwark of the housing market throughout this decade.

The auto industry meanwhile, is now testing its market to see how much momentum will carry over from its spectacular 1965 performance. Auto spending in the second quarter dropped about \$2 billion below the unsustainable \$28½-billion first-quarter rate, but the major test still lies ahead. Even Detroit's sales managers are uncertain that the 1966 models will be greeted with as much enthusiasm as the 1965's; nonetheless, the most pessimistic sales forecast now being quoted from the auto capital would have been considered wildly optimistic a year ago. Producers will soon be completing their 1965 runs, leaving retailers with stocks of perhaps 1½ million new cars in early August. This figure undoubtedly is high, but it represents only a 44-day supply at recent sales levels as compared with a 49-day supply at model-cleanup time last year. Meanwhile, automakers are looking for future strength not only to the basic factors—high consumer income, large numbers of new drivers, high scrappage rates, easy credit terms, and new-car price stability—but also to the extra sales which may be stimulated by the recent excise-tax reduction.

Steel and other prices

For some observers, the above adds up to a definite weakening of consumer and/or business demand. But to those who argue that the boom will soon run out of steam, others reply that offsetting factors—such as escalation in Vietnam—can easily spell overheating. The latter claim, in other words, that inflationary pressures of either the excess-demand variety or the wage-cost variety may begin to develop in coming months.

Consider the wage-cost side. True enough, unit labor costs in manufacturing were about 3 percent below the 1957-59 average throughout the first half of the year, reflecting a strong growth of productivity and a comparative moderation in labor-contract settlements. But manufacturers' prices have been edging up in some areas; wholesale prices of industrial commodities recently averaged about 1½ percent above mid-1964 levels, on the basis of substantial gains in prices of gas fuels, leather, and metals. (Nonferrous-metal prices have gained 12 percent over the year.) Meanwhile, the overall wholesale price index has been pushed up by a 7½-percent year-to-year gain in farm-product prices, highlighted by a 25-percent gain in livestock prices.

To reinforce the Administration's concern over prices, the Council of Economic Advisers released in May some implicit guidelines for current labor-contract negotiations in the steel industry. In its study, the Council pointed out that labor productivity in the industry increased 3 percent a year in the 1957-1964 period, and thereby implied that the steelmakers could absorb a 3-percent gain in labor costs without raising prices. The study emphasized that steel is a basic input for the economy, since changes in steel prices generally force businessmen to reconsider hundreds of other prices. Accordingly, the Council concluded, "A steel price increase is one of the two cost changes most likely to upset the general sta-

bility of industrial prices”—the other being a rise in general basic wage rates greater than gains in productivity.

Meaning of diffusion

With Administration spokesmen showing some wariness of inflationary pressures but even more wariness of pressures on the down side, they are paying increased attention to the statistical series that usually lead turns in business activity. These series anticipate future production and employment; some foreshadowing is involved, for example, when new orders are placed for machinery and equipment, when contracts are let for constructing new plant, and when investments are made in materials inventories.

In recent months the 30-odd leading series developed by the National Bureau of Economic Research have shown no definite movement, since roughly half of the series have been moving up and half have been trending down. Further information may be gained, however, by looking within some of these leading series and examining the “diffusion” of changes among their components. Diffusion indexes, which measure the breadth or scope of statistical change, express for

a given aggregate series the percentage of all industries within that series which have recorded increases over a given timespan.

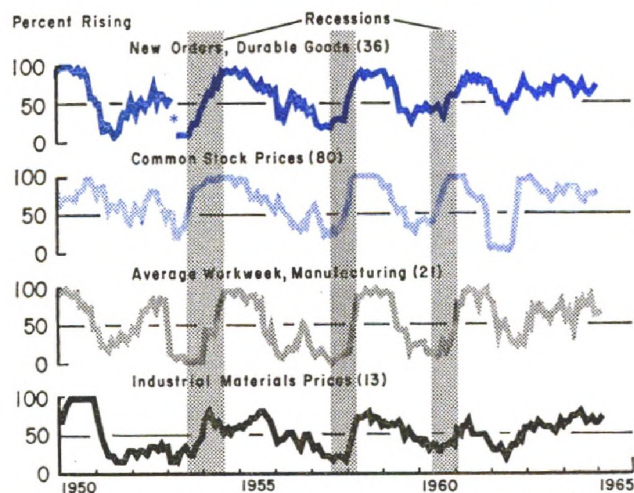
Every postwar recession has been preceded by an irregular decline of six months or so in some of the key diffusion indexes, related to new orders for durable goods, average weekly hours in manufacturing, stock market prices, industrial materials prices, and other such leading series. Since a prolonged decline of this type has not occurred in recent months, the more optimistic members of the forecasting fraternity thus see little evidence of the boom running out of steam. (They would admit, of course, that diffusion indexes should be regarded only as shorthand measures of the fundamental forces which determine economic activity.)

The means and the will

According to the recent statements of the Council of Economic Advisers, the Administration is well prepared to take appropriate action should the early warning signals foreshadow an imminent decline. In Chairman Ackley’s words, “We have the means and, I believe the will to adjust either or both sides of the budget if that should be necessary in a way which will contribute to the steady and adequate expansion of private purchasing power.” But in describing the likely direction of policy, Mr. Ackley recognized that changes in defense spending in future months could limit intended tax reductions or intended spending on domestic programs.

Administration fiscal activity at midyear took the form of a \$0.8-billion retroactive increase in social security benefits and a \$1.8-billion excise-tax reduction, the latter to be followed by a reduction of like size next January. The impact of these measures of course cannot be compared to the impact of last year’s income-tax reduction, which exerted not only a direct stimulus of about \$7½ billion in 1964 and \$9 billion in 1965 but also

Diffusion indexes support picture of broad-based business expansion



Note: Diffusion indexes show for each aggregate series the percentage of all industries within that series recording increases
Source: Bureau of the Census

Excise-tax cuts, social-security gains presage late-1965 fiscal stimulus



Source: Bureau of the Budget (national-income accounts basis)

an indirect stimulus of several times that magnitude. Even apart from the relative size of

the recent as against the earlier fiscal stimulus, doubts have arisen concerning the effectiveness of these recent fiscal measures as opposed to an across-the-board tax reduction—doubts, for example, concerning whether excise-tax cuts would be passed along to consumers in the form of lower prices.

The preliminary report of an inter-agency Administration committee, released in late July, showed that tax savings on autos and air-conditioners generally were being passed on to consumers. But early returns were mixed regarding the effectiveness of tax-*cum*-price reductions in spurring the perhaps-jaded appetites of those consumers. Not everyone agreed with the comment of one culture-conscious retailer who delightedly reported that “pianos are going like crazy.”

William Burke

In the Markets

ACTIVITY in the financial markets continued at a vigorous pace during the second quarter, as businesses, consumers, and governments (particularly at the state and local level) again increased their gross borrowings. Overall, the volume of credit demands increased during the quarter, although some shifts again occurred in the pattern of credit and financial flows. Many observers especially noted the stepped-up financing by businesses in the bond and equity markets, and the still substantial, albeit somewhat slower, increase in business borrowing from the commercial banks.

Wall Streeters in particular noted the shift in the investing public's attitude toward the stock market, where frenetic activity accompanied a 10-percent decline in the Standard and Poor index between mid-May and late June. Though much less spectacular than

1962's sharp break, the market decline, like that of three years ago, ran counter to the generally rising trend of economic activity and, not surprisingly, generated a considerable amount of comment as to its causes. One suggested factor was the June 1 speech of Federal Reserve Chairman Martin dealing with certain “disquieting similarities” between the present economic situation and that of the 1920's. Almost unnoticed by the press were those passages in the speech dealing with the many, and important, dissimilarities with the 1920's. The fact too, that the advent of the market decline preceded Chairman Martin's comments by two weeks also appeared to have escaped general notice.

Turn of the screw

Meanwhile, monetary policy assumed a somewhat firmer tone during the spring months. The level of member bank free re-

serves—a very frequently consulted barometer of the climate of policy—moved from an average of \$60 million of net free reserves to an average level of \$155 million of net borrowed reserves between the first and second quarters. The change in policy came against the backdrop of a strong demand for bank accommodation and a somewhat paradoxical decline of about 25 basis points between late-February and late-June in the market yield on 91-day Treasury bills. The policy shift, of course, actually began in February, when a package program was developed to correct the nation's balance-of-payments difficulties.

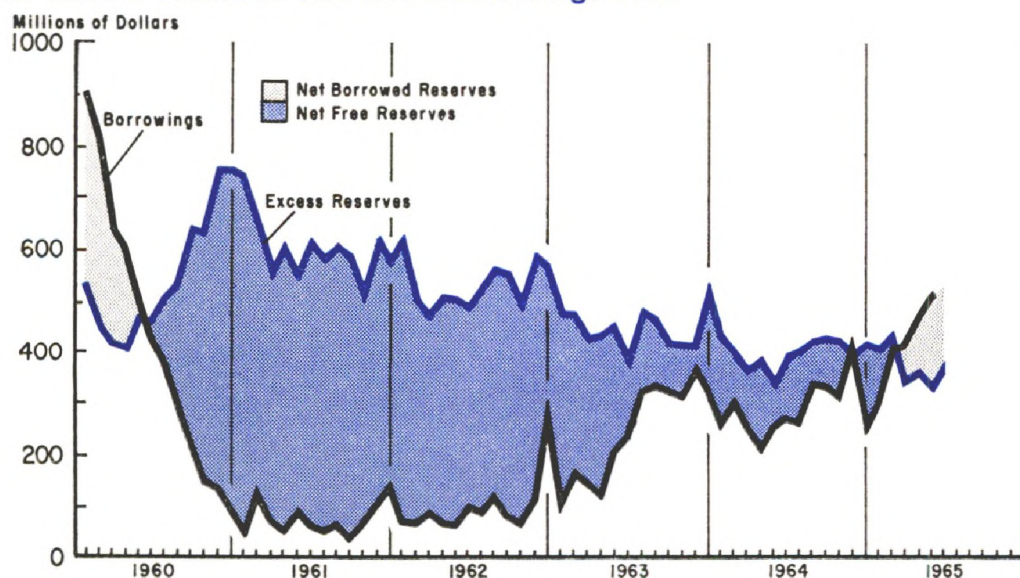
To meet the burgeoning demand for credit, member banks substantially reduced their holdings of U. S. Government securities, largely bills. Borrowings from the Reserve Banks rose by \$130 million in the second quarter, to an average level of about \$500 million; in contrast, excess reserves fell only \$40 million in the quarter, to a level of \$350 million. Thus, the member banks supported the increase in bank credit through a sell-off of Governments and through a greater recourse to the discount window.

The fall in Treasury bill yields did not extend to the remainder of the Treasury list, since the market return on coupon issues remained essentially unchanged from the beginning of the year. Long-term rates on corporate and municipal bonds came under pressure in June as the volume of new issues, together with competing Federal agency issues, coming onto the market approached record proportions. The corporate and agency issues moved into investor hands after some initial congestion, and by early July this sector of the long-term market showed increasing strength. However, the municipal market continued weaker into July, as prices were depressed by large inventories of unsold issues.

Money in the till

The modest dimensions of Treasury activity in the capital markets during the second quarter contributed substantially to the overall stability of interest rates. Although the Treasury ended fiscal 1965 with a deficit, it had reason to be pleased with its financial position. On a cash-budget basis the deficit was roughly about \$2.7 billion — a little more than half the cash deficit for fiscal year 1964, and \$1.3 billion less than had been projected as recently as last January. A \$2-billion reduction in defense outlays, which offset most of the increased expenditures in other areas, and a larger than expected volume of revenues from individual income taxes, were the principal factors contributing to the improvement — an improvement which enabled the Treas-

Banks shift to net borrowed-reserve position as excess reserves fall and borrowings soar



Source: Federal Reserve Board

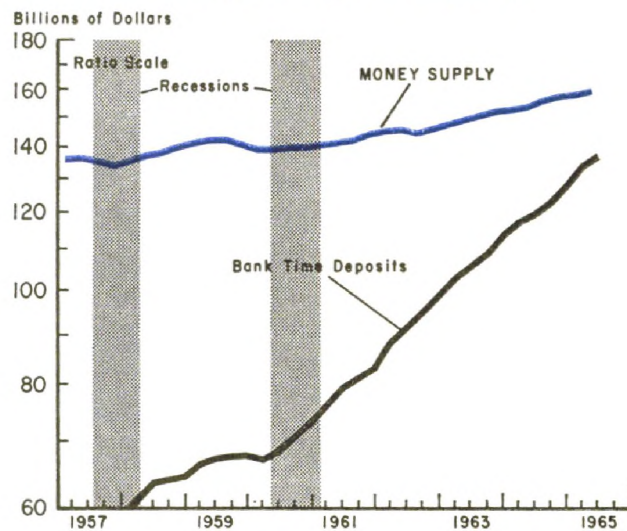
ury to start fiscal 1966 with a cash balance of nearly \$11.5 billion. This was the highest level attained by the general fund since 1946, and represented a gain of about \$1.3 billion over the Treasury's cash position at the end of June a year ago. Furthermore, the improvement was accompanied, during the first half of 1965, by a reduction of \$0.8 billion in the public debt, in contrast to a \$2.4-billion debt increase during the corresponding period a year ago. During both periods, the volume of special securities issued to Government trust accounts increased. On the other hand, public-held marketable debt declined far more rapidly this year than last, and thereby contributed to the general steadiness in yields on Treasury coupon issues and to the decline in the bill rate.

In the state and local government sector, a further rise in spending during the second quarter was again accompanied by an increase in debt offerings. Prices softened under the impact of the new issues and rising inventories in the hands of dealers. However, by cutting prices on older issues in their inventories, dealers during June made considerable headway in reducing their holdings of unsold securities (from about \$900 to \$750 million), thereby minimizing upward pressures on yields on the new issues coming onto the market. Consequently, yields on top-quality general-obligation bonds only rose a few basis points above the level prevailing throughout most of the quarter.

Private sector growth

For their part, consumers increased their borrowings to help finance a rising level of purchases, but they also increased, albeit modestly, their personal saving. Part of the saving increase took the form of increased holdings of liquid assets, although these rose at a much slower pace than during the first quarter. Part of the saving gain also took the form of stepped-up debt repayments. But in

Money supply increases slowly while time deposits grow rapidly



Source: Federal Reserve Board

this connection, a strong rise in credit extensions, bolstered by an exceptionally large increase in personal loans during April (apparently for tax purposes) and by a continued vigorous expansion in automobile credit, raised instalment debt outstanding by a solid \$2.3 billion (seasonally adjusted) during the quarter.

But it was the business sector which again accounted for the lion's share of activity in the nation's credit markets. Business demands were reflected in a continued vigorous pace of borrowing from banks, as loans rose by \$2.8 billion (seasonally adjusted), or at an 18-percent annual rate. Business demands were also reflected in a sharp rise in financing in the bond and equity markets; at \$4.5 billion, offerings for new capital, which included issues totalling somewhat over \$500 million by two New York banks, far exceeded their first-quarter volume. This development contributed to a slight increase in yields on top-quality corporate bonds, from 4.42 percent in March to 4.47 percent in June. On the other hand, the rise in business borrowings from banks was accommodated at a slightly lower average-interest cost, at least on short-term

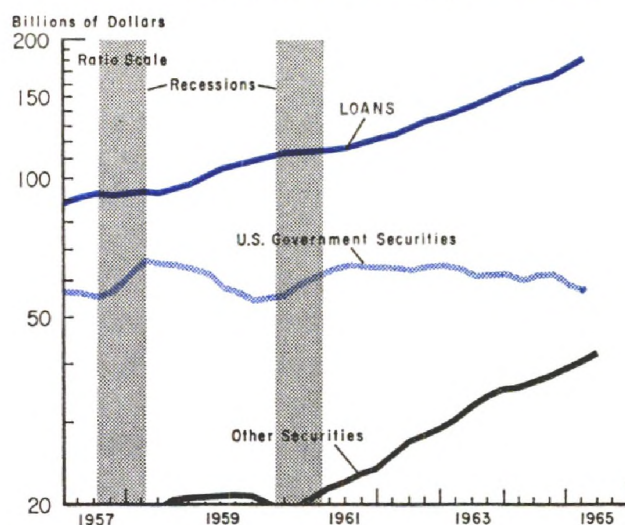
loans, although non-price terms of borrowing apparently firmed during the quarter.

The continued strength of business credit demands was understandable, in view of the continuation of inventory accumulation, the financing of current and prospective increases in fixed-investment outlays, and a growing need for working capital to support expanded operations. Some squeeze on liquidity may also have been involved, although conclusive evidence on that point is still lacking. The very sharp rise in business borrowings over the June tax date reflected the speed-up in corporate tax payments required under the terms of the Revenue Act of 1964. The second-quarter rise in borrowings was accompanied by another increase in negotiable certificates of deposit; in fact, the \$1.3-billion increase in these high-yielding certificates (most of which are held by businesses) almost equalled the first quarter's very strong gain.

Busy bankers

The nation's commercial banks again occupied a pivotal position in accommodating the nation's credit demands, as a \$6.7-billion gain in bank credit (seasonally adjusted) fell only slightly short of the first quarter's record \$8.3-billion increase. Business loans, as noted previously, again experienced a vigorous advance, despite the reduced importance of several special factors which contributed to the particularly strong first-quarter gain—factors such as the financing of goods held up in transit during the dock strike, and the financing of inventory accumulation in anticipation of a steel strike. Similarly, net disbursements under long-term bank loans to foreigners, which exceeded \$450 million during the first quarter, shifted to net repayments of over \$130 million in April and May, as the credit-restraint program adopted to cope with the balance-of-payments problem began to take hold. Nevertheless, 16 of 18 major industry groups increased their bank borrow-

Banks support boom by expanding loan and municipal security portfolios



Source: Federal Reserve Board

ings during the second quarter, amply testifying to the breadth as well as to the depth of business loan demand.

Demands for bank credit from other sectors of the economy also continued strong. Real estate loans, with an increase of \$1 billion, maintained their strong pace of the past year, and thereby indicated a continued willingness on the part of the banks to compete aggressively with other lending institutions for a larger share of a more slowly growing supply of mortgages. Consumer loans, with a gain of over \$1 billion, slightly exceeded their first-quarter increase and considerably surpassed their average quarterly gain of the 1962-64 period.

Portfolios of "other securities" (including tax-exempt issues) recorded a particularly sharp \$2-billion rise, and gave further evidence of the banks' desire to place a substantial portion of their loanable funds in state- and local-government debt issues. But in the second as in the first quarter, the banks helped finance the growth in their loans and other securities by a fairly substantial \$2-billion liquidation of U. S. Government securities. This action reduced one traditional measure

of liquidity, the ratio of portfolios of U. S. Government securities maturing within one year to deposits, to a cyclical low. Similarly, another (inverse) measure of bank liquidity, the ratio of bank loans to deposits, reached its highest level of the post-war era.

Total bank deposits, with a \$7.3-billion increase, grew more slowly than in the first quarter, and the deposit mix also shifted somewhat. U. S. Government deposits rose

by \$2.6 billion as a reflection of the rising levels of tax revenues. But a \$3.1-billion growth in time and saving deposits was only about half the size of the first-quarter gain. (On the other hand, commercial banks—unlike their principal competitors—recorded a larger gain than in the year-ago period.) Private demand deposits at the commercial banks meanwhile increased \$1.6 billion, although the increase was centered in June.

Verle Johnston and Herbert Runyon

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.

The West at Midyear

THE WEST, like the rest of the nation, recorded a slower growth rate in the second quarter of 1965 than it did earlier in the year. Here as elsewhere, nonfarm employment increased roughly ½ percent in the April-June period, as compared with a 1-percent gain in the preceding quarter. At the same time, the unemployment rate rose slightly in Twelfth District states, while continuing to decline elsewhere in the nation.

Unemployment thus has remained a nagging problem in the West—at least in California—even in the face of a sustained cyclical expansion. In the first two quarters of the year, the unemployment rate in California averaged 5.9 percent—close to the average of the 1963-64 period. By way of contrast, the jobless rate in other District states declined from 5.4 to 5.0 percent between 1964 and the first half of 1965, and the jobless rate elsewhere in the nation dropped from 5.1 to 4.7 percent in the same period.

Aerospace off the ground?

By midyear, nonetheless, some improvement was visible in the region's key export industry, aerospace manufacturing—the industry which had been largely responsible for the unsatisfactory growth rate of the past two years. District aerospace firms during the second quarter increased their employment to about 550,000. This increase, although only a slight advance over the first-quarter level, represented the first quarter-to-quarter gain since employment peaked at 640,000 in late 1962. Much of the improvement was due to increased orders for commercial jet production at California and Washington firms.

Hopes for a continued rise in aerospace employment increased, meanwhile, because of recent significant gains in defense and space agency contract awards. In the April-June

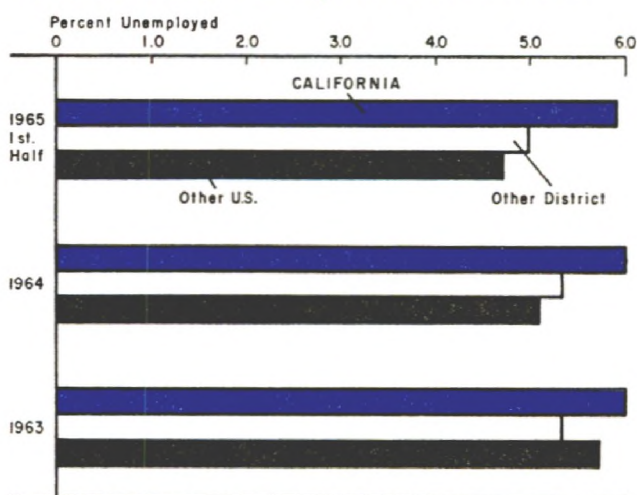
period, for example, District firms received \$1.6 billion in defense procurement awards, as compared with a \$1.3-billion total in the year-ago period. And the supplemental appropriation request sent to Congress in early August suggested even further gains, although increased spending for helicopters, fighter aircraft, and other conventional weapons may be offset by cutbacks in spending for extra-terrestrial vehicles.

Construction mixed

The District's construction industry presented a mixed picture during the second quarter. Contract awards, at \$2.2 billion, were 8 percent below the first-quarter level, but most of the decline could be traced to a drop-off from early 1965's unsustainably high level of heavy construction. Residential construction awards were relatively stable during the April-June period, and nonresidential building continued strongly upwards.

Housing starts, during the second as during the first quarter, held stable at about a 310,000 annual average. But the number of residential building permits trended down-

Unemployment rate remains high in California, but improves elsewhere



Source: State reporting agencies

wards during the quarter; although this did not necessarily portend a further decline in construction volume, it threw a dash of cold water on hopes for a bounceback to early-1964 housing levels.

Nonresidential building, meanwhile, increased by 10 percent over the first-quarter figure. Store awards were up sharply, just as in the rest of the nation. But industrial awards, which have supplied much of the steam behind the national construction boom, rose only modestly in the West, and educational building also lagged the national pace.

Around midyear, construction work at California sites was disrupted by a number of labor contract disputes. The longest and most extensive strikes were called by painters in Northern California and by operating engineers in Southern California. Settlements to date have resulted in fairly substantial increases in wages and fringe benefits.

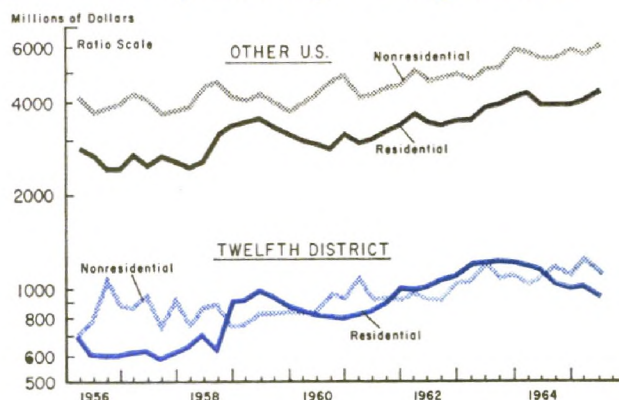
Rising farm prices

The District farm sector reported significant gains in receipts throughout the first half of the year. Crop and livestock marketings both rose, and thereby contributed to a 3-percent year-to-year gain in receipts—a gain in line with the national increase.

Farmers found their price situation quite favorable at midyear. Almost without exception, commercial vegetable producers reported considerably higher prices in June than in last year's marketing season, and meat and poultry producers also reported higher prices. Wheat prices trended downwards, however, because of a change in the technique for supporting wheat prices.

The biggest price news came from the livestock sector. Prices received by District farmers, particularly for meat animals, strengthened considerably during the second quarter. The prices received for fed beef advanced somewhat more than the cost of animals entering feedlots, and this increase in price

Western construction activity sags because of year-long housing decline



Source: F. W. Dodge

spread contributed to a rapid increase in the number of cattle on feed. At midyear, a record number of cattle were being fattened in Western feedlots for this time of the year.

On the other hand, crop production prospects were somewhat weaker at midyear. Crop production in 1965, according to the midyear report of the U. S. Department of Agriculture, should fall below 1964 levels. The wheat crop may increase, but cotton output should decline. Deciduous fruit production should drop as a result of last winter's freeze in important producing areas, and tomato production may fall off substantially.

The labor supply in California was reported generally adequate at midyear, after six months of experience with rigid restrictions on the use of alien farm labor. In the latter part of June, only about 1,500 foreign workers were working on California farms, primarily in the strawberry and asparagus fields. By way of contrast, about 36,000 of these braceros were employed at the same stage of the growing season last year. Nonetheless, the major test of the adequacy of supply of domestic labor is yet to come. The seasonal peak in farm-labor requirements should occur in early September, and a potential shortage at that time could be accentuated by the return to school of the young seasonal workers who have been employed this summer.

Materials producers gain

Western lumber producers reported disappointing results in the spring quarter. Despite good construction weather in most major markets, a hoped-for upsurge in orders failed to materialize and prices remained relatively low. Soft spots in the lumber market centered along the East Coast, where heavy inventories continued to retard new business, and in the Los Angeles area, where a severe decline in apartment building depressed demand. In addition, a shortage of railroad cars seriously interrupted shipping schedules to all destinations. After midyear, however, lumber and plywood markets strengthened considerably, on the basis of Government and construction demand.

Western steel mills turned out a record amount of steel during the second quarter. Output continued strong, even after the May 1 postponement of a nationwide steel-strike deadline took some of the frantic pressure off the market. The District industry's performance was based primarily on the West's strong pace of heavy construction and to a much smaller degree on the type of inventory accumulation that has stimulated production elsewhere. Western mills thus do not anticipate severe declines in stockpile demand, such as may face other mills in the event of a prompt settlement of steel labor negotiations.

The District's aluminum industry also reported a high level of demand in the April-June period. Major aluminum companies in mid-May posted increases of from 2 to 3 cents a pound on prices of soft alloy extrusions, and producers then raised prices 1 cent a pound on most fabricated products immediately after a new labor contract was signed at the end of that month. The industry appears confident of its ability to make these price increases stick—unlike last year, when announced increases were rendered ineffective

by competitive pressures arising from excess capacity conditions.

Other metal markets also remained very strong during the spring quarter. Pressures on copper prices, which were reflected in early May's 2-cent increase (to 36 cents a pound) in refined copper prices, were subsequently relieved by the release of 100,000 tons from Government copper stockpiles. The sale brought about a sharp reduction in premium prices on the dealer and exchange markets, but the producer price remained firm. The 75,000 tons of zinc released from Government stockpiles also found ready purchasers, but consumers purchased only one-third of the 60,000 tons of lead offered at the same time. Western silver producers, meanwhile, lamented the fact that a run-up in silver prices was practically precluded by the Government's action in reducing the use of silver in the nation's coinage.

A reversal of the downward trend in Western crude-oil output appears assured this year because of a combination of more intensive secondary recovery efforts and of increased supplies from new fields. Since heavier domestic supplies are now anticipated, licensed import quotas for the second half of 1965 have been reduced by 67,000 barrels per day from the first-half quota. Meanwhile, Western refiners are spending substantial sums for new facilities and for the modification of existing facilities, in response to the continued growth in overall demand for petroleum products and to the rapidly changing structure of demand for such products. Industry sources estimate the value of construction projects now underway at California refineries at \$365 million, considerably above the year-ago figure.

Underpinning for retailers

In general, Western farmers, miners, and other primary producers benefited strongly from the cyclically expanding demand for

materials during the first half of the year. At the same time, the crucial aerospace and housing industries saw some signs of an end to the recent softness in their markets.

The resultant increase in employment and income provided the underpinning for continued gains in retail sales throughout the District. Overall, sales during the spring quar-

ter rose about 7 percent above the levels prevailing during the tax-cut period of last spring. Some retailers reported declines, however. In particular, apparel stores and furniture-appliance stores both suffered sales decreases of at least 5 percent below year-ago levels. But auto dealers, here as elsewhere, recorded a substantial (16 percent) year-to-year gain in sales.

—Regional Staff

At Western Banks

THE STRONG demand for credit which characterized the national banking scene during the second quarter was much less evident at the regional level. In fact, a \$506-million loan increase at Twelfth District member banks was little more than half as great as the contra-seasonal rise recorded in the first quarter of 1965, while nationally, the second-quarter increase almost matched the record first-quarter gain. On the other hand, District banks invested in municipal and Federal Agency securities at more than double the national rate, as they had during the first three months of the year. Consequently, an \$852-million net investment in "other" securities in the first six months of 1965 more than offset a \$482-million reduction in holdings of U. S. Government securities (all series seasonally adjusted).

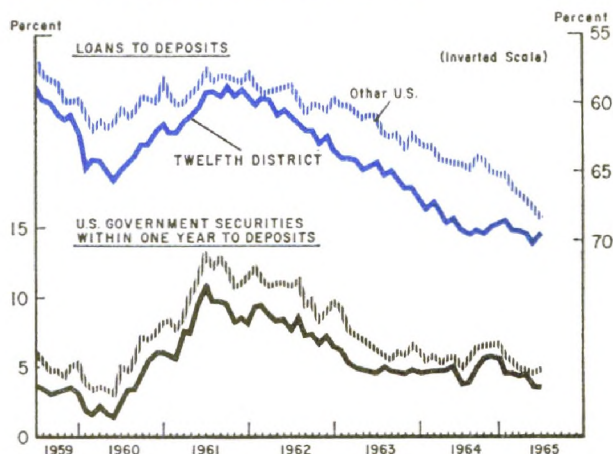
Although District banks displayed less credit growth than other banks, they remained in a tighter liquidity position than banks nationally, as measured by either the ratio of loans to deposits or the ratio of short-term Governments to deposits. Thus, District banks may simply have had less flexibility than other banks in expanding their loan portfolios.

After posting a \$264-million increase in demand deposits adjusted in the first quarter of the year, District banks gained only \$95 million more in such deposits in the suc-

ceeding three-month period. In the time-and-savings category, the \$496-million second-quarter increase was about 25 percent smaller than the inflow recorded in the first quarter, when the higher interest rates paid on such deposits had their greatest initial impact.

For each of these deposit categories, the total first-half increase was somewhat greater than the gain recorded in January-June 1964. Nonetheless, the composition of interest-bearing deposits shifted somewhat between these two periods. Savings deposits increased twice as fast in the first half of 1965 than in the comparable period of 1964, but negotiable time certificates of deposit grew only half as fast as in the earlier period. Since February,

Liquidity positions remain tight, especially for District banks



Source: Federal Reserve Board; Federal Reserve Bank of San Francisco

District banks have not competed aggressively with New York banks for large-denomination CD's. But the large New York banks which have recently increased their capital stock may now become less interested in issuing CD's and may thus remove some of the upward pressure on rates. In that case, District banks might assume a more prominent role in the market.

Business dominates demand

In line with the early-1965 pattern, the business sector accounted for almost half the second-quarter loan expansion. But the \$300-million gain¹ in business borrowing at District weekly reporting member banks fell somewhat short of the increase recorded in the comparable period of 1964, despite heavy mid-June tax borrowing by corporations with increased liabilities under the stepped-up corporate tax schedule. The District business loan gain also fell short of the increase recorded at weekly reporting banks elsewhere, primarily because of the very strong business demand for credit at the New York money market banks.

District business borrowing was widely based during the April-June quarter, just as in the rest of the nation. Public utilities accounted for the largest proportion of total borrowing, reversing their first-quarter pattern of net repayments. Meanwhile, petroleum industry borrowing continued heavier than last year, reflecting the very large 1965 construction program of California refineries. Food, liquor, and tobacco processors made large net repayments in the second quarter, partly because repayments normally made earlier in the year were limited by the first-quarter dock strike. Bankers acceptances, also influenced by the dock strike, showed a decline in the April-June period. But other major borrowing categories were on the plus side.

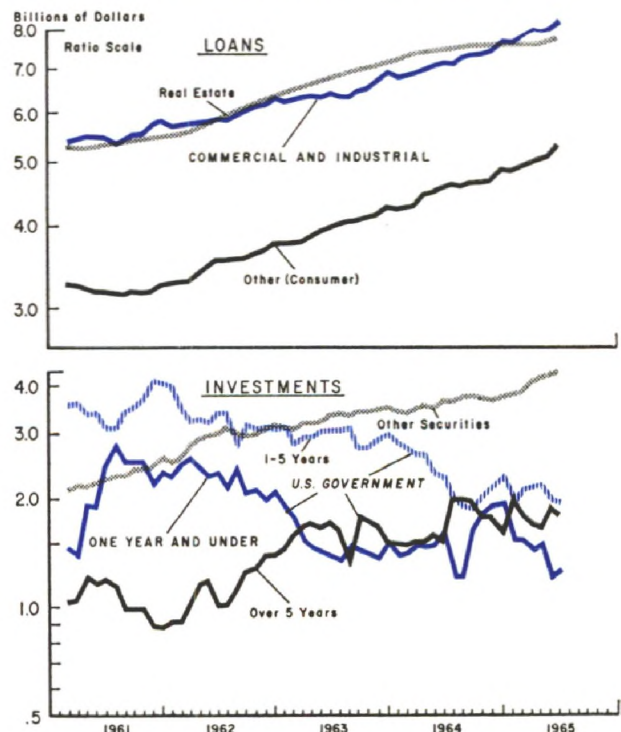
¹Data for weekly reporting member banks are not seasonally adjusted.

While loans continued to expand, the cost of short-term business borrowing dropped 6 basis points below the first-quarter average to 5.05 percent in the early-June survey period. The decline in average interest cost was due to an increase in the dollar volume of loans made at the 4½-percent rate available to borrowers with prime credit ratings. But rates on smaller loan-size categories (under \$500,000) were higher in June than in other recent survey periods. In addition, the spread continued to widen between the average rate paid by borrowers with formal or informal lines of credit and borrowers without established credit lines. Thus, the survey results partially supported other evidence regarding the firming of price and non-price terms of lending in recent months.

Other shifts in assets

In the first half of 1965, mortgage portfolios of District weekly reporting banks fell

Business, consumer loans increase along with municipal security holdings



Source: 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 6/30/65	Second Quarter Dollars	Net change 1965 Percent	2nd Qtr. 1964 Percent	Outstanding 6/30/65	Net change 1965 Percent	2nd Qtr. 1964 Percent
ASSETS							
Loans adjusted and investments ¹	\$33,431	+ 781	+ 2.39	+ 2.71	\$125,007	+ 4.77	+ 3.26
Loans adjusted ¹	24,087	+ 674	+ 2.88	+ 4.13	86,839	+ 6.68	+ 4.44
Commercial and industrial loans	8,154	+ 300	+ 3.82	+ 5.16	38,690	+ 5.23	+ 0.40
Real estate loans	7,712	+ 143	+ 1.89	+ 1.63	13,437	+ 5.33	+ 4.08
Agricultural loans	1,048	+ 48	+ 4.80	+ 8.76	558	+ 2.95	- 1.75
Loans to nonbank financial institutions	1,634	+ 83	+ 5.35	+ 4.62	8,197	+ 11.58	+ 9.48
Loans for purchasing & carrying securities	435	- 76	- 14.87	- 4.66	6,983	+ 17.60	+ 15.73
Loans to foreign banks	320	- 10	- 3.03	+ 4.56	1,257	+ 1.05	+ 11.26
Other loans (mainly consumer)	5,190	+ 202	+ 4.05	+ 6.25	19,617	+ 4.81	+ 5.88
Total Securities	9,344	+ 107	+ 1.16	- 0.57	38,168	+ 0.67	+ 1.02
U. S. Government securities	4,880	- 296	- 5.72	- 3.27	19,374	- 2.10	- 0.31
Other securities	4,464	+ 403	+ 9.92	+ 3.71	18,794	+ 3.70	+ 2.79
LIABILITIES							
Demand deposits adjusted	12,215	- 128	- 1.04	- 0.97	51,592	+ 1.04	+ 0.50
Total time and savings deposits	19,968	+ 572	+ 2.95	+ 1.92	53,848	+ 4.07	+ 3.02
Savings	14,458	+ 137	+ 0.96	- 0.08	28,669	+ 2.38	+ 1.42
Other time	5,510	+ 435	+ 8.57	+ 8.58	25,179	+ 6.05	+ 5.19

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 March 31, 1965 - June 30, 1965 and from April 1, 1964 - July 1, 1964. Source: Board of Governors of the Federal Reserve System; Federal Reserve Bank of San Francisco.

below their outstanding business loans for the first time since mid-1962. Nonetheless, the second quarter witnessed a reversal of the recent deceleration in the rate of expansion of mortgage loans. Real estate loans rose \$143 million during the quarter, after increasing only nominally in the first three months of the year. Thus, the heavy time-deposit inflow of early 1965 apparently has triggered renewed interest in mortgage financing on the part of District banks. And since the ratio of real estate loans to savings deposits at midyear—53 percent—was lower than the year-ago figure, District banks may have room for further expansion of their mortgage holdings, despite the continued aggressive competition for mortgages from nonbank institutions.

District consumers continued to rely heavily on bank credit to finance the endless stream of cars moving from the assembly lines to the highways, and thus they helped to accelerate the already fast pace of consumer lending dur-

ing the spring quarter. (Throughout the year to date, auto financing has accounted for just about 50 percent of extensions of consumer credit.) The total first-half increase in consumer loans was nearly double the gain for January-June 1964.

Non-bank financial institutions increased their debt at District banks by \$83 million during the second quarter. Sales finance companies borrowed heavily during the two weeks preceding the June tax date, and then, following the usual pattern, made large repayments in the following weeks.

Average borrowings by brokers and dealers were higher during the second quarter than in any other quarter of the current business expansion. In recent months District banks financed a significant proportion of their loans to Government securities dealers by purchasing Federal funds (member-bank excess reserves on deposit with the Federal Reserve) from other banks and reselling those funds to

dealers, so as to take advantage of the higher dealer buy rates. Increased time-deposit interest costs have made banks particularly alert to situations of this type, with their possibilities for arbitrage.

Discounting increases

Twelfth District banks operated under greater reserve pressure during the second quarter, as did their counterparts in the rest of the nation. Borrowings at the Federal Reserve discount window were \$63 million on a daily average basis, compared with \$14 million during the first quarter of the year. And along with the increase in the dollar volume of borrowing went an increase in the number of banks resorting to the discount window. Discounts exceeded excess reserves on a daily average basis throughout the quarter; the result was net average borrowed reserves of \$37 million for the April-June period, in contrast to net free reserves of \$17 million during the preceding quarter.

In addition, District banks were net pur-

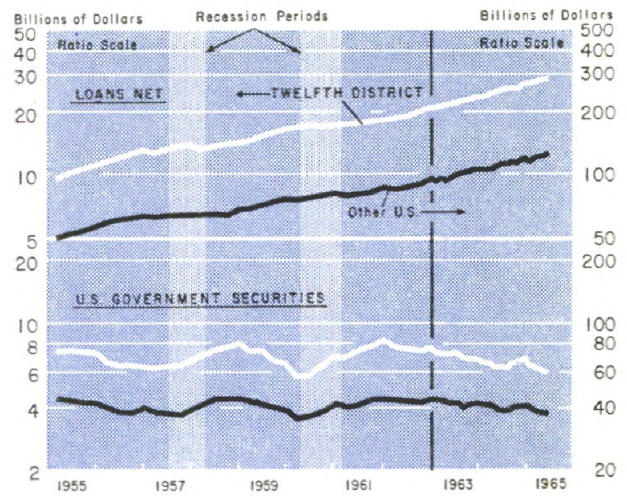
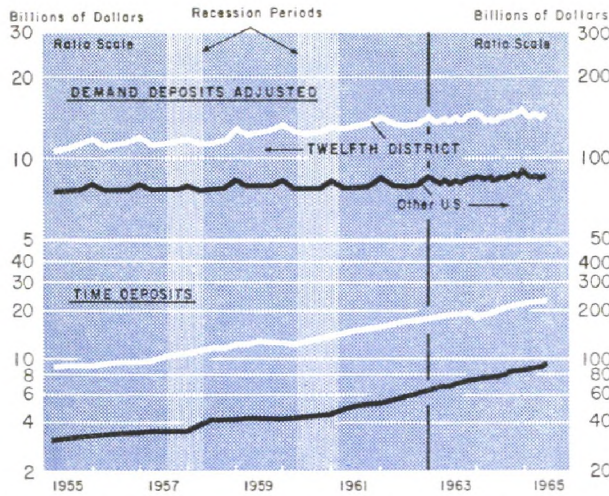
chasers of Federal funds on interbank transactions, except for the first three weeks in April. However, some of the more active net-purchase banks in the interbank Federal funds market were not using these funds to bolster their reserve position but, rather, were reselling the funds to Government securities dealers at higher rates. As indicated above, such arbitraging activity intensified during recent months.

At midyear, District banks generally were lagging behind the gains in earnings reported by banks elsewhere in the country. Moreover, net earnings per share at many major District banks were generally lower than in the first half of 1964, despite wide variation among individual banks. But, on a more optimistic note, earnings improved between the first and second quarters, as the initial effects of higher interest costs on time and savings deposits were offset by earnings from expanding loan volume and increased investment in tax-exempt securities.

—*Ruth Wilson*

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Single and group subscriptions to the *Monthly Review* are available on request from the Administrative Service Department, Federal Reserve Bank of San Francisco, 400 Sansome Street, San Francisco, California 94120.

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 or 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 ⁸ Petroleum	Steel ⁸
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	132 _p
1964											
May	24,126	6,493	14,199	19,813	168 _r	...	119	139	106	112	139
June	24,443	6,380	14,376	19,896	169 _r	5.46	119	137	105	114	131
July	24,912	6,161	14,369	20,152	168 _r	...	119	141	113	115	121 _p
August	24,965	6,212	14,377	20,235	172 _r	...	120	143	107	118	121 _p
September	25,282	6,480	14,689	20,473	167 _r	5.51	120	137	108	121	129 _p
October	25,165	6,519	14,587	20,602	170 _r	...	121	139	111	117	132 _p
November	25,339	6,685	14,503	20,792	172 _r	...	121	150	106	113	149 _p
December	25,561	6,492	14,450	21,300	168 _r	5.48	122	142	106	115	140 _p
1965											
January	25,853	6,337	14,430	21,669	179	...	122	151	110	116	137 _p
February	26,120	6,659	14,453	21,878	176	...	123	146	109	117	142 _p
March	26,539	6,538	14,714	21,996	181	5.44	123	140	119	119	150 _p
April	26,525	6,212	14,405	22,184	180	...	123	134	101	120	149 _p
May	26,755	6,183	14,365	22,211	182	...	124	146	103	122	147 _p
June	27,059	6,010	14,832	22,492	168	5.46	124	147 _p

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.

