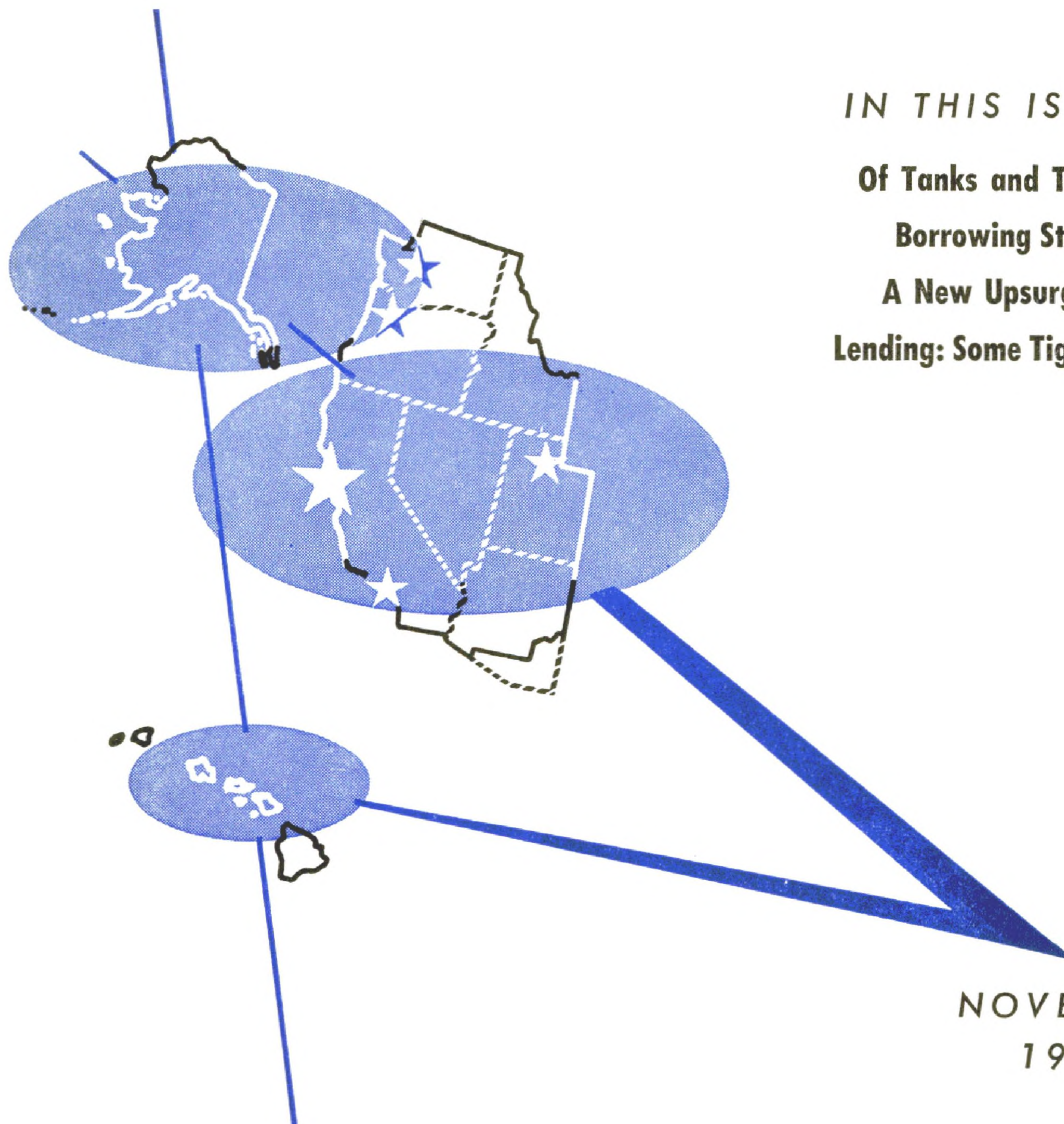
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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NOVEMBER
1965

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Of Tanks and Taxes

... The economy weathers a steel-inventory cutback while wondering about the effects of last year's tax cut and this year's Vietnam.

Borrowing Still

... Monetary policy remains firm, and interest rates edge upward, as borrowers expand their credit demands.

A New Upsurge?

... More jobs develop in the West's aerospace industry, but joblessness continues to cloud the regional outlook.

Lending: Some Tightness

... Western financial activity continues strong, and liquidity tightens, despite a slowdown in the rate of growth of loan portfolios.

Editor: William Burke

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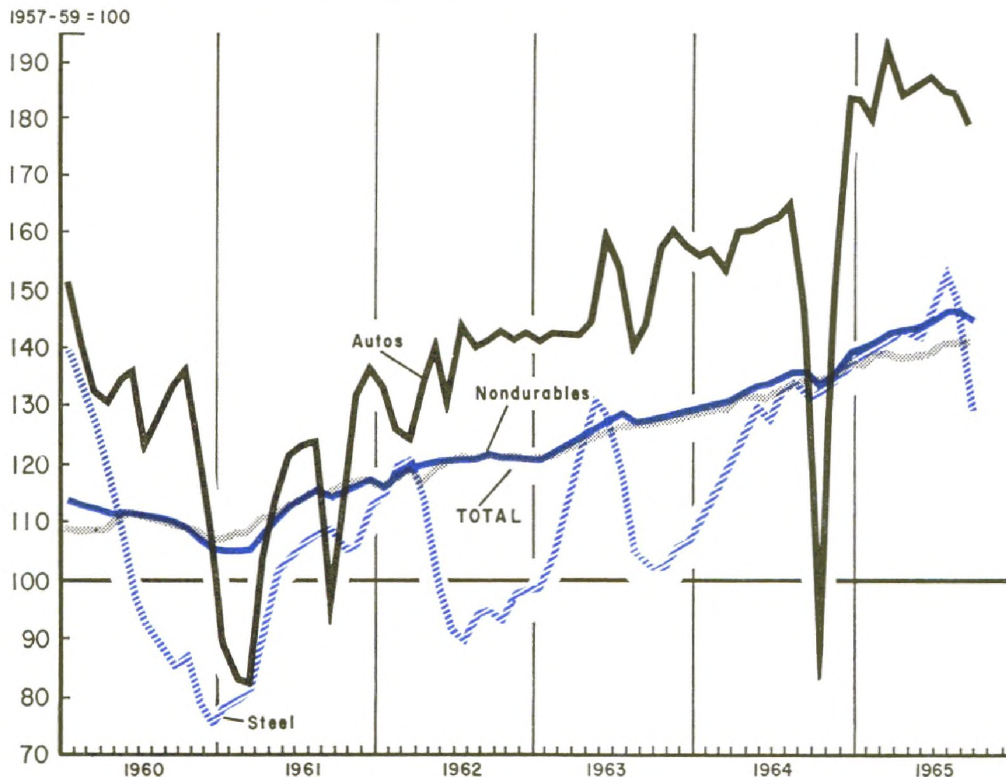
Of Tanks and Taxes

In mid-1965, a year after the tax cut redrew the configurations of the prolonged business expansion, the war in Vietnam added some new and different features to the picture. Now, as the year approaches its end, the effects of more tanks and fewer taxes can begin to be evaluated. Vice-President Humphrey, while discussing the outlook with the Business Council, argued that the amount of spending required for Vietnam could be provided "without inflationary strain or the curtailment of essential domestic programs". Other observers might disagree; nonetheless, the fact remains that the national economy, after acquiring a strong second wind through the medium of the tax cut, must now be prepared to handle a new burst of speed.

Evidences of both the defense-spending stimulus and the tax-cut stimulus were visible in the mid-summer and early-fall statistics. Thus, gross national product rose to $677 billion (seasonally adjusted annual rate) in the third quarter, on the heels of another of the $10-billion-plus quarterly gains that have become so characteristic of this expansion.

Third-quarter data showed the usual upsurge in consumers' spending for food, for services, and (through their state and local governments) for education, health, and other public facilities. But, in addition, Vietnam pushed defense spending up to about a $51-billion annual rate—the highest level reached in over a year. Business fixed-investment spending, at a $68-billion rate, and consumer durable-goods spending, at a $65-billion rate, were both about one-third higher than they were two short years ago. Both sectors reflected the continuing effects of last year's tax cut. In fact, if that stimulus had been lacking (according to the Council of Economic Advisers) GNP during the summer months would have been closer to $650 billion than to the $677 billion actually achieved.

Steel decline pulls down industrial production, but auto industry continues to boom



Source: Board of Governors of the Federal Reserve System

Steel: too much?

But recent statistics also reflected the impact of the problem created by the long-drawn-out steel-contract negotiations. The Federal Reserve industrial-production index slid off one percent from the July-

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August peak to reach 143 percent of the 1957-59 average in September. The decline reflected mostly a cutback in steel output, but it also encompassed strike-inflicted curtailments in aircraft, autos, newspapers, and coal.

After the signing of a new steel contract in early September, steel users slashed their purchases, cancelled some orders, and asked mills to postpone deliveries of sizable tonnages scheduled for October and November delivery. Thus, the scene was reminiscent of 1962 and 1963, when contract agreements were followed by four-month-long adjustments involving production cutbacks of one-fourth or more. By mid-October, steel production was roughly one-fifth below the peak reached last April, and further declines were expected throughout the industry.

Inventories were quite substantial at the time when the contract was finally inked this year. At the end of August, steel consumers had a 60-day supply on hand, as against a 40-day supply when the strike-hedge buildup began last fall. On the other hand, steel consumption remained buoyant throughout the summer and early fall months. After all, business plant-equipment spending was still on the rise, a high rate of auto production was scheduled by Detroit, and increased steel usage in defense products appeared certain.

Budget: how expansionary?

At this stage, too, the Federal budget has begun to feel the impact of increased spending for tanks, helicopters, and the men to use them. Although exact spending figures will not be available until the fiscal-1967 budget is published in January, most observers seem to be thinking in terms of a $5-billion increase in defense spending by mid-1966. (According to Chairman Ackley of the Council of Economic Advisers, the sometimes quoted-figures of a $10-14 billion increase "can at this point only be pure figments of someone's imagination".)

New funds will be needed, not only for weapons procurement, but also for about 340,000 more troops (and perhaps 40,000 more civilian workers), as well as for combat pay and a military pay increase. Incidentally, the 340,000-man buildup scheduled over the next year (to a 3-million total) would roughly equal the buildup that occurred during the Berlin crisis of 1961-62.

Yet much more than Vietnam is involved in the generally expansionary impact which the Administration believes the Federal budget will exert during the present fiscal year. Several recent changes—excise-tax cuts, social-security benefit increases, and the final effects of the 1964 tax cut—should provide a gross stimulus of $6-6½ billion within the year, but this stimulus should be partly reduced by the $2½-billion increase in social-security payroll taxes scheduled to take effect in January. The net stimulus from these sources (roughly $3½-4 billion) would offset roughly half of the normal increase in revenues expected from the growth of the national economy, while the anticipated expansion of defense and other Federal spending should more than offset the rest of our normal revenue growth. The overall effect for the entire fiscal year would be expansionary, although it should be remembered that much of the net stimulus has already occurred.

Business: still building

Meanwhile, the massive tax reduction of a year ago, along with earlier tax revisions, has continued to provide some steam for that major expansionary force—the capital-goods boom. For several years now, continued large increases in business savings (stimulated by tax changes) have been accompanied by continued large increases in fixed investment. Indeed, the rise in business savings in the first half of 1965 was the largest semiannual gain of the past decade, and the concomitant increase in fixed-investment spending was larger

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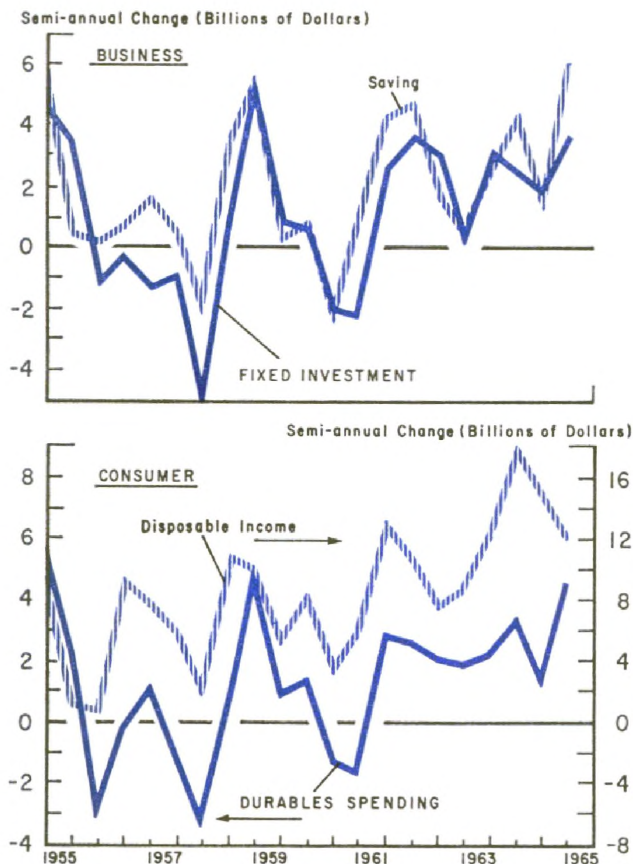
Business and consumer spending jump in response to tax-cut income boost



Source: U.S. Department of Commerce

than in any other period except the post-recession periods of early 1955 and early 1959.

Over the years, total spending for plant and equipment has outpaced by a wide margin the dollar amounts set aside in the form of after-tax profits and depreciation allowances. But these business savings have risen so rapidly that by early 1965 they almost matched the plant-equipment spending total.

Some observers envision a tapering off of the capital-spending boom, which has encompassed a 60-percent gain in spending over the past four years, because of the fear that new plants are now coming on stream faster than the demand for their products is likely to grow. But, although investment spending increased its share of GNP from 9.3 percent in the 1958-1963 period, to 9.6 percent last year, and to 10 percent today, business spending plans still remain quite buoyant.

According to the latest Commerce-S.E.C. survey, plant-equipment spending in 1965 should end up 13½ percent above the already high 1964 level. And 1966 may begin on an even stronger note, in view of the factors that were not reflected in this latest survey—especially the impact on capital-goods demand of the increased procurement of military supplies and equipment. Then again, the current size of investment backlogs also suggests that the boom will continue into 1966. At midyear, for manufacturing firms alone, the ratio of the carryover of projects underway to the current level of investment expenditures was the equivalent of 2.8 quarters, up from 1.9 quarters at the end of 1962. In dollar terms, the rise in backlogs was from $7.2 billion to $15.8 billion.

Consumers: still buying

Last year's massive tax reduction has meanwhile continued to provide the underpinning for another major source of recent strength—the consumer durable-goods boom. Continued large increases in disposable income, attributable in large part to the 1964 tax reduction, have been accompanied by continued large increases in consumer durable spending. The increase in durable goods spending for the first half of this year was a whopping $4.6 billion—a far larger gain than in any other recent period except the post-recession periods of 1955 and 1959.

Auto spending, of course, has been a major element in the 1965 boom, especially with the aid of a summer car buying upsurge which paralleled the spending boom of last winter. And now, at model-introduction time, as Detroit's showrooms become crowded with entertainers doing the Watusi and salesmen doing the hard sell, the industry's sales managers are forecasting another 9-million-unit sales year.

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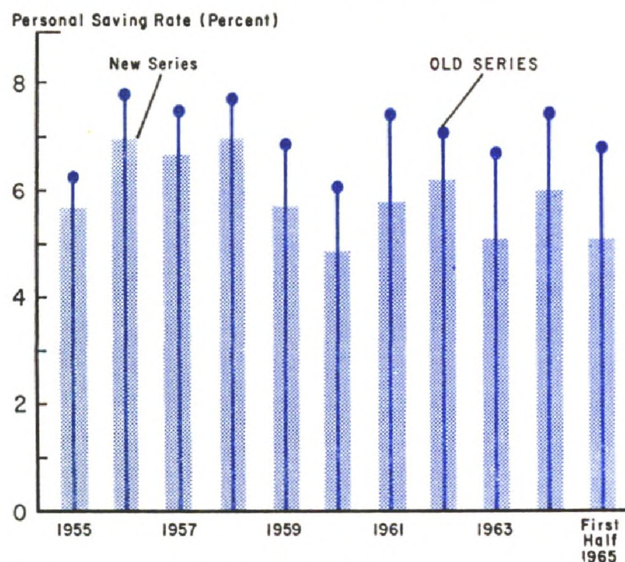
Industry leaders realize that the 1965 model-year sales figure, which was about 10 percent above the preceding year's record, was achieved with the help of several factors which may now be missing—major style and engineering changes, excise-tax reductions, and the initial psychological boost of the Vietnam crisis. In addition, their creditmen will suggest to them that little stimulus can be expected from the further rapid expansion of consumer credit, since new credit extensions exceeded 16 percent of disposable income in mid-1965, as opposed to a 15-percent ratio a year ago. Yet, in the face of all these questionmarks, Detroit is counting on a high level of sales because of high consumer income, high scrappage rates, and a high number of potential customers. Consequently, the industry scheduled production of 2.6 million cars for the fourth quarter, matching the production rate achieved at the second-quarter peak.

Consumers: not saving?

One striking effect of the consumer buying upsurge—an upsurge in other goods and services as well as in autos, color TV, and the like—is a decline in the personal-saving ratio.

Declining trend in personal saving shown by revised GNP statistics



Source: U.S. Department of Commerce

In fact, after a recent revision of the underlying GNP statistics, the data show both a declining trend in the saving rate and a lower dollar level of personal saving than was indicated in earlier estimates.

The lower-than-expected level of personal saving reflects the fact that greater upward revisions have been made in estimates of consumer outlays than in estimates of consumer income. (Some of the changes are merely definitional, but most result from a statistical overhaul made possible by improvements in the basic data sources.) The declining trend is also noteworthy. The personal-saving rate averaged 7 percent in the 1956-58 period, but since then it has averaged only 5½ percent.

It could be argued that the saving rate will soon begin to increase, with opposite effects on spending. For example, the saving rate would rise if repayments of auto credit should approach the level of extensions, instead of lagging as markedly as they have done in the recent past. Again, the saving rate would rise if the advancement of new mortgage money against equity in existing homes should level off. Any decline of this type in the rate of growth of instalment credit or mortgage credit could reduce some of the stimulus to spending which has been exerted so strongly through the increasingly low rate of consumer saving.

But the recent consumer-spending upsurge has been based not only upon a reduction in consumer saving habits but also upon an increase in income due to growing employment opportunities. This year has seen the largest gains in employment since the beginning of the 1961-1965 business expansion. Especially sharp gains have been recorded in the manufacturing sector as a result of the continued business-investment boom, the continued consumer-goods boom, and the now-completed steel-inventory upsurge. As one welcome

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consequence of this rise in employment, the unemployment rate in October dropped to 4.3 percent, an eight-year low.

As of now, the combination of more tanks and fewer taxes has already affected the pace of the business expansion. Moreover, these factors—and the investor and consumer reactions to them—will continue to have an important impact on business activity in coming months. —*William Burke*

Borrowing Still

FURTHER substantial demands upon the nation's credit markets accompanied the continued expansion in the output of goods and services during the third quarter. The business sector again generated the bulk of these credit demands; business firms expanded their borrowings substantially, even though at a slower pace than in the preceding quarter. Consumers added to their debt at about the same rate as they did earlier in the year, with more than two-fifths of the increase again reflecting their seemingly insatiable appetite for new automobiles. State and local governments—the fastest growing sector of the economy—continued to increase their new debt offerings. On the other hand, the Federal Government covered its cash deficit largely by drawing upon its operating balances; in fact, virtually all of the small net increase in Federal debt centered in special issues held by Government agencies and trust funds, as the marketable public debt remained virtually unchanged.

Monetary policy firm

For its part, monetary policy maintained the somewhat firmer tone initiated during the spring months in response to a sustained and vigorous demand for bank credit—and also in response to the nation's continuing need to remedy the imbalance in its external-payments position. Member-bank borrowings rose by about $50 million during the third quarter to an average level of $550 million, but this rise was offset by a comparable increase in excess reserves. Consequently, net borrowed reserves remained almost unchanged at an average level of about $155 million.

This stability was accompanied by a slower growth in total bank credit—about $4 billion (seasonally adjusted), or only about half of the average quarterly gain recorded earlier in the year. But this reduced rate of credit expansion was accompanied by a $2.5-billion rise in the money supply (seasonally adjusted) —a gain larger than that for the entire January-June period. This sharp increase partly reflected an appreciable decline in U. S. Government deposits from their exceptionally high mid-year level.

Yields stiffen

The money and capital markets showed definite signs of tightening, even though the reserve measures of monetary policy indicated just about the same degree of restraint as before. Most yields throughout the maturity range firmed substantially during the third quarter, somewhat in contrast to their behavior during the preceding quarter.

The market yield on 91-day Treasury bills,

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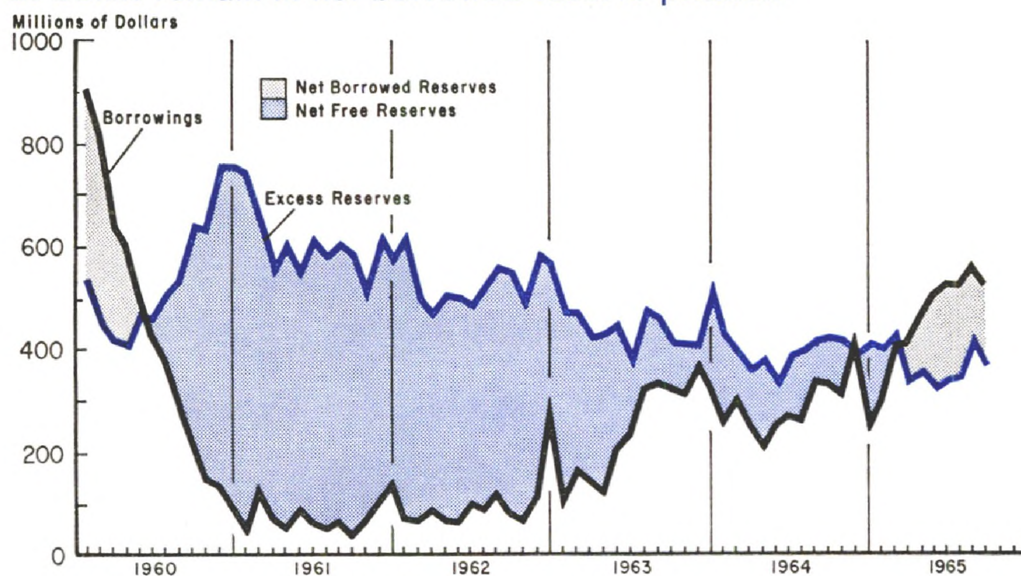
Monetary policy maintains firmer tone
as banks remain in net borrowed-reserve position



Source: Board of Governors of the Federal Reserve System

booming into 1966 re-enforced market expectations of higher interest rates.

Reflecting these various factors, most Treasury issues of beyond one-year maturity were yielding at least 4.25 percent by the end of September, and a number of maturities beyond five years were priced to return around 4.35 percent. Indeed, the average yield on long-term bonds, which had remained stable at about 4.14 percent during the March-June period, reached 4.29 percent by the first of October.

after ranging between 3.81-3.86 percent from the end of June through late August, later moved up strongly. In late September it topped 4.00 percent — a five-year high — after the Treasury announced the tender of $4 billion of tax-anticipation bills. This third-quarter development, with dealers cutting prices to reduce inventories in the face of high financing costs, contrasted markedly with the second-quarter pattern, where a strong investment demand for bills tended to put downward pressure on yields.

The trend toward higher yields was not confined to short-term securities. Psychological and expectational considerations, stemming in part from developments in the Mekong, the Kutch, Sikkim and Threadneedle Street, combined with market factors to push up yields throughout the maturity spectrum. The Vietnam situation, for one thing, bred considerable uncertainty with regard to future increases in defense expenditures and the possibility of larger Federal deficits. Then too, the possibility of a crisis in pound sterling was not alleviated until almost the middle of September. Most important of all, a growing belief that economic activity would continue

Corporates, municipals, mortgages

In addition, market factors strongly affected yields in the corporate and municipal bond markets, and indirectly, in the Government bond market. The volume of new offerings of both corporate and tax-exempt issues was exceptionally large for this normally quiet summer period. The $3.3-billion expansion of new corporate issues, plus the continued vigor in business borrowing from banks, suggested that corporate liquidity might henceforth be squeezed as internally generated funds become less adequate to finance rising outlays for inventories and plant and equipment. Thus, yields on seasoned bonds rose by about seven basis points during the third quarter (to 4.53 percent late in September), and by an additional 4 basis points during the first week of October. The increase since mid-September also was accompanied by a widening in the yield spread relative to

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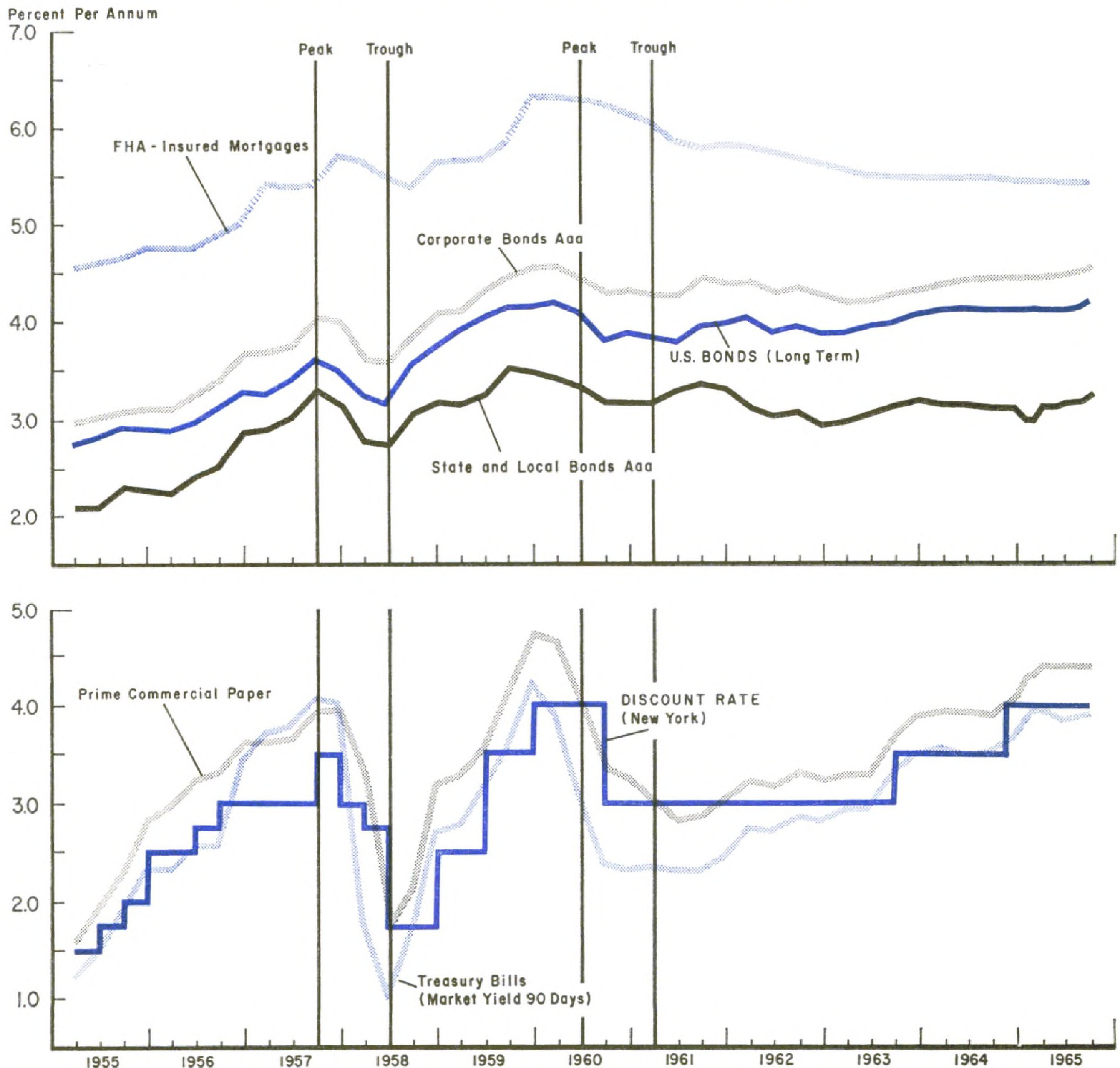
Treasury issues.

Upward pressures were also evident in the state-local government market, where yields continued along the uptrend initiated early in the year, rising by 14 basis points between end-June and end-September to an average of 3.31 percent on top-rated issues. Rising yields reflected both the massive amounts of new municipal offerings coming to market and the large inventories left in the hands of dealers. Both the $2.6 billion of new offerings in the third quarter and the $700 million of issues left unsold in mid-October were close to the record figures recorded this past spring.

Mortgage markets also gave evidence of increasing firmness in August and September as secondary market yields on long-term FHA-insured mortgages edged upward to

Yields move up throughout maturity spectrum,
as money and capital markets show definite signs of tightening



Source: Board of Governors of the Federal Reserve System

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5.46 percent. But the long-delayed firming of mortgage yields was perhaps due more to a moderation in the flow of savings into mortgage institutions than to increased pressure from the demand side.

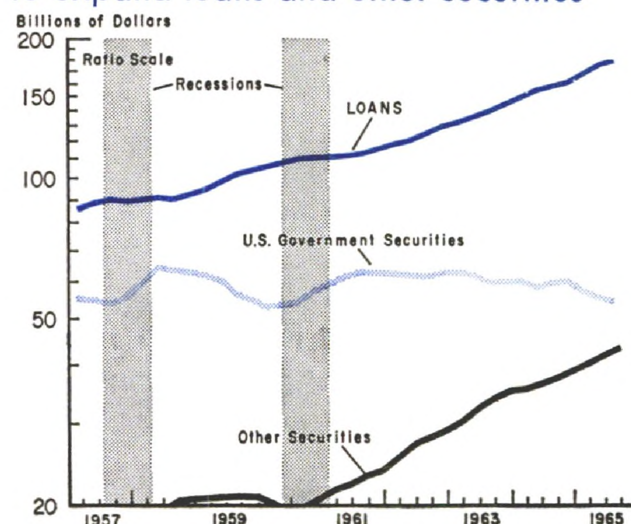
Banks and businesses

In their capacity as the department stores of finance, commercial banks continued to play a key role in the nation's credit markets during the third quarter. Total bank credit—total loans less interbank loans plus investments—rose by almost $4.0 billion (seasonally adjusted). This increase, although less than those recorded in the two preceding quarters, represented a substantial 5.5-percent annual rate of gain. And business loans again accounted for a significant portion of total credit demands, rising at a 14-percent annual rate during the quarter.

Following June's exceptionally strong performance, business loans declined by almost $700 million in July, but then recovered strongly in August and September. (Data not seasonally adjusted.) Significantly, business borrowings over the mid-September tax date surpassed last year's increase by a fair margin, even though corporations had to pay only 19.3 percent of their annual Federal-tax liabilities during the quarter, as against 28.3 percent in the year-ago period. This development, in conjunction with a sharp tax-date decline in corporate holdings of certificates of deposit, again suggests that businesses generally may be experiencing a squeeze on liquidity.

The latest increase in business borrowings, moreover, was accompanied by somewhat greater firmness in non-price terms of borrowing, and also by a somewhat higher average rate of interest. However, on short-term loans, the interest cost was still only slightly higher during the September survey period than in the year-ago period (5.00 percent, and 4.98 percent, respectively). And, while the proportion of loan volume made at the prime

Banks liquidate Governments
to expand loans and other securities



Source: Federal Reserve Board

rate (56 percent) was less than in June, it too, was still higher than in September 1964.

Rising credit, rising deposits

Demands for bank credit by non-business borrowers also remained strong during the third quarter. The banks continued active in the mortgage field, as real-estate portfolios increased by $1.7 billion, the largest quarterly gain in well over a year. Similarly, consumer loans, on the heels of the auto boom, posted a near-record increase of $1.2 billion—and this gain accounted for over three-fifths of the combined increase in consumer debt at all types of lending institutions.

The banks also remained active in the state-local government field, expanding their portfolios of "other securities" by a substantial $1.7 billion. However, the rate of expansion slackened appreciably late in the quarter, as banks found themselves in an increasingly less liquid position from which to accommodate the widespread and vigorous demands for credit accommodation. And, just as earlier in the year, the banks financed the expansion of loans and "other securities" with a further ($1.4 billion) liquidation of U. S. Govern-

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ment securities, along with a $2.1-billion net repayment of borrowings by security dealers.

The other side of the ledger also witnessed some significant developments during the quarter. Private demand deposits rose by about $3.6 billion (seasonally adjusted)—about double the average quarterly gain of the year to date—but this increase was roughly matched by the net decline in U. S. Government deposits. Time and savings deposits rose by $5.7 billion; this gain far surpassed the second-quarter increase, and it almost matched the exceptionally strong first-quarter increase, which reflected the initial impact of the higher rates paid on such deposits. With their impressive recent performance, the commercial banks continued to dominate this category by accounting for three-fifths of the total growth of depository-type savings.

This growth was not without its price. Money-market banks in particular, under the pressure of rising market rates of interest, acted during this period to retain funds by increasing the rates offered on their certificates of deposit. Late in the quarter New York City banks posted a 4½-percent rate—the maximum rate payable on time certificates with maturities of 90 days or more—while banks in widely scattered parts of the country began to offer instruments which would not be subject to interest-rate ceilings (for example, savings certificates and non-negotiable promissory notes). Nor was this all. For the prestige-conscious, a major New York bank announced a soon-to-be opened branch, bearing a French name and "patterned after an exclusive private club," whose privileges and services will be extended only to 800 "properly sponsored and approved members" who promise to maintain a minimum demand-deposit balance of $25,000.

—*Verle Johnston and Herbert Runyon*

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A New Upsurge?

WESTERN INCOME and employment rose at a good clip during the third quarter, on the heels of the escalating situation in Vietnam and the continued expansion in the civilian economy. Nonfarm employment increased about one percent (the same as in the rest of the country) and the gain would have been even greater but for strike-induced cutbacks in the construction and shipbuilding industries. Total civilian employment increased at a slightly slower pace, because of a smaller-than-usual increase in farm employment.

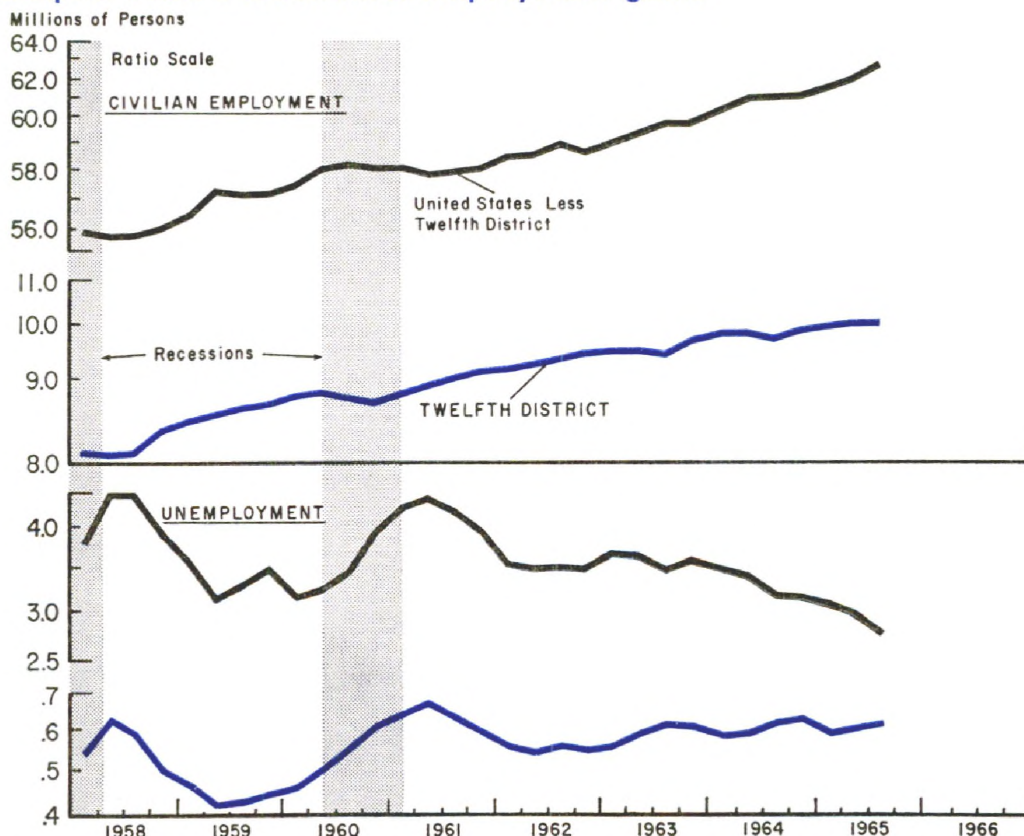
Despite the West's employment upsurge, unemployment remained a problem because of the continuing growth of the region's labor force and the continuing impact of earlier cutbacks in defense-related manufacturing. The jobless rate was 5.7 percent during the summer quarter—about the same as it was when defense employment reached its peak almost three years ago. In contrast, the jobless rate in the rest of the nation declined from 5.6 to 4.2 percent over that same three-year period.

The impact of joblessness, of course, has varied from one District state to another. Oregon and Idaho have followed the national pattern of declining joblessness, and Washington is in roughly the same situation as three years ago. But California, the center of the nation's aerospace industry, recorded a 6.0-percent jobless rate in the third quarter of this year, as against a 5.8-percent rate in late 1962. Utah (5.5 percent) and Arizona (5.8 percent) have encountered rising unemployment.

Jets take off

District states thus were well prepared to welcome the significant turnaround in defense-related manufacturing that has occurred over the past several months. Aerospace-manufacturing employment reached 571,400 in September—4 percent above the first-quarter low although still about 10 percent below the 1962 peak. Employment gains also strengthened in

Jobless problem remains intractable
despite West's substantial employment gains



Source: U.S. Department of Labor; Federal Reserve Bank of San Francisco

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both government and commercial shipyards.

An improvement in commercial-aircraft purchases was a major factor in the recent recovery, as two Western producers received substantial new orders for jet aircraft. The regional industry's thickening orderbooks are reflected in the one-fifth increase in new orders which the nation's aircraft industry has logged in the last several months. And one manufacturer, which claims it has exhausted Southern California's pool of experienced labor, has recently tried to persuade 1,500 aircraft workers to make the long trek from Long Island, New York to Long Beach, California.

Western firms received two major military contracts during the third quarter, but these are likely to have only a minor impact on employment in this region. The manned-orbiting-laboratory project involves a great deal of subcontract work which may be done outside the District, while the C-5A transport plane is scheduled to come off Georgian instead of Western production lines.

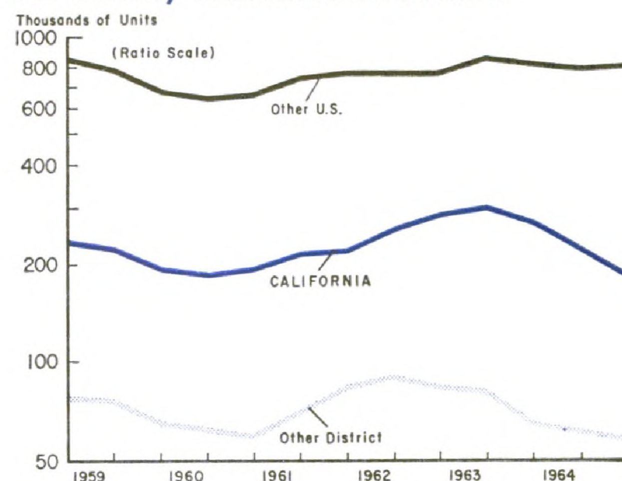
A backward look at Defense Department fiscal-1965 contract data highlights the source of the industry's earlier weakness. District firms received $5.3 billion in DOD prime-contract awards during the year—off 10 percent from the preceding year's total and down even more from the fiscal-1963 peak. The District share of total awards thus dropped from 31 percent in 1963 to 27 percent in 1965. California firms recorded a slight increase in awards in fiscal 1965, but Washington and Utah dropped substantially from their 1964 performance.

More stores, fewer homes

Western construction activity strengthened during the third quarter, despite the continued slowdown in residential building. Now, on the basis of a strong third-quarter performance, total construction awards for the year to date are finally ahead of their 1964 pace.

Awards in both nonresidential building and heavy construction ran 16-18 percent above their year-ago pace during the quarter. Commercial establishments and office buildings contributed to the strength of nonresidential construction, and dam-building and electric power systems continued to dominate the activity in heavy construction.

Western housing slump continues but activity stabilizes elsewhere



Note: Chart shows residential building permits, at seasonally adjusted annual rates.
Source: U.S. Department of Commerce; Federal Reserve Bank of San Francisco

Housing activity fell to a new low during the summer period, as new starts declined 17 percent below the second-quarter rate to 239,000 (seasonally adjusted annual rate). But permit activity remained at a higher level than starts, which suggests that some improvement in actual construction may occur in future months. An upturn in future activity is also suggested by a recent reduction in the size of the West's housing surplus. For example, the rental vacancy rate declined during the quarter to 10.9 percent (seasonally adjusted), as compared with the 11.7-percent peak reached in late 1964. Similar improvement also occurred in the for-sale market, where the inventory of new homes for sale dropped by mid-year to 60,000—down 20 percent from the year-ago level.

The recent sluggishness in housing activity meanwhile continued to exert a depressive im-

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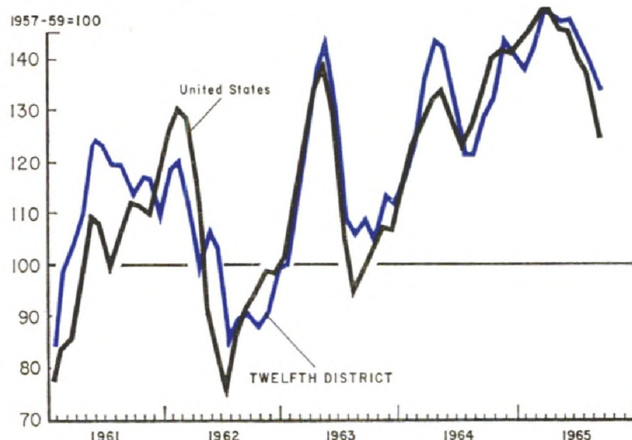
pact on lumber markets. Except for a brief flurry in July, lumber orders remained as weak during the summer quarter as they had during the spring. In addition, a disappointing inflow of new orders from government and civilian customers led by mid-September to a decided weakening of the price structure, which had been supported for several months previously by a backlog of unfilled orders and by transportation difficulties created by a serious shortage of railroad cars and cargo ships.

Steel, aluminum, copper

Metals markets, on the other hand, remained in strong shape throughout recent months. Admittedly, Western steel production dropped sharply after the signing of the labor-contract agreement in early September, but output declined less here than it did elsewhere in the country. By late-October the Western steel industry was operating about 9 percent below its year-ago level, while national output was 23 percent below the 1964 figure. The regional industry's performance resulted from the strong underpinning to demand provided by the pace of activity in nonresidential building and heavy construction. Moreover, Western mills participated less than other mills in the wide swings of inventory buildup and subsequent cutback.

Aluminum dominated the headlines in early November, as major producers backed off from earlier-posted price increases after the Administration announced plans to throw substantial amounts of stockpiled metal onto the market. The cancelled increases involved a ½-cent hike for ingot prices (from 24½ to 25 cents a pound) and a 1-cent average price rise for fabricated items. Defense Secretary McNamara — the largest buyer of aluminum in the country — stated that producers cancelled the posted increases because they "recognized the need to maintain price stability at a time of rising demand and increasing defense production associated with operations in South Vitenam."

West suffers less than nation
from steel-production decline



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

Activity in the nonferrous-metals markets strengthened considerably during the third quarter of the year. Copper, lead, and zinc markets all exhibited strong demand pressures during this period.

Rising industrial consumption of copper, plus strike-induced losses in refinery production, reduced fabricators' and producers' stocks despite the release of substantial amounts of the metal from Government stockpiles. Political tensions in Rhodesia and military tensions in Vietnam also accentuated fears of future shortages of the red metal. Eventually, in late October, Chilean producers responded to a sharp advance in the premium price quoted on the London exchange by raising their export price for refined copper from 36 to 38 cents a pound. Other foreign producers quickly followed suit, but U. S. producers continued to hold the price line at end-month.

Zinc remained in short supply despite the release during the quarter of 75,000 tons of stockpiled metal, which matched the amount released in earlier months. Lead demand picked up late in the third quarter, so stockpile officials at that time began selling 40,000

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tons left over from an under-subscribed April offering. Just before adjournment, Congress authorized the release of 200,000 tons of zinc, and the Administration followed up this action by terminating quota restrictions on the importation of both lead and zinc.

Western petroleum refineries responded to an increased third-quarter demand by stepping up operations to 85 percent of capacity, as against an early-1965 pace of roughly 80 percent of capacity. Military aircraft and shipping requirements led to substantial increases in Government purchases of jet fuel and residual fuel oil. The diversion of shipping from civilian to military tasks led to a drop in civilian demand for residual fuel oil, but this drop was offset by increased civilian demand for gasoline and jet fuel.

Cattle rise, peaches fall

The Western farm-income picture was very strong in mid-summer, as increased marketing of livestock and products more than offset a drop in crop marketing receipts. For the January-August period as a whole, cash receipts were 3 percent above the comparable 1964 figure, as compared with an 8-percent gain elsewhere in the nation. The stronger gain elsewhere reflected a boom in some products, such as hogs and soybeans, that District farmers do not specialize in.

Western cattlemen remained in a strong position during the summer quarter. Beef prices were higher than a year ago, and marketings from Western feedlots were much heavier than in the first three quarters of 1964. But California cling-peach producers presented a different picture. Growers harvested about 20 percent less than the early-season estimate of 37.5 million bushels, and canners produced the smallest pack of the last four years—primarily because unseasonable August rains, on top of planned reductions carried out under a state marketing order, reduced the size of the crop even more than intended.

California growers relied primarily on the domestic labor supply for their harvest needs, despite the importation of some Mexican workers for the processing tomato crop. More than 16,000 foreign workers were employed on California farms in late September, but this was far below the 63,000 figure of a year ago. Yet, despite the resultant pressure on the domestic labor supply, farm-wage rates increased more slowly in California than in the rest of the country over the past year—up 6.2 percent and 7.5 percent, respectively—and wages in other District states increased at a somewhat slower pace.

Significant third-quarter gains in Western employment and Western income created the basis for a future upsurge in consumer buying, which has lagged behind the national pace so far this year. Through August, District retail sales were 5 percent above the 1964 level, as opposed to an 8-percent gain elsewhere. For the year to date, District apparel-store sales were off 9 percent, furniture-appliance sales were down 5 percent—and auto registrations were up only 5 percent in the West (and 3 percent in California) as against a 15-percent gain in the rest of the nation. In view of this unprepossessing sales performance, Western retailers undoubtedly will be looking forward to the Christmas-buying season with even more anticipation than usual.

—Regional Staff

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Lending: Some Tightness

WESTERN FINANCIAL activity remained strong in the third quarter, despite a slowdown in bank-loan expansion, and bank reserve and liquidity positions stayed relatively tight. Total member-bank credit increased by $476 million (seasonally adjusted)—far above the second-quarter gain, but only one-third of the size of the substantial first-quarter increase. But the bank-earnings picture looked happier than it did earlier in the year, which suggests that banks have made progress in overcoming the cost handicap created by the higher rates paid this year on time and savings deposits.

Tightening reserve pressure was increasingly evident in the third quarter, as net borrowed reserves of District member banks edged up to $38 million. Average daily required reserves increased $20 million during the quarter; excess reserves also rose slightly, but daily average borrowings increased from $63 to $70 million. In addition, District banks borrowed more heavily in the Federal funds market. Between the second and third quarters, they increased their net purchases of Federal funds from other banks from $86 to $122 million (daily average basis), and they also reduced their net sales to securities dealers.

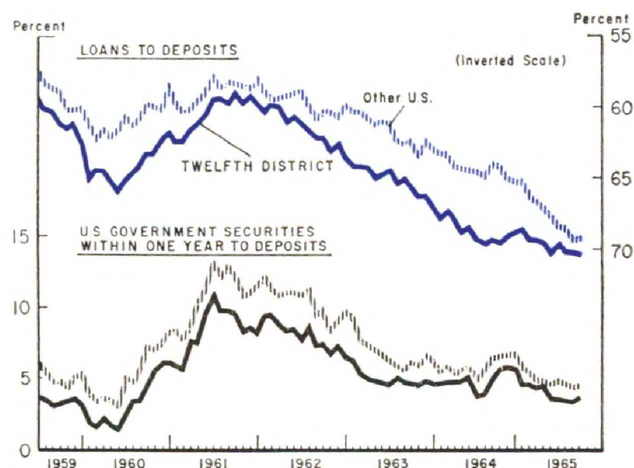
Liquidity and municipals

Despite the relative slowdown in the pace of loan expansion, District-bank liquidity positions tightened during the summer quarter. The loan-deposit ratio, an inverse measure of bank liquidity, rose to a postwar peak of 71 percent in September. Moreover, the ratio of short-term Government securities to deposits dropped from 4 to 3½ percent during the quarter. But this ratio may understate the liquidity of District banks, to the extent that they have increased their holdings of short-term municipal securities. And both liquidity ratios ignore the fact that District banks hold only a relatively small proportion of their total deposits in the volatile form of time certificates of deposit.

While member banks were increasing their loans by $348 million, they were expanding their security holdings by $128 million (seasonally adjusted). Municipal and Federal Agency portfolios continued to increase, as part of the effort by banks to raise operating revenues and thereby offset the higher costs resulting from increased rates paid on time deposits. Actually, the rate of expansion of such securities slowed during the quarter, but the gain for the year to date amounted to 26 percent. Banks meanwhile continued to reduce their U. S. Government security holdings, but by a relatively small amount ($116 million) which reflected the slowdown in the rate of loan expansion.

District member banks recorded mixed trends in deposits during the July-September period. Demand deposits adjusted dropped $103 million (seasonally adjusted), reversing the first-half pattern, and U. S. Government deposits dropped even more in response to

Liquidity positions tighten further during July-September period



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

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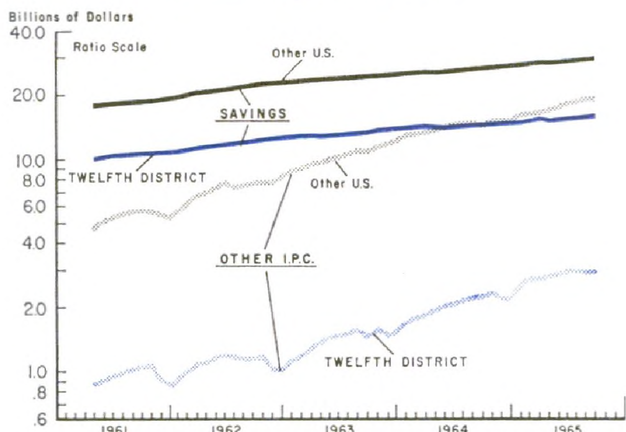
Pace of expansion accelerates in time and savings deposits



Note: Other I.P.C. includes time deposits of individuals, partnerships, and corporations, other than savings.
Source: Federal Reserve Board; Federal Reserve Bank of San Francisco

unusually heavy calls on Treasury tax-and-loan accounts. But the pace of expansion accelerated in time and savings deposits, as a heavy savings inflow contributed to a $592-million increase in the overall category. On the other hand, time certificates of deposit declined during the quarter, as new CD's issued during this period failed to offset those maturing around the September 15 tax date. The largest District banks showed relatively little interest in bidding for large-denomination CD's, partly because the New York money market banks offered increasingly higher rates for such deposits, particularly in the latter part of September.

Heavy business borrowing

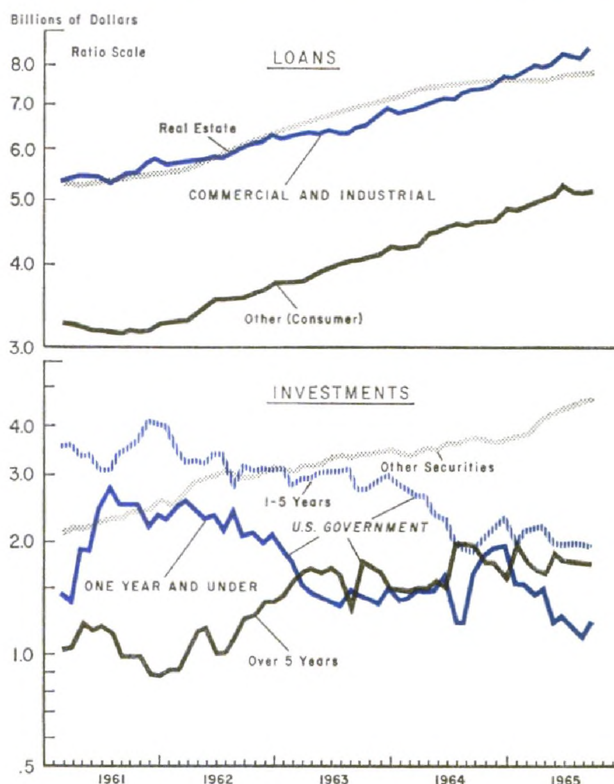
In the loan sector, data supplied by weekly reporting member banks emphasized the importance of business borrowing in the recent bank-credit expansion. (This series, although not seasonally adjusted, is much more detailed and more current than the monthly member-bank series.) Business loans at District weekly reporting banks were up a strong $139 million during the quarter, as most categories showed heavy increases in borrowing. Even so, the Western banks' 1.7-percent quarterly gain lagged behind the 2.9-percent gain recorded elsewhere.

In durable manufacturing, machinery manufacturers recorded a substantial rise in borrowing; in the nondurable field, food-liquor-tobacco processors matched their year-ago pace with a strong seasonal gain. Petroleum processors continued to display a strong demand for credit: this industry is now financing substantial capital expenditures, and it also requires additional operating funds because of sharp increases in military purchases of fuel for aircraft and cargo vessels. District banks during the quarter increased their advances to construction firms (unlike last summer) and conversely reduced their holdings of bankers acceptances (also unlike a year ago).

Higher interest costs

The cost of business loans edged upward during the quarter. In the first half of Sep-

Western banks expand holdings of business loans and other securities



Source: Federal Reserve Bank of San Francisco

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

(dollar amounts in millions)

	Twelfth District				U. S. Minus Twelfth District		
		Net Change				Net Change	
	Outstanding 9/29/65	Third Quarter 1965 Dollars	Third Quarter 1965 Percent	3rd Qtr. 1964 Percent	Outstanding 9/29/65	3rd Qtr. 1965 Percent	3rd Qtr. 1964 Percent
ASSETS							
Loans adjusted and investments	$33,794	+363	+1.09	+ 2.38	$124,983	— 0.02	+2.17
Loans adjusted	24,321	+234	+0.97	+ 2.73	87,433	+ 0.68	+1.57
Commercial and industrial loans	8,293	+139	+1.70	+ 0.92	39,824	+ 2.93	+3.48
Real estate loans	7,829	+117	+1.52	+ 1.09	14,183	+ 5.55	+4.49
Agricultural loans	1,046	— 2	—0.19	+ 2.18	577	+ 3.40	—1.96
Loans to nonbank financial institutions	1,663	+ 29	+1.77	+ 2.62	8,491	+ 3.59	—4.93
Loans for purchasing & carrying securities	392	— 43	—9.89	+97.83	5,061	—27.52	—7.15
Loans to foreign banks	311	— 9	—2.81	— 6.54	1,244	— 1.03	—9.12
Other loans (mainly consumer)	5,197	+ 7	+0.13	+ 1.16	19,943	+ 1.66	+2.04
Total securities	9,473	+129	+1.38	+ 1.53	37,550	— 1.61	+2.64
U. S. Government securities	4,799	— 81	—1.66	+ 0.45	18,031	— 6.93	+2.65
Other securities	4,674	+210	+4.70	+ 3.14	19,519	+ 3.86	+4.23
LIABILITIES							
Demand deposits adjusted	12,316	+101	+0.83	+ 1.99	51,817	+ 0.44	+1.64
Total time and savings deposits	20,318	+350	+1.75	+ 1.52	55,958	+ 3.92	+2.95
Savings	14,868	+410	+2.84	+ 2.32	29,451	+ 2.73	+2.05
Other time	2,731	+ 2	+0.07	+ 6.34	18,272	+ 5.00	+2.62

tember, leading metropolitan District banks charged an average rate of 5.19 percent—14 basis points above the June average—on short-term business loans. But this third-quarter increase made up for only about half of the decline in rates which occurred between last September and this June.

District banks, like those elsewhere, adopted a more selective lending approach in recent months, making the 4½-percent prime rate applicable on a declining proportion of their business-loan volume (45 percent in September vs. 57 percent in June). Banks raised their rates for practically every loan-size category, but the higher rates charged on the largest category ($1 million and over) accounted for the major part of the increase in the overall average rate.

District banks during recent months also granted more long-term loans—those with maturities of over one year. The number of new long-term loans accounted for 3.3 percent of all loans in the September survey—the highest proportion since data of this type were first collected five years ago. But rates on new long-term loans moved up 17 basis points during the quarter, to 5.42 percent.

Bank lending to consumers apparently dropped behind the hot first-half pace during the summer quarter, but this slackening may be only apparent. The quarterly increase probably would have been greater than the reported gain if adjustments had been made for the timing of auto model changeovers. But even so, auto financing continued as a major source of bank-credit demand during the summer period.

Ample mortgage money

The Western mortgage market remained amply supplied with funds as the demand for mortgages slackened during recent months. But there was little evidence of any substantial surplus of funds, so borrowing conditions and terms remained relatively stable during this period.

The savings inflow continued stronger at the banks than at the S & L's—roughly a 2.8-

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percent quarterly gain in savings deposits of weekly reporting banks versus a 2-percent gain in savings balances of Federally insured associations. Some associations have offset their slower savings growth with increased borrowings from Federal Home Loan Banks, but the increased costs of such borrowing and the Home Loan Bank Board's continued admonitions advising restraint should tend to reduce the flow of funds from that source.

In view of the continued existence of excess housing in many Western communities, lenders have continued to expand their mortgage portfolios rather modestly. District weekly reporting banks recorded a $117-million gain in mortgage holdings during the summer quarter, and S & L's increased their holdings by $474 million. (Banks actually stepped up their mortgage-lending pace during this period, but detailed first-half data suggest that they are interested at least as much in commercial-industrial mortgages as they are in residential.) During this quarter, too, foreclosure rates declined and interest rates moved sideways, but rates later tended to stiffen somewhat.

—*Ruth Wilson*

Men, Money, and the West

Western business and financial developments of the past fifty years are surveyed in the report, *Men, Money, and the West,* which is now available from the Federal Reserve Bank of San Francisco. The booklet begins with an overview of national economic and monetary developments of the past half-century, but the bulk of the report is concerned with the greater-than-national growth of Western production, trade, and finance over this history-making period.

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

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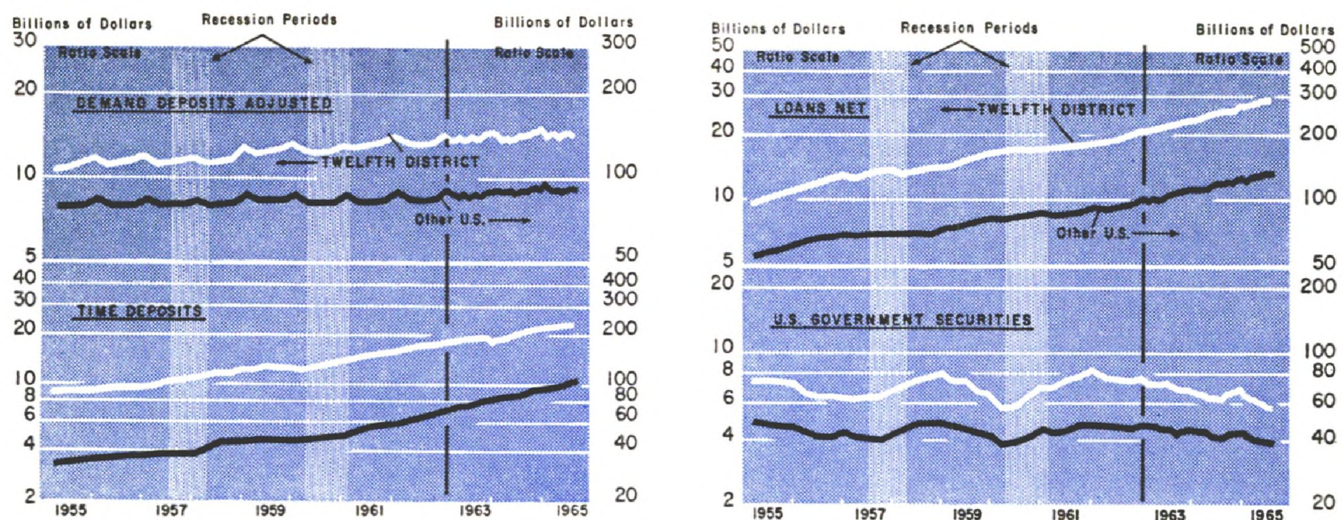
Condition Items of all Member Banks — Twelfth District and Other U. S.



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 nonagricultural employment	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	130
1964											
August	24,965	6,212	14,377	20,235	172r	...	120	143	107	118	119
September	25,282	6,480	14,689	20,473	167r	5.51	120	137	108	121	124
October	25,165	6,519	14,587	20,602	170r	...	121	139	111	117	133
November	25,339	6,685	14,503	20,792	172r	...	121	150	106	113	142
December	25,561	6,492	14,450	21,300	168r	5.48	122	142	106	115	141
1965											
January	25,853	6,337	14,430	21,669	179	...	122	151	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	119	119	150p
April	26,525	6,212	14,405	22,184	180	...	123	134	101	120	149p
May	26,755	6,183	14,365	22,211	182	...	124	146	103	122	147p
June	27,059	6,010	14,832	22,492	168	5.47	124	140	104	120	147p
July	27,327	5,813	14,532	22,718	186	...	124	148	111	125	143p
August	27,283	5,881	14,521	22,805	180	...	125	146	108	122	139p
Sept.	27,409	5.894	14,729	23,084	187	5.53	125	149	...	...	...

[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.

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