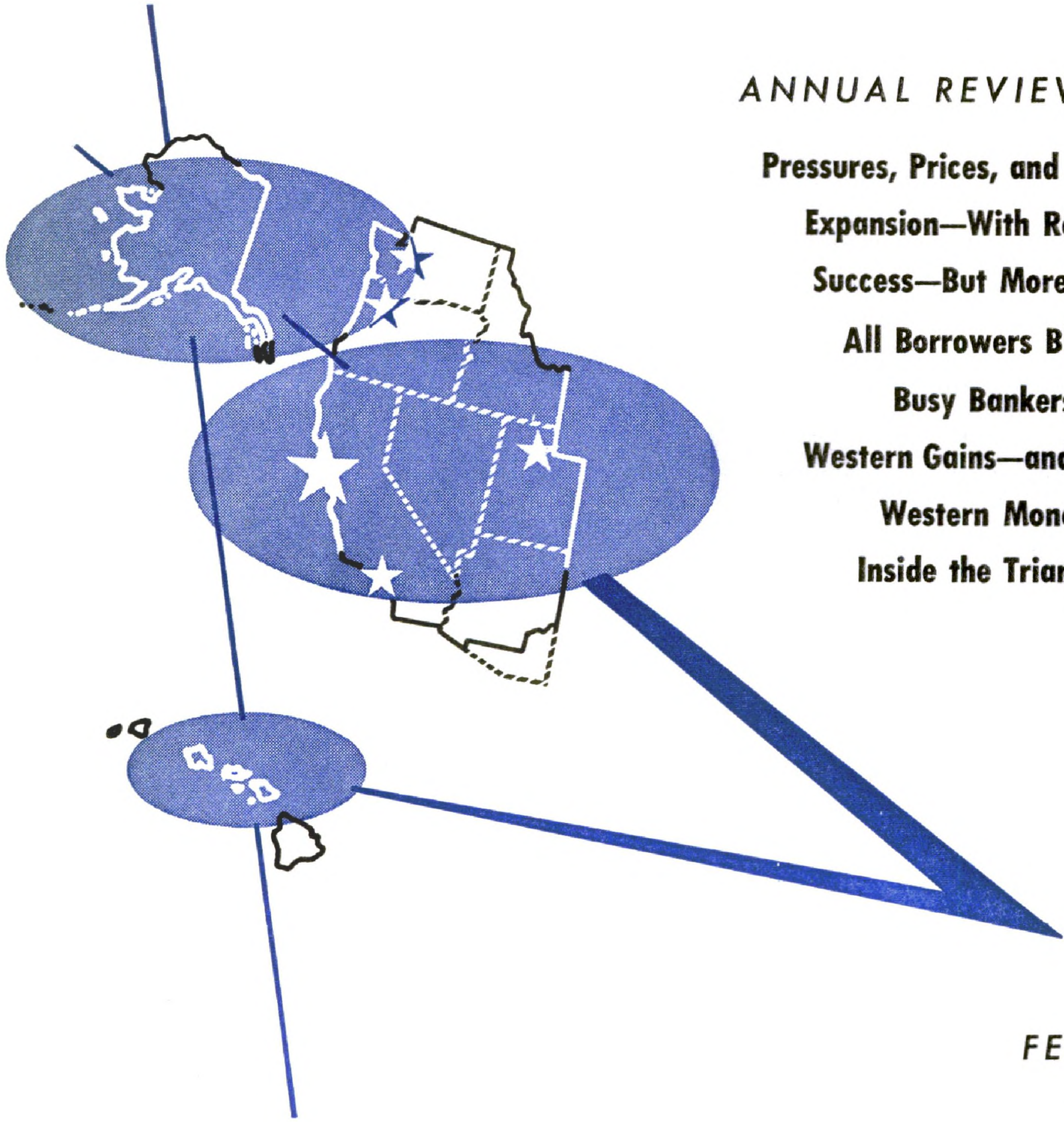
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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1965 . . . . Annual Review

Pressures, Prices, and Prosperity

PROSPERITY is perhaps too mild a word to describe the state of the economy in 1965. Ebullient growth in practically every sector of the economy followed hard on the heels of the tax-cut-inspired growth of 1964, and this performance, coming as it did in the fifth year of unprecedentedly sustained business expansion, led the London *Economist* to enthuse, "At least for a time, America has discovered the secret of balanced growth."

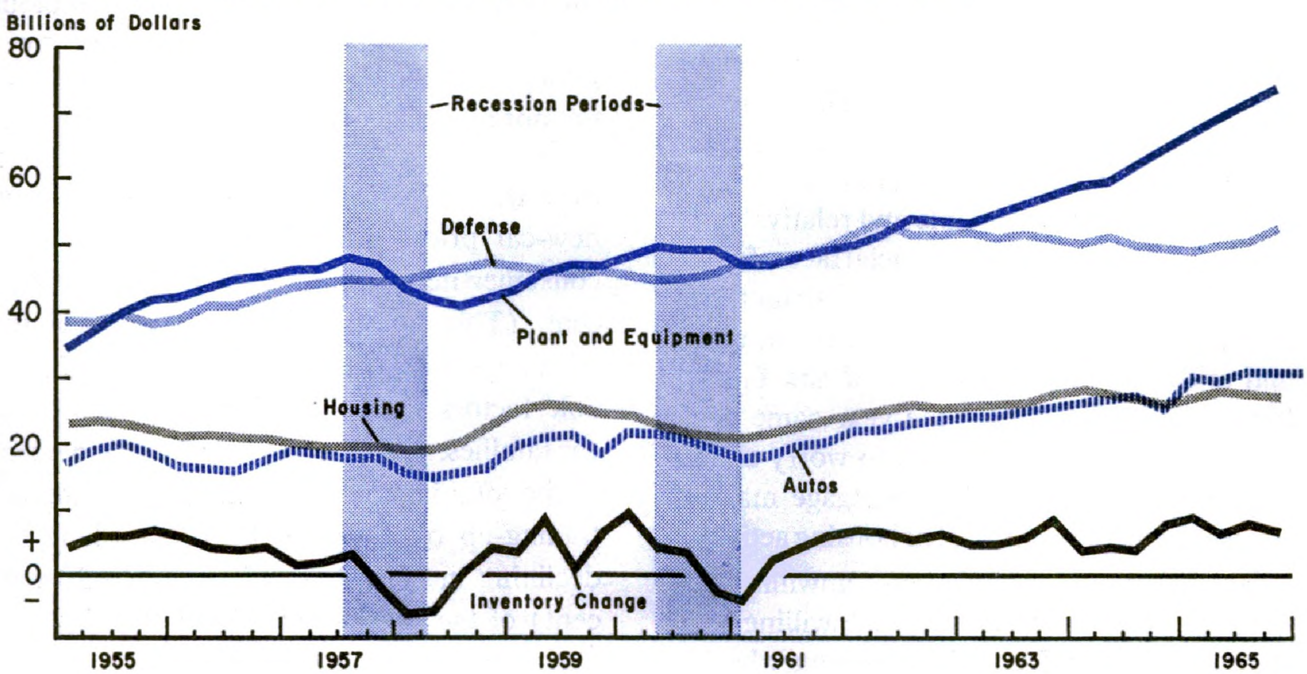
The nation during 1965 achieved at least a measure of success in meeting each of the goals of economic policy. 1) Rapid growth: the U. S. economy expanded about 5½ percent, even after adjustment for price increases, and thus outpaced every one of its major industrial competitors. 2) Full employment: over 2 million new jobs were created, and the long-elusive goal of 4-percent unemployment finally came within sight. 3) Price stability: admittedly, the various price indexes broke out of the narrow range within which they had moved during the several preceding years, but a sustained acceleration in the price rise still failed to appear. 4) Strong international payments position: after great effort, the constantly high negative balance of earlier years was roughly halved, to about $1.3 billion.

Changing expectations

This year of prosperity was not all of a piece. Around midyear, some observers prophesied trouble, arguing that the long-sustained expansion was running out of steam and that new fiscal stimuli would be needed in addition to the already effective income-tax cuts of 1964 and excise-tax cuts of 1965. The possible trouble spots included a weak housing picture, a likely inventory cutback in the aftermath of the steel-labor settlement, a hard-driving auto boom that appeared unsustainable, and a level of business plant-equipment spending that some observers felt would provide more capacity than could profitably be employed.

By late fall, however, the entire atmosphere changed. The Vietnam crisis—acting as both a stimulus and a burden to the economy—led to discussions not of new tax cuts but rather of possible tax increases to keep inflationary

Heady atmosphere generated by auto boom and business-spending upsurge, but late-year upturn in defense spending then creates problems



pressures under control. The long-forgotten question of "guns or butter"—"ammo or oleo" in the current terminology—was back in the news.

Prosperity meant a 7½ percent increase in activity (in current dollars) as GNP rose to $676 billion for the year. Striking increases were recorded in almost every sector of business activity. Reacting to the usual stimulus of population and income growth, consumers increased their spending for food and most other nondurable goods and services, and various governmental units increased their spending for schools, highways, and other public facilities. But, as usual, the most significant changes occurred in several sectors which account for less than one-third of total GNP but which also generate most of the ups and downs in business activity. These sectors include consumer expenditures for such big-ticket items as cars and housing, business outlays for inventories and new productive facilities, and Federal defense spending.

Homes, and wheels

One of these sectors, residential construction, actually provided little support to the boom. New housing activity moved sideways for the second straight year, at about $28 billion, as a relatively good performance elsewhere failed to offset a sustained slump in the Western housing market. In 1965, as in the earlier years of this expansion, mortgage money remained widely available and relatively inexpensive. But this strong financial factor failed to overcome the market weakness attributable to the earlier overbuilding of apartment units and to the continued low level of new-family formation. And then, as the year came to a close, housing analysts began to worry about the impact of a tightening mortgage market on an already reduced level of housing activity.

But what consumers were unwilling to spend for new housing they were willing and anxious to spend for their homes on wheels. Outlays for autos and parts increased about 15 percent during the year, to almost $30 billion, as about 9.3 million new cars (including half a million imports) moved out of the showrooms and onto the freeways. Some of these sales were taken from the 1964 market, which was held down by late-year strike shortages, but even so, the boom pace set in early 1965 continued almost unabated throughout the entire year.

The hottest item was a sports-compact model which jumped to third place in the total sales race, on the basis of a strong demand (according to Detroit's market researchers) by 33-year-old bachelors with a $9,400 income. But obviously there were many other buyers in the market for this and for every other model as well.

The auto market was sustained by a substantial 7-percent increase in disposable personal income and also by a 6-percent gain in the number of older cars headed for the scrap heap and a sharp 35-percent rise in the number of 18-year-olds headed for the used-car lots. More than that, consumers allocated 6½ percent of their disposable income for autos and parts during the 1965-model year—the highest portion since hitherto fabulous 1955. The market was also sustained by a strong increase in auto-credit extensions—up more than 15 percent during the year. The inexpensiveness of the product also helped; over the course of this business expansion, new-car prices dropped 4 percent while all consumer items were going up almost 6 percent. (This situation was partly due to the midyear excise-tax reduction.) Other favorable factors were the rising number of two-car families, up from 19 percent to 24 percent of the total in two-years' time, and a definite trading-up by consumers, evidenced by the declining market share (from 28 to 20 percent) of the two lowest-price categories over the same two-year period.

Business funds; business urges

Businessmen, like auto buyers, had the funds to buy new facilities and the definite urge to spend those funds. After several straight years of substantial gains in plant-equipment spending, businessmen in 1965 increased their expenditures 15 percent more, to $70 billion, and at yearend they were projecting comparable increases for 1966. Spending was sustained by the continued growth of corporate profits and depreciation allowances —up almost two-thirds since the beginning of the 1961-1965 expansion—and by the continued strong sales expectations of most businessmen.

The year-end strength of the plant-equipment boom was also based on management's belief that existing facilities were inadequate to meet current market requirements. Over 60 percent of metal-fabricating industries, for example, considered their present facilities inadequate in late 1965, as compared with only 32 percent who required new facilities the year previously. The high level of earlier expenditures also kept the boom going at yearend; in the fall months, the carryover of expenditures for projects already underway amounted to over $16 billion—almost three-quarters' work at the current spending rate.

Business spending for inventories, at $8 billion, represented the biggest stock buildup since 1951. Heavy first-quarter buying was associated with the strike-hedging activities of steel consumers and post-strike buildup of auto dealers. Yet, despite the late-1965 runoff of steel inventories, the pace of stock-building was consistently higher throughout the year than at any time since the Korean war. And even after the signing of a new labor contract led to a fourth-quarter decline in steel inventories, stockbuilding remained high elsewhere on the basis of the buildup in autos, consumer nondurable goods, business plant-equipment, and defense purchases.

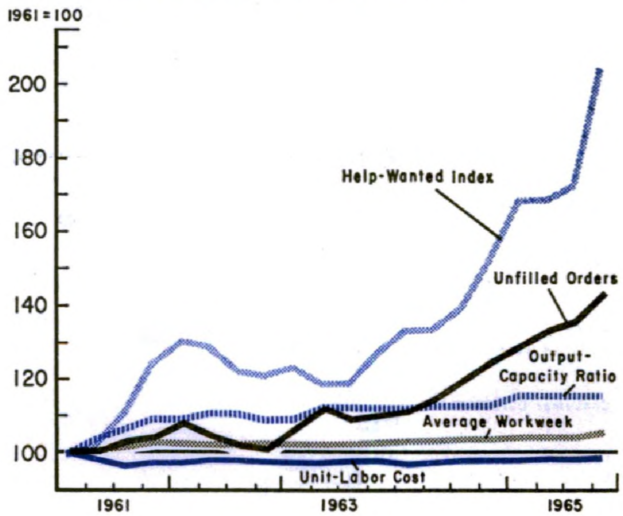
Yet, with all that, the inventory sector provided little evidence of an unwarranted expansion. Inventory gains, in other words, moved fairly closely with gains in total activity. In 1965 as in 1961-64, nonfarm inventories amounted to roughly 21½ percent of GNP, and this figure in turn represented a postwar low.

Vietnam = inflation?

Defense spending, which had strongly stimulated the economy in the 1961-62 period and had then trended downward during a three-year period of Pentagon cost-cutting, turned sharply upwards in the fourth quarter of 1965 as a result of escalation in Vietnam. Total defense spending for the year amounted to $50 billion—the same as in 1964, and the smallest proportion of GNP since 1950. But, as already indicated, the new military situation by yearend meant a significant change in business activity and in business expectations. With escalation, defense spending jumped 5 percent in 1965's final quarter, and this represented only a foretaste of what was in store for 1966.

In this new situation, inflationary pressures became active for the first time in this five-year-long expansion. One hopeful sign was

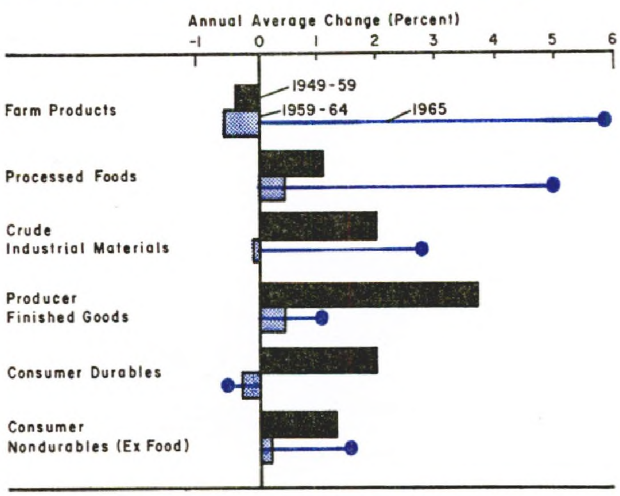
Unit-labor cost remains stable, but other pressure indexes soar



the continuing stability of an important cost indicator, unit-labor cost in manufacturing industries. And yet, by yearend, capacity usage in manufacturing was close to the 92-percent "optimum," and the average workweek in manufacturing was up from the 40-hour norm to 41½ hours (a postwar record). At the same time, unfilled orders of durable goods manufacturers increased about 15 percent over the year, and the Conference Board help-wanted index rose some 30 percent.

The problem by yearend was to keep manpower usage and manufacturers' operating ratios near the optimum levels then attained. Optimists argued that with unemployment near the 4-percent target, and with rapid increases in the labor force, the economy's labor requirements could be met without undue pressure, but pessimists saw obvious signs of strain in the increased workweek and in the shortage of skilled workers. Optimists also envisioned a steady enlargement of manufacturing capacity, comparable to the 5½-percent gain recorded in 1965, through further increases in plant-equipment spending. Pessimists, however, emphasized the strains arising from the inefficiently high level of capacity usage in some industries and from increasing order backlogs and tight raw-material markets.

Wholesale-price index starts rising on basis of farm and food upsurge



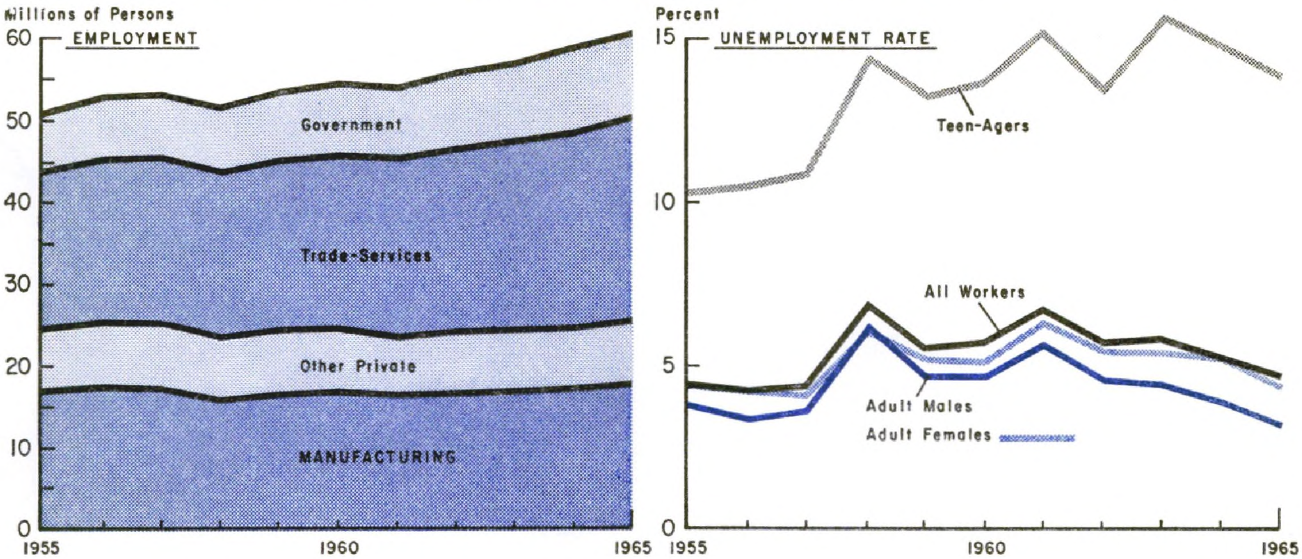
Prices: factory and farm

As a reflection of the actual or incipient pressures operating in the economy, price indexes in 1965 registered larger increases than they did earlier in this business expansion. The consumer index and the total GNP index edged up more than usual, and even the long-stable wholesale index advanced almost 2 percent. Prices of final goods, both producer and consumer, remained relatively stable, but industrial materials' prices increased, and food and farm prices jumped sharply.

In the industrial category of the wholesale-price index, more commodities advanced in price than heretofore; 53 of 73 sub-categories in the industrial index rose during 1965. Nonferrous metals' prices advanced about 10 percent for the second straight year, on the heels of a heavy worldwide demand and strike-created supply shortages. Stable prices of autos and electrical machinery were offset somewhat by increased prices of non-electrical machinery. Household durables' prices dropped because of intense competition in that industry, and building materials' prices also weakened because of the low level of housing activity. At the same time, substantial advances in hide-and-leather prices occurred because of a decline in cattle slaughter.

This mixed picture in industrial prices was overshadowed by the soaring increases in farm products and processed foods. A large 1964 pack kept fruit and vegetable prices relatively low, but hog prices jumped about 80 percent during the year, and meat and bakery prices also rose sharply. The 4-percent increase for foods may prove to be a transitory affair, but observers were reminded of Professor Walter Heller's remark of several years ago regarding price movements: "This month's special non-recurring factors always seem to give way to other non-recurring factors next month."

Prosperity creates substantial increase in employment and concomitant decrease in joblessness, even among teenagers



Prosperity's happier side

The pressures of prosperity also reflected a more hopeful development—a substantial expansion in employment and a concomitant improvement in the unemployment rate. The labor force increased about 1.4 million as the postwar baby boom began flooding the labor market, but nonfarm employment increased 2.2 million as practically all sectors added to their payrolls. Among other developments, teenagers accounted for almost one-half of the new labor-force entrants, even though they represent only about one-tenth of the labor force. Unemployment, meanwhile, averaged 4.6 percent during the year, and dropped almost to the 4-percent "target" by yearend.

Consequently, despite the price and other problems which became manifest by yearend, the dominant impression of 1965 was one of high-level prosperity. Under the impact of the previous year's tax cut, GNP soared to $676 billion in 1965, or perhaps $25 billion above the level that would likely have obtained in the absence of that stimulus. Businessmen saw profit margins rise to 18 percent of corporate gross product, as against 16½ percent in the pre-tax-cut period, and individuals saw disposable income rise to $465 billion, up 15 percent over the level in the 1963 pre-tax-cut year.

Social-security recipients received a 7-percent average increase in their benefits, Federal civilian and military personnel obtained pay raises, and new labor contracts included increases more or less in line with the now-famous 3.2-percent guideline. And even those who had heretofore been left behind—farmers and unskilled workers in particular—considerably improved their situation during the year.

Little wonder then that Americans exhibited great interest in both the obvious trappings of prosperity and the luxuries that are now considered necessities. Consumers, with some abandon, bought ever-larger amounts of electric knives, electric toothbrushes, and the latest electronic favorite, color TV. In the latter case, consumers bought almost twice as many sets as they did in 1964, and apparently they would have bought many additional sets if more of the tinted screens had been available. It was not quite the year that one retailer described in terms of "people buying anything set out on the counter," but it was nonetheless a year of high-level and high-style prosperity.

Expansion—With Restraint

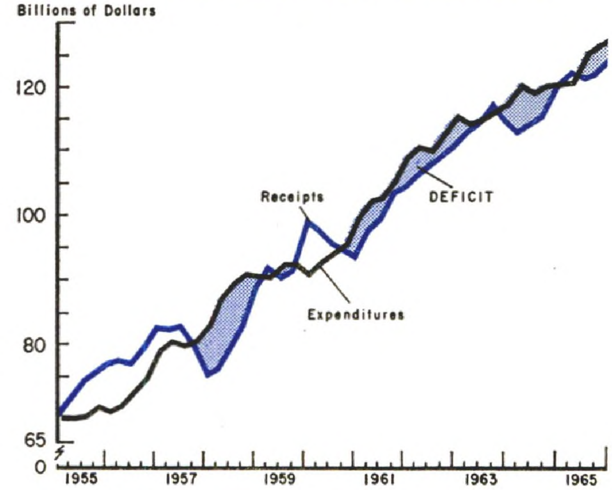
ALL THINGS considered, 1965 was a very good year for the performance of public policies tailored to promote the growth of the economy and to put unused resources to work. The very success of these measures, nonetheless, presented new problems by year-end, as the economy finally approached that happy state of full employment that had been pursued for nearly a decade. The problems of success thus called forth a different mix of policies than had been required in the early years of this business expansion.

Fiscal policy and monetary policy already were less expansive in 1965 than they were the previous year. In spite of a $1.8 billion Federal excise-tax cut that took effect around the middle of the year, the Federal cash-budget deficit was only about half of what it had been in 1964. And monetary policy, which in 1964 had passed from a posture of ease to a more neutral stance, subsequently tightened somewhat; beginning in February 1965, the reserve position of the member-banking system went from net free reserves to consistent net borrowed reserves for the first time since May 1960. This shift in policy was not designed to reduce the flow of credit, but rather was geared to keep the increase in bank credit within reasonable bounds.

Policy: still expansive

Tax-payers in 1965 were twice blessed with tax reductions. First of all, they continued to reap the benefits of the tax cuts embodied in the Revenue Act of 1964, as both individuals and corporations received additions of about $2 billion to their after-tax income. Then, in June, the President signed a measure scheduled eventually to eliminate $4.6 billion of Federal excises on a broad variety of consumer goods and services. The first such reductions became effective on July 1, and were made retroactive to May 15 for passenger autos and air conditioners. On the other hand, the $1.7-billion excise-tax reduction scheduled for January 1, 1966, was more than offset by an almost $6-billion increase in social security taxes effective on the same date. And, in view of the inflationary dangers confronting the nation in early 1966, President Johnson asked Congress to rescind most of that second-stage excise-tax reduction, and also to speed-up the collection of individual and corporate income-tax liabilities.

Budget deficit narrows
despite income- and excise-tax cuts



The tax relief afforded the economy in 1965 was reinforced by increases in Federal spending. Higher social-security benefits and pay raises for the armed forces and for the Federal civil service added to the stream of Federal payments, but the largest spending increase was related to the military build-up in Vietnam. The fiscal costs associated with the intensification of this commitment will be felt more strongly in 1966, since Vietnam will account for most of the projected $7-billion increase in Federal purchases. At any rate, Vietnam-associated spending will more than offset the "fiscal drag" that many economists feared would slow the growth of the economy as a rising level of output generated more than proportionate increases in Federal revenues. Hence, the shift in Washington thinking from the necessity of future tax cuts to the possibility of future tax increases.

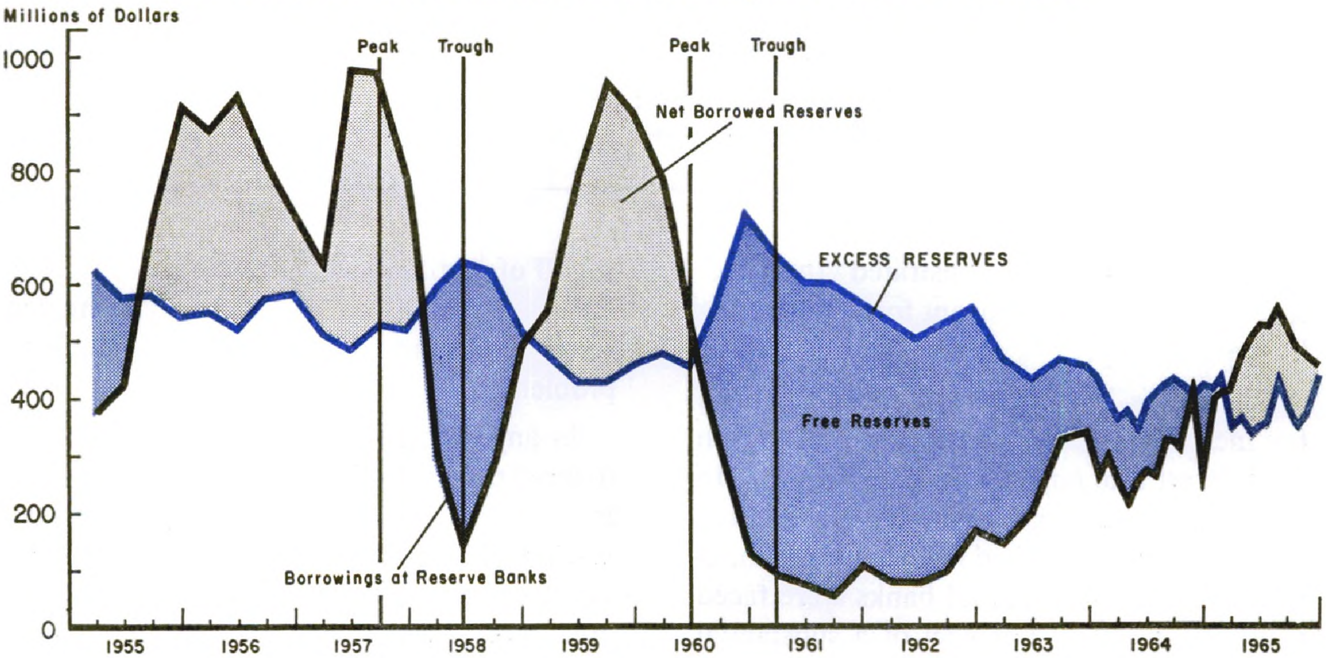
Policy: pulling the string

In a superficial sense, monetary policy actions in 1965 were a repeat of the 1964 performance. In the second half of 1964, a decline occurred in net free reserves (that is, member-banks' excess reserves minus their borrowings), and increases were posted in the discount rate and the maximum interest rates payable on time-and-savings deposits. And the same things happened again in 1965 —although the member banks became net debtors to the Federal Reserve Banks as net free reserves became net borrowed reserves, and the increases in the discount rate and time-deposit interest ceilings came in December rather than November. However, the similarity quickly fades upon closer inspection. The situation differed from that of late 1964, when the discount rate was raised so as to narrow the differential between domestic interest rates and interest rates abroad in connection with our balance-of-payments difficulties: the November-1964 change from 3½ percent to 4 percent did not signal the advent of a policy of domestic monetary restraint, but rather followed directly upon the increase in bank rate by the Bank of England.

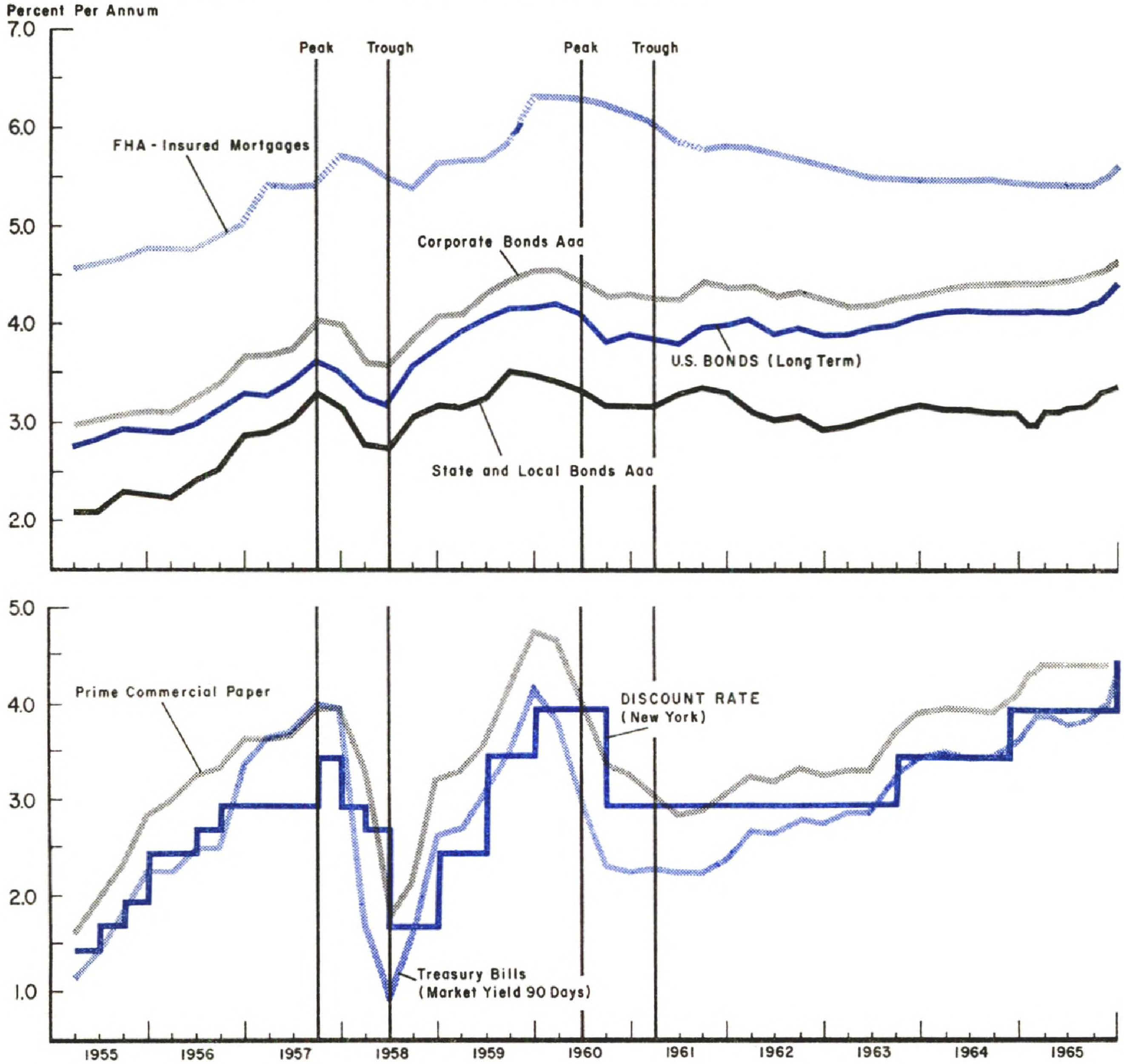
The demand for bank credit in early 1965 was unusually strong at a time of year that customarily witnesses a net reduction in bank loans. As the demand for bank credit pressed upon available reserves, reserves were supplied to the banking system at a slower rate, and the average level of net borrowed reserves increased to over $150 million by midyear. Money-market rates meanwhile eased somewhat, with the 91-day Treasury-bill rate falling from almost 4 percent in February to about 3.77 percent in June. Later, however, money-market rates started upward, and by October the Treasury-bill rate rose above and remained above the 4-percent discount rate.

The subsequent decision to raise the discount rate evoked spirited dissent. Much of the disagreement vanished rather quickly,

Pressure on banking system increases in 1965, as Federal Reserve supplies reserves at slower rate in face of heavy bank-credit demand



Short-term rates rise sharply after discount-rate hike, and upward movement of long-term rates accelerates



however, as events demonstrated the widespread nature of the buoyant forces operating in the economy.

There was less discussion about the need for increasing to 5½ percent the ceiling on the interest rate payable on time deposits. In this case, the market rate on negotiable time-certificates of deposit had risen to the old maximum of 4½ percent, and banks were faced with the unsettling prospect of a substantial runoff of certificates coming to maturity. The lifting of the ceiling to 5½ percent created some headroom for managing this liquidity problem.

In any event, the atmosphere of late 1965 differed considerably from that of the year before. In the more recent period, the money markets confronted a stronger-than-usual seasonal demand for bank credit, along with a great deal of uncertainty concerning the Vietnam situation and its effects on Federal finances. Accordingly, the focus of concern of policy makers shifted from the balance-of-payments deficit to a domestic economy which no longer required an expansive monetary policy.

Credit for the boom

The more restrictive monetary policy that became effective in 1965 did not contain the demand for credit. By almost any measure, the monetary expansion was greater in 1965 than in any of the preceding four years of the current boom. Total bank credit, total bank loans, and the money supply all registered the greatest rates of growth for any single year in the present expansion. In fact, the rate of expansion of bank loans was about one-third above the already rapid pace of the 1962-64 period.

Banks obtained a part of the funds needed to expand their portfolios of loans and other securities by selling off U. S. Government securities, a practice that they have followed since 1961. However, the banking system acquired municipal securities faster than it sold off Governments in 1965, so that the source of bank reserves to fuel the credit expansion had to come from elsewhere. Additional funds were obtained mostly from the net increase in Governments held by the Federal Reserve Open Market Account in its open market operations over the year. Federal Reserve open-market purchases were largely made for the purpose of offsetting the drain on reserves created by the gold outflow and the public's increased holdings of currency.

Moreover, a sharp rise in time deposits supplied reserves through diluting the deposit mix of bank deposits. (Since reserve requirements are lower on time deposits than on demand deposits, this shift lowered average reserve requirements against all outstanding deposits.)

Up across the board

After a year of relative stability in 1964, interest rates started to move up again in 1965. As already noted, the largest part of the increases occurred in the second half of the year, although some upward movement in long-term yields was also evident earlier. Short-term rates demonstrated a small decline in the first six months of 1965, as the 91-day Treasury-bill rate, to which short-term rates are anchored, drifted down thirteen basis points between February and June to around 3.80 percent. In the long-term capital markets, yields on tax-exempt municipal securities came under the greatest upward pressure, advancing about seventeen basis points. Top quality corporate issues edged up slightly in this same period, while long-term Governments fluctuated within a narrow range.

In the second half of the year, short-term rates, as characterized by the yield on 91-day Treasury bills, rose by 63 basis points between the end of June and the end of December. Over half of the increase took place after the December change in the discount rate. The already apparent uptrend in long-term rates meanwhile accelerated, as yields on Governments, corporates, and municipal securities moved up over 30 basis points. As before, the average return on tax-exempt securities led this upward movement. Mortgage rates, which were virtually unchanged through most of the year, did not join the parade until November.

Success—But More to Go

THE NATION made a concerted effort in 1965 to reduce or eliminate the chronic deficit in its balance of payments with the rest of the world. The endeavor was more than halfway successful, since the deficit declined from $2.8 billion in 1964 to $1.3 billion in 1965, when measured on the so-called liquidity basis. The endeavor was not uniformly successful throughout the year, however, and in some sectors the payments position actually worsened.

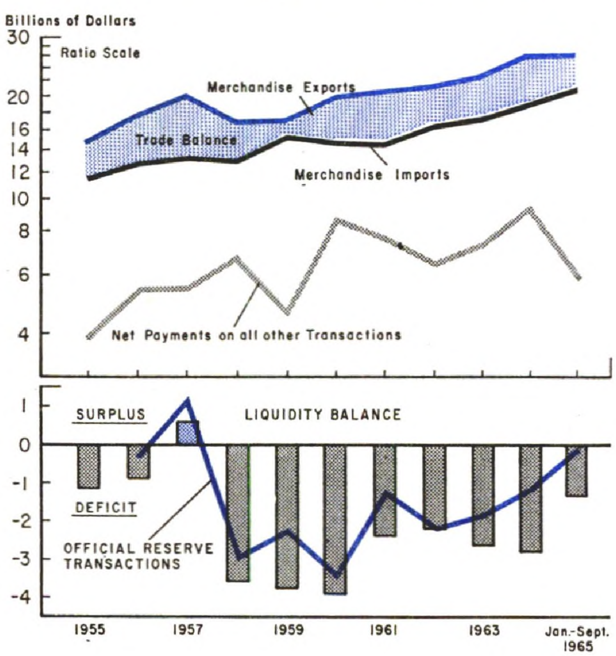
Where we gained

The reduction in the deficit can be traced in large part to the sharp decline in the net outflow of private capital (excluding direct investment). The total outflow on this account dropped from $4.1 billion in 1964 to $0.2 billion (seasonally adjusted annual rate) in the first three quarters of 1965.

The most spectacular improvement in the capital account came in short-term claims, which turned around from an increase of $2.1 billion in 1964 to a $0.9-billion reduction in 1965. This improvement was caused, partly by a decline of U. S. commercial banks' claims on foreigners and partly by a return of liquid balances held abroad by U. S. nonfinancial corporations. Another major improvement was the decline in the outflow of long-term private capital, which amounted to $1.3 billion in 1964 and to a rate of $0.5 billion in the first three quarters of 1965. In addition, income from American investments abroad rose from $4.0 billion to a $4.7-billion rate over this period—partly because of the growing investment base overseas, but partly too because of the response to the Government's balance-of-payments program through the repatriation of earnings and liquid balances held abroad.

The Government itself contributed to the reduction in the payments gap, at least through the first three quarters, by cutting back on its military expenditures and by receiving increased repayments for its previous loans. When final-quarter data become available, however, they may show a deterioration in this account because of the late-1965 intensification of the conflict in Vietnam.

Payments position improves
despite narrowing of trade balance

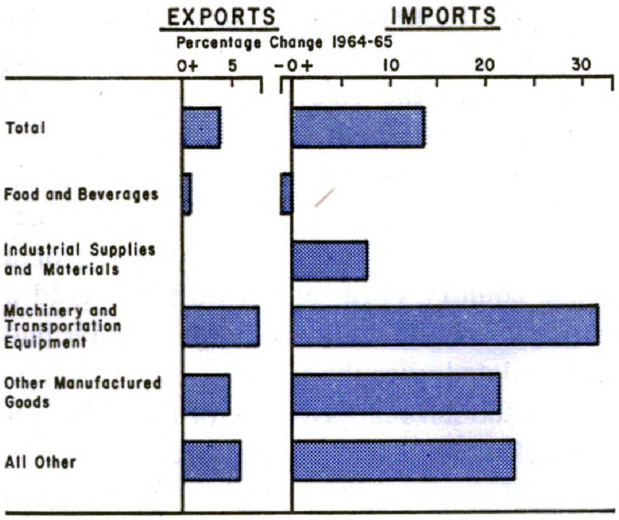


Where we lost

The trade balance, by far the strongest element in the nation's payments position over the years, was something of a disappointment in 1965. Admittedly, the previous year's trade surplus, at $6.7 billion, was abnormally high, but the 1965 surplus, roughly $4.8 billion, was somewhat below expectations.

A number of factors contributed to the worsening of the trade position. A dock strike in the first quarter of the year affected exports to a greater degree than imports, and a steel-strike threat stimulated heavy purchases of foreign steel by U. S. manufacturing firms. But even aside from these special factors, the trade surplus likely would have declined because of the sharp increase in imports attrib-

Booming domestic economy
creates heavy demand for imports



utable to the demands of the booming U. S. economy. This development perhaps should have been expected, since a rapid rate of growth historically tends to induce a heavy demand for imports, and since the 7½-percent U. S. expansion far outpaced the growth rate of other industrial nations during the year.

As Americans traveled abroad in ever-increasing numbers, they widened the "travel gap" between their expenditures abroad and foreign-tourist spending in this country by almost $0.2 billion. And as U. S. corporations increased their spending on foreign facilities by some 20 percent, they increased the direct-investment outflow from $2.4 billion in 1964 to a $3.4-billion rate in January-September 1965. Such expenditures, of course, promote a greater return flow of income in the long run, but they worsen the payments position at the time they are made.

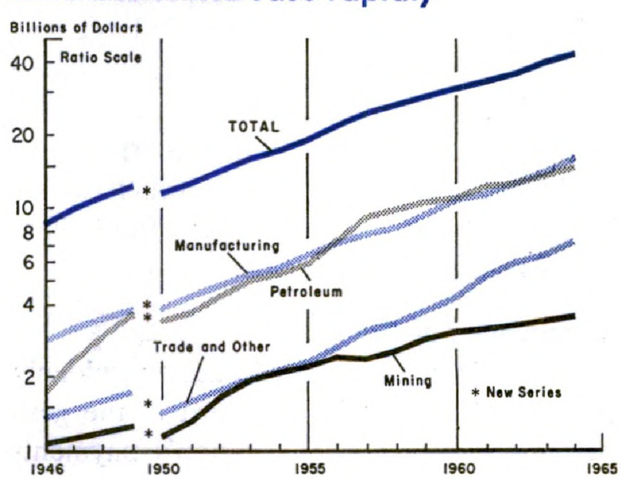
Another minus item was the rise in sales of foreign securities in the American money market, in contrast to the severe cutback in such sales in the preceding year. Moreover, a large net outflow of foreign capital occurred in the spring and summer quarters, when the British government sold off U. S. corporate securities which had been requisitioned from British residents at the beginning of World War II. These sales were essentially a one-shot transaction, but they adversely affected the U. S. payments position because the proceeds of the sales were invested in liquid claims against this country.

A matter of measures

Esoteric definitional problems played an important part in balance-of-payments discussions during 1965, as several official and unofficial groups came forward with alternative proposals for measuring the nation's payments position. (Esoteric or not, the controversy helped throw some light on a hitherto-murky area, principally by highlighting the extent to which different yardsticks can lead to different conclusions regarding the magnitude of the problem.) After extensive study, the Department of Commerce eventually decided to express the payments position on two bases—the "liquidity balance" and the "balance on official reserve transactions" ("official-settlements balance").

Each of these definitions (and every other suggested balance-of-payments definition) relates to changes in U. S. reserve assets. By each definition, a contribution to payments surplus is recorded whenever the reserve holdings of U. S. monetary authorities are increased by gains in gold, claims on the International Monetary Fund, or liquid assets in

Investment in foreign facilities
continues to increase rapidly



convertible currencies. But the measures of balance also take into account changes in certain claims that could be exercised against U. S. reserves. Various types of assets differ in the extent and directness of their claim on U. S. reserves, and these differences are at the basis of the measurement problem.

The liquidity balance spotlights the liquid claims of foreigners, both private and official, against this country. The potential U. S. exposure is measured by the volume of such liquid claims, and any increase in claims which is not offset by a growth of reserve assets is recorded as a U. S. deficit.

The official-settlements balance, on the other hand, draws the line between the dollar holdings of foreign monetary authorities and those of private foreign holders. If an increase occurs in privately held foreign liquid claims, it is treated as an inflow of private capital—as a desired holding of additional dollars and not as an addition to the deficit, as it is under the liquidity definition. The official-settlements concept thus concentrates on the dollar claims that foreign monetary authorities have acquired or relinquished, since it is only those claims that can be directly exchanged for our own reserve assets.

According to preliminary estimates, the U. S. deficit on either basis was about $1.3 billion in 1965. On the liquidity basis, this represents an improvement of about $1.5 billion over the 1964 performance. On the official-settlements basis, however, it represents a deterioration of about $0.1 billion, in large part because of a sharp fourth-quarter rise in liquid claims held by foreign monetary authorities. (This development reflected a sharp rise in confidence in the British pound, which caused foreigners to repurchase pounds for dollars from official British agencies.)

A matter of outflows

But yet in 1965 the gold outflow suddenly accelerated, almost in disregard of the general improvement in the nation's payments balance. Net sales of U. S. gold jumped from $0.1 billion in 1964 to nearly $1.7 billion in 1965—or to about $1.4 billion when allowance is made for a gold transfer made in connection with the enlargement of the U. S. quota in the International Monetary Fund. This outflow—which was concentrated almost entirely in the first half of the year—occurred largely because of the decision of a single country (France) to turn into gold a large part of the dollar holdings which it had accumulated over the years.

The sudden reappearance of the gold outflow, plus the equally sudden late-1964 worsening of the payments problem, brought the problem into the headlines again and, specifically, focussed the nation's attention on what precisely had been accomplished in the last half-decade's attempts to deal with the situation. Since the 1958-60 period, when successive and substantial deficits—highlighted by a $5-billion gold outflow—culminated in the spectacle of a worldwide attack on the dollar, notable progress had been made on some but not on all fronts.

Over the period of a half-decade, military spending abroad was reduced drastically (at least until Vietnam), and practically all new foreign-aid contracts were placed in this country rather than abroad. Moreover, U. S. merchandise exports increased about 50 percent, and income from foreign investments actually doubled. Nonetheless, the substantial improvement in all these sectors was offset by the increase in tourist spending and (especially) by the expanded outflows of private short- and long-term capital. Indeed, the nation's problems were accentuated in many respects by its successful performance in the role of world banker, that is, as supplier of short-term reserves as well as long-term funds to the international community.

A matter of banking

The balance-of-payments predicament may best be understood in banking terms, as Fed-

Balance-of-Payments Program

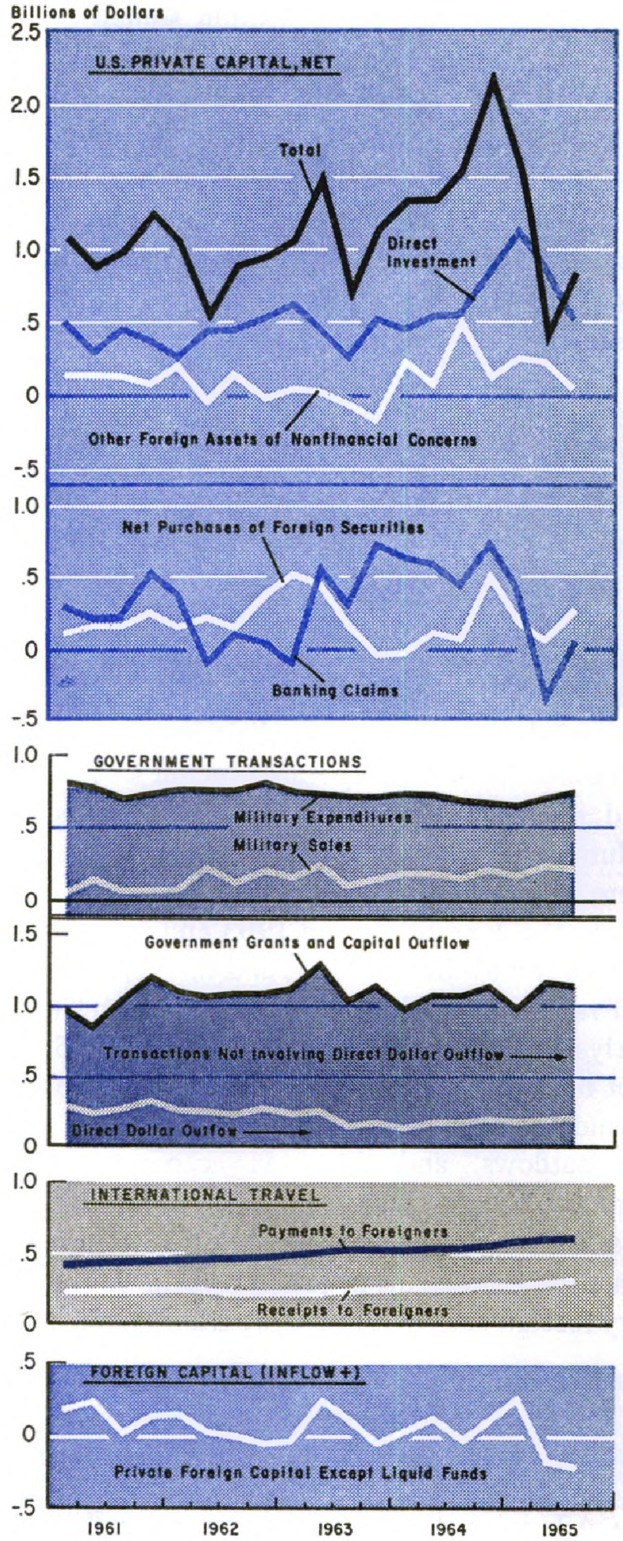
Private-capital outflows were sharply reduced in 1965, as a result of banks' and businesses' voluntary cooperation with the balance-of-payments guidelines.

The revised program for 1966 allows for a small expansion in bank lending and includes specific guidelines to limit direct-investment outflows.

Government agencies, in attempting to reduce the balance-of-payments impact of defense and aid programs, followed several different approaches: tying aid payments to procurement in the U. S., reorganizing overseas military operations, and increasing sales of military equipment abroad.

The travel gap was attacked through the expansion of the "See the U. S. A. program" and the reduction of U. S. tourists' duty-free allowances.

New tax incentives were proposed to encourage foreign investment in this country.



eral Reserve Chairman Martin stated when he presented the official balance-of-payments program to the financial community last February. This country, as a reserve-currency country, has a financial position somewhat like that of a bank. First of all, the U. S. is solvent and has an enviable capital structure. With international assets of over $100 billion and total liabilities abroad of roughly $60 billion, it holds a $40-billion equity position. Its reserve position also is strong. Against a gold reserve of almost $14 billion, there are liquid claims of some $30 billion, so that it has cash on hand equal to almost one-half of the claims against it.

Where then is the problem? In Mr. Martin's banking terms, the problem is one of secondary liquidity. Our lending and investing abroad have increased faster than the desire of others to hold deposits—that is, dollar claims—against us. To solve the problem, we can, like a bank, either increase the willingness of depositors to leave their money with us or else cut back temporarily on our lending and investing abroad. To achieve the first solution, increases in short-term money rates were called for; thus, the Federal Reserve raised the discount rate in 1963 and again in 1964 (and again in 1965), and the Treasury bill rate went up from about 2¼ percent in early 1961 to over 4½ percent in late 1965. But this interest-rate solution had to be supplemented by a second approach limiting dollar outflows, and this was accomplished through the interest-equalization tax (imposed on foreign securities in 1963 and extended to bank loans in 1965) and the voluntary foreign credit-restraint program (1965).

Progress and policy

The results of the credit-restraint program have been generally encouraging. In 1965, U. S. banks as a group complied fully with the Administration request to increase their foreign loans no more than 5 percent above end-1964 levels; despite an early-1965 splurge, their outstandings by late 1965 were only 2 percent above end-1964 levels. Moreover, corporations responded to the Commerce Department's program by repatriating substantial amounts of short-term assets and financing new foreign projects by raising funds overseas—and yet, U. S. corporations wound up with a 20-percent increase for the year in capital expenditures abroad. (Meanwhile, as already noted, exports increased only 4 percent while imports were soaring 15 percent in response to the demands generated by the domestic business boom.)

In early 1966, then, the prospect was for a continuation of the prescription adopted in early 1965. Restraints on bank lending abroad will continue, with guidelines based as before on loans outstanding as of December 1964. But lending targets will now be raised gradually from 5 percent to 9 percent above the 1964 level. Moreover, targets for corporate outflows will be sharpened, with specific guidelines outlined for direct investment. Specifically, dollar outflows for this purpose should be reduced to the 1964 level of $2.4 billion, as against the (January-September) 1965 figure of $3.4 billion.

This selective approach is consistent with the desired composition of the private capital outflow. Exemptions granted in the interest-equalization tax and priorities established in the voluntary programs protect the access of less-developed countries (and countries largely dependent on U. S. financing) to the U. S. capital market. The Federal Reserve program, moreover, gives priority to export financing, within the overall ceilings established by the guidelines. Then, by increasing the cost of borrowing in this country, the interest-equalization tax contains its own escape valve; countries in urgent need of new U. S. capital issues are still free to enter the market, while the less urgent needs are screened out. The guideline approach of the voluntary programs meanwhile leaves it up to business firms and banks to make their own decisions about individual investment opportunities.

All Borrowers Bloom

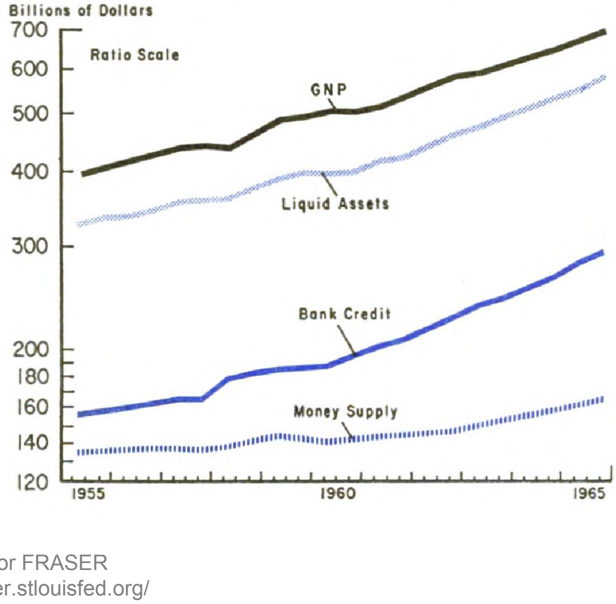
In many respects, 1965's credit-market story closely resembled 1964's happy tale. There were some significant differences, notably a rise in interest rates which commenced in the third quarter and subsequently carried yields on many debt instruments to 30-year highs. But otherwise, the actors and the libretto in this credit-market drama were much the same as in the preceding year.

All performers—consumers, businesses, and governments—recorded higher levels of income, and all of them again supplemented their earnings with increased borrowings to help finance rising expenditures for goods and services. The net gain in borrowings amounted to $72 billion, rising $5 billion above even the substantial 1964 increase. Even so, total debt grew less rapidly than GNP, unlike the normal experience of the earlier years of this business expansion.

Money and its uses

Consumers supplemented a $31-billion increase in disposable income with a $28-billion increase in debt. Businesses, despite a $4-billion rise in corporate net earnings, added $31 billion in new borrowings. (Business firms accounted for over two-fifths of the net funds raised in credit markets in 1965—a significantly higher proportion than the recent norm.) Foreign borrowers increased their debt by only about $3 billion, under the impact of measures designed to remedy the imbalance in the nation's external transactions. In the public sector, the Federal government supplemented an $8-billion rise in tax receipts with only about $1 billion in new borrowings; state-and-local governments, on the other hand, augmented a $4½-billion rise in revenues with the proceeds from over $8 billion in new debt offerings.

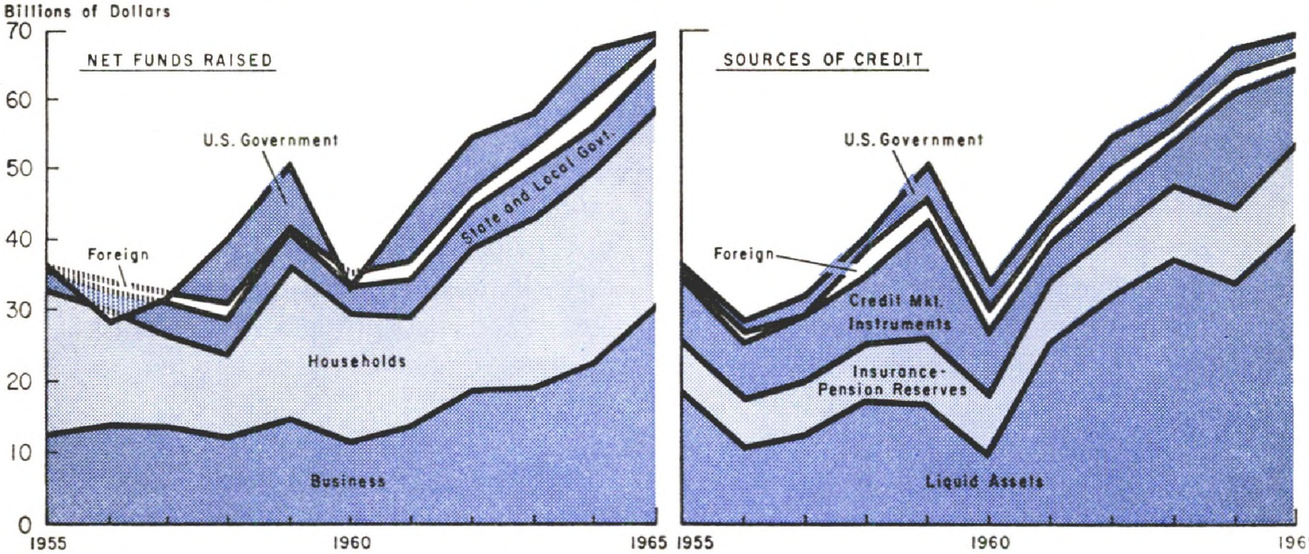
Boom fueled by rapid growth in bank credit and liquid assets



On the supply side of the market, a comparable rise in financial assets occurred. Over three-fourths of this increase took the form of additions to liquid assets and additions to private-insurance and pension-fund reserves. The money-supply component (demand deposits and currency) increased faster than in 1964 as households in particular found higher working balances necessary to finance rising levels of expenditure. But the money supply still grew at a slower rate than GNP, especially since business firms actually reduced their active balances during the year.

Consumers, businesses, and state-and-local governments all responded enthusiastically to highly competitive time-deposit yields and substantially increased their interest-bearing liquid-asset holdings. Moreover, largely as a consequence of this time-deposit buildup, commercial banks obtained the resources to expand their role in credit markets, and commercial-bank credit thus grew faster than GNP during the year. At the same time, the rapid growth of these higher-cost funds at banks and other savings institutions, along with the late-year acceleration in the pace of borrowing, played a significant role in the late-1965 increase in interest rates.

Business sector plays most important role in 1965's credit markets, but household demand also strong . . . liquid assets major source of funds



The leading actor

The business sector was by far the most important influence in credit markets in 1965. The increased reliance of business on external financing could not be attributed, however, to any lag in earnings, since corporate sales and earnings performed excellently in 1964 and then soared to new peaks in 1965. The strong and widespread business expansion helped generate a 14-percent gain in corporate pretax profits and an increase of almost 20 percent (to $44 billion) in after-tax profits. Stockholders were pleased with a $1-billion increase in dividend checks, and corporate treasurers were delighted with a $6-billion increase (double the 1964 gain) in retained earnings.

Corporate cash flow (retained earnings plus depreciation allowances) jumped 10 percent over the 1964 level to $55 billion. Nonetheless, this increase could not keep pace with business financial needs—witness the continued decline in corporate-liquidity ratios—as a sharply expanded volume of trade credit was piled atop a rapid $9-billion growth in outlays for new facilities and inventories.

Business financed its 1965 expansion by borrowing heavily from commercial banks and by taking in $15 billion more from stock and bond offerings. (The increase in security issues was $2 billion greater than the big 1964 increase, which was influenced by two very large utility issues.) The new issues were predominantly debt issues, partly because corporate management preferred to avoid diluting its stockholders' equity, and partly because cost-conscious corporate treasurers tended to favor the interest-deductible feature of debt issues. Corporate treasurers, meanwhile, demonstrated their financial astuteness by keeping their cash balances to a minimum while financing higher levels of receivables and other expenditures. In this way they were able to increase their holdings of interest-yielding assets substantially, as evidenced by a $6-billion time-deposit expansion.

Secondary role

Although upstaged by the business sector in terms of gross credit demands, consumers participated vigorously in the nation's financial markets in 1965. The household sector recorded a $28-billion increase in debt—slightly more than 1964's increase—but it maintained the same debt composition as it did in the preceding year.

The bulk of the increase ($15½ billion) represented additions to mortgage debt. The mortgage gain, however, was only slightly greater than the 1964 increase, reflecting the continued weakness in the nation's housing market. Even so, the ratio of net mortgage financing to new residential spending increased further to 82 percent—sharply above the 57-percent figure prevailing at the beginning of this business expansion. This rising ratio, along with the wide $30-billion difference between the gross and the net mortgage totals (before and after repayments), supports the view that households are using mortgages increasingly as a vehicle for financing autos and other nonhousing expenditures.

Households also boosted their consumer loans by $9 billion in 1965, especially on the strength of an instalment-loan upsurge that expanded one-third faster than in the preceding year. The $7½-billion expansion of instalment debt, under the spur of the auto-financing boom and the substantial growth of personal loans, outstripped even the rapid increase in consumers' disposable income. Consequently, the debt-to-income ratio rose from 13.9 percent in 1964 to 14.3 percent in 1965. Some observers viewed this rising trend with misgiving, especially since the borrowers and the lenders were generally not the same individuals. Optimistic observers, however, pointed to more hopeful signs; for example, delinquent consumer loans declined further during the year, and consumer holdings of financial assets increased $52 billion as against their $23-billion increase in debt.

In 1965 as in 1964, consumers allocated one-half of their increase in financial assets to commercial-bank time deposits and other interest-bearing instruments. Consumers also increased their holdings of most other assets except corporate stocks. They were net sellers of stocks for the fourth consecutive year, and they thereby showed themselves to be more sensitive to current yields than to the prospect of capital gains.

Other actors

The Federal government played a somewhat subdued role in credit markets in 1965, thanks to a whopping $7-billion rise in tax receipts which outstripped the $5-billion increase in government outlays. The cash deficit consequently fell from 1964's tax-cut-induced deficit of $5½ billion, to $2½ billion in 1965. In financing that deficit, the Federal government limited the increase in its borrowings to $1 billion by drawing down its cash balances.

State-and-local governments, on the other hand, played a more prominent role than heretofore in the 1965 credit market. Growing demands for government services generated a faster increase in their deficit than in 1964, even in the face of rising state-local revenues and increased transfers from the Federal government. These governments thus registered a record volume of external financing during the year; their new capital offerings amounted to $10½ billion and their net debt outstanding rose by $7 billion. School bonds predominated in this financing, accounting for two-fifths of the proceeds from new offerings as against only one-third of the total a year ago. But borrowing for other purposes, such as roads, bridges, and housing, actually declined during the year.

Tax-exempt municipals continued to be favored as an investment by individuals and especially by commercial banks. (The latter absorbed almost three-fourths of total municipal-bond offerings in 1965.) A new situation developed after midyear, however. High levels of inventories and a rising volume of new offerings helped bring about a sharp drop in the price of tax-exempts at that time—and municipal treasurers, who had enjoyed relatively stable borrowing costs over the three preceding years, faced a marked increase in those costs by the end of 1965.

Busy Bankers

IN THE contemporary jargon, the process is called financial intermediation, but a century ago the novelist Alexander Dumas coined an alternative description: "Business—It's other people's money." Whatever the semantics involved, the process played a crucial role in the 1965 boom, and the nation's commercial banks were at the very center of the action.

Commercial banks established new records as both buyers and sellers of loanable funds. As suppliers of credit, banks sharply improved their position in the nation's credit markets, mostly at the expense of nonbank financial institutions. Altogether, banks supplied almost two-fifths of the total funds moving in credit markets in 1965. (Their share of the total was one-third in 1964 and only one-fifth in the late 1950's.) Total bank credit outstanding rose $27 billion—a striking 10-percent gain which outpaced even the rapid rise in GNP. This sharp expansion in bank credit directly reflected the upsurge of funds which flowed into the banks, highlighted by a striking 16-percent gain in time-and-savings deposits.

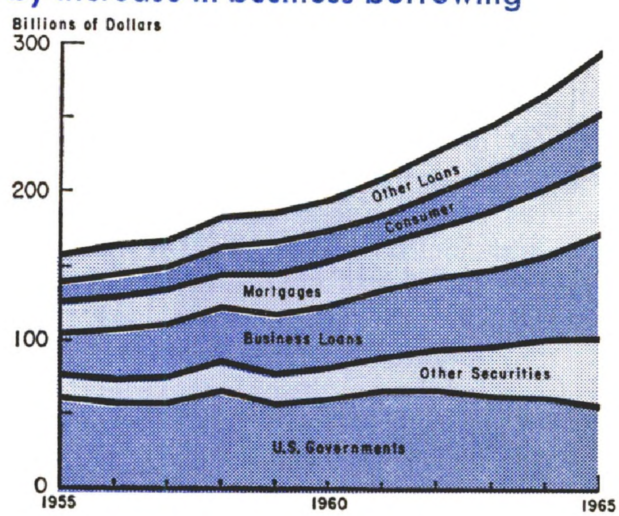
Busy businessmen

Total loans, exclusive of interbank loans, rose 14 percent in 1965. But $11 billion of the $24-billion increase went to the business sector, which expanded its bank borrowings by a substantial 19-percent. This borrowing boom was stimulated in early 1965 by several special factors; these included the East Coast dock strike, which increased the financing requirements of commodity dealers, and the strike threat in the steel industry, which triggered a surge of bank-financed inventory accumulation. But even after these special factors disappeared, business-credit demands remained extremely vigorous, on the strength of rising plant-equipment outlays, continued inventory demand, and a sharply expanded volume of trade credit.

Credit demands were so strong and so widespread that 15 of 18 major industrial groups borrowed more heavily than in 1964. The bulk of the loan demand (in dollar terms) centered in manufacturing, especially in the metals, machinery, transportation-equipment industries. The transportation-utilities sector meanwhile increased its bank-credit demands tenfold over the 1964 level. Manufacturing firms borrowed heavily both at the banks and in the capital market, but the utilities shifted almost entirely to bank financing, largely because of the relative stability of bank-loan rates as against the comparatively high and rising cost of money in the bond market.

Rates charged on short-term business loans remained fairly stable throughout most of 1965. Average rates through September failed to advance above the December-1964 level of 5.00 percent, but the average rate moved up to 5.27 percent in December after the discount-rate increase was followed by a rise in the prime rate offered the most creditworthy business borrowers. Nonprice terms of

Bank-credit boom caused mostly by increase in business borrowing



borrowing meanwhile firmed steadily during the year—witness the larger size of required compensatory balances, which increased the effective cost to business of bank accommodation.

Conspicuous consumers

Businessmen obviously were favored customers in 1965, but mortgage and consumer borrowers also received a hearty welcome from bank lending officers. Mortgage loans increased over $5 billion (20 percent more than in 1964) and consumer loans rose $4½ billion (50 percent above the 1964 increase).

The strong increase in mortgages occurred in the face of a sluggish housing market and a relatively slow increase in mortgage financing. Banks consequently increased their share of institutional-lenders' mortgage activity to 23 percent—up from 19 percent in 1964 and only 11 percent at the beginning of this business expansion. At the same time, banks increased their activity in the booming auto market, and thereby expanded their share of the total consumer-loan market from two-fifths in 1964 to almost one-half of the total in 1965.

Banks expanded their mortgage (and consumer) lending because they obviously needed to find profitable high-earning outlets for the massive inflow of high-cost deposits which deluged them after ceiling rates on their time-and-savings deposits went up in late 1964. But competitive pressures among mortgage lenders kept mortgage rates through October at the virtually stable level prevailing throughout the preceding three-year period. Even the late-1965 upsurge in rates left yields below the mid-1960 peak.

Government in the banks

Bank investment portfolios last year behaved much as they did in 1964, but with a substantially greater liquidation of U. S. Government securities and a substantially stronger expansion of tax-exempt municipals. Holdings of Government securities declined almost $4 billion—but this reduction, unlike the 1964 reduction, was centered in Treasury bills. (One- to five-year maturities also declined, but holdings of longer-term issues increased.) Consequently, one traditional measure of bank liquidity—the ratio of short-term Governments to total deposits—dropped to a ten-year low.

Bank holdings of "other securities" increased almost $6 billion, as banks absorbed about three-fourths of the total 1965 offerings of municipals. The switch in investment portfolios was undertaken primarily for earning purposes, especially since the yield spread between Treasury issues and tax-exempts widened somewhat during the year. Yet, as the market for tax-exempts expanded, banks increasingly viewed their portfolios of these securities as a potential source of liquidity to supplement their reduced holdings of short-term Governments.

Other peoples' money

The deposit side of the bank ledger provided vast amounts of "other people's money" to sustain the rapid expansion of bank credit. Demand deposits increased strongly by $6 billion, but time-and-savings deposits soared $21 billion (16 percent), far outstripping their 1964 gain.

The time-deposit upsurge dates from the late-1964 change in Federal Reserve Regulation Q, which raised the maximum rate that could be paid on such deposits. This change greatly enhanced the competitive attractiveness of bank deposit instruments and thus helped the banks to enlarge their share of interest-bearing funds at depositary-type institutions, from 49 percent in 1964 to 62 percent in 1965. Not surprisingly, the savings inflow into savings - and - loan associations dropped to the lowest level since 1960.

The heavy growth of high-cost funds continued to exert a strong impact on bank lending policies, as was evidenced by their stepped-up purchases of mortgages and tax-exempt securities. But the causal relationship was not at all one-sided, inasmuch as banks' ability to compete for deposits also depended upon the earnings on their assets. The exceptional strength of credit demands in 1965 contributed to the firming in yields on the debt instruments which banks chose to add to their asset portfolios, and this development thus enhanced banks' ability to compete effectively for funds in the form of interest-bearing deposits.

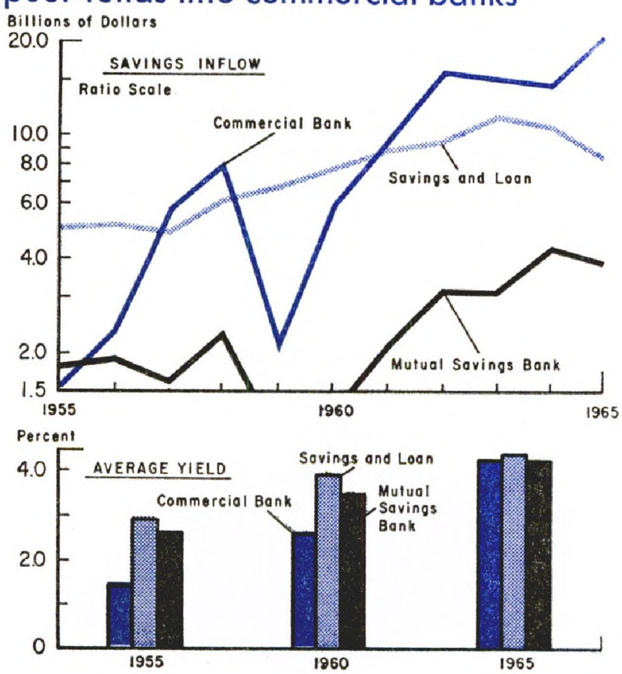
Increasing stringency

The increasing stringency in credit markets created problems for the banks in late 1965, when the rise in market rates of interest reduced the "tenability" (or maintainability) of both the discount rate and the 4½-percent ceiling rate permitted on time deposits. The banks' problems were exemplified by the circumstances surrounding large-denomination certificates of deposit, which increased by almost $4 billion in the first ten months of the year and thereby represented a substantial percentage of the time-deposit inflow.

With market yields generally rising, with banks already paying the maximum permissible rates for certificates of deposit, and with $3½ billion of these CD's scheduled to mature in December, the banks faced a very real possibility of a massive shift of interest-sensitive funds to other investment outlets. Moreover, since the banks had little latitude for meeting a runoff in deposits through the sale of short-term securities, they faced the danger of a forced liquidation of tax-exempts and other securities, to say nothing of tighter lending restraints generally.

The Federal Reserve System could have intervened to supply banks with enough reserves to meet such a deposit runoff. This was a very unattractive solution, however. Such a move, above all else, could have exacerbated already emerging inflationary pressures; in addition, it would have encouraged a massive shift of funds between investment outlets, and would have severely disrupted financial markets in the process. The increase in Regulation Q ceilings, which permitted banks to pay higher rates in order to retain CD's, was a more palatable alternative.

Interest-sensitive savers
pour funds into commercial banks



New groundrules

Market developments stemming in part from the late-1964 change in groundrules thus necessitated a further change in late 1965. This change—the increases in the discount rate and in Regulation Q—succeeded in relieving pressure by bringing certain rates back into line with market yields, but it did so only in the context of a higher overall level of yields. And while the change in Regulation Q was designed (in Chairman Martin's words) to permit the banks to expand their resources sufficiently to provide the economy with adequate medium- and long-term credit, the monetary authorities "purposely refrained" from allowing a rise in the maximum permissible rate payable on passbook savings. Ceiling rates were kept unchanged in this category in order "to minimize the impact of interest-rate changes" on competitive relationships between banks and their principal competitors.

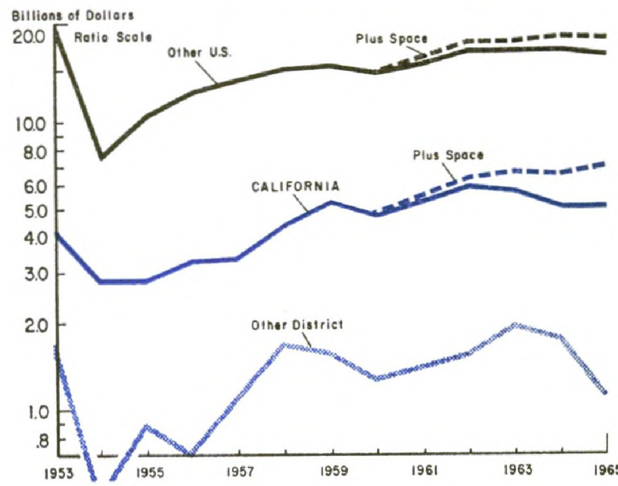
Western Gains—and Losses

THE WEST in 1965 benefited from the expansion generated by the previous year's Federal tax cut, but—unlike the rest of the country—it also felt the impact of earlier reductions on the other side of the Federal budget. Personal income of Twelfth District residents increased roughly 6 percent as against a gain of over 7 percent elsewhere, and District nonfarm employment rose 3½ percent as against a 4-percent gain in the rest of the country. But expansionary factors began to predominate as the year progressed, and the region's unemployment rate consequently dropped from 5.8 percent to 5.3 percent between late 1964 and late 1965.

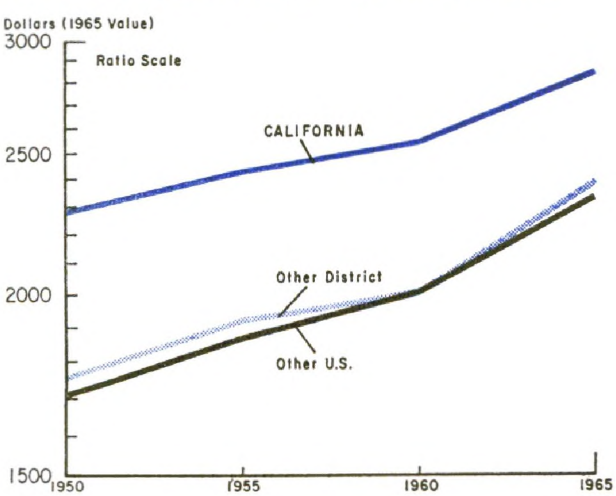
Manufacturing payrolls reversed their 1964 decline, although the 1½-percent increase in factory jobs fell considerably below the rise reported in the rest of the nation. Employment in construction actually dropped 1 percent while rising 6 percent elsewhere, largely because of the concentration of the industry's workers in residential construction, a continuing weak spot.

Retail sales lagged the national pace during most of the year. For the January-September period, Western retail sales increased 4½ percent as against a 7½-percent gain elsewhere. Western auto salesmen, although boasting a very respectable 7-percent year-to-year increase, still lagged substantially behind the torrid sales pace maintained by their national counterparts. Nonetheless, incomplete data for 1965's final months indicate a decided improvement in retail sales in line with the accelerated pace of business activity which occurred at that time.

Space spending offsets defense cuts in California but not other states



Business boom creates sharp rise in real disposable per-capita income



Jet-propelled dynamo

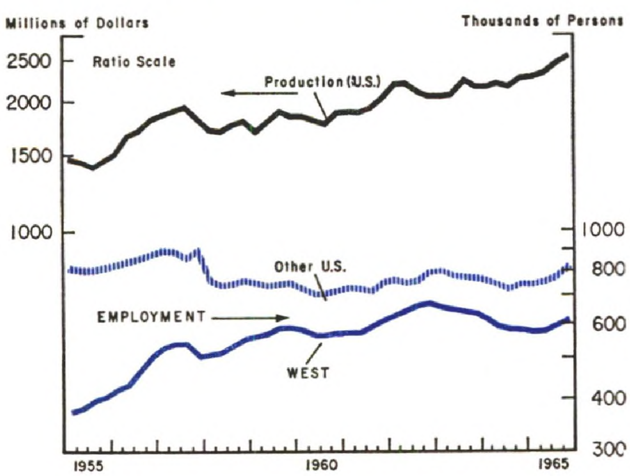
The aerospace-manufacturing industry again revealed itself as the dynamo of the Western economy. This industry, which had laid off 15 percent of its work force between late 1962 and March 1965, then scored a strong recovery during the remainder of 1965. Roughly half of the earlier 87,000 decline in employment was restored by the end of the year. In the process, this industry accounted for one-half of the region's 1965 gain in manufacturing employment, and it accounted for the bulk of the factory upsurge in California and Washington.

The aerospace industry actually received less business from Federal agencies in fiscal 1965 than in the two preceding years, but its order books expanded considerably on the basis of a heavy inflow of commercial-jet orders. Washington and Utah suffered the brunt of the decline in the new defense-space spending, but Washington was also the principal beneficiary of the striking increase in commercial-jet orders. Between late-1964 and late-1965, in fact, California and Washington alone accounted for two-thirds of the nation's total increase in aerospace order backlogs. And then, towards the end of 1965, the regional industry received an inflow of defense orders as a consequence of the escalation in Vietnam.

Hammers and concrete mixers

The Western construction industry recorded mixed results in 1965. Total contract awards remained relatively stable, at $9.1 billion, but only because a strong increase in the nonresidential building and heavy construction sectors offset a one-seventh decline in residential awards. The industry also witnessed a great deal of labor strife in 1965, as a number of long-term contracts expired during the same period and were followed by long - drawn - out negotiations—negotiations which were finally settled by substantial increases in pay and fringe benefits.

West responds later than rest of nation to U. S. aerospace upturn

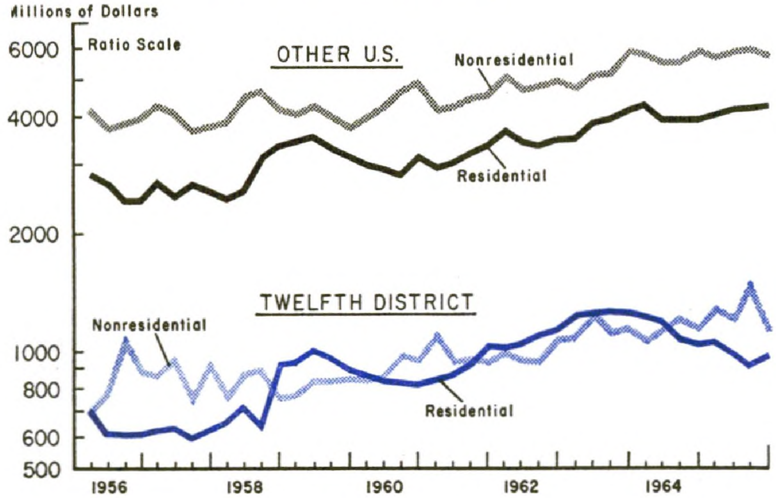


New housing starts in District states dropped 23 percent, to 280,000 during the year. Most of the decline centered in apartment construction, which accounted for 55 percent of total starts during the 1963 building boom but for only 40 percent of new starts during the 1965 slump. And this segment of the housing market still remained weak at yearend; the rental-vacancy rate moved erratically during the year, but still rose, from 11.7 to 12.2 percent, between late 1964 and late 1965 (seasonally adjusted rates).

The region's nonresidential-building boom —up 12 percent to $2.8 billion in new awards —was sparked by a one-third gain in office construction and by substantial building activity for schools and retail establishments. The upsurge in heavy construction—up 19 percent to $2.4 billion in new awards—was based in large part on the expansion of highway building, which accounts for roughly half of the heavy-construction industry. But even larger percentage increases occurred in other heavy-construction sectors, such as bridges, dams and reservoirs, and river-and-harbor work.

The Western lumber industry achieved moderate gains in output and prices during 1965. The industry encountered trouble at the very outset of the year, as flood damage to production and transport facilities at California and Oregon mills caused substantial reductions in output. Although prices rose at that time in response to supply shortages, the higher price structure could not hold because of the impact of the weak housing market on lumber demand. But production and prices again rose in late summer as demand increased for nonresidential purposes, such as the industrial-and-commercial building boom and the expansion of defense requirements. Then, around yearend, prices began to advance sharply under the combined impact of short supplies due to unseasonably poor West-

West's construction spending stable despite continued housing slump



ern weather and strong demand due to unseasonably mild Eastern weather.

Hot metals

Nonferrous metals production boomed during the year, but not enough to keep pace with the record demand from industry and the military. The prices of lead and zinc were kept from rising by the release of substantial quantities of stockpile metal and by the termination of import-quota restrictions. The prices of copper and aluminum, however, remained under strong pressure throughout most of the year.

Aluminum producers, after increasing fabricated prices in the spring months, then attempted in November to increase fabricated prices again and also to advance the price of ingot from 24½ to 25 cents a pound. Copper producers, after hiking the price of refined copper from 34 to 36 cents a pound in May, then tried in November to go to 38 cents, matching a foreign price-rise. Nonetheless, both industries rescinded their posted price increases after Federal authorities announced plans to release substantial quantities of stockpile metal. Copper producers were able to hold their domestic quotation at 36 cents, despite a yearend rise in the foreign quotation to 42 cents, as stockpile authorities released 200,000 tons of copper and readied plans to release a comparable amount later on. Aluminum producers, although equally unsuccessful in obtaining a price increase, were able to get an agreement with stockpile officials providing for the orderly disposal of 1.4 million tons of surplus aluminum.

The Western steel industry increased its output 5 percent in 1965 to a record 6.7 million tons. The regional industry benefited from the strong pace of nonresidential building and heavy construction, and it suffered less than other segments of the industry from the wide swings in inventories which accompanied steel wage negotiations. The foreign penetration of the Western steel market meanwhile continued, as foreign producers increased their market share from 18 to 22 percent over the year. Despite the import threat, producers here and elsewhere raised structural-steel prices by $2.75 a ton at yearend—but Western plants at the same time lowered prices by eliminating a $9-a-ton (6-percent) price premium for cold rolled sheets.

Crude petroleum producers increased their output slightly in 1965 and thereby checked a decade-long downtrend. The bulk of the increase occurred in California, partly through new discoveries but mostly through secondary recovery efforts in existing fields. The increased supply of local crude was not sufficient, however, to support the expansion of processing activities at Western refineries. Expanding market requirements were met from existing inventories of crude oil, as well as from imports of both crude and refined products from Canada, Arabia, Venezuela, and U. S. sources.

Western demand for petroleum products remained heavy during the year because of

INDEXES OF INDUSTRIAL PRODUCTION — TWELFTH DISTRICT

(1957-59 = 100)

INDUSTRIAL PRODUCTION	1958	1959	1960	1961	1962	1963	1964	1965p
Copper	101	86	112	119	127	128	129	140
Lead	92	93	76	99	105	103	96	87
Zinc	94	96	86	97	101	98	93	87
Silver	102	94	91	105	105	105	102	114
Gold	104	90	99	92	86	86	85	116
Steel Ingots	94	92	102	111	100	117	132	138
Aluminum	87	101	101	97	107	118	135	150
Crude Petroleum	98	96	95	96	96	97	97	103
Refined Petroleum	96	101	104	108	111	112	115	120
Natural Gas	96	104	112	121	126	143	147	146
Lumber	98	109	98	95	98	103	109	110
Douglas Fir Plywood	98	118	120	132	142	160	177	180
Canned Fruit	91	112	111	114	119	105	141	113
Canned Vegetables	107	95	101	89	106	96	100	96
Meat	95	101	107	111	112	115	126	124
Sugar	91	108	105	107	113	120	138	141
Flour	102	102	102	99	101	94	96	92
Creamery Butter	96	102	112	120	119	103	103	96

p—Preliminary.
Source: Federal Reserve Bank of San Francisco.

rising gasoline shipments, substantial increases in jet-fuel requirements, and expanded inventory needs for most products. Then, in late 1965, market pressures increased as the military demand for petroleum products (especially residual fuel oil) jumped about one-fifth above year-ago levels.

Farmers and canners

Western farmers last year recorded a 3-percent increase, to about $6 billion, in marketing receipts. This increase lagged behind the 6-percent gain recorded by farmers elsewhere, mostly because of the relative unimportance in the West of several products, such as hogs and soybeans, which dominated the bright national picture. With their gain in receipts and a significant rise in government payments, Western farmers were able to offset rising production costs and thereby record a small increase in net income.

Employment on Western farms and ranches continued to decline during the year, but generally in line with the long-term employment downtrend. A substantial drop occurred in the importation of Mexican workers; Federal authorities authorized the use of 18,000 such workers on California farms in 1965, as against the 62,000 used under the bracero program the previous year. Farm managers responded to this new situation by increasing the use of mechanical harvesters and other labor-saving equipment, and also by diverting acreage from such labor-intensive crops as strawberries and tomatoes. Nonetheless, total farm employment averaged only about 10,000 below the 1964 figure, although the decline would have been greater if favorable weather conditions had not permitted the extension of the normal harvest season.

The farm labor situation was reflected in a sharp output reduction in the canning industry. The supplies available for marketing fell below the 1964 level despite the substantial inventories held over from the preceding season. So with canning volume down and raw-material costs up, processors boosted the prices of most items during 1965. The region's vegetable pack fell off somewhat as California producers of processing tomatoes reduced their acreage far below the levels which supported the heavy 1964 pack. The region's fruit canning production meanwhile dropped about one-fifth below the 1964 peak, mostly because of weather damage to the peach crop in Pacific Coast states.

Western Money

WESTERN BANKING activity, like Western business activity, was less exuberant during 1965 than it was elsewhere in the nation. The pace of lending at Twelfth District banks was somewhat steadier and less headlong than at other banks, and the rate of expansion of security holdings was greater at District banks. (Expansion of security portfolios also was a prudent move, in view of the banks' tightening liqudity position.) Western banks, moreover, were less aggressive than others in competing for large-denomination time deposits, and so they also recorded a smaller deposit growth than their counterparts nationally.

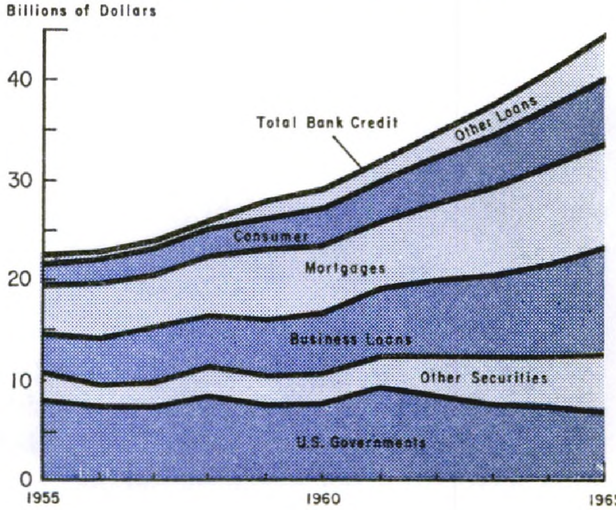
Yet, over the entire course of the 1961-65 expansion, District commercial banks still outperformed others because of their stronger pace in the earlier years of this period. Furthermore, the recent renewed vigor of aerospace and other regional industries, which was reflected in a late-1965 upsurge of loan demand, portends more vigorous activity in credit markets in 1966.

District bank earnings were held down during 1965 by the increased interest cost of time-and-savings deposits—an increase attributable to the higher rates posted by most banks around the beginning of the year. The difficulty of offsetting this increased cost factor, which is related to the heavy proportion of time deposits to total deposits at Western banks, severely limited the success of these banks in improving their net-earnings position. Some banks even recorded a decline from their 1964 earnings, although most by yearend had successfully adjusted to the higher level of interest costs.

Tighter policy

The tightening of monetary policy during 1965 was reflected in increased reserve pressures on District member banks. Borrowings from the San Francisco Federal Reserve Bank grew from a daily average of $26 million to $42 million during the year, while excess reserves increased from $23 million to $30 million—and the member-bank reserve position thus shifted from an approximately even balance in 1964 to average net borrowed reserves of $12 million in 1965. District banks also borrowed more heavily through the purchase of Federal funds, that is, the uncommit-

Exuberant business borrowing
supports District banking activity



ted balances of banks on deposit with Federal Reserve Banks. Net interbank purchases, on a daily basis, averaged $81 million in 1965. Certain banks resold some purchased funds to government-security dealers at higher rates of interest, but by yearend most banks were using funds almost exclusively to adjust their reserve positions.

A heavy inflow of time and savings deposits supplied funds to support a large part of 1965's significant loan expansion, but banks were still faced with significant problems of liquidity. By yearend, the loan-deposit ratio for District banks reached a postwar peak of 70 percent—4 points above the national ratio. Moreover, the ratio of short-term Government security holdings to deposits dropped from 5.9 to 4.7 percent between December 1964 and December 1965, and it reached an even lower point in August before a buildup in banks' Treasury bill holdings permitted a partial recovery.

Exuberant businessmen

The exuberance of business-credit demands dominated the Western banking scene in 1965, just as it did the national scene. District weekly reporting banks expanded their commercial-industrial loan portfolio 17 percent—almost as great as the gain elsewhere and substantially above the 11-percent District bank gain of 1964. And, also in contrast to 1964, an increasing percentage of business-loan demand was generated by large borrowers in the major metropolitan centers.

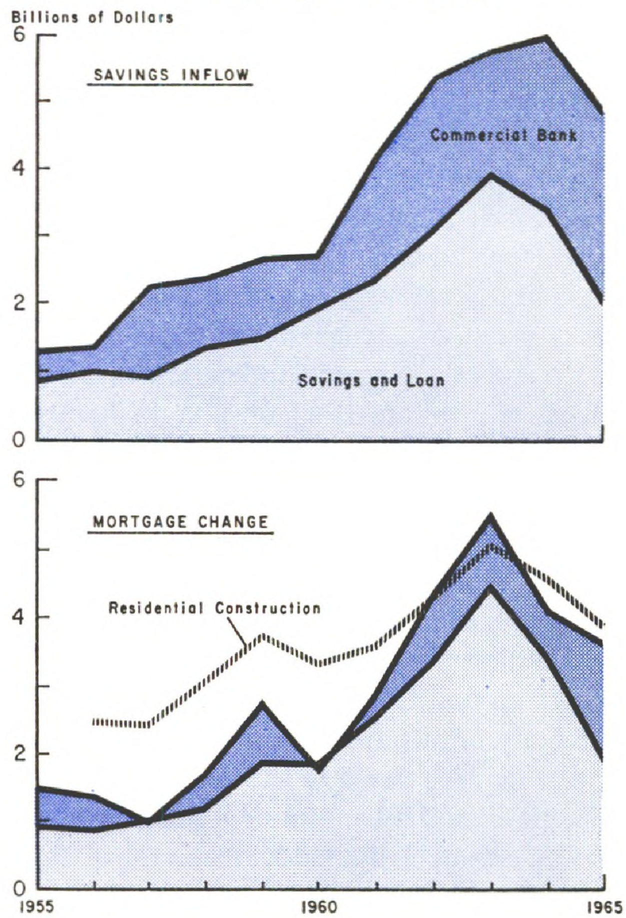
Loan demand rose sharply in durable-goods manufacturing, especially in the machinery-manufacturing and metal-fabricating sectors, and demand also increased in nondurable-manufacturing fields. More strikingly, oil processors substantially increased their reliance on bank credit for both the financing of capital expenditures and the carrying of residual-oil inventories. Public utilities also relied more heavily on the banks, as interest-rate differentials encouraged them to secure increased funds through bank credit rather than through equity or bond flotations.

The shift in lending towards large borrowers influenced the average cost of business loans. Banks in District metropolitan areas adopted progressively firmer lending policies during the course of the year, yet the average interest rate on business loans moved down during the first half of 1965 because of the growing proportion of total loans made at the prime rate available to big corporate borrowers. In December, however, as the prime rate increased from 4½ to 5 percent, the average cost of business credit increased somewhat.

Sluggish mortgage market

The sluggish Western housing market took a lot of steam out of regional mortgage ac-

Sluggish housing market, weak S&L performance highlight mortgage scene



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

(dollar amount in millions)

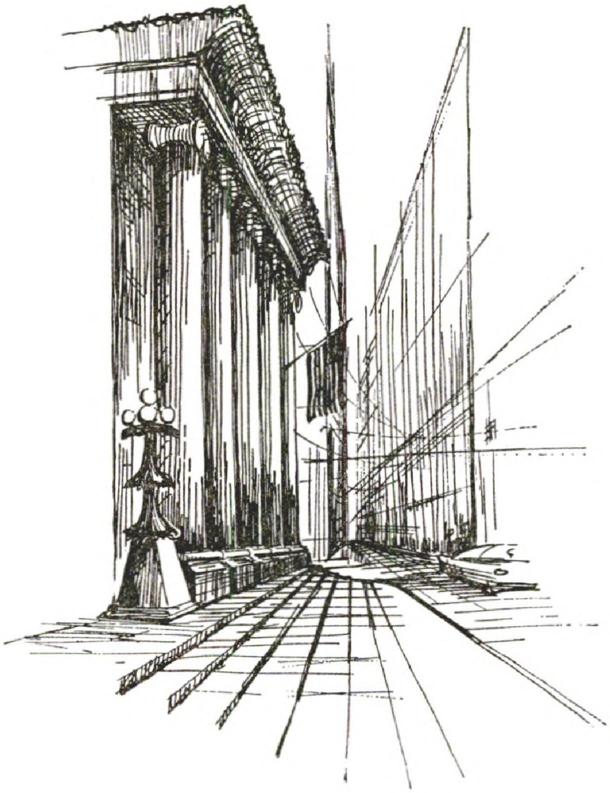
	Twelfth District Outstanding Dec. 29, 1965	Twelfth District Net Change Dec. 30, 1964 to Dec. 29, 1965		Dec. 31, 1963 to Dec. 30, 1964	Other U.S. Net Change Dec. 30, 1964 to Dec. 29, 1965
		Dollars	Percent	Percent	Percent
Total loans and investments	$35,319	+2,484	+ 7.6	+ 8.7	+10.3
Loans adjusted and investments	34,750	+2,436	+ 7.5	+ 7.1	+10.1
Loans adjusted	25,072	+2,166	+ 9.5	+ 10.3	+16.1
Commercial and industrial loans	8,832	+1,251	+16.5	+ 10.8	+21.0
Real estate loans	7,928	+ 383	+ 5.1	+ 5.8	+17.3
Agricultural loans	1,057	+ 44	+ 4.3	+ 7.3	+10.0
Loans to nonbank financial institutions	1,690	+ 165	+10.8	+ 7.6	+22.9
Loans for purchasing or carrying securities					
To brokers and dealers:	219	— 101	—31.6	+ 64.9	— 9.2
To others:	155	+ 19	+14.0	+ 23.6	+11.5
Loans to foreign banks	289	— 17	— 5.6	+ 28.6	+ 5.8
Other loans (mainly consumer)	5,307	+ 450	+ 9.3	+ 13.9	+10.2
Total investments	9,678	+ 270	+ 2.9	+ 0.1	— 1.9
U. S. Government securities	5,059	— 637	—11.2	— 3.6	—12.7
Treasury bills	934	— 173	—15.6	+ 59.3	—16.9
Treasury certificates of indebtedness	0	0	0	—100.0	0
Treasury notes and bonds maturing:					
Within 1 year	724	— 63	— 8.0	+ 24.9	— 4.4
1 to 5 years	1,706	— 502	—22.7	— 24.8	—25.9
After 5 years	1,695	+ 101	+ 6.3	+ 6.9	+15.7
Other securities	4,619	+ 907	+24.4	+ 6.5	+11.7
Total deposits (less cash items)	34,955	+2,235	+ 6.8	+ 5.9	+ 8.4
Total demand deposits (less cash items)	14,040	— 102	— 0.7	+ 0.7	+ 1.3
Demand deposits adjusted	12,924	+ 74	+ 0.6	0	+ 2.8
Time and savings deposits	20,915	+2,337	+12.6	+ 10.1	+18.7
Savings deposits	15,063	+1,160	+ 8.3	+ 5.7	+13.1
Certificates of deposit	1,617	+ 289	+21.8	+ 56.1	+28.7
Capital accounts	2,972	+ 171	+ 6.1	+ 13.0	+10.4
Total assets/liabilities and capital accounts	42,709	+2,791	+ 7.0	+ 5.8	+ 8.9

Source: Federal Reserve Bank of San Francisco.

tivity. Weekly reporting banks increased their mortgage portfolios just 5 percent — somewhat below the year-ago gain and far below the 1965 national gain. The strength of business-credit demand gave the banks an opportunity to bring their mortgage portfolios into better balance with other loan portfolios. In addition, District banks sold off increasing amounts of their mortgage holdings to nonbank financial institutions during the course of the year. Even so, yearend data showed District banks still holding one-third of total loans in the form of mortgages, as against a one-fourth proportion elsewhere in the country.

Western savings-and-loan associations, operating in a strongly competitive atmosphere, experienced only an 8-percent gain in mortgage-loan activity during 1965. Some associations attempted to supplement their available funds with increased borrowings from the Federal Home Loan Bank; on the whole the S & L's kept their mortgage advances generally in line with their reduced inflow of savings.

Consumer lending by banks expanded less rapidly in the District than elsewhere in the nation, mostly because retail auto activity —which usually generates over one-half of the Western banks' consumer credit business



—lagged substantially behind the national pace during the year. Weekly reporting banks in 1965 showed less than a 9-percent increase in consumer loans.

Mixed securities picture

District weekly reporting banks recorded a substantial 11-percent reduction in their holdings of U. S. Government securities in 1965. Western banks adjusted their portfolios in the same way as their national counterparts, concentrating the reduction in short-term maturities—Treasury bills and notes, and bonds of five years or less. Banks here, as elsewhere, actually increased their holdings of long-term governments.

District banks, moreover, offset the decline in short-term governments with a 24-percent expansion in their portfolios of municipal and government-agency issues. This expansion was double the rate of increase recorded elsewhere. District banks tended to favor these tax-exempt securities because their relatively high yields helped to offset the higher interest costs paid on time deposits. In addition, the short-term maturities on some of these municipal issues helped to balance the loss in liquidity caused by the concurrent reduction in short-term Treasury holdings.

Bullish savings picture

Western banks registered a greater deposit increase in 1965 than in the preceding year, but solely because of their larger inflow of time-and-savings deposits—up 13 percent in 1965 as against a 10-percent increase in 1964. Demand deposits were almost stable in each of the two years.

In early 1965, major District banks gained a march in the competition for savings when they increased the interest on their passbook-savings accounts from 3½ to 4 percent. As a consequence, savings and loan associations in District states increased their savings inflow only 9 percent in 1965, as against the 1964 increase of twice that magnitude. S & L's were able to improve their competitive situation in some areas by offering higher rates, but in areas such as California and Arizona, S & L savings rates were already at their practical limits in terms of existing rates on mortgages.

District banks could attribute their substantial inflow of savings not only to the new 4-percent rate on passbook savings but also to the higher rates for longer-term savings which they offered through the medium of savings certificates. These new deposit instruments were so well received that they accounted for the bulk of the early-1965 time-deposit increase (exclusive of passbook savings). In this period, savings certificates played the same expansionary role that large-denomination time certificates performed in early 1964.

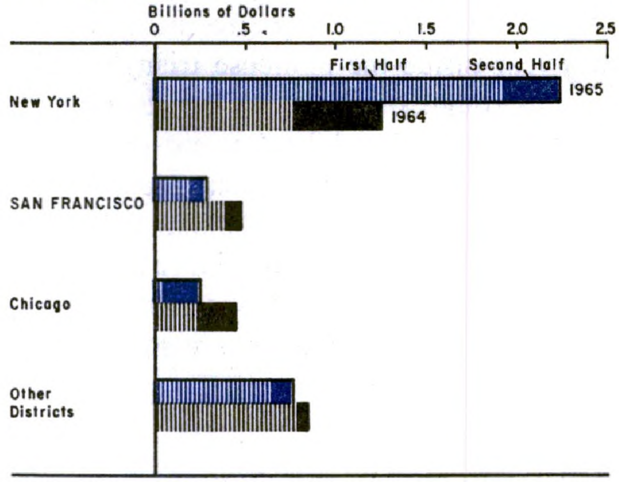
CD's move East

The latter played a smaller part on the Western scene during 1965; although increasing 22 percent, they expanded at less than half the 1964 pace. The major action in the CD market moved to New York, where banks bid very aggressively for these large but volatile deposits. Western banks were less active in this field because they experienced a somewhat weaker loan demand than other banks; and, in view of their success in attracting savings deposits, they were less dependent for lendable funds on CD growth. Moreover, as New York banks pushed CD rates up towards the maximum permitted under Federal Reserve Regulation Q, only the largest Western banks were able to compete for these funds—and some of them were simply not interested in competing at the high New York rates.

December 6, however, signalled the opening of a new era. The revision then announced in Regulation Q did not alter the maximum 4-percent rate on passbook savings, but did permit an upward revision in rates (to a 5½ percent maximum) on other time deposits with 30 days' maturity or more.

Thus, in order to meet competition, many Western banks soon thereafter increased the rates paid on their CD's. However, District banks generally did not raise the rates on certificates to the level offered by some New York banks; in view of the large increase in interest costs which they had to absorb in

CD action moves to New York as deposit growth slows in West



1965, they were understandably reluctant to add further to this cost factor in 1966.

Continued economic growth in the Twelfth District states led to the establishment of 237 branch banking offices in 1965. The District, however, witnessed a definite slowdown in the establishment of new banks. After a record postwar increase of 65 banks in 1964, only 28 new banks opened their doors in 1965, and mergers offset most of this expansion. California, which led the parade in most preceding years, recorded a net decrease of 1 (one) bank in 1965.

Monthly Review is edited by William Burke. Principal contributors to this issue included: William Burke (U. S. business); Herbert Runyon (fiscal-monetary policy); Herbert Runyon and Sandra McKenzie (balance of payments); Verle Johnston (U. S. banking and finance); Ruth Wilson (District banking); George Dimmler, Donald Snodgrass, John Booth, Joan Walsh, Yvonne Levy, and Adelle Foley (District business); R. Mansfield (artwork); and Phyllis Taylor (editorial). *Monthly Review* is published by the Bank's Research Department: J. Howard Craven, Vice-president; Gault W. Lynn, Director of Research.

Inside the Triangle

BUSINESS ACTIVITY varied considerably last year inside the immense triangle which extends roughly from Fairbanks to Phoenix and then on to Honolulu. An aerospace boom in Seattle, earthquake reconstruction in Alaska, a housing boom in Waikiki, a housing slump in Southern California: all of these were facets of the diverse Western economy during 1965. What follows are some of the highlights of the year.

California

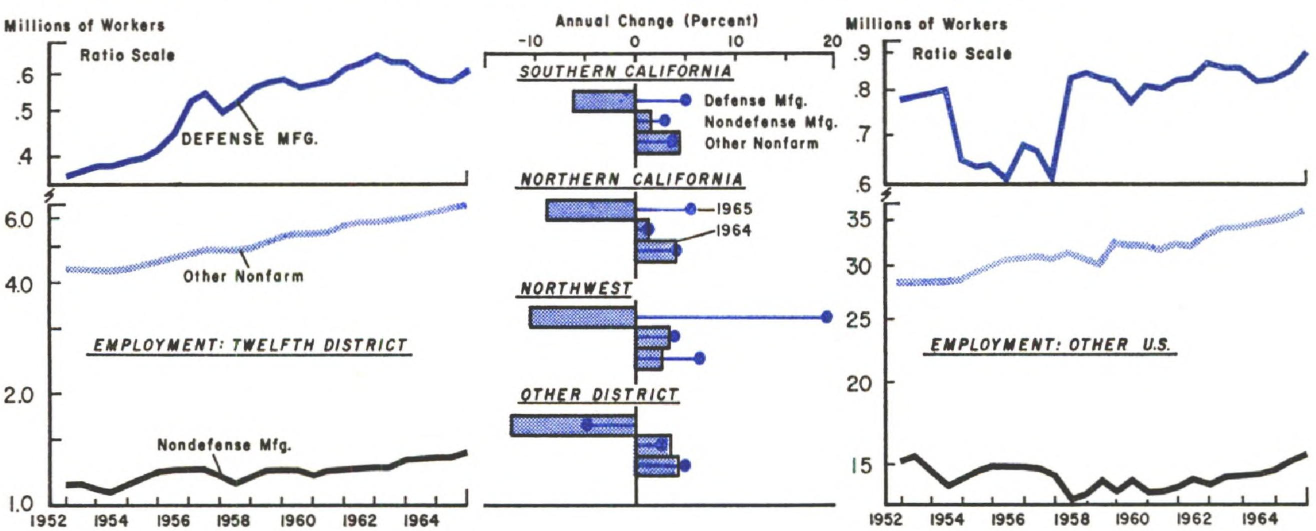
Employment: The state's 3.4-percent gain in nonfarm employment was the best since the first year of this business expansion. The unemployment rate still remained high, averaging 5.9 percent for the year, but it drifted down towards the 5-percent level by yearend. Both Northern and Southern California recorded 5-percent gains in aerospace employment, offsetting their 1964 declines; both ends of the state also improved on their 1964 performance in other manufacturing industries, and both areas roughly matched the 1964 4-percent gains in nonmanufacturing employment.

The recovery in the aerospace sector was caused by a rising volume of orders for commercial jet aircraft and by a partial recovery in defense-space spending. Despite the continued high level of unemployment in the state, skilled aerospace workers became increasingly scarce during 1965.

Construction: Housing remained a weak point in the state's economy during the year. Northern California's 76,000 residential permits were one-fourth below the 1963 peak level, and Southern California's 95,000 permits equalled only half as much activity as in the peak period of two years ago. On the other hand, nonresidential building and heavy construction continued strong in both ends of the state.

Southern California's office-building boom finally got Los Angeles off the ground; this city, long known for its low silhouette, started or completed five buildings of over 20 stories in height, including one 42-story bank building. San Francisco had five such skyscrapers under construction in 1965, and these will be followed in 1966 by the construction of the

Impact of late-1965 upturn in defense sector felt throughout West
. . . job expansion matches or betters 1964 pace almost everywhere



tallest building in the West—a 52-story bank headquarters.

In heavy construction, meanwhile, activity centered around several projects involved in the California water plan, together with a number of other power and reclamation projects, including an $88-million steam electricity plant located in Los Angeles County. The Bay Area Rapid Transit District encountered difficulty when bids on several major projects substantially exceeded its engineering estimates; the District, however, put its test track into operation and also carried forward its work on a tunnel through the Berkeley hills.

Industry: The expansion of the West's largest steel complex continued in the Richmond area as a fabricating works was completed and a continuous galvanizing line was placed under construction. Upon completion, this 6-million-ton fully integrated facility will produce almost as much metal as the entire Western steel industry produced last year. Another major producer continued expanding its Fontana complex with a new mill producing "thin tin" for the container industry; this producer also completed a pelletizing plant at Eagle Mountain, with a production capacity of 2 million tons of highly concentrated iron-ore pellets.

The forest-products industry was hard hit by the devastating Eel River floods of January 1965. About 150 million board-feet of logs and cut lumber were washed out to sea, and the destruction of vital transport facilities was even more crippling than this loss of inventory.

The petroleum industry concentrated its interest on a new field in the San Joaquin Valley, which promises to be the best producer in California history; the industry's optimism is based on a discovery well in this field which produces 9,000 barrels of crude a day. California refineries, meanwhile, began work on $365 million worth of new facilities or modifications of existing facilities. These projects were undertaken because of the continued growth in demand for petroleum products and also because of a changing structure of demand, typified by the growth of the jet-fuel market and the long-term decline in the market for residual fuel oil.

California farmers received a record amount of cash receipts because of substantially improved livestock sales. Their net income tended to be held down by growing production expenses, however; for one thing, they paid for a heavy movement of higher-price feeder cattle to feeder lots, and, for another, they incurred increased labor costs during the changeover from the former bracero-worker program.

Producers cut the acreage of the processing tomato crop, so the tomato pack fell considerably below the size of the heavy 1964 pack. (The same was true for the asparagus crop.) A sharp drop also occurred in the pack of processing cling peaches; a sizable reduction was initiated in order to offset a large holdover of inventory, but unfavorable weather later cut peach supplies even further. Weather conditions also reduced substantially the volume of fruit cocktail and pears for processing.

Banking: Commercial bank loans expanded by $2,162 million—a sizable increase, although somewhat below the 1963-64 pace. Business loan activity was very strong; the $492-million gain at Los Angeles banking offices was several times the gain of other recent years, and the $249-million increase at San Francisco-Oakland banking offices was greater than in any year except 1964.

California banks continued a substantial expansion of their customer services. One such development was the expansion of mortgage financing and receivables financing through the merger of banks with mortgage companies and factoring firms. Several banks announced the establishment of West Coast markets for the short-term investment of corporate surplus cash, and one of these banks opened a New York office for the handling of securities investment. But California banks also faced new competition in the auto financing field; a national retail firm offered auto loans on a statewide basis after obtaining a license for industrial-loan operations, and personal property brokers obtained a chance to expand their auto financing through new legislation which extends the maturities on the types of loans that they can make.

Pacific Northwest

Employment: Both Oregon and Washington recorded substantial gains in nonfarm employment in 1965. Oregon's 6.3-percent increase, by far the highest of any major Western state, substantially exceeded the state's pace of activity in the earlier years of this business expansion. Washington's 3.5-percent increase made up for its relatively weak 1963 - 64 performance. Unemployment dropped sharply in both states, to 4.1 percent in Oregon and 5.1 percent in Washington.

The region recorded a striking 20-percent gain in aerospace employment. A 4-percent increase in other manufacturing employment and a 7-percent expansion of nonmanufacturing jobs also outpaced the region's 1964 performance. The year-long recovery in the aerospace industry was mostly due to a sharp influx of commercial-jet orders, since new defense-space contracts were down sharply in fiscal 1965.

Construction: These states, along with Hawaii, were the West's housing leaders during 1965. Although both operated below their peak housing levels, Oregon's 11,100 starts were close to the 1964 peak, and Washington's 17,100 starts were substantially above the recent (1964) low. Oregon also had a boom in heavy construction, especially in highways. (It leads all other Western states in the pace of construction work on the Interstate Highway System.) Washington expanded rapidly in both heavy construction and nonresidential building. Its boom was due to its economic recovery plus a substantial expansion of dam construction. Significant new projects included a $74-million paper plant in Wauna, Oregon, a $20-million space center in Seattle, and $30 million worth of other aerospace construction projects.

Industry: Each of the region's three major primary-aluminum producers added facilities in 1965. A Vancouver plant expanded in order to produce aluminum electrical conductors, and a Spokane plant added a cold reduction mill to produce aluminum coil for building products and canning. A new entrant into the field meanwhile began the construction of a primary reduction plant at Bellingham; the plant has an initial capacity of 76,000 tons, and officials plan to double that capacity soon in view of the current heavy demand for aluminum.

Oregon farmers received a record amount of cash from crop and livestock marketings; crop output was up and livestock price trends were very favorable. Washington farmers registered a slight drop in receipts because of major freeze damage to deciduous fruits, and this disaster also sharply curtailed the canning industry's output of freestone-peaches and pears. But the region's vegetable pack (peas, green beans, and corn) averaged about one-fifth above the 1964 level.

Banking: Both states chalked up the largest loan increases of the expansion to date. Oregon's $198-million increase was 10 percent above the 1963 peak, and Washington's $271-million expansion was a whopping 50 percent above the 1963 level. The strength of business activity was reflected in a substantial growth of business loans—short-term loans as banks financed producers' increased raw-material and inventory needs, and long-term loans as Northwest bankers assisted local firms in financing plant-equipment expansion.

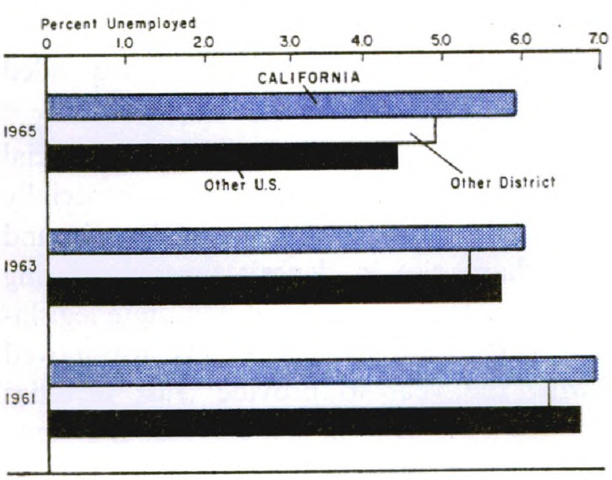
Mountain States

Employment: Activity was generally strong in each of the four states as nonfarm-employment gains fell within the range of 3½ to 4 percent. Each of these states, except Nevada, scored its best performance since the beginning of this business expansion. Unemployment fell sharply in Utah and Idaho, to 4.7 percent and 4.2 percent, respectively, but joblessness increased slightly in Arizona and Nevada, to 5.2 percent and 5.9 percent, respectively.

Aerospace employment continued to decline, although not nearly so much as in 1964. Jobs in Utah's aerospace industry at the end of 1965 were only half as numerous as at the 1963 peak, but Arizona reported some improvement in this sector. Outside aerospace, employment increases in the region matched or bettered 1964 performances, with a 3-percent gain in other manufacturing and a 5-percent gain in nonmanufacturing employment.

Construction: Idaho's 1,300 residential-building permits were not out of line with earlier activity, but Utah's 4,700 permits were about one-third below the 1963 peak, and Arizona and Nevada (with 8,400 and 4,500 permits, respectively) operated at only a fraction of their earlier boom levels. In Phoenix residential permits were off 40 percent in the face of a 20-percent rental vacancy rate, but a continued population influx now appears to be eating into that city's housing surplus.

Jobless rate drops more slowly
in West than in rest of nation



Nevada in 1965 was still paying the price for the housing excesses generated by the tremendous pace of the early 1960's. In this state, moreover, other construction sectors sagged in the absence of the strong demand generated earlier by defense-space building requirements. In Utah, the strong pace of nonresidential building only partly offset the decline in housing and in heavy construction. However, Utah's housing market began to improve by yearend as government and defense activity began rising again. In Idaho, construction was stimulated by two large dam projects; contracts were awarded for both the $28-million Hell's Canyon Dam on the Snake River and the $14-million dam and reservoir in Adams County.

Industry: Improved methods of mineral extraction last year provoked a scramble by leading chemical firms for rights to exploit the bonanza of magnesium and other minerals locked in the brackish water of Great Salt Lake. Utah mineral authorities estimate that the Lake contains a 2,000-year supply, valued at $80-100 billion, of magnesium, potash, lithium, chlorine, and other minerals.

Gold miners concentrated their attention on Carlin, Nevada, where the first major open-pit mine operation in 35 years got under way. This efficient new project is scheduled to produce 200,000 ounces a year and thus become the second largest U. S. producer and the fourth ranking on the Continent. (With present reserves, the mine should produce enough to assure 10 years of operation.) Silver miners meanwhile focused their attention on Congress, but that legislative body dashed their hopes of a price run-up when it voted to remove silver from dimes and quarters and to reduce the silver content of half dollars from

90 to 40 percent. In the same vein, Las Vegas sources report that convention attendance went up 65 percent over the year, but that the increased flow of visitors was unable to increase total gambling winnings more than 3 percent.

Arizona farm marketing returns recovered from the depressed 1964 level as livestock receipts, especially from meat animals, jumped sharply. Utah and Nevada farmers also recorded advances, but they, as well as Arizona farmers, still received less than at earlier peak periods. Idaho farmers, meanwhile, received a record amount of cash receipts, largely because of exceptionally high potato prices in early 1965.

Banking: Utah and Idaho registered a strong expansion in bank loans. Utah, with a \$97-million expansion, and Idaho, with a \$69-million increase, both scored their best gains of the decade to date. But Arizona, with an \$88-million loan increase, and Nevada, with a \$9-million gain, operated substantially below their earlier levels of lending activity.

The Arizona Bankers Association, as a business stimulus, established an industrial fund to provide pooled resources for loans which exceed the loan limits of individual banks. The first such industrial loan was made in mid-1965, and all of the state's commercial banks participated in the project. Arizona during 1965 also joined the growing ranks of states where statewide bank-credit cards are available.

Alaska and Hawaii

Employment: Alaska's 6.4-percent increase in nonfarm employment was the highest recorded in the West in 1965. Hawaii, with a 2.5-percent gain, lagged somewhat behind. Hawaii, however, managed to reduce its unemployment rate to the very low level of 3.5 percent, while Alaskan expansion kept that state's jobless rate stable at 7.1 percent.

Construction: Housing activity was much stronger in these states than elsewhere in the West—substantially stronger in Hawaii. Hawaii's 10,500 residential-building permits represented a one-third gain over 1964's already high level of housing activity. Hawaii's continued boom, based on heavy immigration and tourist expansion, also contributed to a 15-percent expansion of hotel-room capacity at Waikiki. Alaskan construction meanwhile continued strong as a consequence of its earthquake-reconstruction program; its 700 residential-building permits were close to the 1963 housing peak.

Industry: Hawaiian sugar plantations produced a record 1.2-million-ton sugar crop, and in the process pushed crop yields up to 11 tons per acre. The island state's tourist industry logged 600,000 visitors, as a climax to a four-fold expansion of tourism within the past decade. The National Science Foundation meanwhile announced its decision to locate within Hawaiian waters a project designed to penetrate the earth's crust to its mantle (Mohole project).

Alaska's petroleum industry recorded a modest gain in crude production. The search for oil continued, as spending for exploration outpaced the returns from producing fields.

Banking: Both states registered significant gains in bank-lending activity. In particular, Alaska's \$50-million loan expansion almost equalled its entire 1962-64 loan growth. The role played by Alaskan banks in financing reconstruction was thus reflected in both this large growth of loans and in an expanded level of deposits.

The rapid spread of Hawaii's commercial development to the outer islands, especially Maui, led to an increased level of deposits and to a sharp rise in deposit turnover during 1965. Taking advantage of new state legislation, at least one Hawaiian bank also moved during the year to provide trust facilities through a merger with a local trust company.