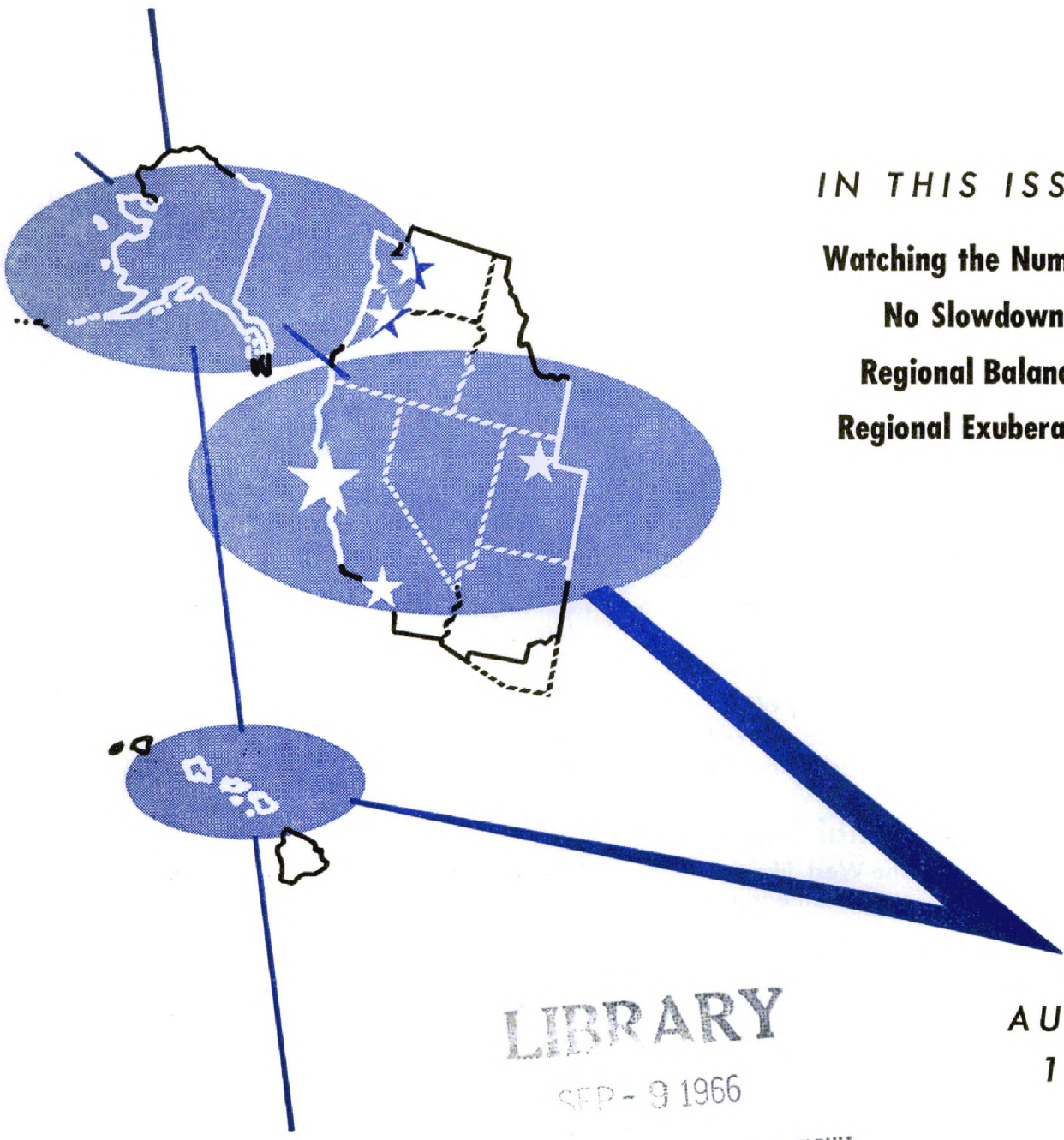


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FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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FEDERAL RESERVE BANK OF PHILADELPHIA

**AUGUST
1966**

Watching the Numbers

. . . Weaknesses in the auto and housing sectors share the headlines with the continuing boom in defense and business investment.

No Slowdown

. . . The nation's credit markets fail to reflect the reduced pace of business; rather, they show signs of increasing tightness.

Regional Balance

. . . The West, like the nation, continues to boom, but at a less startling pace than earlier in the year.

Regional Exuberance

. . . Western banks expand their activity in an atmosphere of growing monetary pressures, rising rates, and stiffer deposit competition.

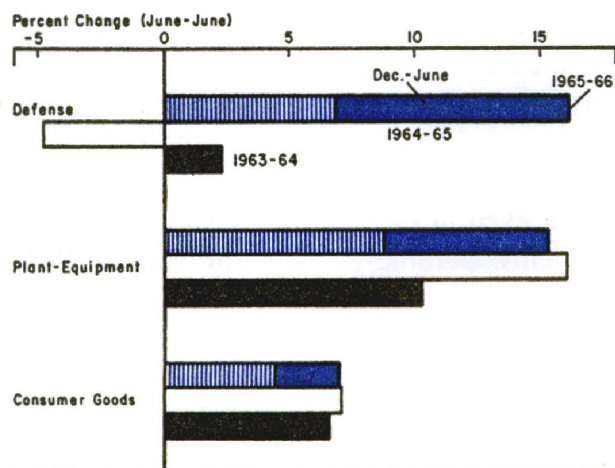
Editor: William Burke

Watching the Numbers

AS THE new fiscal year began, chart watchers in Wall Street watched the market wilt under the impact of the midsummer news from Whitehall, the White House, and the Red River Valley metropolis (Hanoi). GNP number watchers, meanwhile, watched the economy slacken somewhat from its early-1966 over-rapid pace, as weaknesses in the auto and housing sectors shared the headlines with the continuing boom in the defense and business-investment sectors.

The number watchers saw behind them at midyear the end of the first year of a substantial defense buildup, the end of the third year of a still exuberant business-investment boom, and the termination (at least temporarily) of a five-year-long auto boom. GNP rose to a \$732-billion annual rate during the spring quarter, for a 1½ percent gain—but much of this simply represented price increases. Physical output, as measured by the Federal Reserve production index, meanwhile increased 1½ percent over the quarter, or about half as rapidly as it grew during the exceptionally exuberant winter quarter. Similarly, roughly a half-million new workers were added to the employment rolls, or about half as many as in each of the several pre-

Defense and business sectors surge upward, but consumer spending lags



ceding quarters, and the jobless rate thus continued to hover around the 4-percent level.

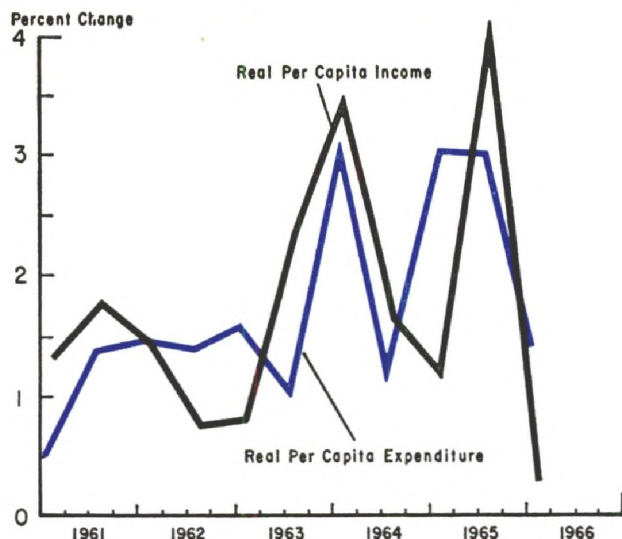
Looking ahead, the number watchers foresaw a definite continuation of the defense boom, although perhaps at a slower rate than in recent months. They foresaw also a possible slackening in the plant-equipment boom as industrial capacity gradually outstrips the need for new production, as well as some prolongation of the recent troubles in the auto and housing industries. A few pessimistic observers were even predicting that a recession would occur sometime in 1967, but Presidential adviser Gardner Ackley, concentrating instead on the problems created by the recent headlong pace of activity, argued that the recession talk was “the least of our worries.”

Pentagon bookkeeping

At midyear, Vietnam and the defense buildup continued to dominate the headlines. Defense spending, at a \$57-billion annual rate in the April-June quarter, has now increased 15 percent over the year-ago level, and most of the acceleration has taken place over the past six months. This buildup represents a major turnabout in Pentagon bookkeeping, since defense spending actually declined 5 percent between mid-1964 and mid-1965.

The future level of defense spending is quite uncertain. Hardly anyone, either outside or inside the Pentagon, knows what the figures will look like a year hence, but most observers have already discarded the assumption implicit in the 1967 Budget that defense spending will soon stabilize near the current level. If the Vietnam war should continue into fiscal 1968, spending for the current fiscal year may be \$5 billion or more higher than the presently budgeted figure of \$58 billion.

Small gain in consumer spending reflects slower growth of income



Corporate bookkeeping

With business fixed investment, as with defense spending, continued increases are expected over the near term, but again, the level of future spending remains definitely conjectural. Fixed investment outlays, at a \$78-billion annual rate in the second quarter, were 13 percent higher than a year ago as business continued to build up its capital stock, especially of equipment. And now, the latest Commerce Department investment survey indicates 3-percent spending gains in each remaining quarter of 1966.

The early 1966 boom came on the heels of sharp gains in business sales and corporate profits and a continued high rate of capacity utilization. (Firms holding over one-half of total fixed assets in manufacturing reported during this period that they had inadequate capacity to maintain their current level of operations.) Nonetheless, the second-quarter expansion was slightly less headlong than the earlier boom, as some producers postponed plans because of shortages of money, men, and materials.

At this point of the boom, rapid expansion of plant-equipment spending becomes a double source of concern. A 7-to-8 percent annual increment to the nation's capital stock pro-

vides welcome strength in the context of Vietnam, but it creates the spectre of over-capacity in a normal year when the economy's growth is capable of absorbing only a 4-to-5 percent expansion of productive capacity. More than that, recently rising costs of machinery, equipment, and construction threaten to work their way through the economy in the form of higher costs, thus accentuating the cost-push inflationary problem at home and worsening the competitive position of American products abroad.

Stockroom accounts

Inventory spending jumped sharply by mid-year, increasing from a high \$9-billion rate in the first quarter to an even higher \$12-billion rate in the following quarter. The recent expansion reflected both the planned growth in business output and the completely unplanned slowdown in auto and other retail sales. Many observers thus look for smaller gains in inventory spending in coming quarters, as some businesses reduce the pace of their stock buildup and as others move painfully to deal with their excess stocks.

Auto dealers started the spring quarter with a 46-day supply of new cars, and they ended the quarter with a 60-day supply. So when automakers came to realize that their dealers' lots were beginning to resemble a rush-hour scene on the Hollywood Freeway, they slashed production schedules for the first time in this prolonged business expansion. In addition, some producers shut down their 1966-model production lines completely by the end of July, and as they sweated down their supplies, they transmitted the impact of their cutbacks to other suppliers in turn.

But even in the face of the auto industry's problems, durable-goods manufacturers generally have been able to keep their inventories in line, as is seen from several closely watched ratios. Midway in the second quarter, their materials inventories amounted to 55 percent of new orders, their goods-in-process inven-

tories amounted to 28 percent of unfilled orders, and their finished-goods inventories equalled 51 percent of shipments—and each of these ratios remained substantially below the averages of the last several years.

Straitened consumers

Consumer-goods spending in the spring quarter, at a \$67-billion annual rate for durables and a \$205-billion rate for nondurables, was 6½ percent above the mid-1965 level. Nonetheless, the decline in autos and in other durables created a substantial slowdown in the growth of this spending category. Yet this slowdown was quite understandable, among other reasons because it came on the heels of a sharp \$18-billion increase in outlays for consumer goods over the previous year—and on the heels of a slowdown in take-home pay initiated by a substantial rise in social-security and withheld income taxes. (Per capita disposable income, after adjustment for price changes, actually declined during the second quarter.)

The most striking element in the consumer spending picture was the automotive situation, measured by a 10-percent sales decline in the spring quarter alone. Industry observers had to hark back a decade to find a parallel to this unexpected shock; although the sales rate dropped sharply with the introduction of the 1958 and 1961 models, the only comparable drop in sales in the middle of a model year occurred away back in the spring of 1956.

Auto pundits could find a number of factors to account for the unexpected decline. The presence of one young lawyer at Congressional hearings on auto safety was a factor, and so, too, was the absence of the many young drivers who are now riding Vietnam by-roads instead of American freeways. More than that, the impact of higher taxes and higher prices on consumer real incomes was painfully apparent to consumers forced to pay for other things besides autos out of their month-

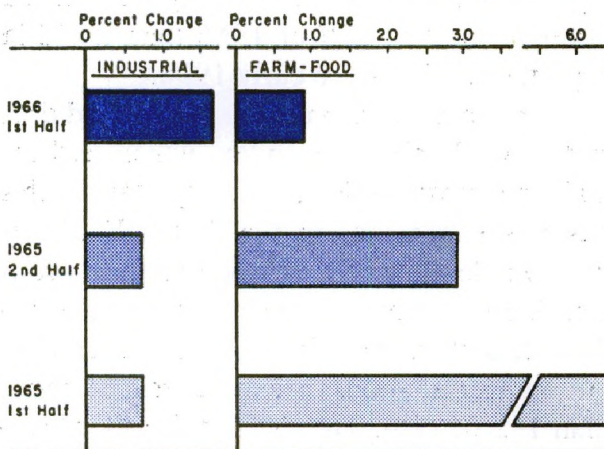
ly paychecks. Finally, with credit conditions tightening, dealers at clean-up time were unable to count on the factor which so strongly supported 1965 and early-1966 sales—that is, a continued growth in the percentage of new cars sold on credit and a continued increase in the average amount loaned on new cars.

Housing and money

Housing, another consumer big-ticket item, was also hampered by tightening credit conditions as the year advanced. Admittedly, spending on new housing, at a \$28-billion annual rate in the second quarter, was close to the spending plateau maintained throughout the last several years. Yet, new housing starts dropped 10 percent during the quarter and thereby portended a future decline in spending as well.

The national housing market thus got a taste of the situation which has prevailed in the West over the past three years. While new starts declined by half in the West, starts in the rest of the nation remained relatively stable over this three-year period; in fact, a mild housing boom occurred in the industrial Northeast and North Central regions as a reflection of the strong regional expansion in durable-goods manufacturing. But housing experts throughout the country have now be-

Wholesale industrial prices rise more sharply than farm-food prices



come rather pessimistic about the short-term outlook, especially when they look back at the 20-percent decline in starts which occurred in the last (1959-60) tight-money period.

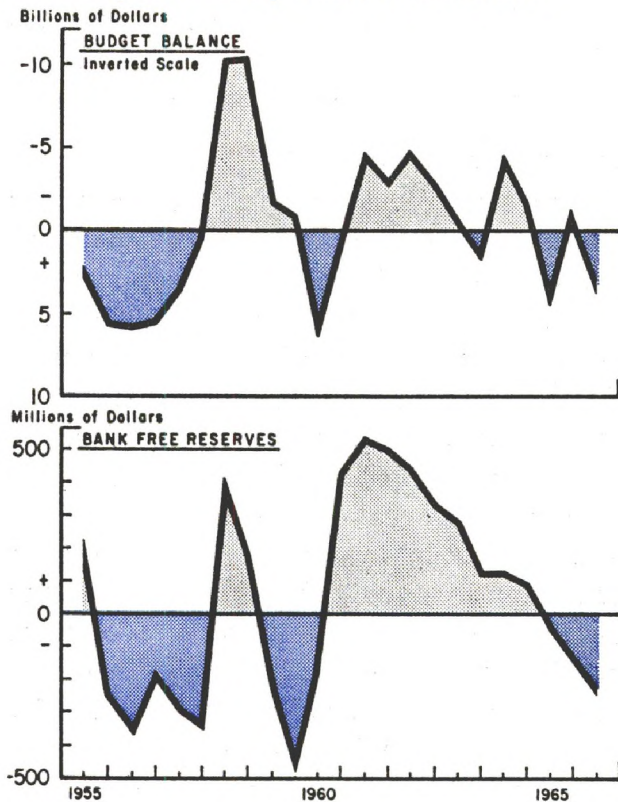
Actually, mortgage funds were generally available in the early part of this year, but mainly because of the heroic efforts of the Federal National Mortgage Association to support the flow of funds into housing by purchasing existing mortgages. In the January-April period alone, FNMA's net mortgage purchases amounted to as much as in the two preceding years put together. However, continued support on this scale is quite unlikely. Consequently, many observers foresee no improvement in the housing market until mortgage funds become available through the weakening of credit demands in other sectors—or until Congress supports the market through such measures as the proposed legislation which would expand FNMA's borrowing authorization and thereby permit that agency to inject \$2 billion or more into the housing market.

Ever-present danger

All in all, business analysts at midyear were beginning to raise questions about possible future declines in consumer and business spending. Policy makers, on the other hand, had to contend with present as well as future dangers—including the ever-present danger of rising prices. For example, the consumer price index, which in June was 12.9 percent higher than the 1957-59 average, advanced faster in the first half of 1966 than it did in any other period since early 1958.

Even more worrisome was the upward drift in the wholesale price index, which had remained almost stable in the early years of this business expansion. In the first half of this year, wholesale prices of food and farm products increased about one percent—substantially less than they did throughout 1965—but industrial-goods prices increased more than 1½ percent. The rise in this crucial cat-

Monetary policy tighter, fiscal policy less expansionary than heretofore



egory was largely caused by an 8-percent increase in hides-and-leather prices and a 6-percent increase in lumber-and-wood prices, but significant advances also occurred in many other sectors of the industrial-goods index. These increases were posted even before the announcement of a 2-percent price hike on steel, sheet and strip, which account for almost one-third of the steel industry's total shipments.

Up to now, the wholesale price record has remained far superior to the Korean-war record and distinctly better than the performance of the inflationary mid-1950's. Even so, today's price situation remains distinctly worrisome. One major danger stems from the fact that the wage negotiations now reaching the bargaining table are taking place in an atmosphere of 3-to-4 percent annual increases in consumer prices and concomitant declines in take-home pay. The contract settlements reached in this environment thus could give

rise to excessive wage increases—and thereby to increases in unit-labor costs which could seep through the entire price structure.

Tightening policy

Policy makers, although faced with the possible dangers of a deflationary future, consequently are now forced to confront the more pressing dangers of an inflationary present. Accordingly, monetary policy continued to tighten in recent months and fiscal policy shifted to a somewhat less expansive stance. During the first half of the year, member-bank borrowed reserves averaged \$230 million (and they reached \$353 million in June); meanwhile, the Federal budget showed a \$3.0-billion *surplus* (national-accounts basis) as against a \$1.3-billion *deficit* in the preceding half-year period. (Nonetheless, the recent budget surplus is relatively small in terms of present levels of resource use, and besides, the budget may slip back into a deficit in the current half-year.)

Federal expenditures increased sharply by

\$11 billion (annual rate) over the first half of the year—and they may gain perhaps \$6 billion more in this present quarter, primarily as a consequence of rapid increases in spending for Vietnam and for medicare. The first-half surplus developed, however, because revenues were substantially greater than expected, mostly as a result of the extra profits and incomes generated by rising national output and rising prices.

The stabilization task of fiscal and monetary policy will be exceedingly complicated, first, by the over-rapid advance of the recent past and, second, by the possible slowdown of some sectors in the near-term future. Few observers would suggest very definite answers at present. At best, there is only the nautical question posed by the Administration's former economic steersman, Walter Heller: "In the turbulent waters of high-pressure prosperity, are we going to founder on the rocks of inflation before we reach those calmer, inviting waters of long-term expansion?"

—William Burke

Foreign Investment

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

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

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

No Slowdown

THE over-exuberant pace of business activity may have moderated somewhat during the second quarter, but little or no slowdown was evident in the nation's credit markets. True enough, several sectors increased their borrowings by only small amounts, but credit demands elsewhere were exceptionally strong, especially in the business sector.

The growth of consumer debt decelerated, as a consequence of the reduction in auto sales and the continued uptrend in debt repayment. Federal marketable debt declined more than usual, as a reflection of the welcome and somewhat unexpected tax inflow generated by rising incomes and rising prices. On the other hand, state-local governments — like business firms — raised a record volume of funds in the capital market during the spring months.

Tighter still

In the context of continued strength of credit demands and continued pressures on the price level, monetary policy moved further in the direction of restraint. Borrowings from Federal Reserve Banks jumped sharply, from \$551 million in March to \$674 million in June, and net borrowed reserves increased over the quarter from \$246 million to \$353 million (daily average basis). Actually, borrowings and net borrowed reserves were considerably lower than in other tight-money periods, both in dollar terms and in relation to total bank credit. However, they undoubtedly would have been larger but for the rapid growth in recent years of an alternative source of member-bank borrowing, the Federal-funds market.

Even so, evidence of growing monetary tightness was not difficult to find. This was apparent in the slower growth of the money supply, which increased at about a 4½-percent annual rate during the first half of the year—

slightly less than the gains in each of the years 1964-65. Tightness was apparent also in a further decline, to a postwar low, in the commercial banks' own liquidity; in June, the loan-deposit ratio reached 67 percent for all banks and 81 percent for the major New York banks. Moreover, evidence of tightness became evident in a further upsurge in interest rates, in some cases to levels unseen since the 1920's.

Higher still

The rise in interest rates reflected the worries attendant upon Vietnam, the balance of payments, and the business outlook. But, primarily, the rise reflected the interplay of basic market forces as corporations, state-local governments, and Federal agencies all trooped to market with record amounts of offerings.

During the spring quarter, corporations floated a record \$5.3 billion in new offerings; yields on new issues thereupon rose 30 basis points to 5.31 percent, while yields on top-rated seasoned corporates rose 10 basis points to 5.09 percent. Similarly, state-local governments floated a record \$3.2 billion in municipal issues, so as inventories rose and as new-issue calendars expanded, yields on these tax-exempts jumped 21 basis points to 3.64 percent. Meanwhile, higher yields appeared in the mortgage and government bond markets as institutional investors, faced with a reduced inflow of funds, curtailed their investment in long-term debt instruments.

At the short end of the maturity range, commercial-paper rates rose sharply during the second quarter, while Treasury-bill rates moved erratically before advancing strongly during July. By the end of June, the rate on short-term paper reached 5.50 percent. At the same point of time, the 90-day Treasury-bill rate reached 4.47 percent—18 basis points below the mid-April peak—but then,

in late July, it soared to within a shade of 5.00 percent.

The April-to-June slide in bill rates reflected several influences: heavy Federal Reserve purchases to accommodate seasonal reserve requirements, the decline in outstanding Federal debt (especially tax bills), and a good public demand that reduced dealers' bill inventories to very low levels. The record rise in bill yields in July (and a 40-year low in bond prices) reflected the growing uncertainties which followed the late-June hike in the prime rate, the reserve-requirement changes in time deposits, and renewed talk of another rise in the discount rate.

Expanding assets

The nation's commercial banks felt the same pressures which affected the credit markets, as they experienced a \$6-billion credit expansion in the second quarter on top of a first-quarter increase of like magnitude. The lending picture continued to be dominated by corporate demand, as business loans expanded at an annual rate of more than 20 percent during the spring period. (A \$3-billion gain in business loans at weekly reporting banks was half again as great as the first-quarter increase.) On the other hand, mortgage loans

tended to increase at a slower pace, and consumer-loan growth slackened appreciably.

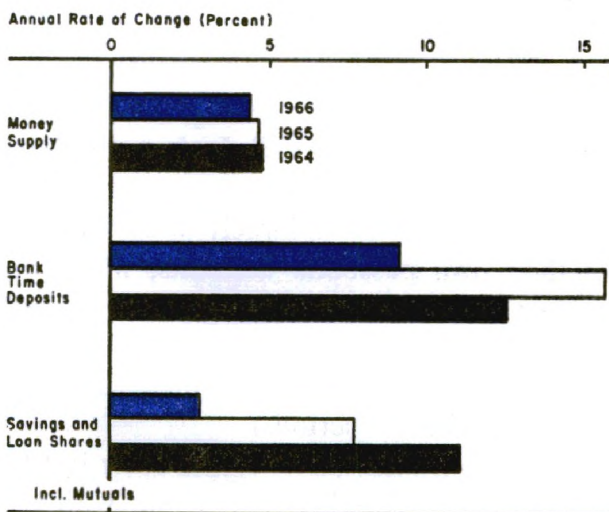
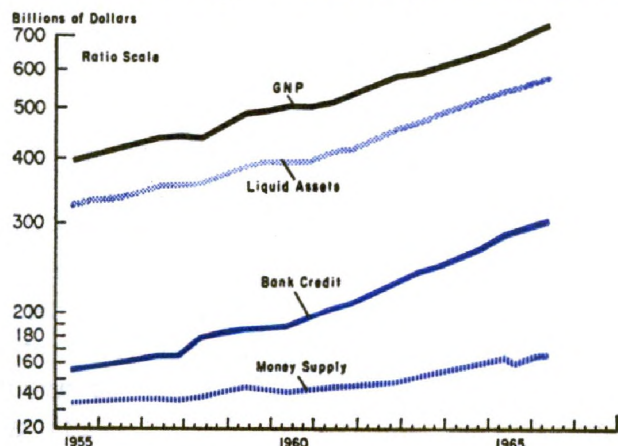
Banks recorded no change in their overall investment portfolio, even in the face of their sharp expansion in business lending. But their portfolio balance changed considerably, as a \$1.4-billion increase in holdings of tax-exempts and other securities was offset by a comparable decline in holding of U. S. Government securities. Because of this liquidation of governments (mostly Treasury bills) the liquidity situation of banks tightened considerably; one key liquidity measure, the ratio of short-term governments to deposits, dropped to 5.4 percent by midyear.

Expanding liabilities

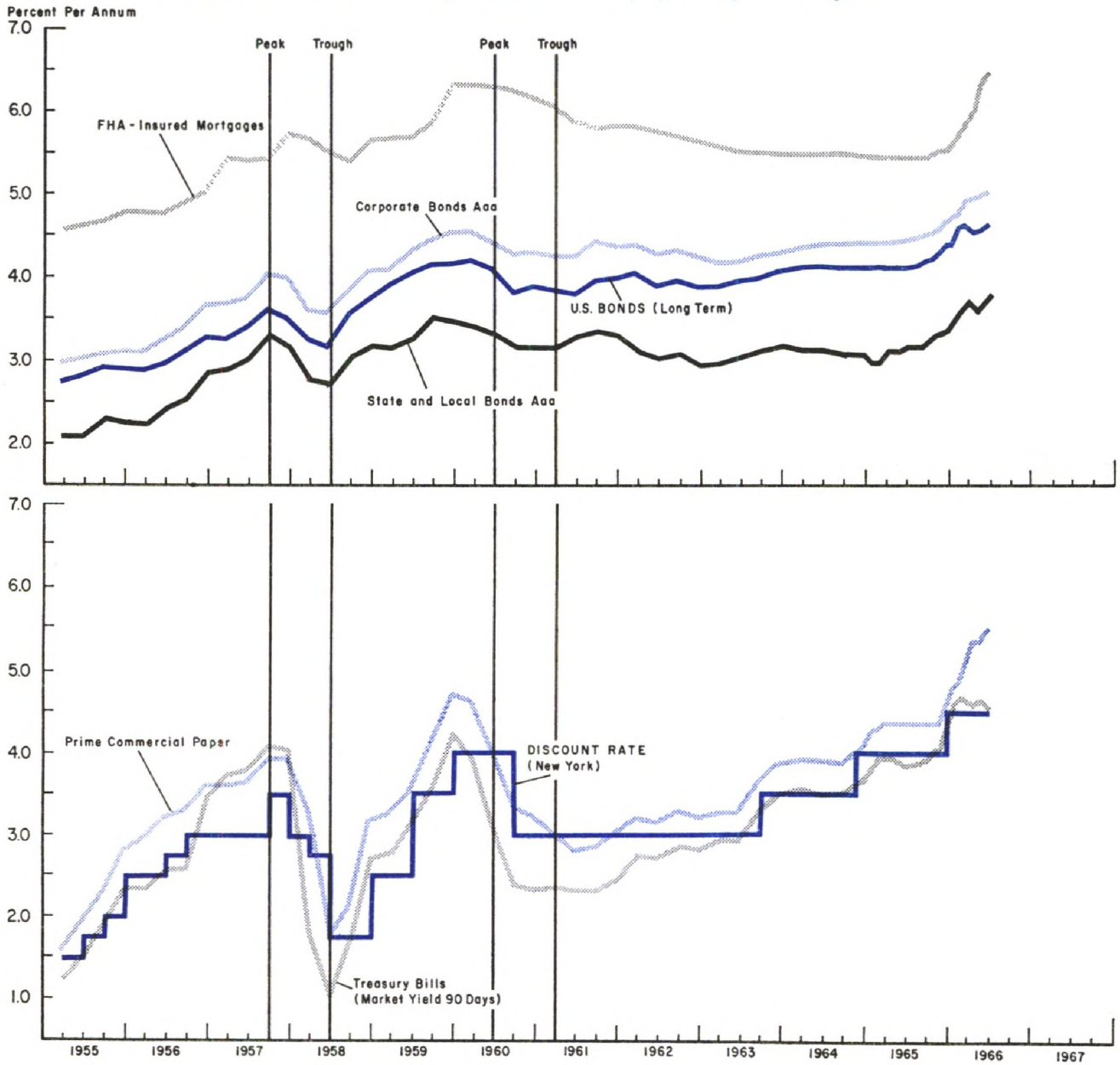
Despite the frenetic activity in bank lending during the spring quarter, most attention centered on the deposit side of the banks' balance sheet—and not only because of the sharp \$8-billion gain in total deposits. The main developments of this period were a \$4-billion increase in time deposits and an actual decline in savings inflows at the nation's savings-and-loan associations.

The time-deposit growth was partly attributable to the increased use of high-yield consumer-type savings certificates, but other fac-

Slowdown in growth trend reflects less rapid growth of money supply—and distinctly smaller expansion of money substitutes



Evidence of growing tightness seen in continued rise of interest rates . . . market forces as well as expectations help push yields upward



tors were involved as well. In fact, the large banks holding the bulk of such deposits increased their holdings largely at the expense of their own passbook accounts, which are subject to a 4-percent ceiling under Federal Reserve Regulation Q. (Passbook savings at weekly reporting banks declined \$2 billion in the April-June period.)

Above all, banks, S&L's, and other institutions found themselves competing with one

another for a limited amount of savings funds in an atmosphere of rising rates. Thus, for the first half of 1966 as a whole, bank time deposits increased roughly at a 10-percent annual rate (seasonally adjusted) as against a 16-percent gain in the full year 1965, and savings-and-loan shares increased at about a 3-percent rate (seasonally adjusted) as against gains of 8 percent in 1965 and 11 percent in 1964.

Official countermoves

In this situation, in order to moderate the growth of bank credit and to restrain the issuance of time certificates, the Federal Reserve Board of Governors raised, from 4 to 5 percent, the amount of reserves which each member bank must maintain against its non-passbook time deposits in excess of \$5 million. (The Board reinforced this action in mid-August when it raised the reserve requirement again, to the legal maximum of 6 percent.) But, meanwhile, the Federal Home Loan Bank Board withdrew its earlier restrictions on borrowing privileges of associations posting "excessive" dividend rates.

A number of S&L's posted higher dividend rates (a few ranging as high as 5½ percent on passbook savings plus a ½-percent bonus on longer-term certificates) even before the Bank Board eased its borrowing regulations—and the move to higher rates became widespread throughout the industry in the wake of the Board's announcement. In fact, industry spokesmen credited the rise in rates for keep-

ing the July savings outflow from being as large as originally feared.

During this period, Bank Board Chairman Horne reiterated his earlier request for Congressional authority to set S&L rate ceilings comparable to the authority the Federal Reserve exercises over bank time deposits through its Regulation Q. At the same time, he argued for "coordination" of rate setting by the authorities supervising the commercial banks and the savings-and-loan associations.

Several basic questions remained at issue: How uniformly must administrative regulations apply to financial institutions competing in the same markets? Again, how far must the groundrules be altered to modify the impact of market forces upon the allocation of financial (and real) resources? The questions are not new, but they are increasingly important at this time because of considerations of "equity" and because of their implications for monetary policy. Consequently, they are certain to receive increased attention from regulators and regulated alike in the months ahead.

—Verle Johnston

TWELFTH DISTRICT BUSINESS

Year and Month	Condition items of all member banks (millions of dollars, seasonally adjusted)				Bank debits 31 cities (1957-59 = 100)	Bank rates: short-term business loans	Total nonfarm employment (1957-59 = 100)	Industrial production (1957-59 = 100)		
	Loans and discounts	U.S. Gov't. securities	Demand deposits adjusted	Total time deposits				Lumber	Refined Petroleum	Steel
1959	15,908	6,514	12,799	12,502	109	5.36	104	109	101	92
1960	16,612	6,755	12,498	13,113	117	5.62	106	98	104	102
1961	17,839	7,997	13,527	15,207	125	5.46	108	95	108	111
1962	20,344	7,299	13,783	17,248	141	5.50	113	98	111	100
1963	22,915	6,622	14,125	19,057	157	5.48	117	103	112	115
1964	25,561	6,492	14,450	21,300	169	5.48	120	109	115	130
1965	28,115	5,842	14,663	24,012	182	5.52	125	111	120	138
1965: June	27,059	6,010	14,832	22,492	168	5.47	124	107	120	147
July	27,327	5,813	14,532	22,718	186	...	124	111	125	143
Aug.	27,283	5,881	14,521	22,805	180	...	125	109	122	139
Sept.	27,409	5,894	14,730	23,084	187	5.53	125	111	121	134
Oct.	27,595	6,203	14,705	23,261	188	...	126	114	122	126
Nov.	27,796	6,103	14,653	23,596	184	...	127	111	123	125
Dec.	28,115	5,842	14,663	24,012	187	5.62	128	118	115	121
1966: Jan.	28,497	5,840	14,761	23,869	195	...	129	120	122	128
Feb.	28,748	5,737	14,790	23,904	206	...	130	111	119	135
Mar.	28,938	5,638	15,027	24,164	212	5.89	130	108	117	143
Apr.	29,267	5,309	14,924	24,579	227	...	130	113	122	147
May	29,157	5,128	14,812	24,735	221	...	131	107	125	145
June	29,688	4,919	14,780	25,001	220	6.18	131	144

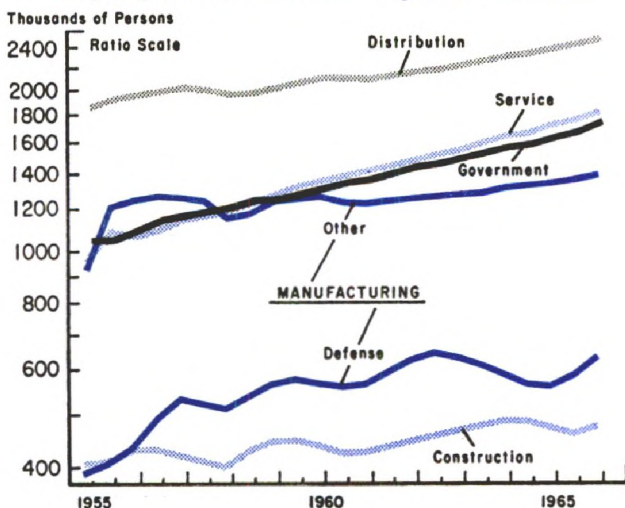
Regional Balance

THE West followed the national pattern during the second quarter: its economy continued to boom, but at a less startling pace than earlier in the year. Total employment in Twelfth District states increased by 1.2 percent during the April-June period, as against a 1.7-percent increase in the preceding quarter, as practically all industries reported continued employment gains.

In the year to date, regional business activity has advanced at a well-balanced pace. Almost all major sectors have expanded employment by about 3 percent over the late-1965 level—the obvious exception being aerospace manufacturing, with a 10-percent increase. Even construction, despite the severe slump in housing, has recorded a gain in employment because of the boom in industrial, commercial, and public building.

The regional boom has brightened the unemployment picture, too. California's unemployment rate remained high, near the 5-percent level, during the first half of 1966, but this figure was far below the average 6-percent rate of the 1964-65 period. The rest of the District, because of the exuberance of the Northwest business scene, boasted a 3.5-percent jobless rate in the January-June period,

All sectors exhibit gains in employment . . . aerospace booms



as against the 1965 average of 4.8 percent. (This rate was one of the lowest regional rates in the entire country.)

High flier

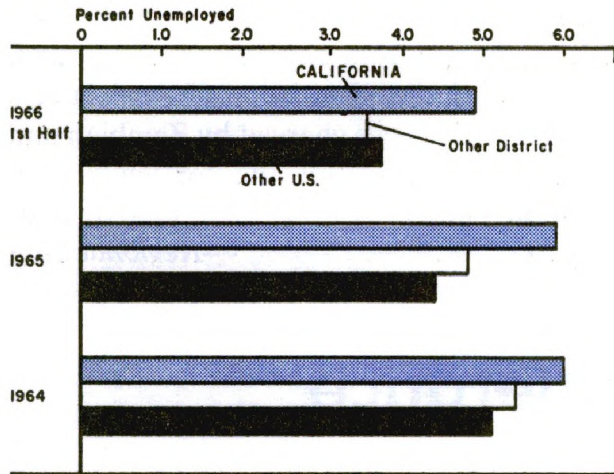
Aerospace-manufacturing firms boosted employment by 4 percent during the spring months, and thereby reached a new peak of 646,000 in June. The commercial-aircraft boom rather than defense demand provided the basis for this sharp year-long upsurge in aerospace employment. However, shortages of engines and aircraft parts are now delaying deliveries of some commercial aircraft, and these production difficulties could dampen the earnings picture for the major aircraft producers.

The war in Vietnam exerted a smaller impact on Western manufacturing than it did elsewhere, although it continued to stimulate a sharp expansion in shipping and related activities. District defense manufacturers chalked up a 10-percent year-to-year gain in prime contract awards, to \$1.8 billion, in the first quarter, but this gain was quite modest in terms of the total national increase. Consequently, the Western share of defense contracts dropped from 31 to 26 percent of the total between early 1965 and early 1966.

Even keel?

Regional housing activity continued to slump during the spring quarter, but a rise in activity in other sectors kept total construction on an even keel. Residential construction awards dropped 17 percent, in dollar terms, as declines occurred in both single-family and multi-family awards. (The pattern of decline was somewhat spotty, however, since housing activity boomed in the Northwest states during this period.) Non-residential construction awards, meanwhile, increased by 27 percent, mostly on the basis of several large contracts for dam construction.

Jobless rate drops sharply as business expansion continues



The West's three-year-long housing slump, initiated by the over-built condition of many communities but aggravated recently by the drying-up of mortgage money, shows up clearly in regional statistics on the number of housing units authorized by new building permits. Between the 1963 peak and early 1966, the West sustained a one-third decline in single-family permits and an even sharper two-thirds decline in multi-family permits. Yet, elsewhere in the country, single-family permits increased slightly and multi-family permits rose significantly higher over the same three-year period, and no drop-off in activity occurred until the spring of this year.

Basic producers

In the District's farm sector, receipts lagged behind the year-ago level during the second quarter, after rising substantially during the earlier months of the year. During the spring months, crop receipts declined as vegetable prices dropped to more normal levels, while livestock receipts continued high on the basis of a strong price situation. But elsewhere in the nation, total farm receipts continued at a very high level.

The Western lumber industry witnessed a strong reversal of the first-quarter price run-up during the spring and early summer months. Defense and construction needs, plus labor

uncertainties, had contributed to the earlier increases—a 25-percent year-to-year price rise for lumber and a 37-percent rise for plywood. But almost half of the lumber-price increase, and practically all of the plywood-price rise, disappeared in the wake of the nation's housing decline and the industry's labor contract settlement.

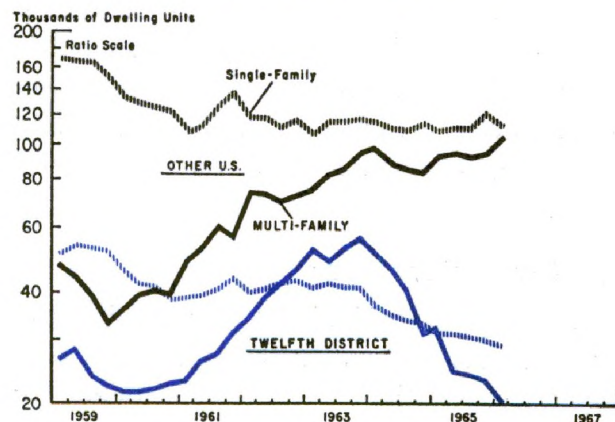
Crude petroleum output in the District ran 10 percent above year-ago levels during the spring months. Jet fuel requirements for military and civilian planes accounted for a significant share of the increased demand. Moreover, military requirements for residual fuel oil contributed substantially to market strength.

Pouring more metal

Western steel producers boosted output during the second quarter to meet the growing demand for defense items (such as tanks and aircraft landing mats) and for structural steel for commercial and industrial building. During the January-June period as a whole, Western steel production ran only 4 percent below the high early-1965 pace, which was dominated by heavy inventory hedge-buying, and steel consumption thus ran at least level with the year-ago consumption figure.

Aluminum producers in the Pacific Northwest raised their primary production to record levels this spring in response to growing mili-

Western housing slump persists, even after three years of decline



tary and civilian demand. Future capacity requirements also gained attention, as the start-up of a 76,000-ton potline at Bellingham launched a new primary producer into the industry.

Western copper producers expanded output during the quarter to help meet the severe copper shortage, and the Administration also worked to this end by releasing 100,000 tons

of stockpile metal. Nonetheless, pressures on the domestic producers' price, currently 36 cents a pound, intensified when Chile raised its export price from 62 to 70 cents a pound, in a move designed to bring Chilean quotes into line with prices charged by Zambian and Congo producers. But the foreign supply situation—and prices—began to ease by mid-August. —*Regional Staff*

Regional Exuberance

THE Western financial scene was eventful, to put it mildly, in the spring and early summer months. Amid a national environment of increasing monetary pressures, rising interest rates, and intensified competition for deposits, Twelfth District weekly reporting banks expanded their security holdings by more than \$400 million—and their loans by close to \$1 billion—during the April-June quarter. Moreover, they increased their total deposits by \$835 million during this period (daily average basis), even in the face of April's record monthly decline in private time deposits. But more surprisingly, District banks had a \$6-million net *free* reserve position, while in contrast, banks elsewhere recorded net *borrowed* reserves of \$330 million (daily average basis).

Under the impact of extremely heavy business credit demands, regional lending activity accelerated; District bank loans increased almost 4 percent in the second quarter on the heels of a 1-percent first-quarter gain. And in practically all categories, the lending pace in both quarters was above the strong 1965 pace.

On the factory floor

In the first half of 1966, durable-goods manufacturers borrowed at twice their year-ago pace, and thereby accounted for the lar-

gest part of the overall gain in business loans. In particular, borrowing was very substantial in the transportation equipment, fabricated metals, and machinery categories, because of heavy defense demand in those industries.

Nondurable-goods manufacturers also increased their borrowings; food processors recorded an unseasonally small second-quarter loan decline, and petroleum processors meanwhile expanded their borrowings heavily. (The oil industry has now increased its outstanding bank debt by two-thirds over the past year.) The miscellaneous category, which includes mostly service firms, also recorded a sharp expansion during the quarter.

In the face of these strong credit demands as well as the rising cost of bank funds, business-loan rates moved to a postwar peak during the quarter. In early June, District metropolitan banks charged an average rate on short-term loans of 5.89 percent—84 basis points above the year-ago level and 27 basis points above the earlier (June 1960) peak. The June survey reflected the two earlier (December and March) increases in the rate charged to prime business borrowers. However, that survey preceded the late-June and mid-August hikes in the prime rate, so if another survey were made today it would undoubtedly show an even higher level of rates.

Although the business sector dominated the credit picture, other bank-lending activities also expanded during the spring quarter. Mortgage loans increased more rapidly than in the year-ago period, and ten times more rapidly than in the first quarter of 1966. Consumer loans also outpaced the rather nominal first-quarter gain, in part because individuals needed funds to meet their April income-tax payments.

Meanwhile, District weekly reporting banks expanded their total security portfolios even while increasing their loans. But this increase was due entirely to continued heavy purchases of municipals and Federal-agency issues; banks continued to reduce their holdings of

governments, although to a smaller degree than earlier in the year.

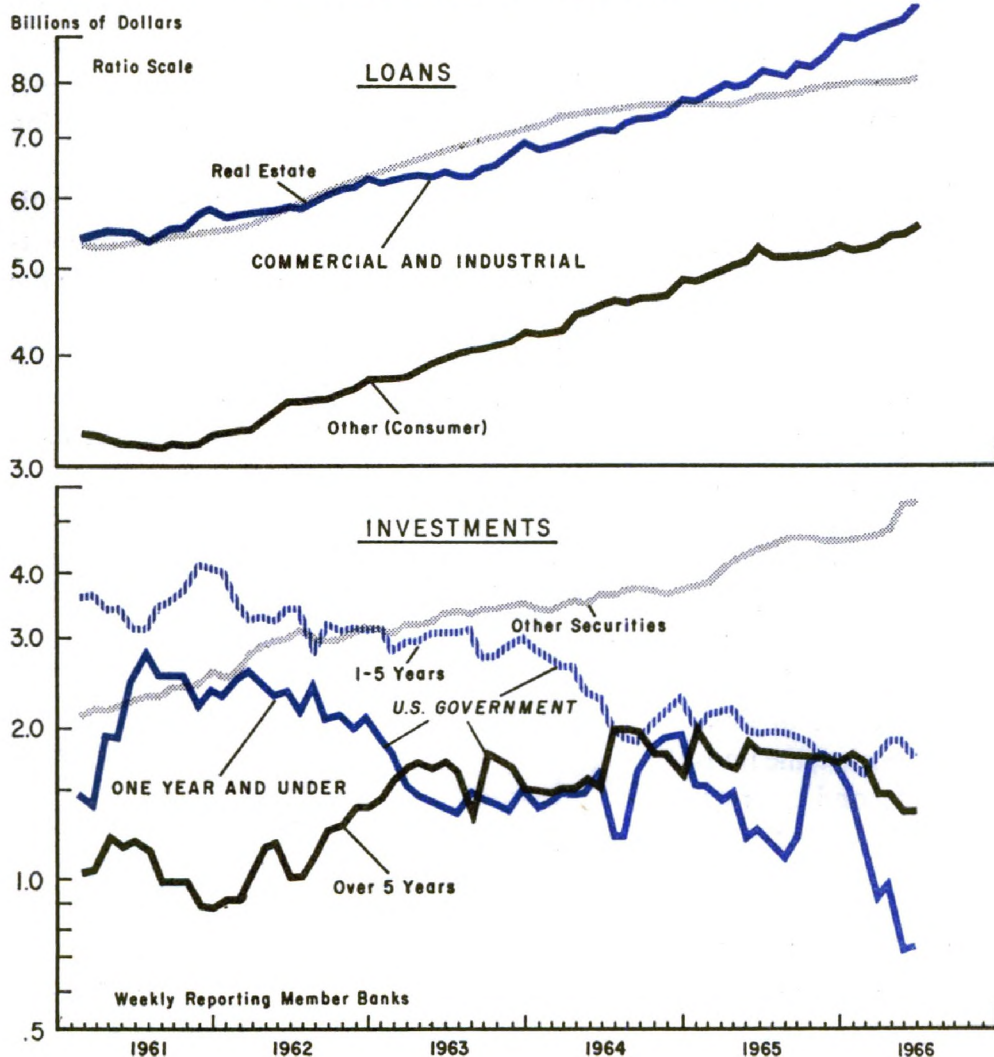
At the teller's window

Yet, despite all these events on the asset side, the most dramatic developments continued to unfold in the deposit sector. At the beginning of the spring quarter, many large banks (particularly in California) began to offer higher rates to individual savers on deposits held in the form of savings certificates and similar instruments. Many of these banks soon found their interest costs rising 25 percent for the same funds, since the immediate impact of the new rate offer was a massive shift of deposits out of passbook savings (with a 4-percent maximum permissible rate) into time certificates (with new rates of 5 percent or more).

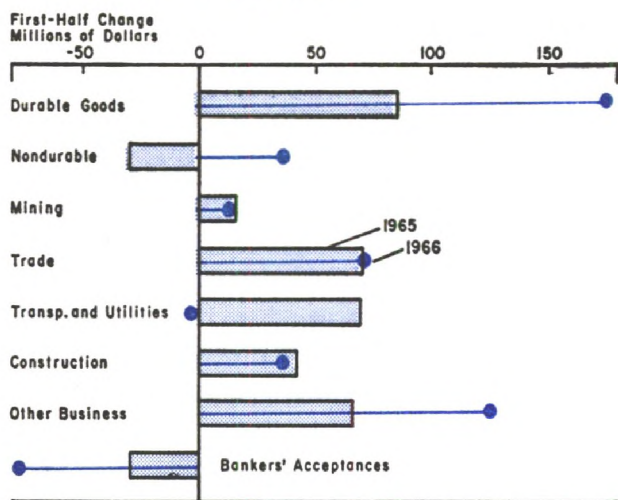
In April, District banks suffered a substantial decline in passbook savings, because of the higher rates available on certificates but also because of the normal seasonal withdrawals for income-tax purposes. In May and June, banks continued to lose passbook-savings funds, but (unlike April) they recorded offsetting gains on other time certificates of individuals, partnerships, and corporations.

District banks were especially ef-

Banks accelerate lending pace, especially in business loans, but continue selling short-term governments



Durable-goods firms borrow at twice year-ago pace



fective in expanding their issuance of large-denomination (\$100,000 and over) time certificates of deposit. At midyear they had \$2.1 billion in outstanding CD's—exceeding Chicago-area banks for the first time, and holding second place only to New York banks, which tend to dominate the CD market. Moreover, District banks exhibited a much smoother maturity pattern than other banks, which suffered substantial runoffs over the June dividend and corporate-tax dates.

Tighter or easier?

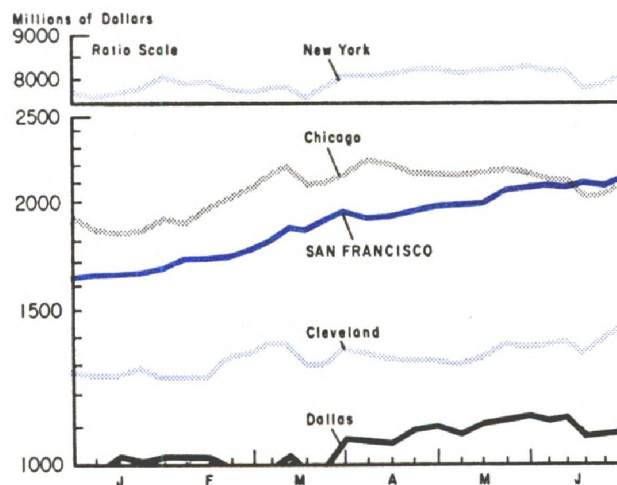
Despite the strength of credit demands and the tightening of monetary policy, regional banks paradoxically maintained an easier reserve position in the April-June period than in the preceding quarter. In the first quarter, District member banks were net borrowers of funds at the Federal Reserve discount window, and were also net borrowers of funds from other banks through purchases of Federal funds (reserves held on deposit at the Federal Reserve Bank). In the second quarter, District banks shifted to a free-reserve position, as their excess reserves exceeded their borrowings from the Federal Reserve by \$6 million (daily-average basis), and major District banks also became net lenders to other banks through sales of Fed funds.

This easier reserve position, in the face of a much tighter position elsewhere, can be explained by the much stronger deposit inflow at District banks. These banks increased their total deposits by \$835 million during the quarter (daily average basis); they thus accounted for almost one-fourth of the nation's quarterly gain in deposits, although they normally hold only one-sixth of the national total. After securing large amounts of business-type time deposits in the first quarter, District banks benefited from a substantial inflow of consumer-type time-deposit funds in May and June. In addition, these banks recorded a small increase in demand deposits in the second quarter, at a time when banks elsewhere were losing \$400 million in such deposits.

But the figures on bank reserve positions were only part of the story, since other measures pointed to increasingly severe strains on bank liquidity. Between January and June, the loan-deposit ratio of weekly reporting banks rose from 71 to 73 percent—the tightest figure since the 1920's. Meanwhile, their ratio of short-term governments to deposits dropped from 4.7 to 2.1 percent—close to the tight-money low reached five years ago.

District banks also face a liquidity problem by virtue of holding substantial amounts of time deposits of state-local governments—

West second only to New York in issuing large-denomination CD's



in fact, about one-fourth of the U. S. total. Most District states require 110 percent collateral for such deposits in the form of specified types of securities. And with the higher amount of such deposits outstanding this year, this requirement immobilizes from \$2.2 to \$2.6 billion in securities, and thus precludes those securities from being used for other collateral purposes or from being liquidated for loan-expansion purposes.

For all these reasons, and now for other reasons as well, banks will find their elbow room somewhat limited in coming months. The new change requiring 6-percent reserves on non-passbook time deposits (in excess of \$5 million) will affect District banks more than other banks because they hold a relatively large volume of such deposits—about one-fifth of the national total. The new change decreasing the effective rate on “multiple maturity” time deposits will weaken banks’ competitive position vis-a-vis savings-and-loan associations and other investment outlets, which are now offering rates higher than the time-deposit ceilings. So the banks, faced with a liquidity squeeze, rising costs of acquiring funds, and prospective losses on securities sales—and now faced also with higher reserve requirements and lower ceilings on rates they are permitted to pay for funds—will find it difficult to maintain the high profit margins which showed up in their early-1966 reports.

No mortgage money?

Even so, the problems of the banks continue to be eclipsed by the problems of the S&L’s. In the spring quarter, District associations were forced to contend with a reversal of their normal savings inflow; in fact, in the April-May period their withdrawals exceeded their deposits by a whopping \$578 million.

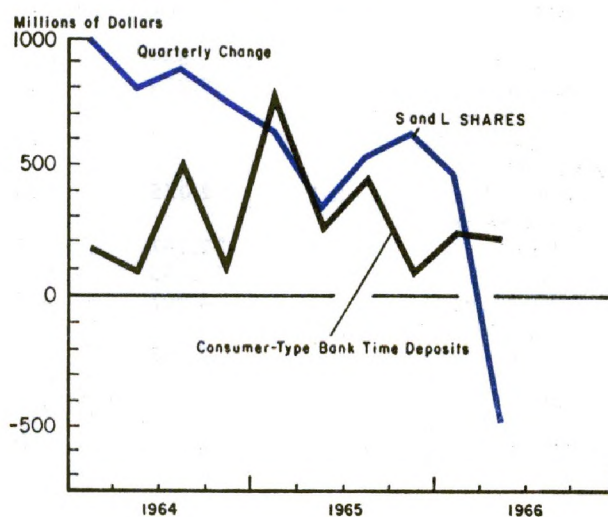
The outflow of funds admittedly was small in relation to the associations’ total deposits of \$26 billion, but it severely affected the Western mortgage market, since the S&L’s savings inflow normally represents a large

part of the funds available for new mortgage loans. Moreover, several other important sources of funds for the regional housing market also tended to dry up during the quarter; S&L mortgage-loan repayments declined, and their mortgage participation sales to associations elsewhere diminished to a trickle.

The industry consequently took in its belt during the spring and summer months. A number of California associations declared a moratorium on new loans, and most associations throughout the District tightened their lending policies. Loans closed during the April-May period dropped to \$777 million—more than one-third below the year-ago pace—and the backlog of loan commitments contracted by almost one-half, and thereby led to gloomy predictions concerning future loan volume.

In an effort to retain savings, associations began to offer higher rates for deposits in late June and early July. The new rates generally ranged between 5 and 5½ percent—the most common being 5¼ percent—and many associations offered an extra ½ percent on three-year maturity plans. As a consequence, the July savings outflow was less than predicted, and was considerably less than the outflow experienced elsewhere.

S&L’s contend with reversal of normal savings inflow



FEDERAL RESERVE BANK OF SAN FRANCISCO

In view of all these developments, mortgage funds became both increasingly scarce and increasingly expensive in recent months. Interest rates on conventional mortgages reached 6.80-6.90 percent in July, in contrast to the 6.10-6.15 percent rate prevailing in the District until last fall. Moreover, discounting of government-backed mortgages continued to grow, even though the Federal Housing Administration and the Veterans Administration raised their rates to 5.75 percent early in April in an attempt to restore the traditional relationship of government-backed rates to conventional rates.

With limited funds available for its market-support operations, the Federal National Mortgage Association reduced its purchases of government-backed mortgages during the second quarter. FNMA purchases in the Western region declined from \$98 million in March to \$64 million in May. And by limiting its purchases of mortgages to those of \$15,000 or less, the agency severely limited its role in the Western market, since few mortgages on new homes meet that criterion in this region. So all in all, Western mortgage financing promised to continue in the doldrums for some time to come.

—Ruth Wilson and John Booth

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

(dollar amounts in millions)

	Twelfth District				U. S. Minus Twelfth District		
	Outstanding 6/29/66	Net Change		First Quarter 1966 Percent	Outstanding 6/29/66	Net Change	
		Second Quarter 1966 Dollars	Percent			Second Quarter 1966 Percent	First Quarter 1966 Percent
ASSETS							
Loans adjusted and investments ¹	\$35,485	+ 1,410	+ 4.14	— 1.94	\$134,194	+ 3.56	— 0.86
Loans adjusted ¹	26,261	+ 982	+ 3.88	+ 0.83	98,305	+ 5.56	+ 1.13
Commercial and Industrial loans	9,521	+ 475	+ 5.25	+ 2.42	46,271	+ 6.14	+ 4.30
Real estate loans	8,096	+ 152	+ 1.91	+ 0.20	15,420	+ 3.33	+ 2.12
Agricultural loans	1,071	+ 43	+ 4.18	— 2.74	604	— 2.58	— 2.52
Loans to non-bank financial institutions	1,721	+ 78	+ 4.75	— 2.78	9,913	+ 10.45	— 2.74
Loans for purchasing and carrying securities	497	+ 26	+ 5.52	+ 25.94	6,271	+ 12.71	— 7.97
Loans to foreign banks	253	— 19	— 6.99	— 5.88	1,252	— 2.11	— 3.62
Other loans (mainly consumer)	5,549	+ 231	+ 4.34	+ 0.21	20,728	+ 1.86	+ 0.06
Total securities	9,224	+ 428	+ 4.87	— 9.11	35,889	— 1.56	— 5.61
U. S. Government securities	3,835	— 253	— 6.19	— 19.19	16,440	— 5.44	— 9.41
Other securities	5,389	+ 681	+ 14.46	+ 1.93	19,449	+ 1.99	— 1.84
LIABILITIES							
Demand deposits adjusted	12,075	— 399	— 3.20	— 3.48	53,086	— 1.36	— 5.19
Total time and savings deposits	22,047	+ 812	+ 3.82	+ 1.53	60,819	+ 1.76	+ 4.22
Savings	14,043	— 911	— 6.09	— 0.72	29,061	— 3.63	— 0.47
Other time, I.P.C. (Neg. CD's \$100,000 and over)	4,907	+ 1,479	+ 43.14	+ 23.62	22,607	+ 9.04	+ 12.16
	2,125	+ 194	+ 10.05	+ 19.42	15,618	+ 2.33	+ 5.40

¹Exclusive of loans to domestic commercial banks and after deduction of valuation reserves; individual loan items are shown gross. Note: Quarterly changes are computed from December 29, 1965 - March 30, 1966 and from March 30, 1966 - June 29, 1966. Source: Board of Governors of the Federal Reserve System; Federal Reserve Bank of San Francisco.

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