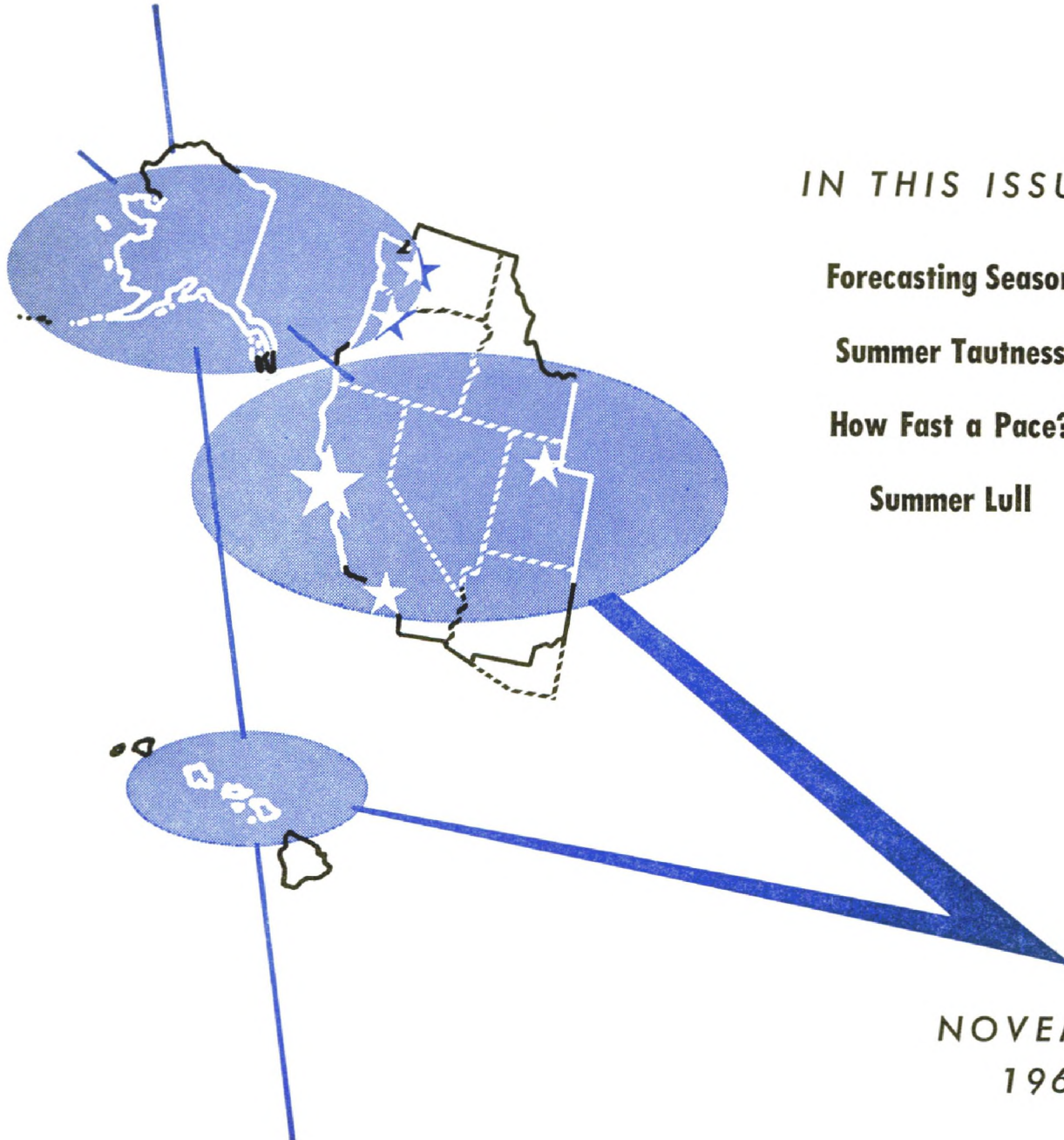


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FEDERAL RESERVE BANK OF SAN FRANCISCO

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# MONTHLY REVIEW



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**NOVEMBER  
1966**

### **Forecasting Season**

... Depending on his choice of statistics, the forecaster can now predict—with equal plausibility—either recession or inflation.

### **Summer Tautness**

... All sectors (especially business) clamored for money during the third quarter, and pressed upon a slow-growing supply of funds.

### **How Fast a Pace?**

... After growing at a hyperactive pace in earlier months, Western business expanded at a more sedate pace in the third quarter.

### **Summer Lull**

... District banks responded to growing reserve pressures this summer by reducing their loans and adding to their securities.

**Editor: William Burke**



## Forecasting Season

THE favorite spectator sport this fall, aside from watching the bears pursue the bulls through the canyons of Wall Street, is watching the forecasters agonize over their model-building for 1967. Signs of inflationary pressures can be found on every hand, but so too can signs of incipient weaknesses. As a result, in the presentations they are now making to bemused management groups, the forecasters are including more ifs, buts, and whereases than even they are normally prone to use.

The latest GNP statistics admittedly revealed little of this agonizing uncertainty, but rather showed all the signs of a continued rapid expansion. The nation's total output rose sharply in the third quarter, by \$12 billion, to a \$745-billion annual rate. This was better than the second-quarter performance, in real terms as well as in current-dollar terms; just about one-third of the gain was diluted by price increases, whereas over half of the \$11-billion second-quarter gain was washed out by higher prices.

The summer advance was marked by sharp increases in defense spending and business investment. Defense spending was roughly 20

percent above the year-ago level, and business spending for plant and equipment was up about 14 percent over the year. Moreover, consumer durable-goods spending recovered to the first-quarter peak. Purchasing agents continued to pile up inventories and importers continued to scramble for foreign goods, and amid all this, only residential construction remained in the doldrums.

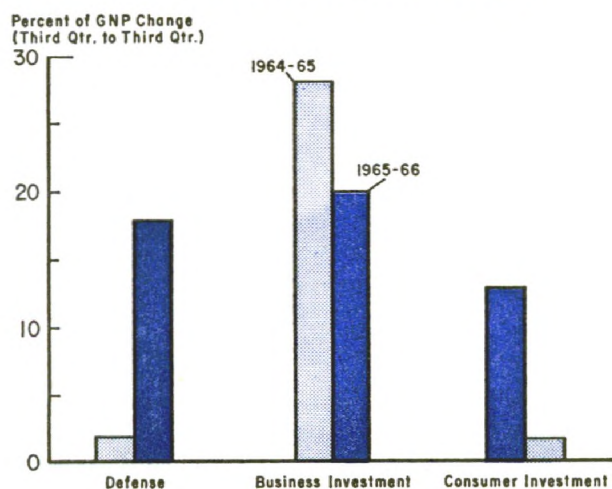
Over the past year, the defense sector accounted for almost one-fifth of the *rise* in GNP, and business investment was responsible for a comparable share of the overall increase. Consumer "investment" in durable goods and new housing, however, increased hardly at all over the same time span.

### Diversions and pressures

These statistics represent a vast diversion of resources inside the national economy. In addition, other statistics point to strongly increasing pressures on the nation's total resources. There are labor shortages, with unemployment below the 4-percent mark throughout the third quarter and with innumerable vacancies in skilled trades. There are delivery tie-ups, with about three-fourths of the nation's purchasing agents reporting increased delays in receipt of orders. There are increased order backlogs, now about one-fourth higher than a year ago, and even higher for defense products and machinery. There are rising imports, now about one-fifth higher than a year ago and undoubtedly higher still if raw materials had not been released from government stockpiles. Finally, there are rising prices, with the consumer price index  $3\frac{1}{2}$  percent above a year ago and creating pressures for substantial wage increases in upcoming contract negotiations.

These indicators lead some forecasters to

### Defense and business investment benefit from diversion of resources





predict the continuation of inflationary pressures throughout 1967. Other statistics, however, lead some analysts to come up with a forecast of decreasing pressures. Industrial production was level in September, after a 10-percent rise in the preceding twelve-month period. New orders for durable goods remained on the high plateau reached last spring. Wholesale prices were off slightly in September, after rising throughout the several preceding months. And, finally, stock prices were off more than slightly, so that this commonly watched leading indicator cast a rather dark shadow on the 1967 scene.

### **How much for defense?**

Yet, on balance, the recent picture has shown mostly the continuation of pressures arising from large factory backlogs, increased usage of machinery and labor, and (especially) the demands of Vietnam. Defense spending rose sharply in the summer quarter, to a \$61-billion annual rate—a rate 7 percent above the preceding quarter and 20 percent above the year-ago level. If the present trend continues, spending next spring would be at the \$72-billion peak rate reached in World War II.

Admittedly, the present high level of defense spending represents only about 8 percent of GNP, as opposed to 40 percent of GNP during World War II and 13½ percent during the Korean episode. Moreover, the troop-strength increase of 485,000 and the spending increase of \$8 billion reported over the past year amount to only about one-third of the first-year Korean War increases. But even so, the pressures now resulting from the necessary diversion of resources from other sectors show that the conflict cannot be financed out of the nation's small change.

Looking ahead, many defense analysts foresee smaller increases in defense spending to finance a Vietnam expeditionary force of 500,000, so that defense contracts for fiscal 1967 could approximate the \$38.2 billion re-

corded in fiscal 1966. (The 1965 total was \$27.9 billion.) If so, pressures on some industries could decrease. Defense set-asides for aluminum and copper might drop, as has already happened in the case of steel, where set-asides have been reduced from 6 percent to 5½ percent of total industry shipments for the first quarter of 1967. Yet, even with developments of this kind, durable-goods industries will continue under heavy pressure because of defense procurement demands.

### **Too much for business?**

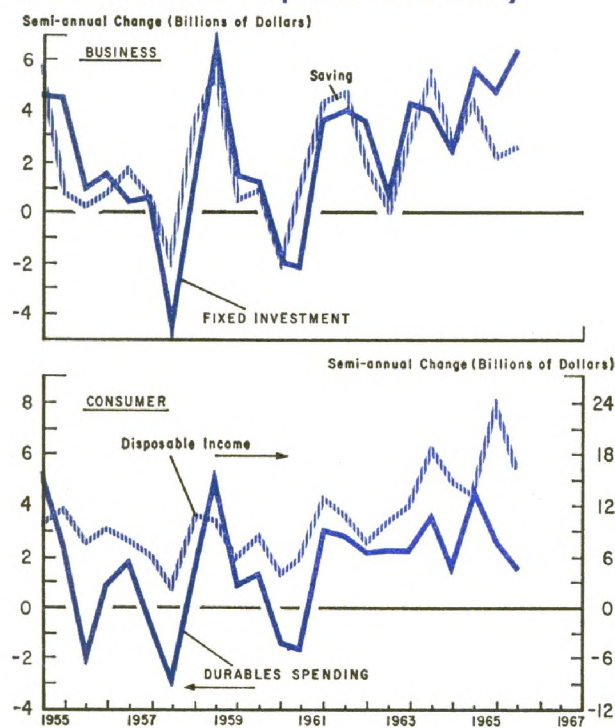
The business sector showed continued strength as the fall season began. Inventory building during the third quarter was at about a \$10-billion annual rate, and business fixed investment rose 3 percent during the quarter to an \$80-billion rate.

Inventory building, although quite high, was slightly below the spring-quarter pace, and a Commerce Department survey indicates that the fourth-quarter pace will be somewhat slower. The expected reduction in stockbuilding may be related to an over-rapid build-up of stock in some industries. Between February and August, the inventory-sales ratio jumped from 1.43 to 1.48 as businessmen in general and durable-goods manufacturers in particular rapidly built up their stocks.

In the plant-equipment sector, a fix on 1967 will have to await the Commerce-SEC December survey, especially since the latest quarterly survey gave rather mixed signals. For 1966 as a whole, the survey showed a 17-percent year-to-year gain in plant-equipment spending—a remarkable gain when placed back-to-back with last year's comparable increase. On the other hand, the quarterly increases expected for late 1966 were substantially below the increases recorded in 1965 and early 1966. Durable manufacturers, for example, after recording a \$700-million gain in capital spending in the second quarter, expected to show no increase at all in the fourth



## Business firms increase spending despite reduced rate of saving, but consumers respond differently



quarter of this year. These findings were underlined by a recently-released industry survey, which predicted only a 5-percent gain in total spending for 1967.

The reduced availability of internally generated business funds is one factor in this development. In the first half of 1966, total business investment increased \$6.2 billion over the preceding half-year period, whereas business savings—mostly retained profits and depreciation allowances—increased only \$2.5 billion, partly because of a narrowing of profit margins and partly because of the tax speed-up which will put corporations on a pay-as-you-go system by mid-1967. Thus, in the first half of this year, corporations were forced to rely on external financing for 29 percent of their investment funds, as against 18 percent in the 1961-64 period. Increasingly, then, corporations in their investment planning have been forced to take account of the (record high) level of interest rates and the (tight) availability of credit.

## No longer isolated

As of several years ago, the business investment boom could proceed almost in isolation from the outside world. As late as 1964 corporations' net cash flow exceeded their capital outlays (including inventory) by a goodly margin, but the reverse is true today. Capital outlays now far exceed net cash flow, and this year the excess may be twice as great as the \$6-billion record achieved during the 1956 investment boom.

Notwithstanding this shortage of internally generated funds, plant-equipment spending accounted for a near-record share of real GNP in the first half of 1966. But, with the economy operating near capacity and with critical shortages developing for skills and materials, this massive expansion tended to aggravate the already heavy pressures on supply, to lengthen delivery schedules, and to push upward the cost of money and the cost of capital goods.

Consequently, in early September, the President proposed legislation to reduce inflationary pressures and to bring the investment boom to a more balanced level, and the Federal Reserve meanwhile warned banks of the necessity to slow down the accelerated pace of business lending. Congress thereupon suspended, from October 10 of this year to the end of next year, the business tax incentives which had played such an important role in stimulating the massive investment boom of the mid-decade. The suspension of the investment tax credit increases the cost of machinery and equipment by about 2.4 percent for short-life items and by about 7.5 percent for items with a useful life of 8 years or more, and the suspension of several accelerated-depreciation procedures increases the cost of structures by about 4 percent. (Even so, one big business was delighted with the tax legislation, since an unrelated rider to the bill granted antitrust immunity to the recent professional-football merger.)



Balance-of-payments statistics showed the impact of defense spending and of the investment boom in January-September 1966, the deficit being roughly in line with the \$1.3-billion deficit recorded last year. Spending increased sharply for foreign goods, foreign travel, and foreign military operations, especially the latter; defense demand accounted for a large share of the overall deficit and contributed to the lower trade surplus through its stimulus to imports.

The rising tide of imports continued to wash over American shores during the third quarter. At a \$39-billion annual rate, imports in the summer period were 5 percent higher than in the preceding quarter and an amazing 50 percent higher than three years before. Exports also increased during the summer but at a much slower pace. Next exports, at a \$4.4-billion average rate in the spring and summer quarters, thus fell far below the \$8.5-billion mark recorded in 1964. And, although defense demands contributed to this import upsurge, the business investment boom was also involved, with capital-goods imports rising 40 percent over the past year alone.

### **Cars rolling, houses sliding**

Rising demand and rising prices pushed up the level of consumer spending throughout recent months. Consumer disposable income rose at a slower pace, however, so the personal savings rate dropped to about 4.7 percent in the summer period from 5.3 percent in the preceding quarter. Durable-goods spending recovered to the first-quarter's \$70-billion peak rate during the summer months because of an improvement in auto sales. In the residential-construction sector, meanwhile, the prolonged slump continued, with spending of \$25 billion at the lowest level of the last four years.

As new-model introduction time approached, the auto industry succeeded in reducing its heavy spring inventory of 1966

models. New-car stocks at the end of August were about 1.1 million—the same as a year ago and far below the June level of 1.7 million units. To make the industry happier, the '67 models met with a reasonably good early acceptance, although few observers could envision a repetition of the smashing success of the initial '66 models.

In housing, few signs of optimism were evident this fall. Inadequate financing, reflecting the vast diversion of funds to the business and defense sectors, combined with the earlier over-adequacy of supply to bring about the lowest level of housing activity of the postwar period. Housing starts, which had been as high as 1.5 million (annual rate) as late as the first quarter of this year, were around 1.1 million throughout the third quarter and were quite likely to go lower. For one reason, new housing permits in September, for both single units and apartments, were one-fourth lower than even the depressed mid-year levels. For another reason, the principal mortgage lenders, especially the savings-and-loan associations, continued to have problems of their own in attracting funds.

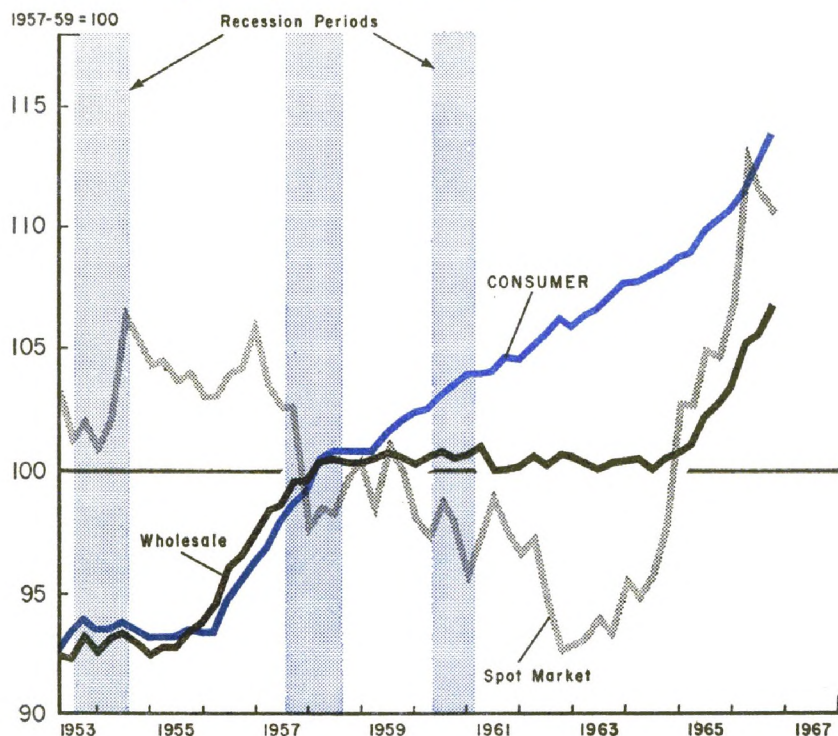
### **How much price pressure?**

On the price front, wholesale prices were 5.2 percent above the 1957-59 average during the third quarter. During this period, farm and food prices rose to a level 8 percent above the year-ago figure but industrial prices steadied after their earlier rise, at a level 2½ percent above the year-ago figure. And, what with the reversal of last spring's upsurge in hides and nonferrous metals, raw industrial materials have actually dropped 10 percent in price from their spring peak.

Demand pressures on resources were a strong factor in the earlier advance, but some easing of these pressures has lately become apparent. The industrial production index, which rose at a 12-percent annual rate over the winter months, rose at only half that pace



## Price trends remain worrisome despite drop in spot market index



between March and September. Pressure on machinery prices meanwhile has continued because of the strength of the business-investment boom and of defense procurement. The 2-percent rise in this category so far this year equals the total rise for the preceding 2½ years—but this contrasts with a 20-percent price rise during the 1955-57 investment boom. The increased capacity of the machinery industry and the relative stability of steel prices have contributed to a much better price performance than a decade ago in this crucial sector of the economy.

On the consumer front the problem is more worrisome. Food prices have risen rapidly this year despite an improvement in the livestock and meat area, and the prices of services have increased just as sharply, particularly in the areas of medical care and mortgage-interest costs. At the same time, prices of non-food consumer goods have also advanced faster than heretofore.

The recent developments in food and serv-

ices have sharply affected the housewife's budget and her husband's wage negotiations. Housewives have begun to picket supermarkets throughout the country; in Denver, they carry signs reading "Down with frills, stamps, and gimmicks," and in Florida they parade under the banner MILK (Mothers Interested in Lower Costs).

The situation which has led to their revolt has several aspects. There is the rise in farm and food prices, reflecting the reduced production of livestock in 1965, the slightly lower crop yields of 1966, and the great strength of both domestic and foreign demand for American foods. There is also the sharp rise in service prices, reflecting

the slow pace of productivity in that sector, the heavy demand for the short supply of medical workers, and the pressure to lift wage floors for low-paying service jobs in a full-employment economy.

On balance, the perplexed forecasters are now handling their forecasting tools with considerably more caution than usual. Many of them, in fact, are dismissing the normal array of indicators and are basing their forecasts instead on one single indicator, defense spending. Using Professor Walter Heller's rule of thumb—that is, a \$20-billion total impact from fiscal '66's \$8-billion rise in defense spending—they envision a much sharper stimulus from a projected \$15-billion rise in fiscal '67 Pentagon spending. In their view, the five-sided building across the river from the nation's capital acts as a uni-directional pointer for the national economy.

—William Burke



## Summer Tautness

**T**HE accelerated expansion in the nation's output of goods and services during the third quarter was accompanied by a growing tautness in the credit markets, as increased borrowings by the public and private sectors alike pressed upon a less rapidly growing supply of loanable funds. Nonetheless, total debt failed to grow as vigorously as earlier in the year, largely because of reduced, but still substantial, borrowings by businesses and state and local governments.

Consumers stepped up their borrowings, largely to finance the acquisition of autos and other durable goods, although the growth of consumer debt still fell considerably short of the average 1965 pace. For its part, the Federal Government added some \$5 billion to its outstanding debt, over and above a heavy volume of Federal Agency offerings, and at the same time drew heavily upon its cash balances to meet the discrepancy between expenditures and revenues. But what was most significant, in terms of its direct impact upon the credit markets as well as its influence upon monetary and fiscal policy, was the continuing demand for funds from the business sector.

### **Business, front and center**

While a number of factors contributed to this business demand, including stepped-up tax payments and expectations of a lessened availability and higher cost of credit in the months ahead, it primarily reflected the failure of internally generated funds to keep pace with rising outlays for plant, equipment, and inventories. With the shortfall running at an annual rate of about \$13 billion during the second quarter, and promising to continue at a high level at least during the remainder of the year, businesses continued to put strong pressure on the credit markets. Thus, the \$4.4 billion in new capital raised in the bond and equity markets in the July-September

period was a record for any third quarter, even though it failed to match the exceptionally heavy sales of the first half of the year.

At the same time, outstanding commercial paper increased by over \$3 billion during this period, to a record \$14 billion at the quarter's end. But this increase, which carried the rate on prime commercial paper to 6 percent early in October (the highest level since the 1920's) partly reflected the lessened ability of business borrowers to obtain accommodation from the nation's commercial banks.

Following an exceptionally strong spurt in June and July, businesses increased their bank borrowings in the next two months at a moderate 5-percent annual rate, far below the 20-percent annual rate recorded earlier in the year. A reduced rate of inventory accumulation, and stepped-up loan repayments with the proceeds of bond and equity offerings, contributed to the slowdown, but adjustments on the supply side were also involved. These adjustments included a perceptibly greater firmness in both price and non-price terms of bank lending, including the third increase this year in the prime rate and stiffer requirements regarding compensating balances. Businesses also faced a much closer screening of loan applications, especially those involving the financing of non-local customers, long-term capital expansion, mergers, and "speculative" activities.

### **General—and selective—restraint**

In this environment, monetary policy moved still further in the direction of restraint and, significantly, did so in a manner that was selective as well as general in its approach. The Federal Reserve System admonished the nation's bankers in early September to moderate the pace of their business lending, arguing that the high and rising levels of credit-financed business spending have contributed

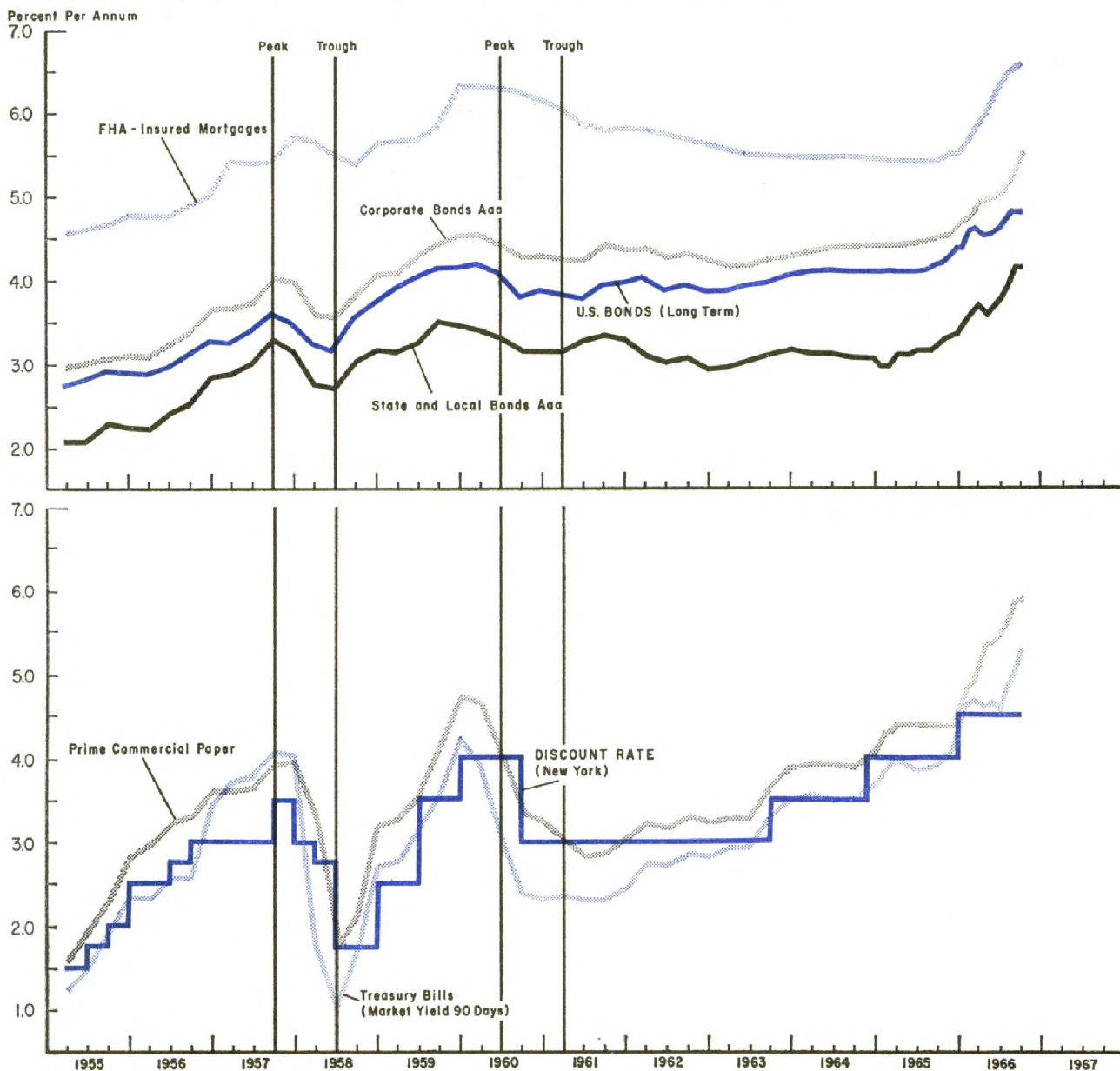


substantially to inflationary pressures, and at the same time have distorted the overall allocation of loanable funds and impaired the banks' own liquidity.

This action went along with a further increase, from 5 to 6 percent, in the reserves which banks must hold against time deposits (other than passbook savings) in excess of \$5 million—a move designed to restrain

banks' ability to expand credit by tempering their ability to compete for large-denomination time certificates. Nor was this all; in a related action, the Federal Reserve implemented its newly authorized power to set interest rates on the basis of the size of deposits, by rolling back, from 5½ to 5 percent, the ceiling rate which banks may pay on non-passbook time deposits of less than \$100,000.

### Summer quarter witnesses further rise in the level of interest rates, as yields at both ends of the maturity range reach record highs





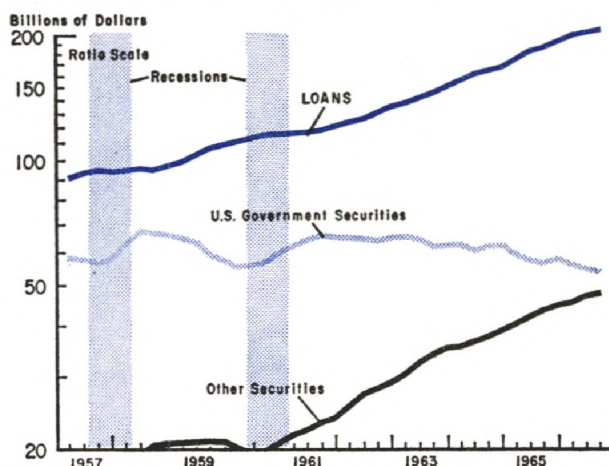
The rollback of rates was specifically designed to maintain "a viable competitive balance" between different types of lending institutions—most notably between commercial banks and savings-and-loan associations. Meanwhile, for the first time, the S&L's also became subject to interest-rate ceilings. Yet in contrast to the geographically uniform ceilings imposed upon the commercial banks, the Home Loan Bank Board made allowance for regional variations in setting S&L ceilings. As a result, associations in three Western states were permitted to pay higher rates—up to 5¼ percent—than associations elsewhere.

### Better balance

Through a series of moves which were thus selective in their application—sector-wise, institutionally, and geographically—policy makers sought to achieve a better balance in the flow of credit, while at the same time avoiding a further escalation in the interest-rate structure. In fact, this latter consideration led them to reject such possible alternatives as a further hike in the discount rate and an increase in interest-rate ceilings. However, they also recognized that, in an environment of rising market rates of interest, the retention of the ceiling on large-denomination CD's could simultaneously reduce the banks' ability to compete for funds and lead to an attrition of these interest-sensitive deposits. The upshot could be further pressure on banks to liquidate securities, resulting in added pressure on yields and a further reduction in the banks' own liquidity. Consequently, the Federal Reserve emphasized in its September letter that the discount window would stand ready to help banks adjust to any loss of reserves which they might suffer while striving to moderate the pace of their business lending and achieve a more "reasonable balance" in their overall allocation of funds.

Borrowings from the Federal Reserve Banks increased from a daily average of \$674 million

### Banks expand loans at slower pace as liquidity squeeze tightens



in June to a \$764-million average in September. Evidence of restraint from the supply side was not limited, however, to the rise in bank borrowings. It was also evident in a net quarterly decline in both the money supply and total member-bank reserves. It was evident, too, in a further rise in the level of interest rates, as representative yields at both ends of the maturity range reached record highs. At the short-end of the yield spectrum, the 90-day Treasury bill rate registered a net increase of 92 basis points, to 5.39 percent at the end of September. At the long end, top-rated corporates rose by 36 basis points to 5.47 percent, top-rated tax-exempts by 24 basis points to 3.88 percent, and long-term U. S. Governments by 3 basis points to 4.72 percent. Nonetheless, the peak in yields, aside from yields on mortgages and Treasury bills, was reached early in September, and rates subsequently tended to decline.

### Enter fiscal policy

This development was generally credited to the President's announcement of a multifaceted program designed to make fiscal policy a more active partner of monetary policy in contributing to the orderly development of the economy. Included in the program were



measures calling for a holding down of "non-essential" appropriations, along with the temporary suspension of the investment tax credit and accelerated-depreciation allowances. In addition, the Administration's stated intention to seek a general tax increase should future conditions warrant, and the announced suspension of some \$2 billion in prospective Federal Agency offerings during the remainder of the year, exerted at least a temporary stabilizing influence upon the bond markets.

Questions remained, however, about the probable impact of these various fiscal measures—including the timing of those measures aimed at business spending. In addition, the prospect of increased Treasury borrowing to meet Federal Agency financing requirements lessened considerably the significance of the Agencies' direct withdrawal from the markets.

### Less available, at higher cost

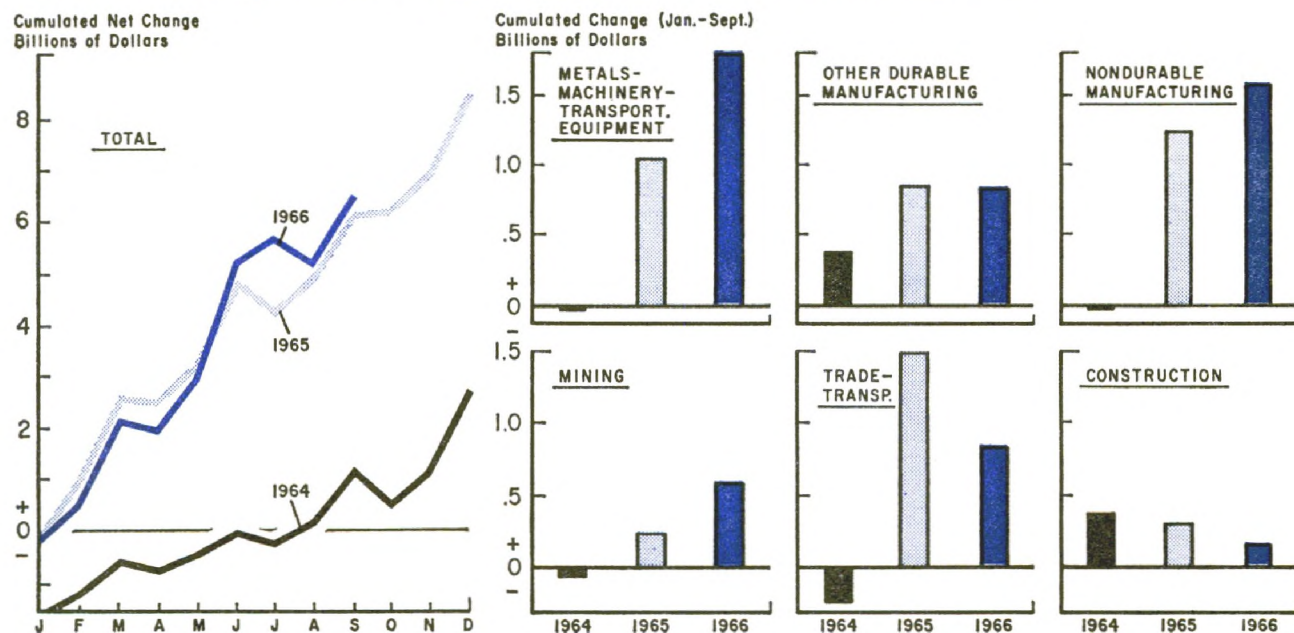
A considerably reduced pace of expansion characterized commercial bank activity in the credit markets during the third quarter, as the banks attempted to adjust to a much slower growth in their supply of loanable funds.

Total deposits, which had risen by \$7 billion during the March-June quarter, showed virtually no net change through September. Total time and savings deposits rose by more than \$3 billion, but the increase was almost offset by a \$1-billion decline in private demand deposits and a \$2-billion decline in U. S. Government deposits (seasonally adjusted data).

Furthermore, the time-deposit increase fell about \$2 billion short of the second-quarter gain, due in large part to a runoff in large-denomination CD's. Weekly reporting banks, which had a record \$18.6 billion in such deposits in mid-August, registered a decline to about \$17.0 billion at the end of September—and to about \$16.1 billion in late October. This decline, coming as it did after a strong and protracted upsurge in CD's, was attributed to such factors as the decreasingly attractive 5½-percent maximum yield on large-denomination certificates and the growing liquidity squeeze affecting corporation and public treasurers.

On the lending side, total bank credit increased at a 3-percent annual rate during the

### Business demand for bank loans continues to rise, but at reduced pace ... investment-goods manufacturers remain banks' best customers





# FEDERAL RESERVE BANK OF SAN FRANCISCO

quarter—less than half the previous quarter's gain. Real estate and consumer loans increased more rapidly (\$1.2 billion and \$0.9 billion, respectively, on a seasonally adjusted basis) but security loans fell by \$1.3 billion because of liquidation of inventories by Government security dealers. More significantly, the \$2.4 billion rise in business loans — although amounting to a 13-percent annual gain—was only two-thirds of the previous quarter's increase.

Borrowings by producers of machinery and transportation equipment, and borrowings by the transportation, communications, utilities, and natural gas industries continued at a high level, while the construction, retail trade, and service industries made net repayments. But business borrowers found bank credit more costly as well as less available; the average rate on short-term business loans increased from 5.82 percent in June to 6.38 percent in Sep-

tember. (A year ago, it was 5.00 percent.) Furthermore, only 4 percent of these loans were made at less than 6 percent in September, whereas 73 percent of the total carried such lower pricetags in June.

Banks again reduced their U. S. Government security holdings during the quarter, by about \$500 million, to help meet the continuing strong loan demand. Moreover, with a slight (\$100 million) decline in "other securities," they shifted from a net buying to a net selling position in the tax-exempt market. (The figures are seasonally adjusted, and are also adjusted for a reclassification, from loans to other securities, of about \$1 billion in Agency participation certificates.) As a result, banks found themselves in a very tight liquidity squeeze — the loan - deposit ratio reached a record level, 67 percent, and the ratio of short-term Governments to deposits fell to a new low of about 5 percent.

—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: 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	...	129	111	119	135
Mar.	28,897	5,589	15,006	24,169	212	5.89	130	108	117	143
Apr.	29,267	5,309	14,924	24,579	227	...	131	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	105	128	144
July	29,791	5,071	14,753	25,265	227	...	131	104	130	143
August	29,764	5,473	15,120	25,271	215	...	131	95	119	136
Sept.	29,532	5,190	15,659	25,159	229	6.58	132	...	...	140



## How Fast a Pace?

**W**ESTERN business continued to expand during the third quarter, although not at the hyperactive pace maintained during the first half of the year. Total employment in Twelfth District states increased by 0.5 percent during the summer period—somewhat below the increases recorded earlier in 1966. But because of the strong earlier pace, the West boasted over 5 percent more jobs than a year ago, as against a 3-percent year-to-year gain elsewhere.

As the civilian labor force continued to grow during the summer months, the slower expansion of jobs brought about an increase in the region's jobless rolls. The unemployment rate rose from 4.5 to 4.8 percent of the labor force over this period—far below earlier levels, but still about one percentage point higher than the rate elsewhere. (All data are seasonally adjusted.)

In contrast to the early-1966 pattern, the West's third-quarter pace was slower than the national pace for almost every major industry. Manufacturing employment, for instance, rose by 1.1 percent in the District but by 1.4 percent nationally. Construction employment meanwhile declined, for the second straight

quarter, at a sharper rate than elsewhere; the summer-period decrease was 2.8 percent in the West and 2.2 percent in the nation as a whole.

Another sign of reduced pressure was a smaller-than-national increase in consumer prices. In contrast to a 3.5 percent year-to-year advance in the national index, prices were up by about 2.7 percent in Los Angeles and Seattle, and by about 3.3 percent in San Francisco and Honolulu, mainly because of relatively small increases in Western food costs.

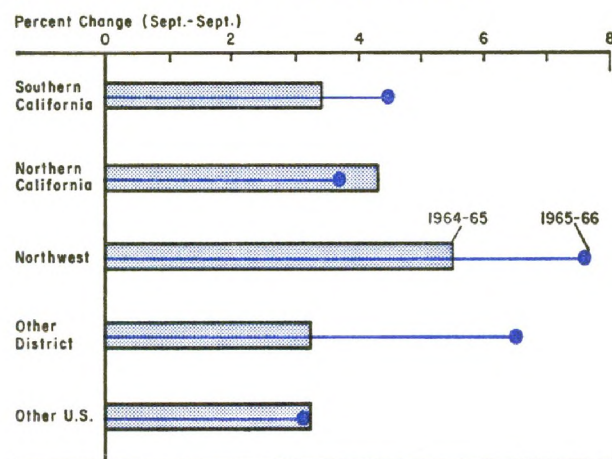
### Weakest element

The housing industry continued as the weakest element in the regional business picture, as the third quarter witnessed a 25-percent drop in residential construction awards on top of the second quarter's 17-percent decline. The national industry also suffered a decline in the spring and summer months, but the drop was far more precipitous in the Western states.

The Western housing industry's plight probably reflected its earlier problems with overbuilding as well as its more recent problems with scanty mortgage money and soaring mortgage interest rates. Despite earlier reductions in construction activity, many communities were still susceptible to a decline this year because of their continued surplus of unsold housing as well as their shortage of mortgage funds. Recent declines have been greatest in areas where large surpluses still exist—Southern California, Utah, and Nevada—while the volume of building has held up fairly well in areas where demand has strengthened—notably Washington and Hawaii.

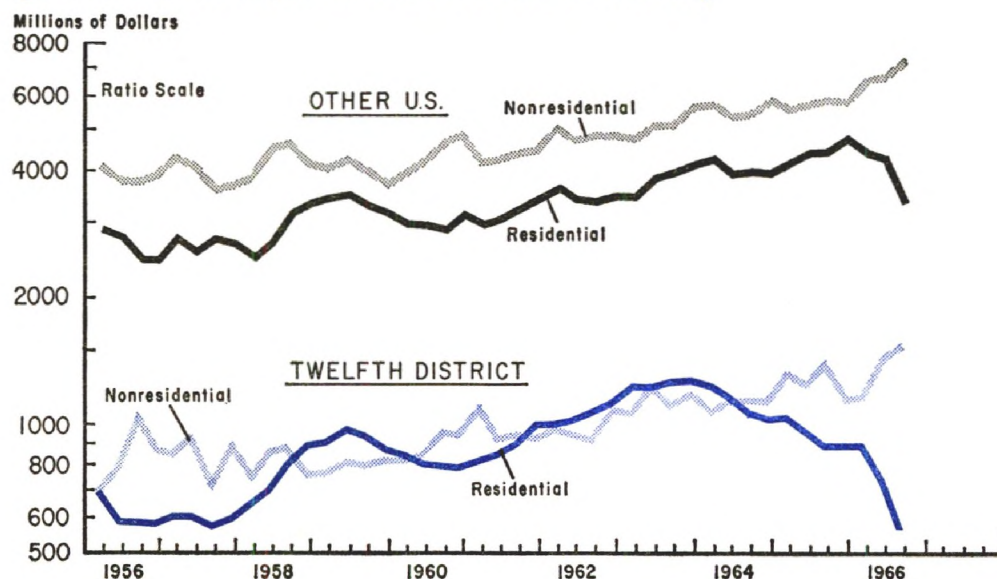
In nonresidential and heavy construction, as a whole, the statistics continued to tell a quite different story. Contract awards rose to a new high in the third quarter, as contractors

### Past year's employment gains greater in West than elsewhere





## Housing slump and business-building boom go hand-in-hand, in West as in rest of country



still sustained the heavy pace of activity typical of the last several years. Industrial construction and health-facility construction—up about 25 and 50 percent, respectively, over year-ago levels—were major factors in the regional as well as in the national building boom. Another favorable factor was the start-up of several large public-works projects. In the third quarter, construction began on the Dworshak Dam in Idaho (\$131 million) and on the Rapid Transit Tube under San Francisco Bay (\$90 million), while work continued on an early-1966 project, California's Yuba Dam (\$101 million).

### Strongest element

Like the rest of the nation, the West felt the impact of defense spending as well as the business-investment boom during the summer quarter. District aerospace manufacturing firms added about 25,000 workers during this period—roughly in line with the increases recorded earlier in the year. Industry employment thus reached a record 670,000 in September. However, the hiring pace slackened considerably after July, at a time when aero-

space firms elsewhere were adding workers rapidly.

Commercial orders, along with military orders, strengthened District producers' backlogs during the summer. One major firm, whose backlog of commercial orders increased by one-tenth (to \$2.4 billion) in the third quarter alone, was beset by production problems as it at-

tempted to cope with the rising tide of new orders. Another major firm meanwhile held a \$1.2-billion sheaf of orders for jumbo jets, none of which is scheduled for delivery before 1969.

Western steel producers, reacting to the heavy defense and industrial demand, reduced production only slightly during the traditional summer vacation period. Regional output for the January-September period ran only about 2 percent below the record 1965 pace, and undoubtedly would have been even stronger but for the rising tide of foreign steel imports.

### Primary producers' strength

Aluminum producers in the Pacific Northwest boosted their production and shipments to record levels in the third quarter to meet expanded military and civilian requirements. The industry meanwhile proceeded with blueprints for a substantial expansion of capacity over the next several years. With the recent announcement of plans for a 130,000-ton reduction plant at Anacortes, Washington, Northwest producers are now scheduled to add 500,000 tons of new capacity by 1970—40 percent of the total new capacity planned for the entire nation.



The pressure on the Western copper industry eased somewhat during the summer months, helped along by the release of another 100,000 tons of the metal from the Government stockpile. But in October, as defense and industrial demand quickened and as a two-week strike at Arizona mines created supply difficulties, the 36-cent-a-pound

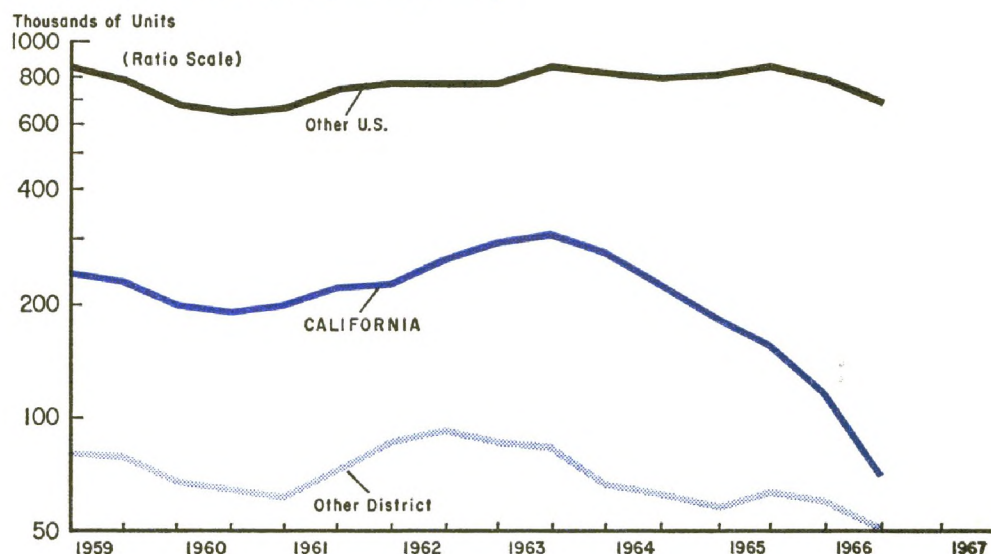
quotation for domestic copper again came under pressure. One strike-affected Arizona operation raised its quotation to 47 cents a pound, effective November 1.

Western petroleum refiners continued to outpace their year-ago performance during the third quarter, but the gain was modest when compared with the increase in the rest of the country. This expansion in Western refinery activity was supported primarily by increased output of crude petroleum from established California fields as well as from new wells off the Southern California coast.

Amid all these buoyant sales and production reports, the Pacific Coast lumber industry sounded a more somber note. After reaching near-record levels of activity in the early spring months, the industry was forced to work down inventories built up in expectation of a lumberman's strike which failed to develop and a housing demand which all but disappeared. Thus, Douglas fir prices, which had risen 25 percent above year-before levels in the first quarter of 1966, were 3 percent below the year-ago figures in mid-October.

District farmers and ranchers meanwhile

### California shows most dramatic decline in residential construction activity



continued to ring up a record level of receipts during the summer months. Despite a drop in crop output, which may amount to a 6-percent decline for the year as a whole, marketings this summer were bolstered by an increased volume of livestock sales and higher prices for both crops and livestock.

California farmers increased their employment of American workers during the third quarter, but they also hired 7,800 foreign contract workers in order to meet harvest labor requirements. Even so, this was less than the number of foreign workers hired for the 1965 harvest, which was the first to be brought to market under new legislation restricting importation of bracero labor.

As the summer turned into fall, the Western economy thus showed continued strength in all but the depressed housing sector and its satellite lumber industry. The requirements of Vietnam and of a booming civilian economy, although not quite so clamorous as in the rest of the country, still supported a strong expansion of Western jobs and Western incomes, and provided a strong basis for optimism in the forthcoming forecasting season.

—Regional Staff



## Summer Lull

**T**HE heady pace at which Twelfth District banks operated in the second quarter came to an abrupt halt in the July-September period. The most dramatic change occurred in the business-lending field; even over the September corporate-tax date, the increase in business borrowing fell far below the gains recorded in June and in September 1965. On the deposit side, these banks had a smaller volume of total deposits at the end of September than at mid-year, despite an increase on a daily-average basis, because September's large run-off of negotiable CD's coincided with a greater-than-seasonal reduction in public time deposits to more than wipe out deposit gains made in July and August.

### More discounting

Furthermore, District-bank reserve positions finally began to reflect increasing monetary pressure. Borrowing at the Federal Reserve discount window rose in the third quarter from \$26 to \$56 million, resulting in a \$23-million net borrowed-reserve position, in contrast to a net free-reserve position in the March-June period. The increased tightness was partly due to two increases, in July and again in September, in the required reserves on time deposits other than savings. These two one-percent increases *each* added about \$90 million to District-banks' required reserves—a relatively large amount due to the high ratio of their time to total deposits. Required reserves also were greater than in the preceding quarter because of a \$523-million increase in deposits. (All data are on a daily-average basis.)

Reserve pressure was reflected, not only in this greater recourse to the discount window, but also in the Federal-funds transactions of 12 large District banks. During the summer quarter, their Fed-funds purchases from other banks exceeded their sales by \$32 million, in

contrast to a net sales position of \$71 million in the second quarter. Although their net sales to Government securities dealers were again high, their position on total Fed-funds transactions (interbank plus dealer) fell off sharply to net sales of \$33 million, as compared with a second-quarter figure of \$309 million. Bank borrowing of funds through corporate repurchase agreements was relatively large in the latter part of the summer quarter, and this supplied further evidence of their increased reliance on borrowed funds.

### Credit contracts

Total credit (loans adjusted and securities) declined \$38 million at District weekly reporting banks in the third quarter. Total loans decreased \$114 million, on the heels of a massive \$1-billion second-quarter expansion. (In the year-ago period, loans increased by over \$200 million.)

Repayments by business borrowers were relatively heavy in the July-September period, and the consequent net reduction in business lending was mainly responsible for the turnaround in total loan portfolios. (A slower pace was visible everywhere, but business borrowing in the rest of the nation still increased by 2.6 percent during the quarter.) The District's \$103-million increase in real-estate loans was the largest gain recorded in any loan category, although the increase was less than that of other recent quarters.

District weekly reporting banks added \$76 million to their security holdings while they were reducing their loan portfolios. A relatively heavy \$152-million run-off in Federal Agency participation certificates was offset by net purchases of Treasury bills and short-term tax-exempt securities—which gives some indication of these banks' desire to bolster their liquid asset position in preparation for the normally heavy year-end loan demand.



## Business-loan lull

Throughout the District, the reduction in business loans generally occurred outside the larger metropolitan areas. Demand for bank credit continued strong from the durable-goods sector, especially on the part of transportation-equipment manufacturers. Nondurable-goods firms also maintained a high level of bank borrowing, partly because food, liquor and tobacco dealers recorded a normal seasonal increase in mid-August and September on top of a less-than-seasonal decline in the earlier part of the quarter. On the other hand,

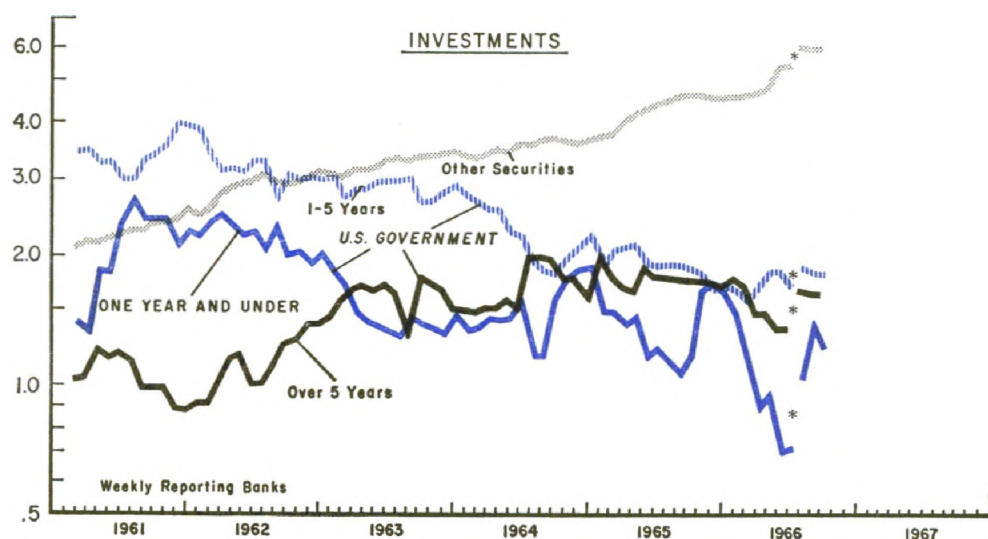
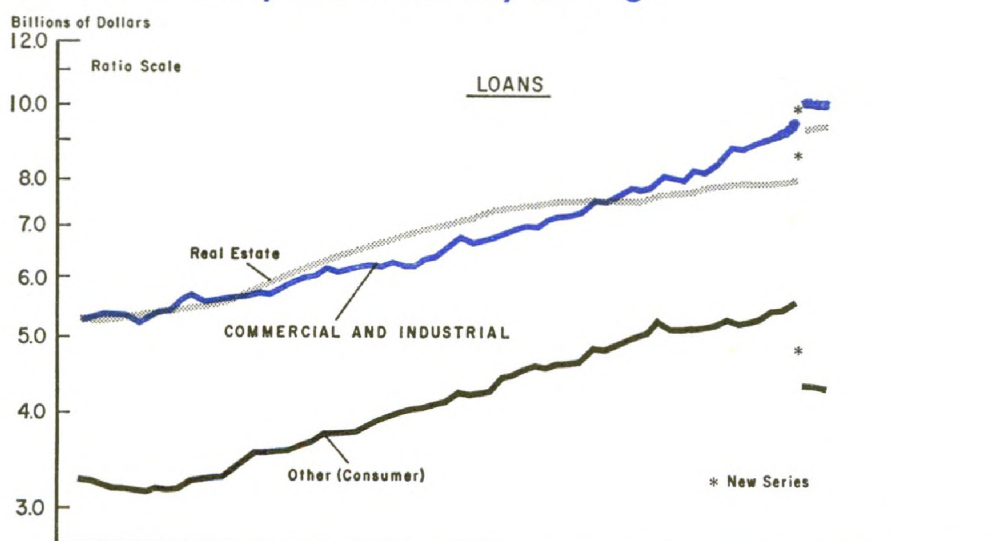
District banks reduced their financing of bankers' acceptances and their loans to service industries.

Business firms paid record high interest rates for credit during the first half of September. The average rate on short-term loans at District metropolitan banks rose to 6.33 percent—44 basis points above the rate in June, and 114 basis points higher than the year-ago September rate. The steep climb in interest costs reflected the two prime-rate increases, from  $5\frac{1}{2}$  to  $5\frac{3}{4}$  and then to 6 percent, which occurred after the June survey. The average

rate of 6.39 percent on term loans (loans with maturities over one year) also was higher in September, and fewer such loans were made, although loans of this type again accounted for 5 percent of the dollar volume of total loans reported during the survey period.

In the light of the recent emphasis on curtailing the over-rapid pace of business borrowing, it is interesting to note that District weekly reporting banks not only decreased their business lending recently—as opposed to continued expansion elsewhere—but also had a much slower rate of expansion in their total lending over the

## District banks reduce business-loan portfolios but add Treasury bills to security holdings





past year. Thus, they may be relatively less vulnerable than other banks to monetary measures taken to curtail bank credit to business, or to any future shift in demand for bank credit from business.

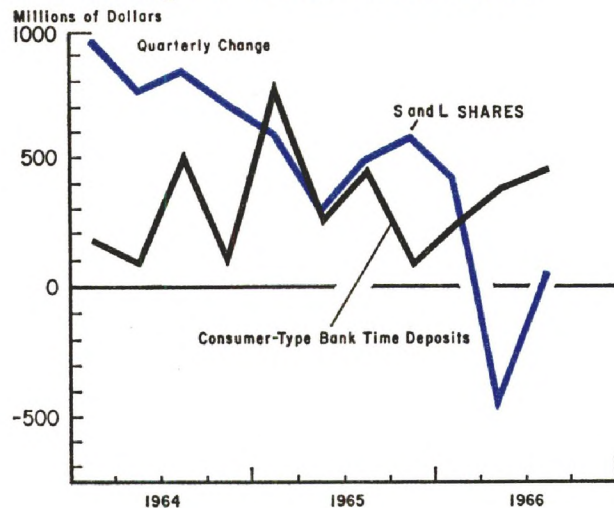
### Mortgage lull

Another key sector, the mortgage market, continued to tighten in the third quarter, although market conditions were slightly less tumultuous than during the spring months. District savings and loan associations — the bulwark of the Western mortgage market — lost some savings during the July reinvestment period, but by the end of the quarter they recorded a net inflow of savings, in contrast to their sad second-quarter experience. And, as noted below, District banks recorded a larger gain in consumer-type time deposits than during the second quarter.

Interest rates on mortgages continued to creep upward, as rates on conventional loans rose as much as  $\frac{3}{4}$  of 1 percent over year-ago levels. Home buyers were inhibited by these higher interest rates, as well as by the high discount rates, ranging up to 8 or 9 percent, asked on FHA-insured loans. When FHA and VA rates were raised to 6 percent at the end of the quarter, the Federal National Mortgage Association lowered its offering price on government-insured mortgages by an offsetting amount, which reduced the likelihood that discounts generally would be much affected by the rate change. But FNMA also raised the ceiling amount on its mortgage purchases from \$17,500 to \$25,000, thus greatly expanding the number of mortgages eligible for its purchase.

FNMA nonetheless still faced a sizable problem in its efforts to supply funds to the mortgage market, despite the vastly increased purchase authority it received during the summer. FNMA purchases have been declining over the past year as its borrowing authority has been used up. Purchases of the Los An-

### More savings flow into banks and savings-and-loan associations



geles office, which has accounted for as much as one-third of the national total, declined from \$259 million to \$94 million between the first and third quarters. The new \$4.7-billion authority would permit a several-fold expansion in FNMA mortgage portfolios, but most of the funds to buy mortgages must still be procured from the heavily strained money market.

### Deposit losses

District weekly reporting banks recorded a slight (\$22 million) decline in demand deposits during the quarter, on a daily average basis. But because of an early July increase in private demand deposits, demand deposits adjusted were \$250 million higher at the end of September than at the end of June, while on the other hand, U. S. Government demand deposits were \$612 million lower. These shifts adhered closely to the year-ago pattern.

In the time-deposit category, however, District banks followed a markedly different pattern, with a \$55-million decline as opposed to a \$378-million gain in the July-September period last year. This reduction was mainly due to greater-than-seasonal (\$444 million) withdrawals of time deposits held by states and political subdivisions. In addition,



the September run-off of large-denomination negotiable CD's more than offset the July-August gains in this category—but even so, District banks suffered a smaller percentage decline than was recorded by the New York banks which dominate the CD market.

Savings deposits again declined in the third quarter as savers switched to higher paying time certificates. However, the reduction in savings deposits was almost a third less than in the second quarter, and the total gain in consumer-type deposits was somewhat greater than in the April-June period.

The September change in Regulation Q,

which rolled back to 5 percent the maximum rate payable on time - certificates in denominations under \$100,000, will affect a very small portion of the time deposits of District member banks—and probably much less than one percent of their *total* deposits. Nonetheless, some District banks that had been offering higher rates may face a period of readjustment as a consequence of the revised regulation. Obviously, the new ceiling will have its most immediate effect on those banks that had been issuing shorter-term maturities at rates above 5 percent.

—Ruth Wilson and John Booth

### SELECTED ITEMS FROM WEEKLY CONDITION REPORT OF LARGE BANKS IN THE TWELFTH FEDERAL RESERVE DISTRICT

(dollar amounts in millions)

	Twelfth District				U. S. Minus Twelfth District		
	Outstanding 9/28/66	Net Change Third Quarter 1966		Third Quarter 1965	Outstanding 9/28/66	Net Change Third Quarter 1966	
		Dollars	Percent	Percent		Percent	Percent
<b>ASSETS</b>							
Loans adjusted and investments <sup>1</sup>	\$39,405	— 38	— 0.10	+ 1.16	\$143,234	— 0.36	+ 0.09
Loans adjusted <sup>1</sup>	28,760	—114	— 0.39	+ 1.01	103,252	— 0.81	+ 0.76
Commercial and industrial loans	10,126	— 93	— 0.91	+ 1.73	49,273	+ 2.60	+ 3.01
Real estate loans	9,301	+103	+ 1.11	+ 1.65	18,030	+ 3.24	+ 5.20
Agricultural loans	1,181	— 10	— 0.84	— 1.29	615	+ 9.43	+ 4.29
Loans to non-bank financial institutions	1,719	—107	— 5.86	+ 2.40	9,102	— 9.96	+ 3.69
Loans for purchasing and carrying securities	488	— 40	— 7.58	—10.17	5,334	—17.22	—27.52
Loans to foreign banks	271	+ 21	+ 8.40	— 7.40	1,239	— 0.72	— 0.92
Consumer instalment loans	4,328	—11	— 0.25		11,618	— 0.58	
Loans to foreign governments, etc.	114	— 26	—18.57	+ 0.45	1,018	+ 1.50	+ 1.61
All other loans	1,717	+ 50	+ 2.98		9,305	— 5.32	
Total securities	10,645	+ 76	+ 0.72	+ 1.55	39,982	+ 0.81	— 1.40
U. S. Government securities	4,670	+171	+ 3.80	— 1.50	18,457	+ 2.64	— 6.42
Obligations of states and political subdivisions	5,187	+ 62	+ 1.21		18,979	+ 1.44	
Other securities	788	—157	—16.61	+ 4.99	2,546	—14.25	+ 3.82
<b>LIABILITIES</b>							
Demand deposits adjusted	13,899	+250	+ 1.83	+ 0.89	57,153	— 0.83	+ 0.49
Total time deposits	24,198	— 55	— 0.23	+ 1.72	66,181	+ 0.38	+ 3.80
Savings	15,124	—362	— 2.38	+ 2.79	32,113	— 2.44	+ 2.64
Other time, I.P.C.	6,210	+801	+14.81	+ 0.48	24,094	+ 3.46	+ 4.96
States and political subdivisions	2,052	—444	—17.79	— 2.73	5,732	+10.34	+11.58
(Neg. CD's \$100,000 and over)	2,211	— 44	— 1.95	— 2.97	14,757	— 7.85	+ 5.15

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

Note: Quarterly changes are computed from June 30, 1965 - September 29, 1965 and from June 29, 1966 - September 28, 1966.

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



