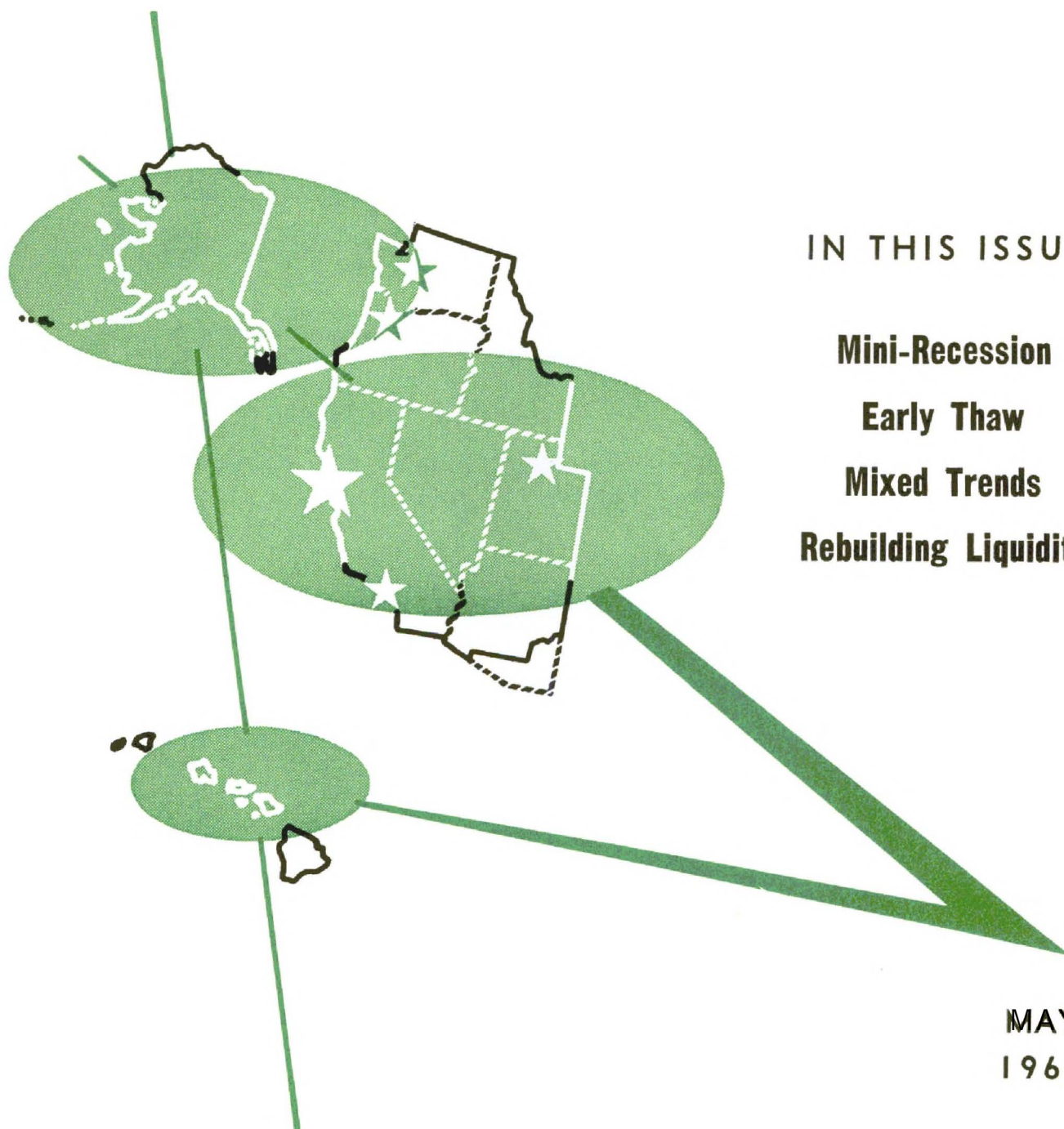


FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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MAY
1967

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Mixed Trends

... Most Western industries continued expanding, but at a slower pace than during the 1965-66 boom.

Rebuilding Liquidity

... Because of large security purchases, Western banks expanded bank credit at twice the 1966 pace in the early months of this year.

Editor: William Burke

Mini-Recession?

BUSINESS pundits could make what they would of the early spring statistics; the figures were mixed enough to provide support for any sort of interpretation. Recession-minded analysts could point with alarm to falling production in such key industries as steel, autos, machinery, and textiles. Inflation-minded analysts could point with similar alarm to the fact that all of the \$5-billion first-quarter increase in GNP was eaten up by price increases. More sanguine spirits meanwhile could point to the continued strength of employment and income, as well as to the fact that final sales (total GNP less inventories) showed more strength in the first quarter than at any other time in the past year.

Analysts who ponder the more esoteric business cycle indicators were of little help. Those, for example, who contend that rising hemlines always mean rising business indicators were confounded by the news that Carnaby Street is featuring bell-bottom trousers this year rather than miniskirts. And there were even arguments about what to term this present tumultuous period. Some were inclined to designate it a quasi-recession — a term somewhat in vogue during the 1962 stock-market break; others were inclined to term it a mini-recession. To complicate the matter, former Administration stalwart Walter Heller recently concluded: “The worst of the business adjustment is over. There never was a recession.”

First-quarter GNP statistics provided the uncertain framework for these somewhat uncertain attitudes. In that period, GNP edged upward from a \$759-billion to a \$764-billion annual rate. The total encompassed a sharp cutback in inventory accumulation,

an increase in defense purchasing, high-level stability in business fixed investment, and substantial strength in consumer buying.

Escalation in the Pentagon

On the military scene, escalation continued in Pentagon expenditures as well as on the Vietnam battlefield. Defense buying rose to a \$70-billion annual rate in the first quarter and now stood almost 50 percent above the level prevailing before the big buildup began two years ago.

At that figure, defense buying is already close to the level projected for fiscal 1968. Expenditure projections remain uncertain, however, since they of course depend on the level of military activity in Vietnam. In that theater, over 400,000 troops are already committed and the number may rise to 475,000 by yearend — and some congressional critics insist that 600,000 are needed to complete the job. Even at present force levels, the chew-up of material and materiel is amazingly large; for example, ammunition usage already exceeds one million artillery rounds and one hundred million small-arms rounds every month.

The economic impact of future war requirements remains uncertain too; recent expenditure gains may overstate the impact of stepped-up defense orders, just as they initially understated the impact two years ago. Military budget analysts have continually emphasized that defense purchases in the national accounts are recorded at time of delivery — so that they tend to lag the actual economic impact of increased military orders, especially for items with long lead times. The key series to watch — new orders for defense products, defense procurement obligations, and defense contract awards —

have been relatively trendless in recent months after rising more than 50 percent since the initial onset of escalation. But these key data could again outrun the lagging data on expenditures if the conflict is further escalated.

How strong the consumer?

The consumer sector in the early spring months showed somewhat mixed trends. Disposable personal income rose sharply by \$11 billion in the first quarter, to a \$529-billion annual rate, and this rise permitted a solid increase in consumer outlays as well as the continuation of an above average (6-percent) savings rate.

The employment data underlying these income gains, however, were less forthright. Nonfarm employment in early 1967 exceeded the 70-million level for the first time in history, but the expansion since last fall still lagged considerably behind the job upsurge of the several preceding years. The jobless rate meanwhile hovered around the low 3.7-percent rate maintained throughout most of 1966. (Yet the insured unemployment rate has risen by a half percentage point over the

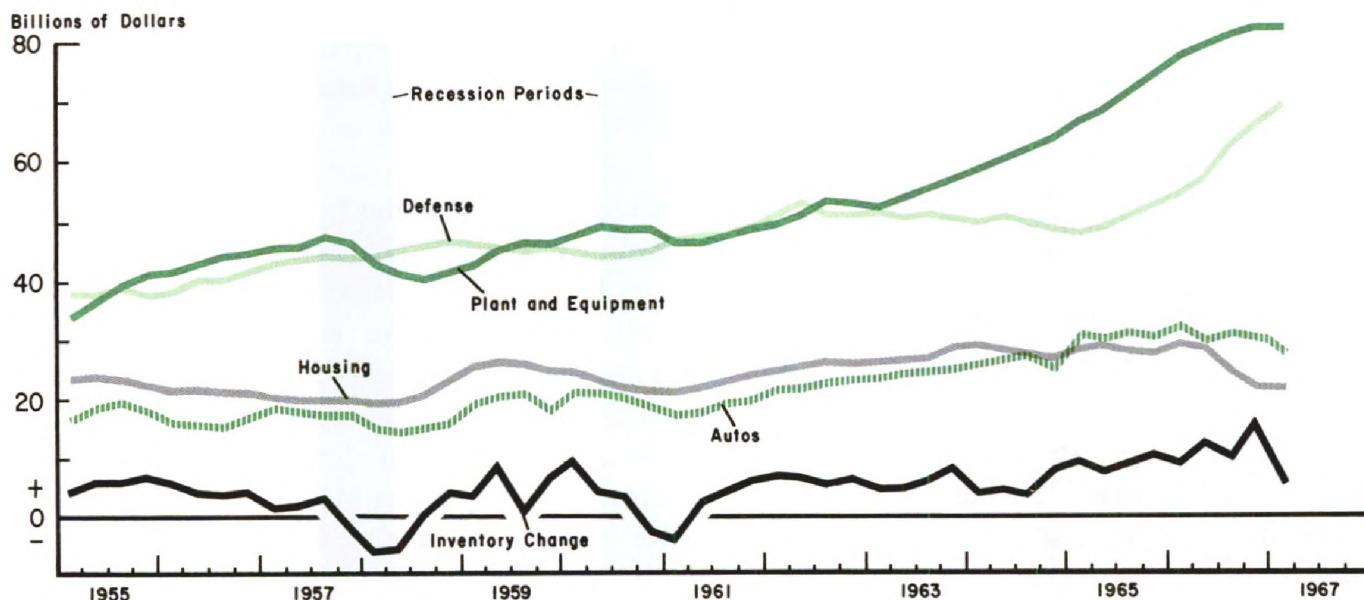
past six months, to 2.6 percent.) Moreover, the growth in incomes has been somewhat less than it might otherwise have been, because of a drop in the average factory work-week, from 41½ to 40½ hours, in the same six-month period.

These conflicting trends showed up in a strong first-quarter sales performance for consumer nondurable goods and services, somewhat offset by continued weakness in durable goods buying as well as in new residential construction.

Still sluggish

Early in the year, automakers seemed prepared to write off the 1967 models. Total spending for autos and parts was at a \$27½-billion annual rate in the winter quarter, roughly 8 percent below the average sales performance of the 1965-66 period, and new-car sales during this period were at a 7-million unit rate as against the 9-million rate of last spring. But perhaps something can still be salvaged from this model year, since new-car sales began to improve during April, and automakers immediately responded with a boost in their production schedules.

Defense spending continues rising, but business spending reaches peak and consumer buying of cars and new housing reaches cyclical low



Slack conditions meanwhile continued in the housing market. During the January-March period, spending for residential structures continued at the low \$22-billion annual rate reached last fall, and new housing starts rose to a 1.2-million rate from the abysmally low level of late 1966. In both cases, activity ran about one-fifth below the average rate of housing activity maintained in the earlier years of this decade.

As mortgage funds became more readily available to builders, the housing industry again came to life, but homebuilding's support to the economy continued to be more of a projection rather than a realization. The savings flow to thrift institutions improved sharply in the first quarter — the \$3-billion quarterly increase in savings-and-loan shares was almost equal to the total increase which S&L's garnered last year. Even so, some lags remained evident in the process of converting savings into mortgages. Thrift institutions made their first order of business the restoration of their own liquidity rather than the expansion of their mortgage lending. Homebuyers meanwhile showed continued hesitation in borrowing; not all the oversupply of housing has been absorbed, and the mortgage rates prevailing this spring still remain a full percentage point above the level prevailing a year and a half ago.

How much on the shelves?

Questions about the future trends of defense and consumer buying were somewhat overshadowed this spring by questions about the future trend of business inventories. Inventory expansion in the first quarter was at about a \$5½-billion rate — the smallest increase of the last two years and a welcome contrast to the unsustainable \$16½-billion rate recorded in the final quarter of 1966. Even so, most observers agree that an unwanted overhang of inventories still beclouds the 1967 business picture.

Last year's scramble for goods has left its mark in rising inventory ratios at each stage of the production process. In relating materials inventories to new orders, goods-in-process inventories to unfilled orders, or finished-goods inventories to shipments, purchasing agents discerned a worrisome uptrend over the past year, although in some cases inventory ratios remained below the levels recorded in earlier years of this decade. (For example, over the past year the ratio of finished-goods inventories to shipments rose from 50 to 56 percent for metals, 65 to 75 percent for machinery, and from 20 to 24 percent for transportation-equipment manufacturers.) Altogether, 28 percent of all manufacturers — almost twice the year-ago figure — reported at the start of the year that their inventories were too high, and in some sectors the problem remains serious.

Stockpiling has been most evident in work-in-process inventories; these stocks now represent three-fifths of all hard-goods inventories as against only two-fifths of the total in the early 1960's. This shift reflects the sharp increases in military procurement of equipment and in business buying of capital-goods items, all of which require long lead times in production. But, with unfilled orders for military hardware and business capital goods now beginning to recede, the expansion in such stocks may taper off in future months.

Some caution in inventory purchasing is visible from the slow recent buildup of materials inventories. This probably reflects purchasing agents' worry over the high levels of good-in-process inventories, which are uncomfortably high when the long-lead items ordered by business and the military are excluded from the total. This caution may also reflect worries about involuntary accumulation of finished-goods inventories, which remain high even after a sharp reduction recently in auto dealers' new-car stocks.

End of a boom?

Purchasing agents' uncertainties over the inventory situation are matched by front-office uncertainties over the future course of business capital-goods spending. In the January-March period, spending for new structures and producers' durable equipment remained at the \$81½-billion rate reached in the preceding quarter, and only modest gains are now anticipated for the remainder of this year.

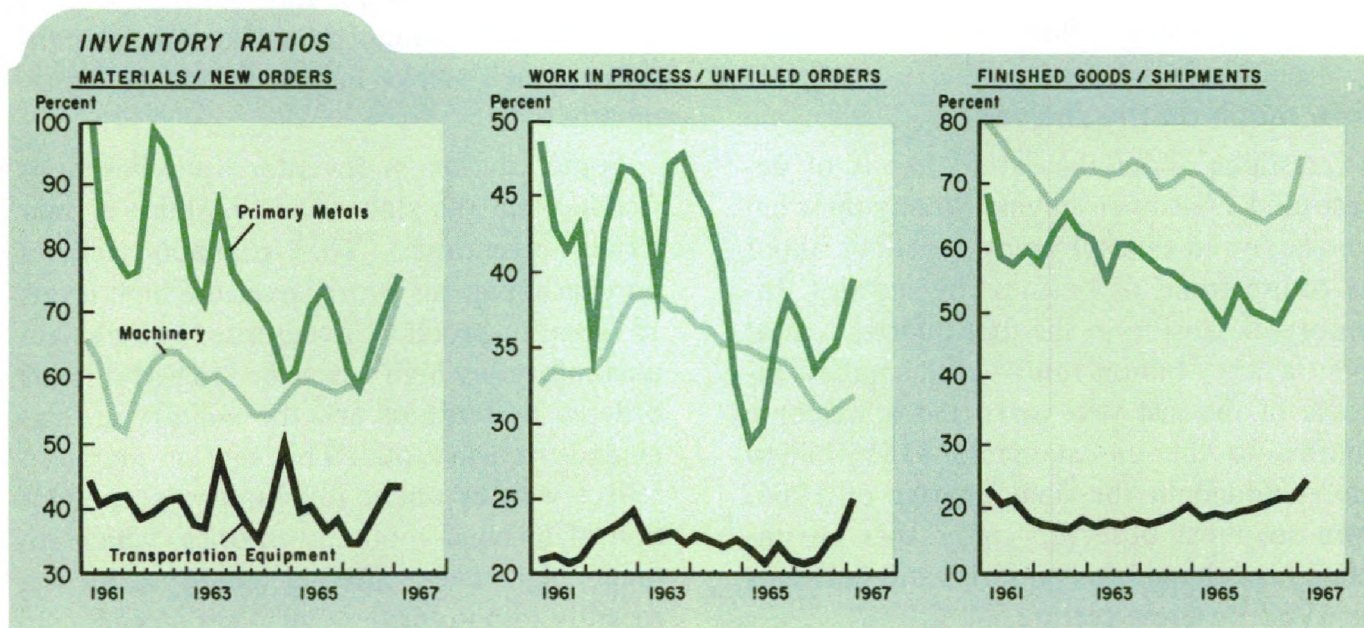
The latest Commerce-SEC survey of plant-equipment spending projected a 4 percent-gain for 1967, in contrast to the gains of 15 percent or more recorded in each of the three preceding years. Some industries, such as machinery, rubber, and non-rail transportation, plan to expand their capital stock substantially again in 1967, but even these industries anticipate smaller increases than what they have become accustomed to in the last several years.

Business firms' reduced spending plans reflect the recent sharp increase in manufacturing capacity, which grew by 7 percent in 1966 on top of a 4½-percent annual average

gain throughout the 1961-1965 period. Their plans reflect also the reduced need of production facilities in recent months, as well as growing uncertainties about the near-term course of sales and profits.

The latest investment survey was taken before the Administration proposed the restoration of its temporarily suspended investment-tax incentives. Business originally reduced its 1967 investment programs by about \$2.3 billion because of last fall's suspension. But this does not mean that the restoration of those incentives will lead to an automatic \$2.3-billion increase in spending. One complicating factor is that of timing; the lead time between new investment decisions and capital expenditures entails a timespan of several quarters, so that a mid-1967 restoration of tax incentives may be felt mostly in 1968. Another complicating factor is the present state of the business cycle; deteriorating demand and a declining rate of capacity utilization may persuade businessmen to take a far different view of their investment requirements than they had a year ago.

Major durable-goods sectors exhibit sharp rise in inventory ratios at each level of industrial production process



Less pressure, less profits

Business investment planning, and business activity generally, reflect the declining pressures now evident in many parts of the national economy. Manufacturing capacity utilization dropped to 87 percent of capacity in first-quarter 1967, in contrast to the 91-percent level maintained throughout most of 1966. In the price sector, meanwhile, industrial prices have remained rather stable in recent months, roughly 6 percent above the 1957-59 average, and the overall wholesale price index has declined in tandem with a sharp reduction in farm prices.

Industrial prices are still rising in some categories, but not to the extent they did in the investment boom of a year ago or in the comparable boom a decade ago. Over the past half year, metals and machinery prices have risen at roughly a 2-to-3 percent annual rate; in contrast, a decade ago they jumped by roughly 8-to-10 percent annually.

Signs of weakening pressure have shown up also in corporate profit statements. Since last summer the ratio of manufacturers' prices to their unit labor costs has dropped from 106 to 102 (1957-59 = 100), since growing market competition has kept prices down while declining capacity utilization has pushed costs up. Moreover, since last spring the ratio of after-tax profits to corporate income has dropped from 13.3 percent to below 12 percent.

After-tax profits peaked in the first half of 1966, at a \$49-billion annual rate, declined to a \$48-billion rate in the second half of the year, and are now dropping even further. Needless to say, there has been little evidence of the 20-to-30 percent decline in profits characteristic of each of the postwar recessions. Even so, some further slippage in profits and in profit margins remains possible this year, as the decline in capacity utilization and the overhang of unwanted inventories

puts downward pressure on prices and upward pressure on costs.

Growth and 6 percent

Despite all the questionmarks, the strength of final demand in recent months — especially when seen in the context of a stimulative monetary and fiscal policy — leads Administration economists to project a rising growth trend throughout the near-term future. In the words of Economic Adviser Gardner Ackley: "All the economic forces we can discern point toward a strong revival later this year and into 1968." And, in Mr. Ackley's view, a 6-percent income tax surcharge remains desirable in the light of the strong underlying trend of demand and the stimulative policy environment; otherwise, "without a surcharge there is the danger of a resumption late this year of inflationary pressures such as we had last year."

Some Congressmen argue that a tax increase should await at least several months' evidence of a strong economic pickup. Others argue differently, contending that the pickup already is at hand and that a stronger stimulus will develop in coming months from increases in Federal highway and housing spending, increases in Federal payrolls, increases in social-security benefits, and decreases in revenues from the reinstated investment-tax credit. Without a tax boost, they claim, the budget pressures from these measures and from growing defense spending could lead to a massive and politically unsupportable Federal deficit.

On the economic scene, the question remains how sharp a business readjustment is possible in the presence of rapidly easing monetary conditions, rising defense and non-defense spending, and what may be a whopping Federal budget deficit. The stock market this spring provided an answer of a sort. In April the market appeared to be shaking itself clear of the financial debris generated

by the headlong expansion of 1965-66, and the market indexes surged strongly upward — in the case of the comprehensive New York Stock Exchange index, to a new record high.

Some observers, more attuned to the real world of corporate stockpiles than to the financial world of corporate stocks, had a less exuberant answer. They argued that a

quasi-recession, a mini-recession — call it what you will — had already begun amid an atmosphere of unwanted inventories, reduced investment plans, and falling profit margins. Others, looking at the underlying strengths of consumer and defense demand, agreed with Walter Heller: “There never was a recession.”

—William Burke

Early Thaw

MONETARY and fiscal policy actions in early 1967 were undertaken in the context of an economy which was at a standstill in terms of real growth. There was no longer any need to restrain the demand for credit, since the demands upon the physical resources of the economy were obviously easing. Thus, the first quarter continued the period of transition initiated last fall, when public policy makers first shifted from a restrictive policy designed to contain inflation to an easy policy designed to promote expansion. Fiscal policy, already expansive in later 1966, became increasingly so in first quarter 1967 when the Federal budget showed a \$10-billion annual deficit (national-accounts basis). Monetary policy meanwhile became progressively easier during the first quarter.

Monetary policy shifts

In the six-month period encompassing November through April, the Federal Reserve System made use of all of its general monetary controls. The shift from the earlier policy of firm restraint dates from the November 22 meeting of the Federal Open Market Committee. In its directive of that date to the Manager of the System Open Market Account, the Committee instructed that

“... System open market operations, until the next meeting of the Committee, shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be resuming a rapid rate of expansion . . .” In late December the Federal Reserve rescinded the September 1 letter which had urged member banks to hold down the extension of new loans, particularly business loans. With this as a background, monetary policy moved increasingly toward the position of fairly generous ease evident in April.

Most of the first-quarter increase in member bank reserves was provided through open-market operations. In mid-March an additional \$850 million of reserves was released when the reserve requirement against savings deposits and time deposits of less than \$5 million was reduced from 4 percent to 3 percent. Finally, on April 6, the discount rate — the cost to member banks of borrowing from the Reserve Banks — was cut from 4½ percent to 4 percent, following a rapid decline in money market rates during the preceding weeks.

The net effect of these monetary policy actions was to change the member banks' reserve position from an average level of \$165 million of net borrowed reserves in

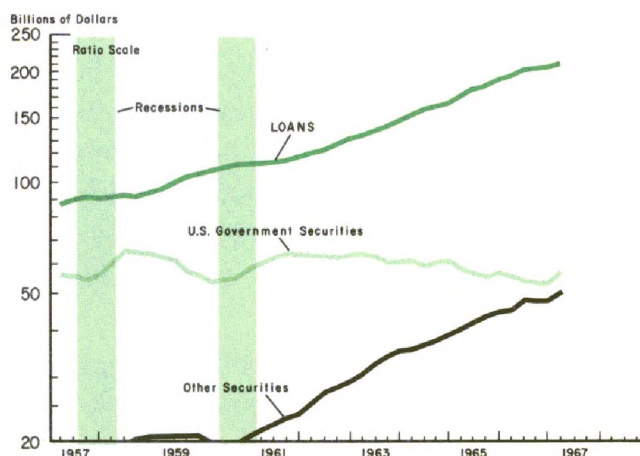
December to net free reserves of \$233 million in March. Member bank borrowings fell from an average of \$557 million in December to \$199 million in March. In the first three months of the year, total reserves of the member banks increased at an average annual rate of 17½ percent.

Of course, not all of this increase in member-bank reserves may be attributed directly to open-market operations and reduced reserve requirements. The inflow of time-and-savings deposits to commercial banks rose sharply in the first quarter, increasing at an annual rate of nearly 18 percent. This represents a process of "reintermediation"; for as yields on money-market instruments fell (reflecting both easier monetary policy and a decline in loan demand at commercial banks), the rate of return on time-and-savings deposits again became attractive. The rates offered by commercial banks on time-and-savings deposits of individuals changed hardly at all in the first quarter, although reductions were reported in various parts of the country in late April. However, the rate on large-denomination negotiable certificates of deposit (30-day maturities) fell from the ceiling rate of 5½ percent at the end of December to as low as 4 percent in mid-April.

Fiscal policy expands

Early-1967 changes in fiscal policy were much less dramatic than the monetary measures effected during the same period, but they too weighed in on the expansion side of the scales. In three separate actions, the Administration released a total of more than \$2.1 billion of funds for highways, public construction and mortgage assistance that had been frozen last October. The Administration also requested the restoration of the 7-percent investment-tax credit that had been suspended last September for a fifteen-month period. In a variety of related actions,

Banks restore liquidity by increasing security purchases



funds also became more readily available for residential construction: the Federal Home Loan Bank Board eased the terms upon which savings-and-loan associations might obtain advances, and the Federal National Mortgage Association increased its purchases of home mortgages. Altogether, the Federal budget during this period stimulated the economy with a deficit more than twice the size of what had been anticipated in January.

On the other hand, the 6-percent surcharge on personal and corporation income-tax liabilities that was requested in the President's January budget message remained in the forefront of discussion in early spring. The economy's lackluster performance did not create any particular pressure for enactment of this measure by July 1, the date on which it was originally scheduled to become effective. But in view of the recovery in the growth rate projected for the second half of the year, the Administration contends that this tax increase will then be needed to contain inflationary pressures.

Banks rebuild liquidity

The banking system took advantage of the relaxed climate of monetary policy to improve its liquidity position during the first quarter. Total bank credit increased at a 14-

percent annual rate (seasonally adjusted), mostly because of very large acquisitions of securities. For the quarter as a whole, banks purchased about \$3.6 billion of state-local securities, and they added about \$3.3 billion of U.S. Government obligations despite substantial sales of such issues during January. Most of the first-quarter acquisitions were in short-term maturities, which suggests that liquidity was a major motive in the selection of securities acquired.

Total commercial-bank loans increased by about \$4 billion during the quarter — roughly in line with the 1966 average pace. Business loans accounted for the largest part of the gain, as real-estate loans and consumer loans showed rather modest increases. The 13-percent annual rate of gain in business loans was well below the early-1966 pace but substantially ahead of the rate of growth in the second half of last year. Corporations

met an increasing part of their credit needs in the capital market in the first quarter, using receipts from this source to reduce their indebtedness to the banking system and to meet their tax liabilities.

Time-and-savings deposits at commercial banks grew at an 18-percent annual rate in the first quarter. Large-denomination negotiable certificates of deposit increased by \$3.6 billion in the January-March quarter despite a steady decline in rates on these instruments during the second half of the period. The money supply meanwhile grew at an average annual rate of almost 6 percent — a sharp turnaround from the slight decline which took place in the second half of last year.

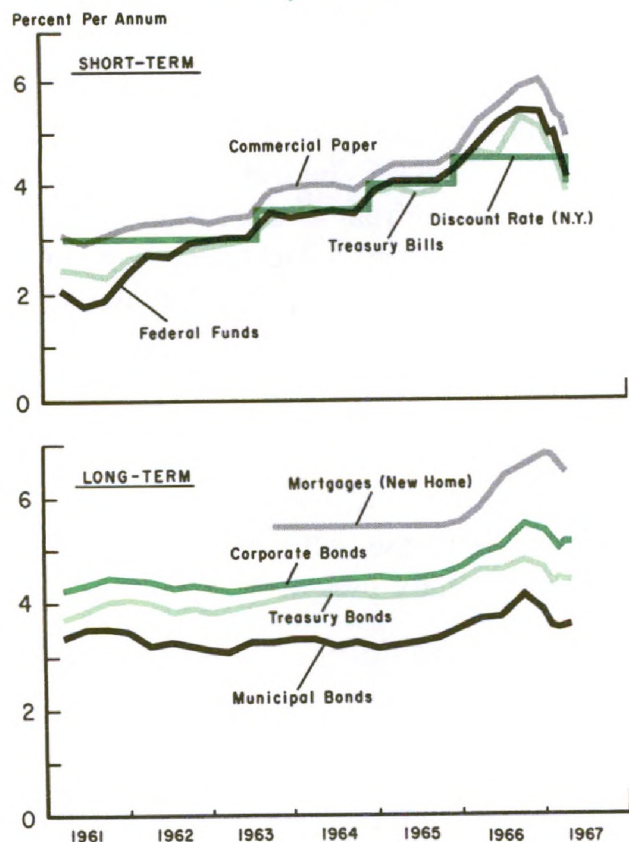
Interest rates drop . . . mostly

In late 1966, interest rates had already started to decline from their record third-quarter levels. Then, in the first three months of 1967, this downward trend was sharply accentuated, particularly in money-market rates, which fell off by more than a full percentage point. The yield on 91-day U.S. Treasury bills dipped below 4 percent prior to the April reduction in the discount rate, and was down below 3.70 percent within a month. The Federal-funds rate — the rate on overnight purchases and sales of claims to balances at the Reserve Banks — also declined, pointing up the growing ease in member banks' reserve positions.

Long-term interest rates presented a somewhat different pattern. After falling about 40 basis points from the end of December to mid-February, the yield on high-quality corporate bonds regained about half of this decline by early May, reaching a level of 5.19 percent. A similar reaction developed also in the long-term Treasury bond and municipal bond markets.

The recent increase in long-term yields reflected the very large volume of publicly

Interest rate decline continues in early 1967

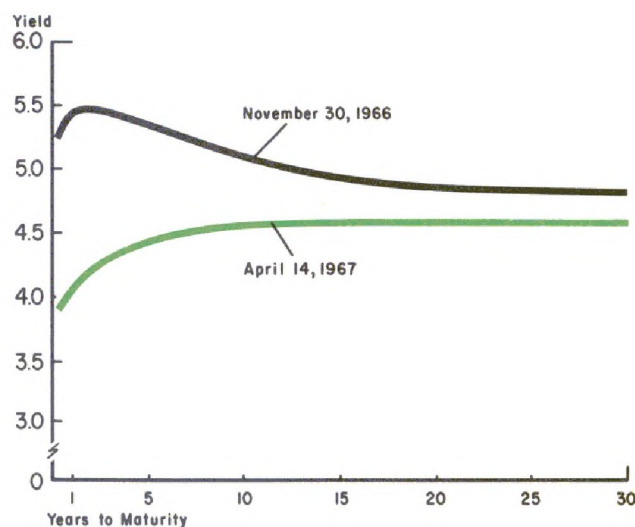


offered issues which came to market during the first quarter. About \$5.8 billion of corporate securities and \$3.7 billion of state-local securities reached the market — about 15 percent and 25 percent, respectively, above the peak figures recorded in first-quarter 1966.

March was a particularly heavy month, since offerings of participation certificates in pools of Federal loans and foreign and World Bank securities swelled the total for that month to around \$4 billion. The fact that the capital market was able to absorb this volume of securities without a substantial run-up in interest rates gives further testimony to the increasingly easy tone of the credit markets.

The structure of interest rates now has changed considerably from what it was in November, when monetary policy first turned in the direction of ease. The yield curves for U.S. Government obligations show that while interest rates on outstanding issues have

Humpbacked yield curve disappears as short-term rates drop



fallen absolutely for the entire spectrum of maturities, the drop has been much more pronounced in the one-to-five-year maturity range than further out on the time scale. Consequently, the "humpbacked" contour of last fall's yield curve has now disappeared.

—Herbert Runyon

TWELFTH DISTRICT BUSINESS

Year and Month	Condition Items of all member banks (millions of dollars, seasonally adjusted)				Bank debits 22 SMSA's (billions \$)	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		5.36	104	109	101	92
1960	16,612	6,755	12,498	13,113		5.62	106	98	104	102
1961	17,839	7,997	13,527	15,207		5.46	108	95	108	111
1962	20,344	7,299	13,783	17,248		5.50	113	98	111	100
1963	22,915	6,622	14,125	19,057		5.48	117	98	112	115
1964	25,561	6,492	14,450	21,300	501	5.48	120	107	115	130
1965	28,115	5,842	14,663	24,012	535	5.52	125	107	120	138
1966	29,858	5,444	14,341	25,900	618	6.32	132	103	123	140
1966: Mar.	28,897	5,589	15,006	24,169	605	5.89	130	108	117	143
Apr.	29,267	5,309	14,924	24,579	617	...	131	113	122	147
May	29,157	5,128	14,812	24,735	618	...	131	107	125	145
June	29,688	4,919	14,780	25,001	622	6.18	131	105	128	144
July	29,791	5,071	14,753	25,265	628	...	131	104	130	143
August	29,764	5,473	15,120	25,271	622	...	131	95	119	136
Sept.	29,532	5,190	14,819	25,159	629	6.58	132	93	123	140
Oct.	29,583	4,987	14,719	25,085	645	...	133	96	121	142
Nov.	29,538	5,267	14,800	25,318	642	...	135	89	125	142
Dec.	29,858	5,444	14,341	25,900	634	6.62	135	97	120	141
1967: Jan.	30,274	5,468	14,437	26,134	638	...	136	98	123	142
Feb.	29,923	5,889	14,376	26,425	644	6.28	137	96	119	135
Mar.	29,980	6,483	14,855	26,892	645	...	136			123

Mixed Trends

THE West, like the nation, exhibited mixed trends in business activity during the winter and early spring months. Employment and consumer buying remained generally strong, and the region's long-dormant housing industry meanwhile began to come out of its hibernation. At the same time, most of the region's pace-setting industries expanded somewhat more slowly than they did in the 1965-66 boom.

Total employment increased about 1 percent in Twelfth District states over the December-March period. Since employment growth outpaced labor-force growth during this period, the unemployment rate declined, from 4.9 percent in December to 4.6 percent in March.

Sideways in aerospace

The aerospace industry, which accounted for well over half of the 1966 expansion in District manufacturing employment, continued to advance in early 1967, but at a slower pace than heretofore. On the basis of a first-quarter increase of 2,400 jobs, total aerospace employment in the District rose to 700,000 in March. However, this slower pace was observable not only here but throughout the national industry.

In the aircraft sector of the aerospace industry, employment actually declined from last November's peak. This development largely reflected the production difficulties of commercial-jet producers, who have been plagued by delayed deliveries from subcontractors because of the pressures created by increased military requirements.

In a major development looking toward the 1970's, President Johnson in late April authorized development work to proceed on an 1800-mile-an-hour supersonic transport. The preliminary design stage ended in Jan-

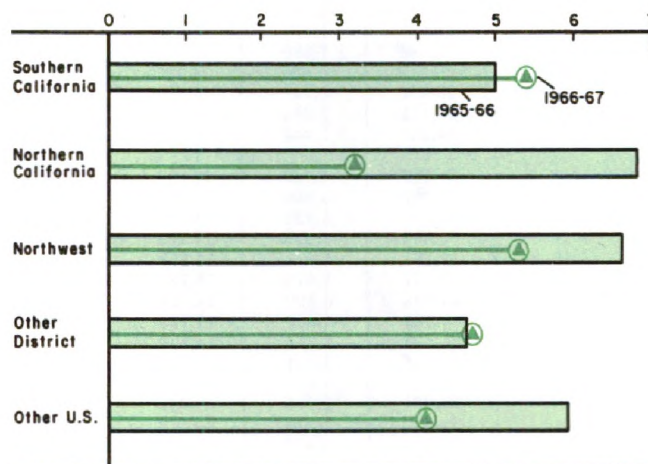
uary with the choice of a Boeing-General Electric design for the American entrant in the supersonic sweepstakes. In the forthcoming \$1.1-billion development phase, two prototype planes will be produced for flight testing in 1970. First commercial service is scheduled for 1974.

Construction and its satellites

Largely because of an improvement in residential construction — as evidenced by increases in both the dollar volume of contract awards and the number of housing starts — total construction activity increased slightly in Twelfth District states during the winter quarter. Non-residential construction awards declined, mainly in California and Arizona, but housing awards increased by 13 percent, and heavy construction awards by about 4 percent, during this January-March period.

Residential construction began to recover in the winter months, as housing starts rose to a 176,000 annual rate — 17 percent above the reduced level of the preceding quarter. Even at this level, however, starts still lagged

Employment rises over past year, but generally at reduced pace



a third below the relatively low level of a year ago. The lag was largely due to the continuing problem of oversupply of housing in some areas of Southern California, Nevada, and Utah, and to the wait-and-see attitude of builders and prospective homebuyers who generally anticipate even easier credit conditions in future months.

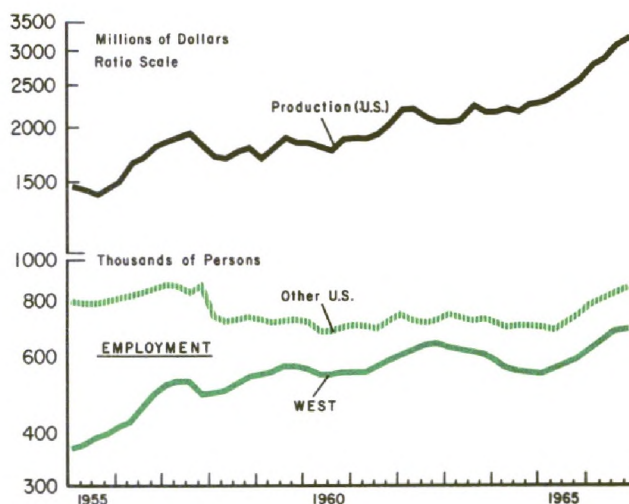
The Western lumber-products industry responded to the upturn in the national housing industry, and prices and production began a sporadic recovery from the severely depressed levels of late 1966. The initial upturn, arising from inventory buying by wholesalers and retailers, contributed to a sharp rise in orders and prices in February. Some scattered signs of weakness developed again in mid-April, however, when spring weather throughout the nation failed to stimulate a spring-like upsurge in orders. At this stage, prices for key grades of Douglas fir lumber lagged about one-fifth below the peak levels of a year ago. Prices of interior-grade sanded plywood meanwhile weakened during the winter and early spring period, dropping about one-third below year-ago levels.

Western steel producers, responding to a decline in the construction industry's demand for structural steel, reduced their output moderately during the January-March period. Despite a spring upturn, their output remained about 3 percent below year-ago levels in mid-April. Steel imports meanwhile rose by 7 percent over a year ago, as foreign steel continued to add to its share of the Western market.

Mixed trends in extraction

The copper industry faced a tight supply situation at the turn of the year, not only because of heavy civilian demand but also because of increased military requirements and sharply curtailed supplies from African sources. These factors caused Western producers in early January to raise refined-

Defense expansion continues in West as in rest of nation

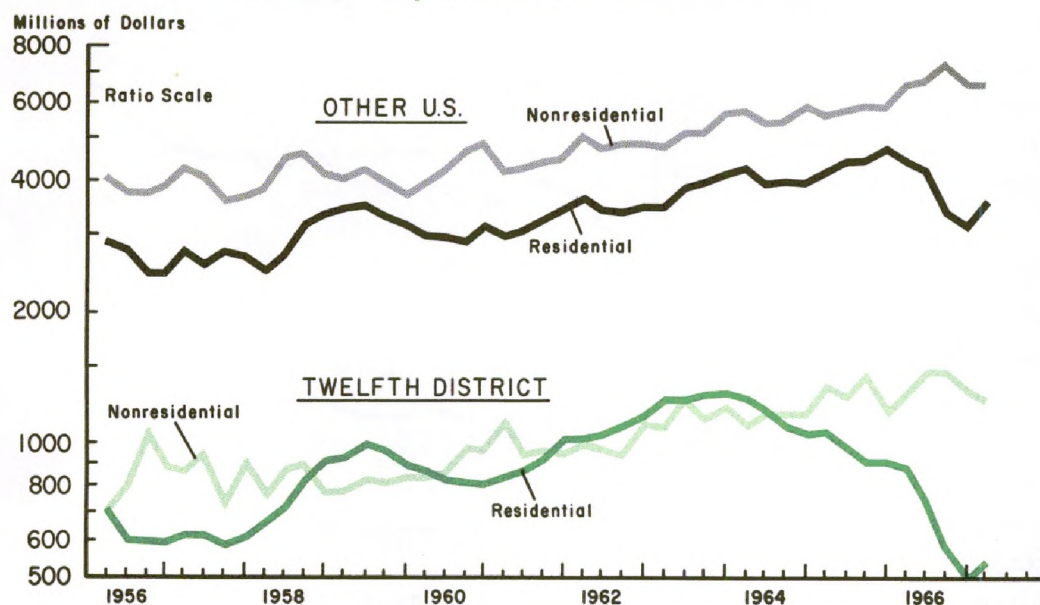


copper prices from 36 to 38 cents a pound — their first price boost in a year-and-a-half long period during which foreign producer prices had jumped by one-third. But in subsequent months, as domestic production increased and copper fabricators' requirements declined in response to reduced auto and appliance demand, the shortage eased and prices declined on the dealer and exchange markets. By mid-April, wire scrap prices had fallen below refined copper prices for the first time in the last several years, and the spot quotation on the London Metal Exchange had dropped to less than half of its year-ago level.

Aluminum producers, like copper producers, raised prices in early January, boosting their aluminum-ingot quotation from 24½ to 25 cents a pound, and increasing fabricated-product prices by 1 cent a pound. Shipments during the first quarter ran 3 percent above year-ago levels — a modest gain in comparison with the sharp increases recorded throughout 1966. Even so, the industry found it necessary to draw heavily on the Government stockpile to meet the early-1967 level of demand.

Expanded regional demand for refined petroleum products stimulated an increase in

Homebuilding industry begins to recover, but weakness develops in other construction



Production has been affected so far this year by weather problems. District farmers have planned increased plantings of field crops, especially wheat and processing vegetables, and their supplies of irrigation water are considered ample in most areas and at least adequate in Arizona. Nonetheless, the prolonged period of spring rains sharply depressed production prospects for deciduous fruits and de-

refinery activity above year-ago levels, although the production gain was modest in comparison with the expansion elsewhere. A sharp rise in demand for residual fuel oil was the major factor in the marketing picture, but demand also increased for gasoline and for military jet fuel.

Western crop receipts dropped 5 percent below year-ago levels in the winter quarter—in contrast to a 3-percent year-to-year decline in the rest of the nation—primarily because California and Arizona vegetable growers could not match the unusually high level of prices received in last year's winter period.

delayed the growth of spring vegetables. Meanwhile, in the livestock sector, cattle feeding activity leveled off and the prices received for fed cattle dropped below year-ago levels.

The major District industries thus had their full quota of problems in early 1967—production problems in aerospace, demand problems in construction, lumber, and metals, and weather problems in agriculture. Despite all this, the general tone of the regional economy this spring was strong, with good gains in employment, income, and consumer buying, and a noticeable reduction in the unemployment rate.

—Regional Staff

Rebuilding Liquidity

IN the first quarter of 1967, large commercial banks in the Twelfth District recorded an \$837-million increase in total bank credit, in sharp contrast to a large decline in the early 1966 period. In further contrast to their early 1966 experience, these banks reduced their outstanding loans and directed their funds into securities, thus rebuilding liquidity positions which had deteriorated during two years of rapid loan expansion.

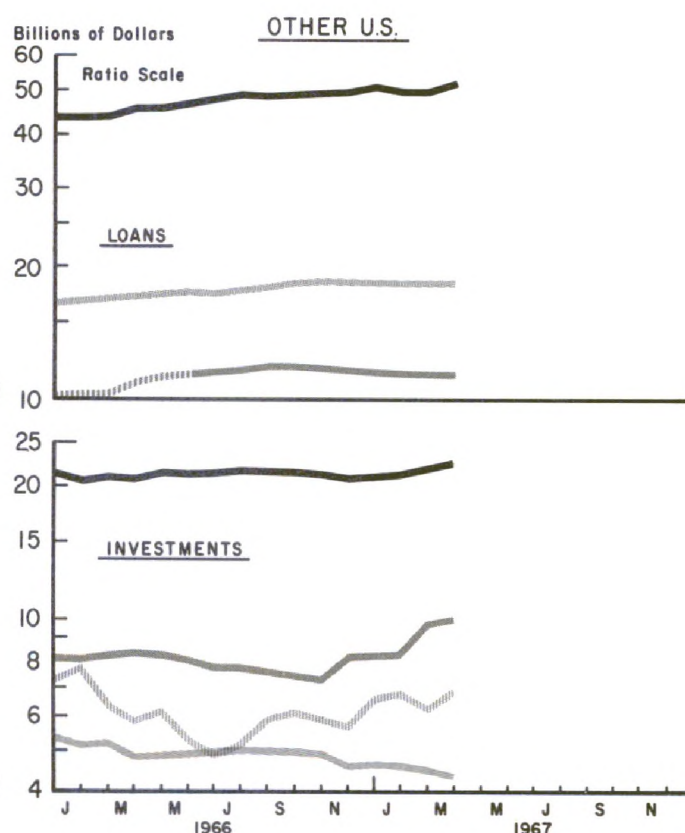
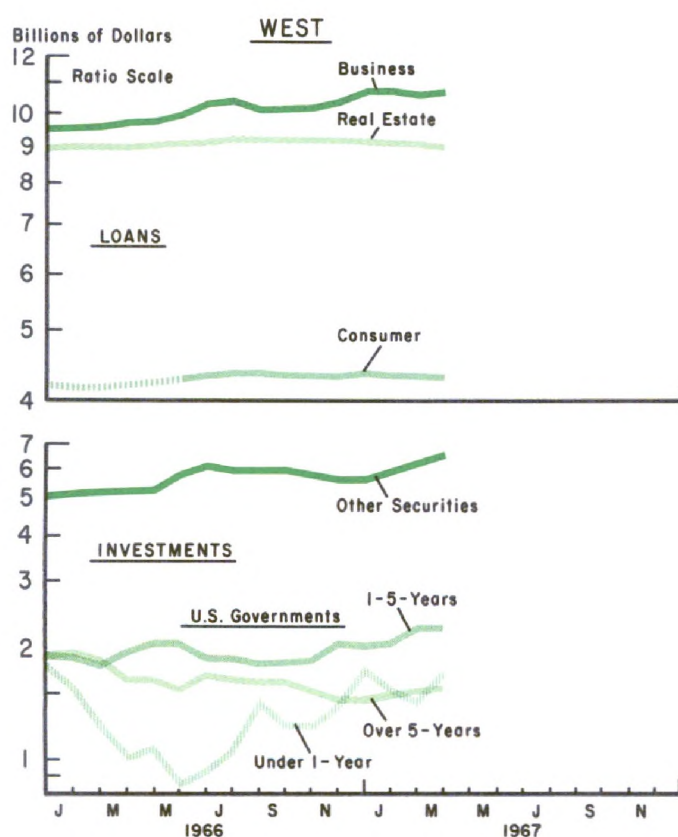
All major loan categories (except loans to brokers and dealers) either declined or showed only nominal increases for the first three months of 1967. A \$355-million reduction in total loans adjusted compared with an increase of \$262 million in the first quarter of 1966.

During this period, large District banks added \$303 million to their Treasury security holdings and even more (\$764 million) to their municipal portfolios. Over two-thirds of the increase in Governments went into issues maturing in one to five years, with the remainder invested in longer-term issues; almost one-half of the increase in municipals went into warrants and other short-term issues. This broad expansion across the maturity range added a needed cushion to banks' security portfolios.

Weakening business demand?

In the first quarter, Western businessmen exhibited weaker loan demand than their counterparts elsewhere. District business-

Strong expansion of bank credit centered in security investment ... District banks show weaker business-loan demand than other banks

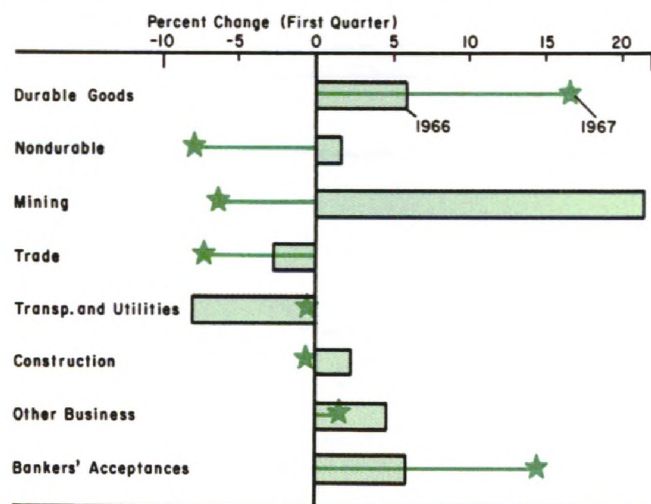


loan demand expanded in March, because of borrowing to meet mid-month corporate tax payments, but this increase was relatively weak, leaving outstandings at the end of March at the same level as at year-end. In contrast, the March expansion in business borrowing in the rest of the nation was substantial enough to raise outstanding business loans almost 3 percent above the year-end level of outstandings.

Despite the slackening in regional credit demand, the net increase in borrowing by durable goods manufacturers was four times greater than in the first quarter of last year. Machinery manufacturers accounted for the major part of this increase, but loans to transportation-equipment manufacturers also rose, reflecting the high level of both defense and non-defense production. On the other hand, food-liquor-tobacco processors recorded a greater-than-seasonal debt repayment, and thereby brought about a net decline in loans to non-durable goods manufacturers. In addition, trade firms reduced their outstanding loans by a greater amount than in the comparable 1966 period.

Consumers in the West, as elsewhere in the nation, reduced their bank-held installment debt during the early months of 1967.

Durable-goods firms account for most business-loan demand



New credit extensions were no higher than a year ago in the field of auto financing, but continued along a rising trend line in the field of other consumer goods.

Improving mortgage demand?

The Western mortgage market began to show signs of life during the first quarter, as evidenced by a rise in savings-and-loan mortgage commitments. But outstanding mortgage loans continued to decline at both banks and S&L's.

At District banks, a \$179-million first-quarter decline in outstanding real-estate loans was nearly three times greater than the preceding quarter's decline. This figure may overstate the decline in new mortgage activity, however, since renewed interest in mortgage purchases by insurance companies and other institutional lenders probably increased the volume of mortgages sold by District banks out of their own portfolios.

For their part, District S&L's sustained a \$100-million decline in outstanding mortgage loans, almost all occurring in the first month of the period. This decline took place in the face of a sharp \$780-million net savings inflow, and despite an almost 50-percent increase in new loan commitments over the three-month period.

The lag in lending was accompanied by a sharp rise in S&L repayments of advances and other borrowings from the Federal Home Loan Banks — some \$540 million, or three-fourths of the entire net amount borrowed last year. But the lag in lending also reflected a hesitancy on the part of prospective borrowers — a hesitancy perhaps induced by some doubts as to the future course of the economy generally, and by expectations of a further easing in price and non-price terms of borrowing. Evidence of easing was apparent in a first-quarter decline of about 25 basis points in conventional rates for both

**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 3/29/67	Net Change		First Quarter 1966 Percent	Outstanding 3/29/67	Net Change	
		First Quarter 1967 Dollars	Percent			First Quarter 1967 Percent	First Quarter 1966 Percent
ASSETS							
Loans adjusted and investments ¹	\$41,097	+ 837	+ 2.08	— 1.75	\$147,968	+ 1.35	+ 0.72
Loans adjusted ¹	28,969	— 355	— 1.21	+ 0.95	104,058	— 1.31	+ 1.18
Commercial and industrial	10,712	+ 9	+ 0.08	+ 2.41	51,250	+ 2.67	+ 4.26
Real estate	9,062	— 179	— 1.94	+ 0.48	18,069	— 1.04	+ 2.12
Agricultural	1,167	+ 7	+ 0.60	— 2.38	657	— 2.81	— 1.77
To non-bank financial institutions	1,404	— 211	—13.07	— 3.02	8,208	—14.96	— 2.34
For purchasing and carrying securities	797	+ 119	+17.55	+25.00	5,845	— 2.79	— 8.26
To foreign banks	265	— 32	—10.77	— 5.41	1,130	—11.79	— 3.69
Consumer instalment	4,325	— 55	— 1.26	+ 0.47	11,436	— 0.93	+ 0.14
To foreign governments, etc.	120	— 4	— 3.23		962	— 8.73	
All other	1,614	+ 6	+ 0.37		8,970	— 3.37	
Total securities	12,128	+1,192	+10.90	— 8.65	43,910	+ 8.24	— 5.16
U. S. Government securities	5,553	+ 303	+ 5.77	—18.67	21,217	+ 8.51	— 9.00
Obligations of states and political subdivisions	5,674	+ 764	+15.56	+ 2.57	19,988	+ 7.86	— 1.35
Other securities	901	+ 125	+16.11		2,705	+ 8.98	
LIABILITIES							
Demand deposits adjusted	13,916	— 300	— 2.11	— 3.13	58,925	— 3.25	— 5.03
Total time deposits	25,992	+1,343	+ 5.45	+ 1.61	70,141	+ 7.93	+ 4.09
Savings	15,023	— 96	— 0.63	— 0.43	32,075	— 0.06	— 0.33
Other time, I.P.C.	7,241	+1,177	+19.41	+21.53	26,798	+16.83	+12.43
States and political subdivisions	2,703	+ 117	+ 4.52	— 9.85	6,544	+14.55	+ 5.53
(Neg. CD's \$100,000 and over)	3,032	+ 682	+29.02	+18.02	16,267	+22.38	+ 5.80

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

NOTE: Quarterly changes are computed from December 28, 1966 — March 29, 1967 and from December 29, 1965 — March 30, 1966.

new and existing homes. But even after falling to 6.80 percent, rates in the Western region were still substantially above the year-ago level of 6.55 percent.

Time deposits rise sharply

Large District banks posted a lower level of demand deposits (daily average basis) in the first quarter of the year than in January-March 1966. On the other hand, they recorded a gain of over \$1 billion in total time and savings deposits — nearly three times as much as in the comparable period last year. But within this category, savings deposits declined \$96 million as depositors continued to shift funds to higher-yielding consumer time certificates.

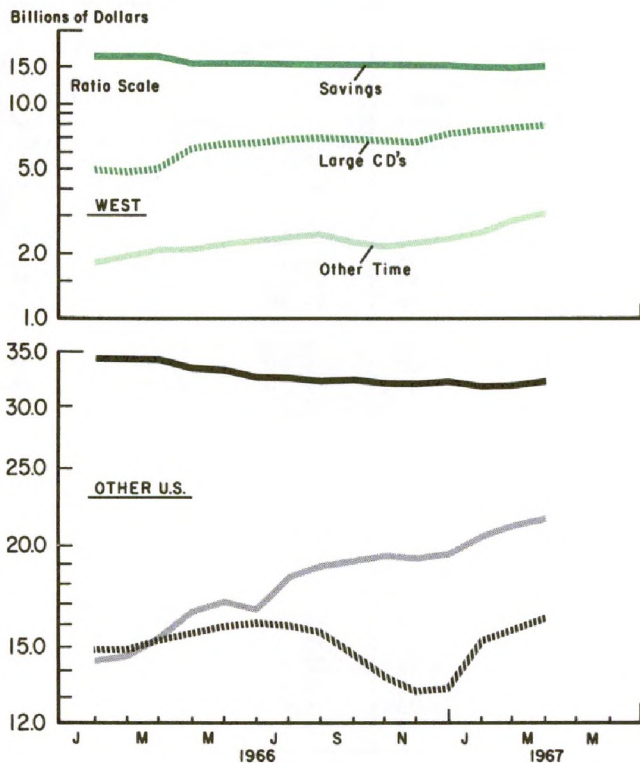
Although offering rates were reduced, yields on large-denomination CD's became more competitive with other money market instruments in early 1967, and outstanding

CD's thus rose to a record high of \$3 billion at Western banks by the end of March. Western banks again showed only a minor reduction in CD's over the March 15 corporate-tax date, in contrast to the substantial fluctuation recorded by Eastern banks. The competitively attractive yields on time certificates also stimulated a contra-seasonal increase in time deposits held by states and other political subdivisions.

Borrowed funds support expansion

A significant portion of the relatively large first-quarter expansion in District bank credit was financed through borrowed funds. In fact, Twelfth District banks moved against the national trend in reserve behavior, shifting from net *free* reserves of \$5.4 million in fourth-quarter 1966 to net *borrowed* reserves of \$3.5 million in first-quarter 1967 (daily average basis).

Depositors continue placing funds into "other time" deposits



Furthermore, a major shift occurred in their "basic" reserve position — excess reserves less discounting and less net borrowing through Federal-funds transactions.

The seven major District banks in the national Fed-funds sample borrowed \$587 million through net purchases of Fed funds in the January-March period, in contrast to purchases of about \$60 million in the year-ago period (daily average basis). About 85 percent of these funds were then lent to securities dealers. The remaining Federal funds, plus discounts of \$33 million from the Federal Reserve Bank (daily average basis) and borrowings from corporations under repurchase agreements, were used by these banks to meet their reserve requirements and for investment in securities. In this way, District banks used borrowed funds, along with funds obtained through deposit expansion, to effect the high first-quarter rate of credit growth.

—Ruth Wilson and Verle Johnston

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New Luster for the White Metal

Silver made news again in mid-May, when the Treasury Department announced the discontinuance of silver sales to all except "legitimate domestic concerns which use silver in their businesses." The Department also invoked its legal authority to ban the "melting, treatment, and export of silver coins." These actions, which became effective immediately, were necessitated by the recent sharp increase in brokers' purchases, mostly for export, from the Treasury's stock of "free silver." Just between May 1 and May 12, orders of this type have jumped from 200,000 to 5,767,000 ounces.

Congress is still debating legislation which would eventually free for sale some 430 million ounces of silver now held as backing against outstanding silver certificates. The legislation would permit the Treasury 1) to "write off" immediately those certificates which it estimates have been destroyed, lost, or held in collections, and 2) to free the remaining portion of the frozen silver one year later, after which time silver certificates no longer would be redeemable in silver.

Under present law, the Treasury is authorized to sell, at a price of \$1.2929 per troy ounce, only the silver in excess of that which it must hold as a reserve against silver certificates. This "free silver" stockpile, which has declined from 115 to 55 million ounces within the last several months, is the stock affected by the new Treasury restrictions.

A background analysis of the subject is available in the publication, "New Luster for the White Metal." This report discusses silver's historic role in the nation's monetary system, including the virtual elimination of silver from the coinage under the Coinage Act of 1965.

Copies of "New Luster for the White Metal" and other Monthly Review publications may be obtained free upon request from the Administrative Service Department, Federal Reserve Bank of San Francisco, 400 Sansome Street, San Francisco, California, 94120.

