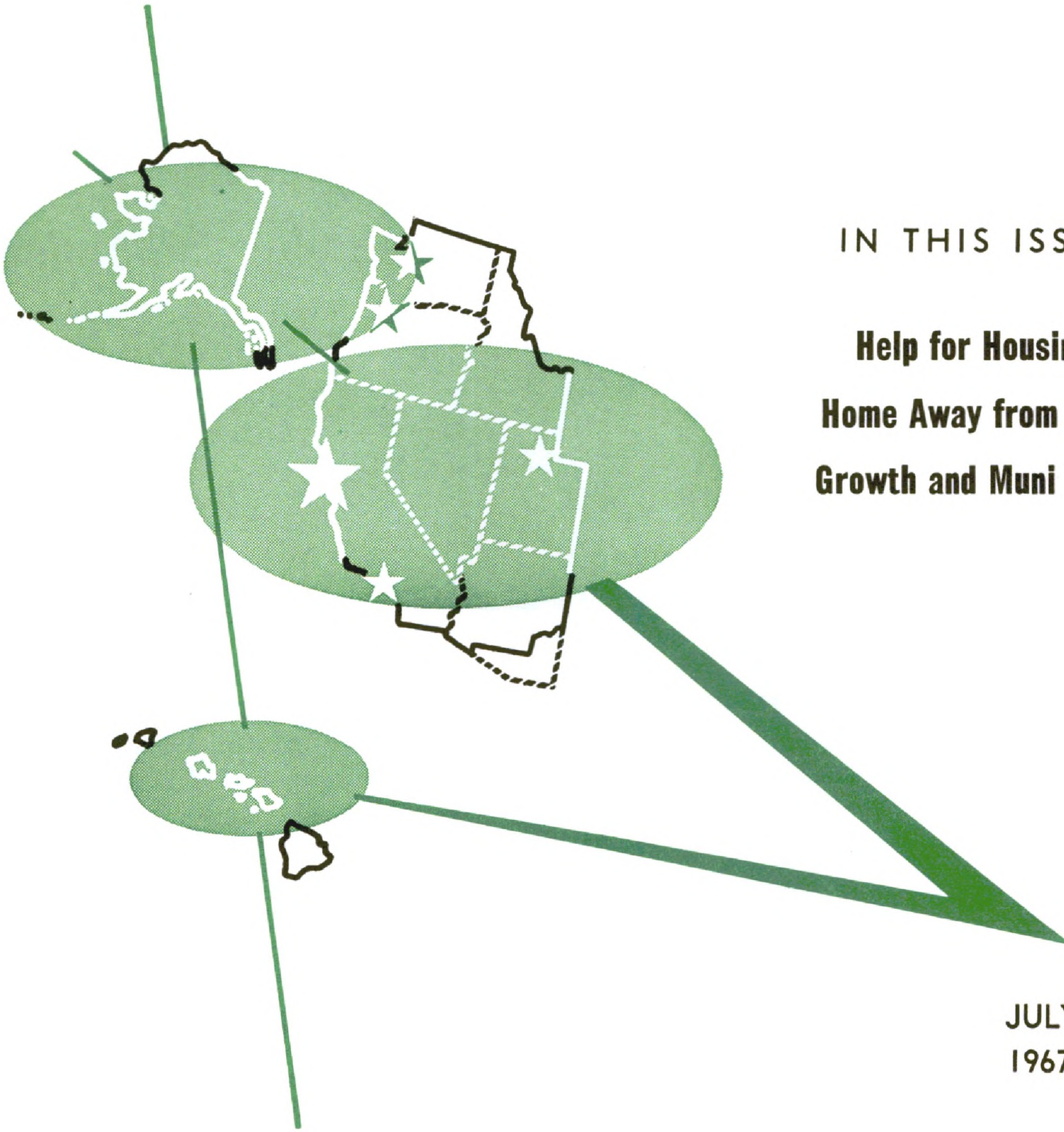
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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Editor: William Burke

Help for Housing?

Although the housing slump is still far from over, a number of recent developments indicate that an upturn is in the making. Three years of fairly steady decline brought U.S. housing starts last year to a level barely three-quarters of that reached during the recent high of 1963. During the first five months of 1967, however, starts in the nation averaged 24 percent above the annual rate attained during 1966's final quarter — and in the West, where the level of activity last year was almost 60 percent below that of the pre-slump period, the construction pace early this year was 28 percent ahead of the late-1966 figure. Contract awards, building permits, and the flow of savings into mortgage-lending institutions also picked up, and (at least temporarily) mortgage rates declined and non-price lending terms eased.

Nevertheless, the turnabout has been neither so great, nor so far removed from the "crunch" of 1966, as to dispel memories of last year's traumatic experience in the mortgage market. In fact, the recent improvement has been accompanied by a vigorous examination of proposals — some old, some new — designed to give special assistance to one sector or another of the housing industry, and thereby to reduce the vulnerability of housing to a recurrence of the difficulties which beset it last year.

These proposals run the gamut from entirely new arrangements — such as direct public subsidies to home buyers — through extensions of earlier reforms, to slight modifications of existing policies or institutional practices. Proposed reforms include the development of a broadened secondary market for mortgages, an administrative "rollback" of interest-rate ceilings on time and savings deposits, greater flexibility (if not the elimination) of rate ceilings on government-insured mortgages, and diversified lending powers for heretofore specialized mortgage institutions.

Central mortgage bank?

Several of the most widely discussed measures to help housing would achieve this objective indirectly, by improving the mortgage market. One such proposal would transform the Federal National Mortgage Association into a central mortgage bank, with a trading desk whose function it would be to buy and sell, continuously, government-backed mortgages and possibly conventional mortgages as well. A related proposal, originally advanced by the American Bankers Association several years ago, would establish Federally chartered private corporations to insure conventional mortgages and to buy and sell loans in secondary market operations.

By acting as a clearing house of information with ready bids and quotes, the trading desk would bring prospective buyers and sellers together and would thus enable mortgages to be traded more like corporate, municipal and Treasury obligations. This, in turn, should result in lower marketing costs and, hence, lower costs to the borrower.

Full guarantees?

Federal Reserve Governor Maisel's suggestion that investors be allowed full recourse against FNMA for any mortgages purchased from it — in effect, a government guarantee — also should enhance the marketability of mortgages, and thereby should contribute to a greater supply of available funds and help reduce the cost of borrowing. In fact, a guarantee of this sort, whether made by FNMA or even by private firms, might be essential to the development of a broad and active secondary market for conventional mortgages, which account for three-quarters of all mortgages outstanding. Conventional mortgages are not characterized by the same degree of uniformity as FHA's and VA's but vary rather considerably, depending upon the location and credit rating of the individual borrower, the description and appraisal of the property, and a host of factors influenced by individual state laws. (Legislation of this type deals with ceilings on rates and fees, limits on loan-to-value ratios, maturities, mechanics liens and even documentation.)

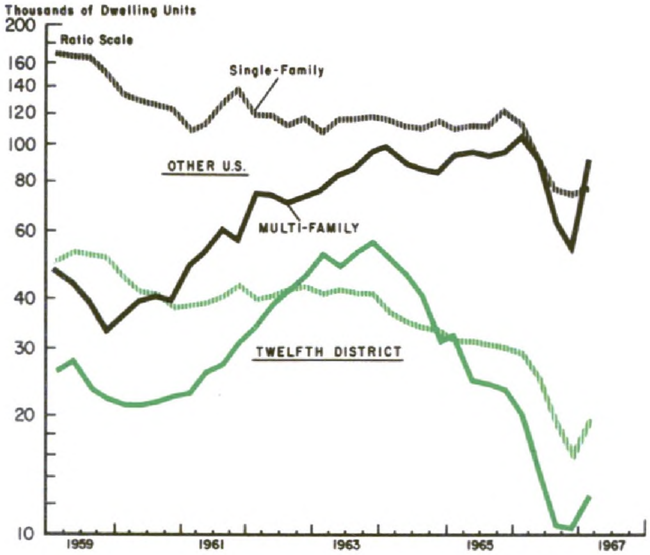
Consequently, a guarantee provision should substantially enhance the marketability of the mortgage, simply by making it unnecessary for the investor to evaluate each individual loan in his portfolio. However, the provision of such a risk-eliminating guarantee presumably would have to carry a fee if it were not to involve an implicit element of subsidy.

Most observers foresee formidable obstacles which could hamper FNMA purchases and sales of conventional mortgages, because of the wide variation in state laws and the lack of uniformity in the conventional mortgage. Overcoming these obstacles would require a considerable expansion of FNMA offices and staff to handle the screening and processing of the expanded loan volume. Besides, more FNMA resources for the purchase of conventional loans could mean less FNMA resources for the purchase of FHA and VA loans, to the detriment of the lower income and lower down-payment homebuyers who rely so heavily upon these types of financing. Beyond that, there remains the question of whether a government agency should properly deal at all in non-government backed mortgages.

Compete with private lenders?

Another proposal would have housing agencies augment the supply of funds available for mortgage financing by issuing their own securities, specifically tailored to meet the needs of special categories of investors, such as individuals and pension funds. (At the present time pension funds have only about $6 billion of their $160 billion invested in mortgages.) In fact, both FNMA and the

Upturn begins, but housing still has far to go on recovery road



Federal Home Loan Bank Board already have the authority to market long-term obligations. Some observers argue that a greater exercise of this authority — by FNMA to raise more money with which to purchase FHA mortgages, and by the FHLB to increase its advances to member S&L's for expansion purposes—would do more to iron out sharp fluctuations in the availability of mortgage funds than would the creation of a central mortgage bank.

The U.S. Savings and Loan League, for example, contends that a central mortgage bank could hamper home finance by drawing funds away from the thrift institutions which are engaged in mortgage lending — S&L's, mutual savings banks and commercial banks. Actually, FNMA's increased volume of open-market offerings last year did help to push up interest rates, and to some extent probably diverted savings from thrift institutions.

The mortgage bank, it is argued, apart from offering added competition to other mortgage institutions in bidding for the supply of loanable funds, might well accumulate a substantial volume of funds during periods of monetary ease, but might still find it difficult during tight-money periods to attract enough money at interest rates that builders and borrowers could live with. Even so, a properly functioning mortgage bank by definition would not contribute to overbuilding during periods of ease because it would be careful not to flood the market with low-cost loanable funds. If it were to float longer-term obligations during such periods it could then make the funds available to borrowers on favorable terms during periods of general credit restraint and higher interest rates.

Greater flexibility in rates —

But while housing analysts disagree about the need for special mortgage facilities to improve viability of secondary markets, they agree almost unanimously about the need for greater flexibility in FHA and VA interest-rate ceilings, so as to avoid the heavy discounts which characterized last year's mortgage market. Three successive increases in the FHA ceilings in 1966, from 5¼ to 6 percent, failed to keep pace with rising market yields generally, and consequently failed to attract the funds of private investors, so that discounts around the country averaged close to 10 points in some areas last fall.

Discounts—which are the means by which the market adjusts to administered rates — under some state laws must be computed as part of the interest rate subject to rate ceilings, even if they are paid by the builder or seller. This constraint, of course, further impedes the flow of funds into mortgages. Just what the reaction of the market would be to a "freeing" of administered rates at a time when market rates are rising and discounts on mortgages are deepening, however, is somewhat uncertain.

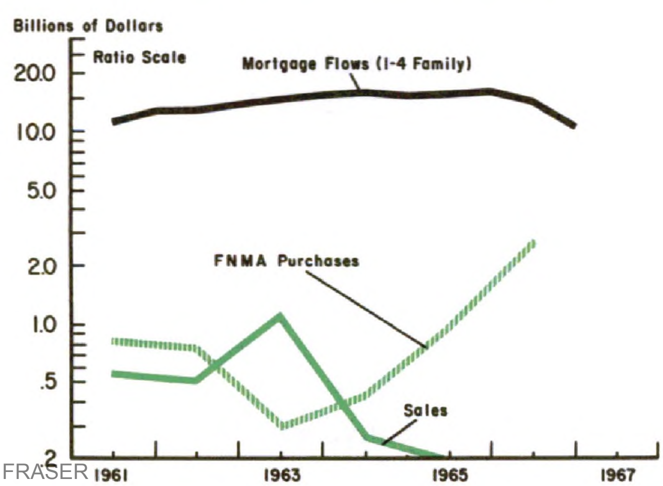
The supply of housing might increase as sellers are relieved of the burden of absorbing discounts. If buyers are themselves eager, of course, mortgage rates may rise even in a situation of relative ease in the housing market. At the same time, if buyers are reluctant and resist a shifting of discounts from the seller, rates themselves might even soften. As the president of the Mortgage Bankers Association has pointed out, if administered rates *had* been free to move higher in 1966, borrowers at least would have had a greater *opportunity* to borrow mortgage funds.

— and flexible rates on outstandings

Another proposal would tie the rates on *outstanding* mortgage loans to some other market rate, or index of rates. As interest rates rose, the cost of the homebuyer's previously borrowed funds would rise, and as market rates declined, the cost of his mortgage loan conversely would be reduced. The adjustment could be made in the loan maturity rather than in the monthly payment.

Supporters of this approach argue that a flexible rate would preclude home buyers from "holding off" at a time of high yields generally, because they would know that they could also "benefit" from a future decline in rates. Mortgage demand and housing activity would then be smoothed out over the cycle, and the mortgage lender happily would not find himself in an earnings squeeze during periods of general credit restraint and rising yields.

Mortgage flows slowed in '66 despite heavy FNMA purchases



However, the evidence suggests that the enthusiasm of the home buying public for such an arrangement is minimal. Efforts by a few S&L's last year to involve the fine print "escalation clause" in their mortgage contracts elicited a sufficiently negative response on the part of their borrowers to force a retreat. This of course was a one-way escalation adverse to the borrower; without a firm contractual system for downward rate adjustments in periods of easier money, the desired inducement for sustained mortgage borrowing during high-interest periods is lacking.

Implicit and explicit subsidies

Closely related to the problem of administered rates is the issue of whether rates on government-insured mortgages should be lower than those which the market would provide. The issue essentially boils down to the desirability, on economic and social grounds, of loan programs which involve an implicit or explicit element of subsidy. Those who argue in the affirmative, with the weight of Congressional opinion behind them, point out that lower-than-market rates on government-backed mortgages are often needed to encourage homebuying by lower-and-middle income families, which means that some special-support operation with public funds becomes necessary. Some critics oppose subsidies per se, while others maintain that even if an element of subsidy is desirable, it might better be extended by direct means, such as loans or grants directly to the home buyer to cover part of the interest cost or purchase price of a home, rather than through oftentimes self-defeating efforts to segment the structure of market yields.

Still, explicit subsidies could create new problems. The proposal for the Federal Government to make direct rental payments to low-income families has already run into snags. Treasury Secretary Fowler, viewing the alternative of direct government loans, has concluded that these should only supplement, not substitute for, private financing. It is conceivable, for example, that direct government lending could become so large in some areas as to preclude private financing, because of such factors as the increase in unit overhead costs which private lenders would face in administering a smaller volume of loans.

Beyond that, there remains the problem of establishing eligibility criteria for any such subsidies — size of income, size of family, "need," or whatever. Furthermore, an invariant application of these criteria conceivably might accentuate economic fluctuations at the very time when economic conditions call for monetary, fiscal and credit policies of a contra-cyclical nature.

Insulate the mortgage market?

Still another proposal would go even further in an attempt to insulate housing from fluctuations in the nation's capital market. As advanced by the Department of Housing and Urban Development, this insulation would be achieved through massive Federal Reserve purchases of FNMA and FHLB debentures, the proceeds of which would then be used to finance FNMA mortgage acquisitions and FHLB advances to member S&L's. (These advances would then be used by the S&L's to expand their mortgage lending over and above any increase in their savings flows and repayment flows.)

By exerting a downward pressure on yields, Federal Reserve open-market purchases could, it is argued, result in the elimination of discounts. But as last year's experience indicated, any such downward pressure on mortgage yields could cause a shift of private funds out of mortgages if other market yields were rising at the same time. And since overall credit conditions during a tight-money period call for open-market *sales* rather than *purchases* of the instruments in which transactions are made, either the Federal Reserve would sell some FNMA and FHLB obligations along with the usual Treasury securities —thus increasing their yields—or the special Federal Reserve support of mortgages would necessitate still further sales of other instruments, generating upward pressures on *their* yields. Under these circumstances, the market might witness a re-emergence of discounts on mortgages, a drying-up of private mortgage funds, and an accelerating reliance on the Federal Reserve to provide the nation's mortgage funds.

Rolling back savings rates

Another possible means of easing the policy impact on the mortgage market would be a "rollback" in the interest-rate ceilings which thrift institutions may pay on their time-and-savings deposits. A forced reduction in the cost of these funds is necessary to the thrift institutions (so the argument goes) if the price at which these funds are then made available to mortgage borrowers is to be reduced. The problem, of course, is that an administered rollback in the rates paid to depositors might prove to be self-defeating if the yields on the other instruments which compete for investors' funds should rise. The funds would roll out of the thrift institutions (and fail to roll in) and the ability of these institutions to make mortgage loans would tend to evaporate.

There remains, too, the problem of just what rate ceilings should be applied to the various types of thrift institutions. Until recently, for example, S&L's in certain Western states were allowed to pay higher rates than their counterparts elsewhere, the differential being based on the grounds that these states are fast-growing capital-deficit areas with a relatively greater "need" for long-term funds. Yet no such regional or local differential is allowed commercial banks in these same states, notwithstanding the fact that they have traditionally maintained a much higher ratio of time-and-savings to total deposits than banks elsewhere in the nation, as well as a much higher ratio of real-estate to total loans.

Building up liquidity —

Yet another proposal, designed to reduce the housing industry's vulnerability to credit changes by bolstering institutional liquidity, has been advanced by the Home Loan Bank Board and endorsed by the Council of Economic Advisers, the American Bankers Association, and the Federal Reserve Board of Governors. This proposal would have thrift institutions—most notably the S&L's—build up a buffer stock of cash and government securities during periods of general monetary and credit ease, sufficient to help finance continued mortgage lending during periods of credit restraint.

Such a buffer stock of liquidity would not only reduce the S&L's vulnerability to reductions in savings inflows, but would also make them less dependent upon FHLB borrowings. Also, by its very nature, it would reduce lenders' incentive to make loans of inferior quality during periods of general credit ease.

A related proposal would have the S&L's and mutual savings banks supplement their normal sources of loanable funds by issuing a greater variety of longer-term securities. If issued during periods of credit ease and generally low interest rates, the securities not only would provide the institutions with a greater proportion of funds "locked in" at lower rates — thus improving their earnings — but would make them less vulnerable to savings outflows during periods of credit restraint and rising yields.

— and diversified lending

Finally, there remains a somewhat controversial proposal that has been advanced not so much to help housing as to help the S&L industry. This is the suggestion that nonbank depository institutions specializing in mortgage lending be allowed to diversify their loan and investment portfolios—in effect, making them more like commercial banks.

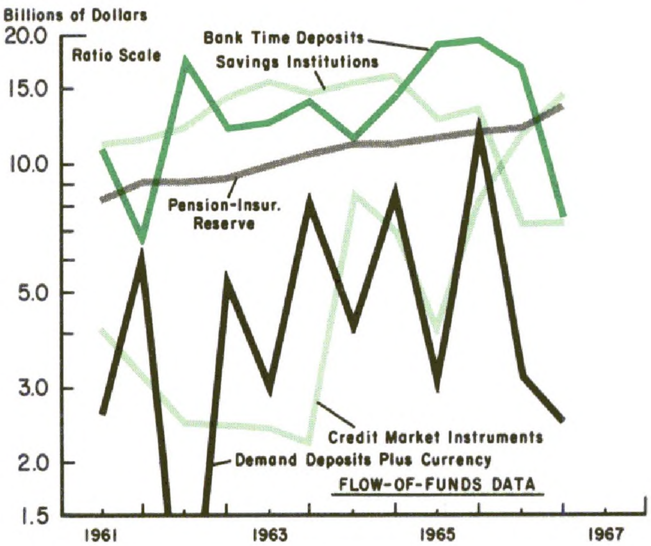
Savings-and-loan men argue that such diversification would not only result in greater competition, to the advantage of the public at large, but would also help to spread the impact of monetary policy actions more evenly throughout the financial system, and perhaps lessen the need for a system of structured rate ceilings on the deposits of the various types of thrift institutions. By increasing the flexibility of S&L's, diversification also would improve their earnings, and this in turn would make it easier for them to limit savings outflows by adjusting rates paid to savers as yields rise during periods of heavy credit demands.

Those opposed to a broadening of the lending powers of heretofore specialized institutions maintain that any such diversification would, by its very nature, divert funds to uses other than the financing of mortgages. But there is yet another dimension to the problem — to what extent can nonbank depositary institutions be made more like commercial banks on the lending or asset side of the ledger, without corresponding adjustments on the capital and liabilities side as well?

Some such adjustment may be desirable so as to achieve a more equitable incidence of taxation, and also to achieve a more effective "incidence" of monetary policy. The potential for destabilizing shifts of funds between various types of institutions might be increased if lending powers were more nearly equalized but reserve and liquidity requirements were not — that is, if S&L's were not required (as their competitors are) to immobilize a large part of their assets into cash and relatively low-yielding assets out of deference to reserve and liquidity requirements.

As the foregoing pages indicate, all quarters of the financial world have developed ideas about what went wrong with the mortgage market in 1966 and what can properly

Mortgage market hampered
by last year's slump in savings inflow



be done to cushion the impact of such an experience if it should re-occur. The Board of Governors of the Federal Reserve System, in analyzing this subject, came up with several broad guidelines in a report prepared recently for the Senate Banking and Currency Committee. The guidelines are:

—A flexible policy should play a greater part than it did in 1966 in acting, when needed, to restrain aggregate economic activity. Timely reductions in income tax rates earlier in the 1960's contributed greatly to the sustained economic growth that developed after the 1960-61 recession. If, with the added economic stimulus provided by escalation of the Vietnamese war, an income-tax increase had been enacted early in 1966, the burden of restraining general economic activity would have fallen less heavily on monetary policy and hence less severely on the residential mortgage market and on housing.

—The residential mortgage market—both primary and secondary—should be integrated closely with the general capital market, not insulated from it. But at the same time, certain institutional changes should be made to enhance the ability of the residential mortgage market to compete prudently for the limited aggregate supply of available credit. It should be recognized that the result would involve payment of higher rates at certain times for savings funds and for mortgage credit.

—If special public measures appear warranted to ease the impact of tightening general credit conditions on the availability or price of residential mortgage credit, such actions should be taken without sacrificing the objectives of monetary restraint. Moreover, the extent of the subsidy element involved should be revealed clearly, and the substitution of public for private credit should be minimized.

The Board also suggested (although without endorsing) several specific actions designed to stabilize the housing market:

(1) Improve the liquidity of thrift institutions so as to withstand better the pressures that develop when general credit conditions tighten.

(2) Improve the marketability of residential mortgages so as to make them more attractive and to permit lenders to adjust their portfolio positions more readily to conditions of general credit restraint.

(3) Improve the allocation of residential mortgage funds so as to assure a more efficient distribution of credit during periods of general credit restraint.

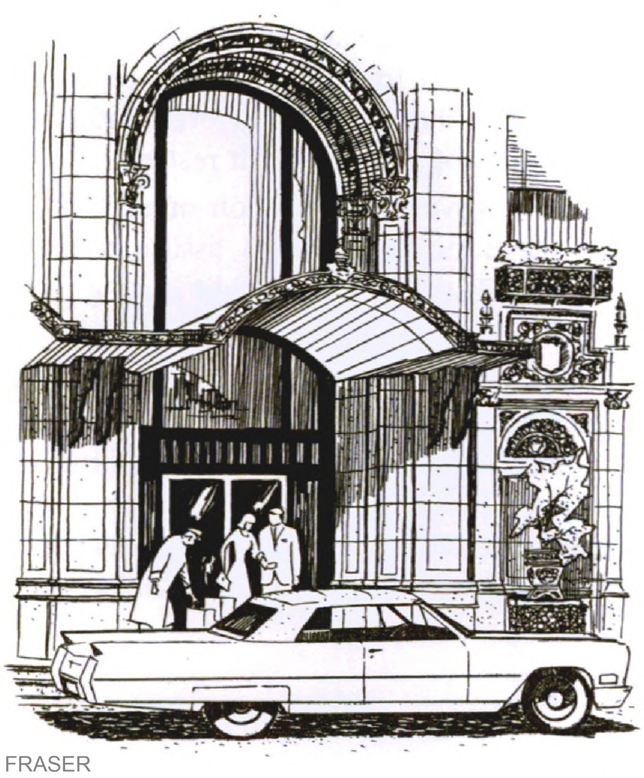
(4) Broaden sources of funds available for residential mortgage investment, thereby relying less on depository institutions that tend to be vulnerable to conditions accompanying general credit restraint.

—Verle Johnston

Home Away from Home

BUSINESSMEN and pleasure-seekers spend roughly $1.5 billion a year at Western lodging establishments in payment for rooms, meals, liquor, and other goods and services. On the basis of these receipts, the region's lodging industry employs over 120,000 workers and carries an annual payroll of over $500 million.

Hotel-motel employment in District states has increased recently at a 6-percent annual average rate, rising from 75,000 in 1955 to 121,000 in 1965. Wages are rather low in the industry, because of the relatively low level of skills required and because of the reliance on tips as a supplement to wages, so the industry—although employing about 1 percent of the total working force — accounts for only 0.8 percent of total wages in District states and for 0.6 precent of total wages elsewhere in the nation. In some Western states, however, the industry's importance is far above average—it accounts for 10 percent of total wages in Nevada and for 1 to 2 percent of the total in Hawaii and Arizona.

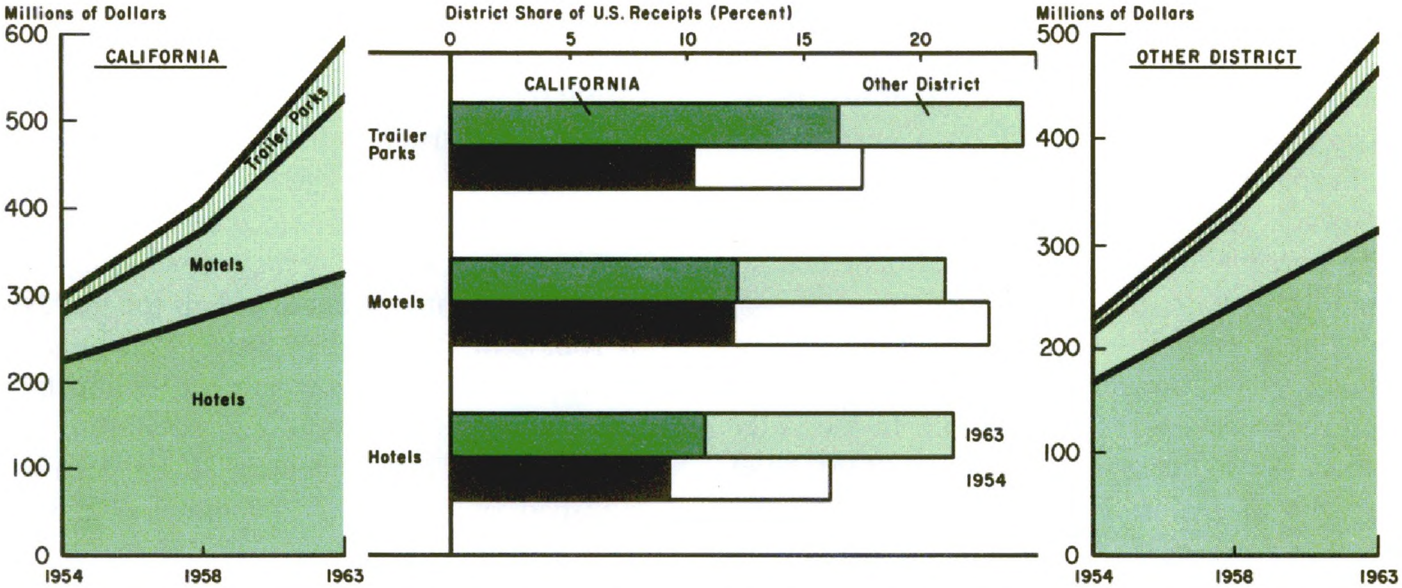


Diverse growth trends

The region's lodging industry is extremely diverse, including as it does some older—even decrepit — hotels and trailer camps along with some of the world's most palatial pleasure domes. Moreover, establishments vary considerably in size, ranging from massive convention hotels in Los Angeles, San Francisco, Honolulu and Las Vegas to mom-and-pop operated motels located in small rural communities. (Over one-third of the motels and one-half of the trailer parks in District states do not report any payroll.) And the industry also exhibits a wide range of growth rates; between the 1954 and 1963 Business Census years, hotel receipts in Western states grew by two-thirds, to $641 million, while receipts in the automobile-oriented lodging places more than tripled, to $442 million. (California and the Pacific Northwest actually registered a decline in hotel-room space over this period.)

Hotels have encountered difficulty in adjusting to the auto and jet age. Because they were originally located near downtown railroad stations, they have lost tourist traffic to freeway-oriented motels and trailer parks, and have lost considerable business traffic as businessmen have shortened their out-of-town stays in tune with jet-age plane schedules. Hotels nonetheless have fought back by catering to jet-age tourist and convention business and by expanding their downtown parking facilities. Motels meanwhile have matured along with the automobile age; the newer establishments stand in sharp contrast to the stage-coach inns of the nineteenth century and in almost as sharp contrast to

Receipts rise at hotels, but even more rapidly at auto-oriented lodgings . . . Western establishments obtain growing share of total receipts



the cold-water shacks of the 1930's.

The lodging industry has gone through drastic changes in the postwar period. The increased number of travelers, the longer vacations, the sharp rise in auto traffic—all have spurred an especially heavy demand for wayside accommodations which could not be met by the traditional commercial hotels and the older motels and trailer parks. The result is the "grand motel"—an establishment with a hotel-style range of services but motel-style conveniences and parking facilities. Located as they are near airports, in major shopping centers, and even in downtown areas, the new-style elegant motels have become a characteristic feature of the postwar landscape.

Strong income trends

Despite the faster growth of motels, Western hotels have been able to expand their *average* receipts at the same rate as their competitors. Annual receipts per room increased by about two-thirds in both types of establishments over the 1954-63 period, to $2,900 for hotels and $2,100 for motels. Average receipts for hotels in the West were about one-fifth above the average hotel income in other regions, while receipts for motels were roughly in line with the average elsewhere.

Higher average receipts for hotels reflected both a higher level of room rates and a wider range of income-producing services. In 1963, less than half of hotel receipts in Western hotels came from room rentals — much of the rest was generated by restaurant and bar facilities — while three-quarters of motel receipts came from room rentals.

Rising hotel income was accomplished despite the increasing age of the industry's physical stock; two-thirds of the region's hotels, as against one-third of its motels, commenced operations before 1949. Rising income was achieved also in the face of a decline in occupancy rates; occupancy, which had exceeded 90 percent during and immediately after World War II, declined from 72 to 62 percent between 1955 and 1965. Motel occupancy rates have been maintained above 70 percent during the past decade, as the aggregate demand for motel space has grown at the expense of traditional hotels.

But the hotel industry's problems have centered around the older, smaller hotels that are both short of modern conveniences and are located in the smaller population centers which have been bypassed by the major airlines and freeways. The magnificent new establishments which cater to the tourist and convention trade have generally prospered. In the 1963 Business Census year, occupancy rates in large hotels in California, Nevada, and Hawaii ranged between 69 and 77 percent, in contrast to a national (large-hotel) average of 63 percent.

Even in the larger convention centers, however, a downtrend in hotel space occurred between 1954 and 1963. In the latter year, New York maintained 122,000 hotel rooms, as against 70,000 in Chicago, 40,000 in Los Angeles, 35,000 in Miami, and 33,000 in San Francisco—which means a drop in room space of one-tenth or more in almost every area. But Hawaii was an exception to this downtrend; hotel-room space in that rapidly growing vacation center tripled over the decade, and recently has grown even more.

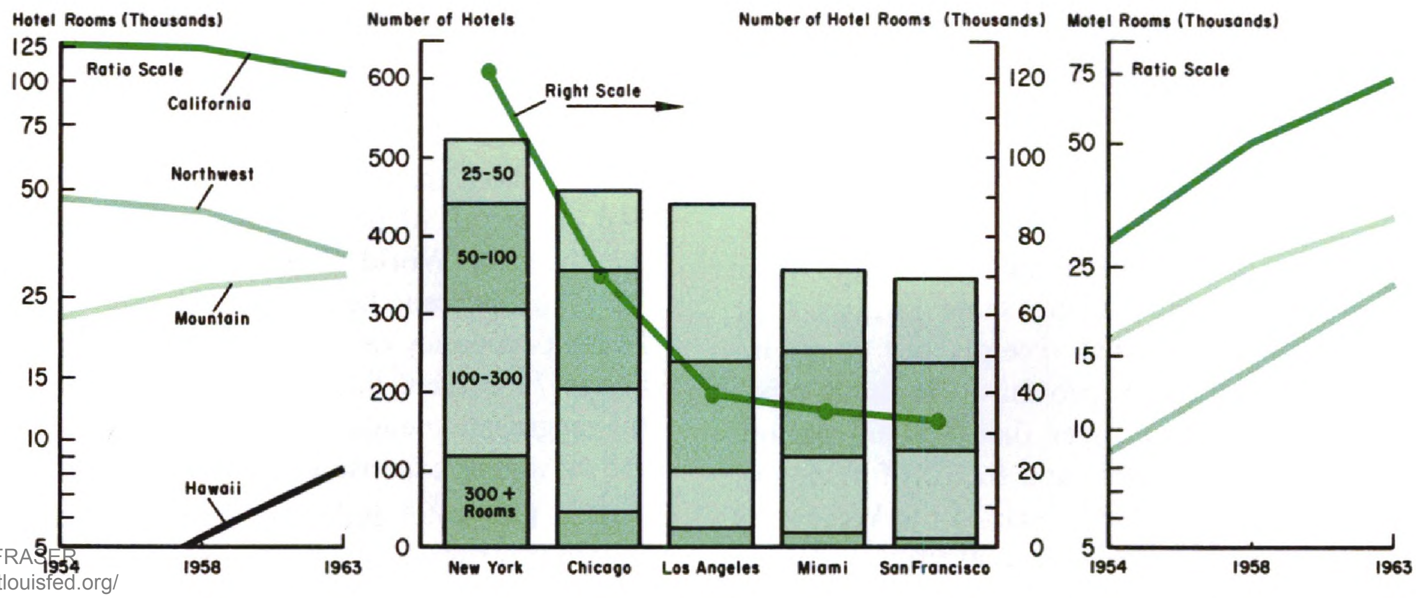
Travelers' impact on construction

Meeting the transient population's demand for housing has been a major stimulus to the nation's construction industry over the post-war period. Between 1949 and 1963, the industry produced 5,000 new hotels (almost 1,000 of them in the West) plus 17,000 new motels (more than 3,000 of them in this region).

Motel construction benefits from relatively low building costs. A new 2-to-3 story motel requires only one-half to four-fifths of the cost per room of the average new hotel, and typically it contains less than half the number of rooms of the average hotel. Using mass-production techniques which permit substantial cost savings — and consequently, low room rates—"instant motels" have been established by large national motel chains to take advantage of the high-density traffic generated by major freeways. Financing of such facilities is usually done through life-insurance firms, commercial banks, and even oil companies, which frequently guarantee mortgages in addition to operating motel service stations.

In the future, the rapidly growing number of business, tourist, and conventioneering travelers promises to generate a growing amount of business for Western hotels, mo-

Demand shifts cause sharp expansion in motel (but not hotel) room space . . . hotel space concentrated in New York and other convention cities

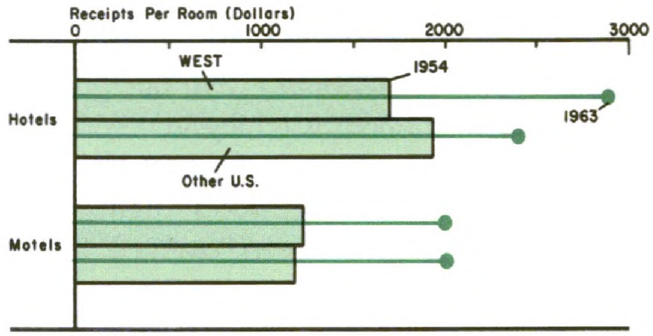


tels, and tourist parks. With more people on the highways, and more coming on the skyways with the advent of jumbo jets, a growing influx of visitors can be expected to tax present lodging capacity and thereby create a need for increased construction of motels and hotels—or at least of those establishments which will offer a wide range of modern facilities in convenient locations. But as the following sample indicates, the Western lodging industry already is preparing for the growing tide of visitors.

In California, construction in recent years has included three large motels, each with 250 to 400 rooms, near San Francisco airport, plus a 1,200-room hotel in downtown San Francisco and a 800-room facility in Beverly Hills. In the planning stage are two large hotels in San Diego, two in Los Angeles, one in Oakland, and one in Anaheim, with room sizes ranging from 400 to 1,000 rooms, plus two more large hotels in the 700-800 room category in San Francisco. One of the latter will contain the largest ballroom-banquet facilities in the West.

In Nevada, convention facilities and gaming tables have attracted a sharp rise in tourism and a consequent boom in construction. Room capacity reached 24,000 in 1963, for a one-fifth increase in four year's time,

Western establishments hold edge in average room receipts



and it is now sharply higher. Las Vegas in recent years has built a 680-room and a 1,000-room hotel, and major new hotel-convention facilities are now planned for Reno and Henderson (near Las Vegas).

In Hawaii, a substantial construction boom has gone hand-in-hand with its tourist boom. Hotel room space more than tripled in the 1955-65 period, to 15,000, and a 50-percent expansion of this capacity will probably be completed within the next several years. The industry recently added two new hotels of 880-room and 1,060 room capacity, respectively, and in the planning stage are two more large hotels at Waikiki as well as several smaller establishments on the islands of Kauai and Hawaii.

—*Paul Ma*

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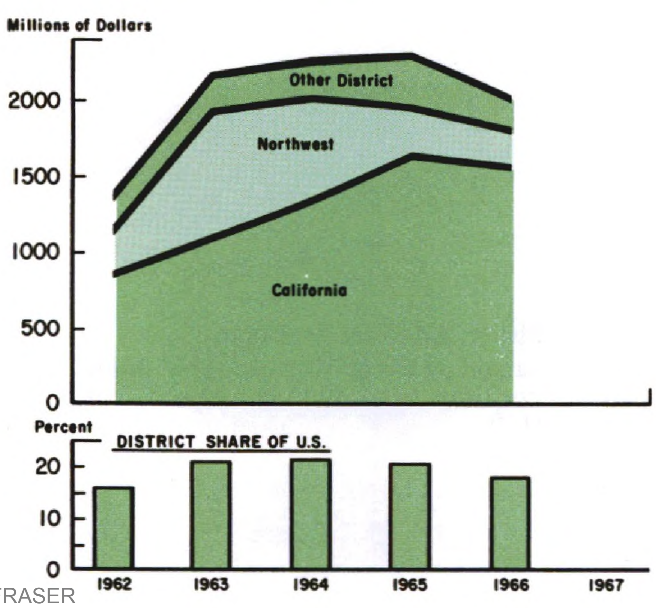
Growth and Muni Bonds

Along with other financial markets, the market for state-local government bonds (municipal bonds) felt the pressure of restrictive monetary policy in 1966. Yet, despite a sharp drop in muni-bond sales during the summer period's tight-money peak, total state-local sales reached $11.05 billion for the year as a whole. This was exceeded only by the previous year's record sales of $11.14 billion.

Over the 1962-66 period, municipal-bond sales exhibited a 6-percent average annual rate of growth. This upsurge in borrowing accompanied a sharp rise in state-local government spending, which over the postwar period has increased far more steeply than federal spending. By late 1964, in fact, state-local expenditures on goods and services actually exceeded those of the Federal government, and continued to do so through the middle of last year, when sharply increased expenditures for Vietnam reversed the balance once again.

Interest rates on municipal bonds have fluctuated with overall monetary conditions. In the last several years, little variation in spread has developed between muni-bond yields, on the one hand, and corporate and Treasury bond yields, on the other. In 1962, the average yield on Aaa municipal bonds was 3.03 percent; by 1965, it was 3.16 percent; and for 1966 it was 3.90 percent with a peak of 4.18 percent being reached in September. Lower-rated bonds followed a roughly similar path, but there was one new development: the spread between Aaa and Baa bonds tended to narrow somewhat over time. In 1962 the spread varied between 57 and 80 basis points, while in 1966 the spread was from 39 to 60 basis points.

Muni-bond sales slacken during tight-money period



West outpaces nation

Governmental units in Twelfth District states increased their borrowing as well as their spending at a faster-than-national pace during the 1962-66 period. Total new issues rose from $1.38 billion in 1962 to $2.30 billion in 1965, before declining to $2.02 billion in 1966. Thus, the West's share of total bond sales rose from 16 to 18 percent over the period, and actually exceeded 20 percent in 1964 and 1965.

The average volume of borrowing has tended to vary directly with the various states' population and income. While there are, of course, other forces influencing decisions to borrow, the high degree of correlation of these two factors with bond sales is quite clear, and the relationship undoubtedly is mutual. Income and population growth, in other words, have been major factors inducing and supporting the growth of Western state-local borrowing over this timespan, and the consequent rise in state-local spending has added to income and attracted potential migrants.

California governmental units naturally

were the largest borrowers over this period; their issues were never less than half the District total of funds raised, and in 1966 California issues ($1,642 million) made up almost four-fifths of the regional total. Furthermore, in every year since 1962, they accounted for the largest dollar volume of issues of any state in the union. The totals were bolstered during the past three years by five State of California issues of $100 million or more.

Washington came next in regional importance, being second to California in every year of this period except 1966. Washington's peak was reached in 1963, when its $722 million in new flotations—mostly associated with the financing of the Columbia River power project—gave it fourth place in national rankings. That state also floated a $314-million offering in 1964—the fifth largest single issue sold in the nation up to that time.

Physical and human resources

A breakdown of last year's total flotations permits an analysis of the purposes for which Western governmental units borrow so heavily. The largest category last year, making up one-third of the District total (as against one-sixth nationally) was public utilities and conservation. California's program dominated both District and national borrowing in the category of water-resource and recreation development. Six issues, ranging from $20 million to $160 million in size, helped push the state-wide total to $638 million.

Next in importance was education, which took more than one-quarter of total funds raised in the District last year. Higher education in District states accounted for almost 6 percent of total borrowing, as opposed to a 3-percent share nationally. The District also outpaced the nation in borrowing for elementary and secondary education. Over the 1962-66 period as a whole, California governmental units led all others in borrowing for this purpose, as the state in some years devoted almost 30 percent of its bond receipts to elementary and secondary schools.

Social-welfare activities, such as public housing, veterans, and recreation, amounted to 14 percent of District borrowing last year. Almost one-third of the total was concentrated in a single State of California issue, which divided $100 million equally between recreation and veterans programs. Oregon also raised $30 million in two issues for veterans.

Transportation issues took under 9 percent of District borrowing, concentrated mostly in two large bond issues—$50 million for the San Francisco Bay Area Rapid Transit District and $48 million for the California Toll Bridge Authority. Transportation issues, by the way, have been declining in importance over the past decade, since the Federal highway program has relieved much of the financial burden on states and local governments.

The District failed to participate in the upsurge of industrial-aid financing, which

PURPOSES OF BORROWING, BY STATE, 1966
($ millions)

	Elem.-Secondary Education	Higher Education	Transportation	Utilities, Conservation	Social Welfare	Other	Total
Alaska	—	—	—	5	—	6	11
Arizona	14	28	5	16	7	23	93
California	346	60	131	638	219	190	1,584
Hawaii	—	—	1	—	3	20	24
Idaho	5	1	1	—	3	1	11
Nevada	10	—	19	13	3	6	51
Oregon	33	17	11	18	49	13	141
Utah	8	1	—	3	1	2	15
Washington	21	7	8	27	6	16	85
Total	437	114	176	720	291	277	2,015

Source: Investment Bankers Association

on the national scene was perhaps the most noticeable development in the field of state-local finance last year. This type of financing, which uses the tax-free feature of municipal bonds to provide facilities at a lower cost than private corporations can obtain, is designed to attract new industry to develop particular areas. Nationally, industrial-aid issues doubled in 1966, to $504 million, or roughly 5 percent of total state-local borrowing, but none of these bonds were issued by Twelfth District states. Actually, only four District states permit the issuance of such bonds, which have come to be widely criticized as a doubtful fiscal practice.

States expand their borrowing

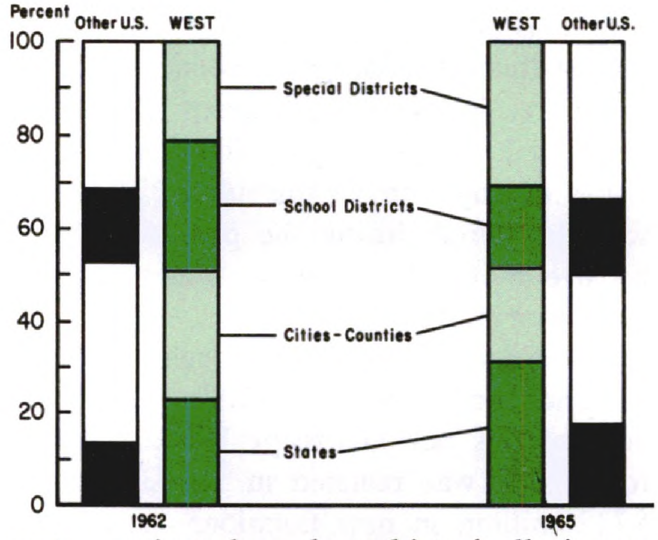
In the West as in the rest of the nation, borrowing by state governments has increased relative to that by cities and counties. Borrowing by special districts and similar public bodies meanwhile has risen substantially, because of the capabilities of such organizations for accomplishing area-wide projects or because of the desire to avoid limitations on borrowing imposed by state constitutions.

School-district financing has tended to lag, but since educational expenditures have remained high, this simply represents a shift to state-government borrowing. The State of California, to cite the most obvious case, borrowed over $600 million between 1962 and 1966 to provide credits for local school-construction programs.

The dollar volume of bonds raised by special districts more than doubled in the 1962-65 period alone, thereby financing such heterogeneous activities as toll bridges, electric companies, water works, and irrigation projects. These public bodies have been set up to handle projects not easily operated by ordinary government organizations or to undertake joint functions for several governments.

In the West, where public power and

State-government borrowing more important here than elsewhere



water projects have been historically important, the special district has continued to play a major role. The Columbia River project was largely financed by public-utility districts in Washington, while California's water-development program has stimulated local water and irrigation districts to increase their activities. California meanwhile has witnessed the development of a new form of public agency—a special authority which constructs some project, usually a civic building or stadium, and then leases it back to the city or county concerned. Recent issues under this kind of arrangement include the $27-million San Diego Stadium and the $26-million Oakland-Alameda Stadium.

Like public bodies everywhere, District governmental units have expanded their borrowing in order to finance their growing expenditures. A temporary setback occurred during 1966's period of monetary restraint, but the basic uptrend has now reasserted itself; in the first half of 1967, muni-bond sales in the nation as a whole were about 30 percent higher than in the like period of a year ago. Indeed, the strong growth trend in municipal borrowing seems certain to continue in line with the upward trend in state-local expenditures.

—*Robert Johnston*