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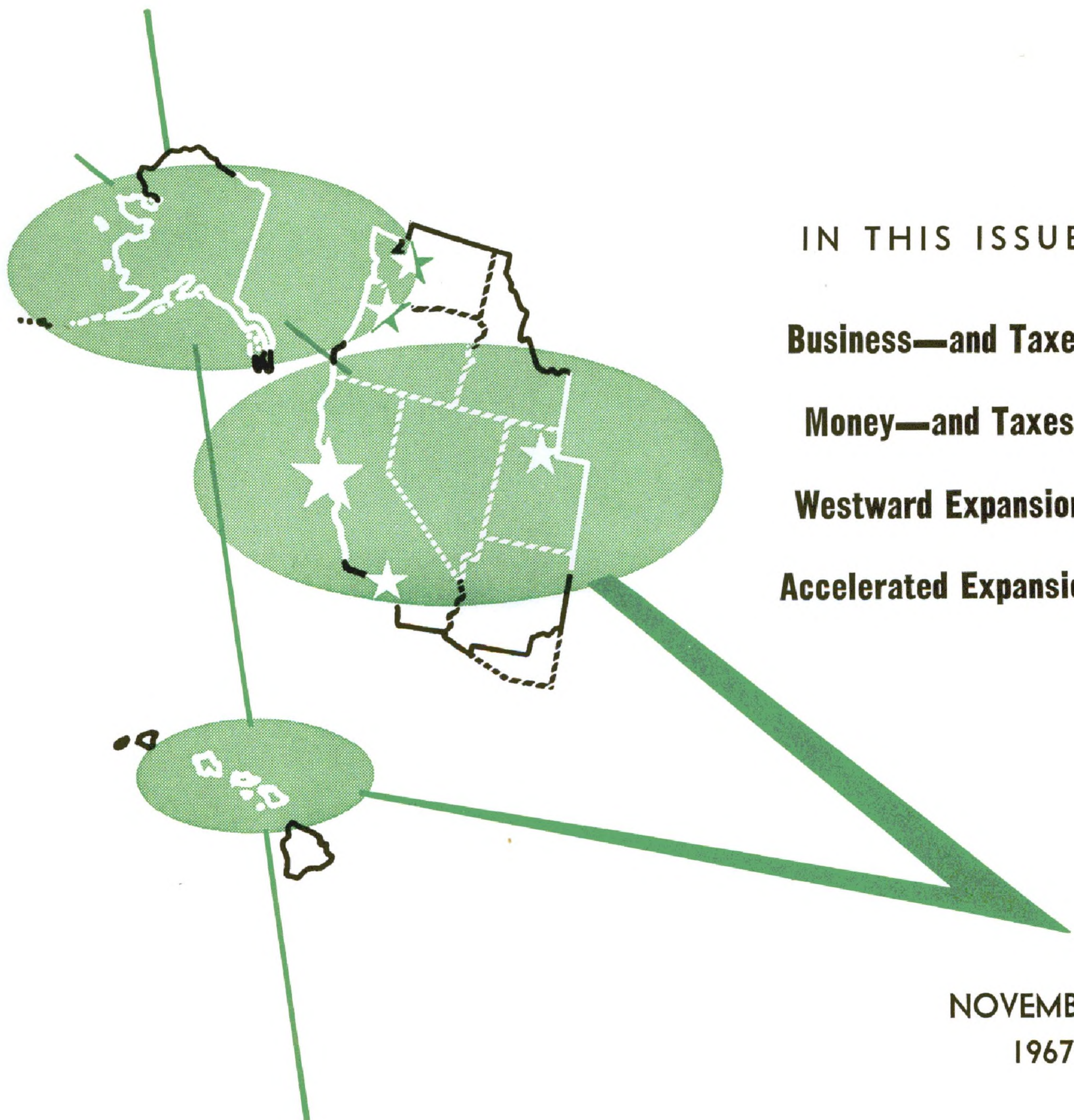
MONTHLY REVIEW



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NOVEMBER
1967

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Business—and Taxes

. . . The near-term future may witness unwelcome signs of inflation along with welcome signs of expansion.

Money—and Taxes

. . . If the Treasury can't reduce the deficit through higher taxes, it will have to borrow more money—and put more pressure on rates.

Westward Expansion

. . . Business activity speeded up in the summer and early fall months, led by booming aerospace and a recuperating housing industry.

Accelerated Expansion

. . . Large District banks boasted a massive credit expansion during the summer quarter, nearly matching the entire first-half increase.

Editor: William Burke

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Business—and Taxes

GNP climbed to the $790-billion level in the third quarter—an 8-percent annual rate of gain—as the 1967 inventory adjustment neared its conclusion and as a heady spending pace was maintained in other sectors of the economy. The summer and early fall months witnessed a continued (yet slower) growth of defense spending and an expanded household demand for consumer goods and new housing, along with the apparent turnaround in inventory-buying policy. The upsurge, however, took place despite a lack of support from the business fixed-investment sector, where spending has remained relatively stable for the past year, as a reflection of the slackened pace of production and profits.

The experience of the last several quarters underlined the importance of the role played by the Federal budget. Heavy budgetary support, along with an expansionary monetary policy, helped to keep end-product demand rising in the face of an $18-billion drop in inventory demand, the worst in our postwar history. The contractionary effects of an inventory adjustment were thus effectively quarantined, and as the economy absorbed this shift, a somewhat flabby first half was transformed into what now appears to be a rather firm second half.

Rebound from near-recession

This contribution to economic stability, however, was accomplished only at the cost of a huge rise in the Federal deficit. With revenues ceasing to grow because of a decline in corporate profits and a slackened growth in personal income, and with Federal defense and non-defense spending both rising sharply, the deficit (national-income basis) jumped from a $3-billion to a $15-billion rate in the first half of 1967—and remained high after midyear. Because of the need to close this gap and to keep the economy from over-heating on its present rebound, the Administration pushed hard this fall to get Congressional approval of a 10-percent income tax surcharge.

Defense spending, at a $74-billion annual rate in the third quarter, has risen only half as fast in the past six months as it did in the preceding year-and-a-half's rapid buildup. This reflects the relative stability of defense obligations and new orders over the past year, after a gain of 50 percent or more in the first year of Vietnam escalation.

Yet, in view of the continued strength of both defense and non-defense spending at the Federal level, and in view of the inexorable growth of state-local government spending, most observers expect the government sector to remain a strong plus factor in the near-term outlook. The midsummer Federal budget review, for example, suggests that defense spending will continue to rise at least as fast in the remainder of this fiscal year as it has in the last several months.

Consumer rebound

Similarly, consumer spending for big-ticket items has turned out to be both a source of strength in the immediate past and a potential source of inflationary worry in the immediate future. In the third quarter, consumer durable-goods spending rose slightly to a $73-billion annual rate, with autos and parts accounting for $30 billion of that total. (Auto spending has remained at that level for four of the past five quarters.)

The 1967 auto model year ended with new-car sales of about 8.4 million units,

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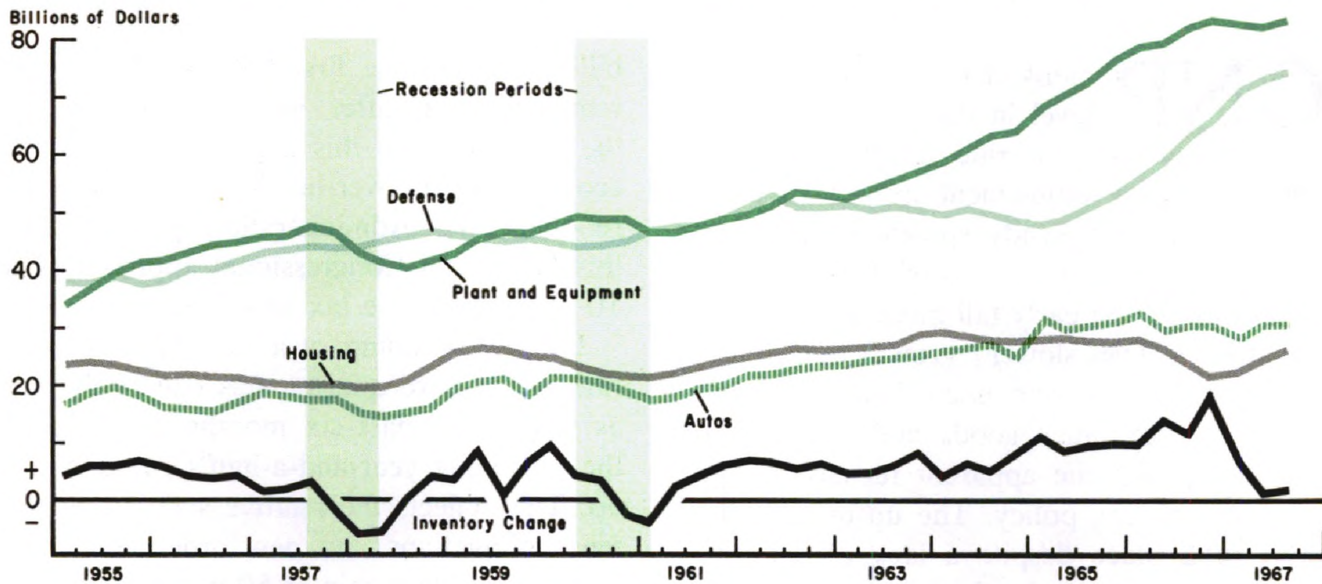
Continued defense expansion, turnaround in housing and inventories, and high-level stability in other cyclical sectors mark summer upsurge



but Detroit's marketing men hope for a 9-million-unit sales pace during the new model year. Achieving this goal may be somewhat difficult, however, in view of the after-effects of the 1965-66 buying binge, the continued absence of many would-be buyers in Vietnam, the problems involved in hammering out an industry-wide wage settlement, and the almost inevitable price increases that will occur as the industry's accountants add up the costs of the equipment going into '68 cars and the wages of the men producing them.

Residential construction was another source of strength in the third quarter. At a $25½-billion annual rate in the July-September period, the homebuilding sector has now made up most of the 28-percent loss suffered between early and late 1966, and by September of this year housing starts approached the 1.5-million norm of the 1962-65 period.

Widely published industry forecasts of a 15-percent year-to-year rise in housing starts suggest only that construction will level out at this present level (1.5 million starts). This is easily within the realm of possibility, since the present level of activity lags behind new demand created by new household formations of about one million a year plus replacement needs of perhaps two-thirds million per year.

Basic housing demand thus is relatively strong at the present time. An exceptionally large number of young people are looking for separate quarters because of the rising number of marriages and the expansion of consumer income. Moreover, recent months have witnessed a sharp decline in the inventory of unoccupied housing units and the lowest level of apartment vacancy rates since 1959.

On the other hand, the cost and availability of mortgage money is a question-mark. If open-market interest rates continue rising, funds again could flow out of the mortgage market and the housing industry again could be undermined. Mortgage money has been adequate throughout most of this year, but the recent rise in rates is worrisome; the FHA mortgage rate, at 6.60 percent in early September, was close to the year-ago peak and a full percentage point above the level maintained throughout the early years of the decade. And the impact on family budgets has been considerable.

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Rising interest rates, along with continued increases in construction and land costs, have raised the average monthly mortgage payment by roughly 25 percent in the past two years, as against a 14-percent increase in per capita income.

Softness in fixed investment . . .

In the business sector, somewhat less strength has been visible in recent months. Fixed-investment spending rose slightly to an $83-billion rate during the third quarter, as increased durable-equipment spending offset the continued weakness in commercial-industrial construction. Yet, despite the high level of expenditures in this category, 1967 as a whole will show only a moderate year-to-year increase, in contrast to a 15-percent gain in each of the two preceding years.

Mixed trends in the fixed-investment sector have been evident throughout most of this year. The carryover of expenditures on projects already underway, which had jumped from $10 billion to $18 billion between early 1964 and early 1966, subsequently increased by only $½ billion. The percentage of manufacturers reporting inadequate facilities dropped from 50 percent in mid-1966 to 43 percent in mid-1967, and new capital appropriations, which normally lead expenditures by almost a year, dropped by roughly one-fifth over the same timespan. On the other hand, industrial building contracts have recently been rising, and new orders for machinery have approached their 1966 peak.

Taken together, these trends suggest something of a standoff in fixed-investment spending in the near future. Some producers may raise their investment plans because of fear of inflationary pressures, but the upsurge may be dampened by several other factors. In the future, the projected tax increase may limit the growth of both corporate investable funds and final consumer demand. And right now, the profit downturn has limited the funds available for investment, while the relatively low utilization of capacity, stemming from this year's stable level of output and a 6-percent annual growth of capacity, has dampened the expansion mood.

. . . but upturn in inventories

Business expanded its inventories at roughly a $1½ billion annual rate in the third quarter, and this slight increase above the second-quarter figure suggests that the sharp reaction to last year's buying spree might be about over. Inventory-sales ratios at retail are close to the lowest level of the last two years, and although manufacturers' I/S ratios are still fairly high by the standards of the early '60s, they have been declining sharply too.

Inventory spending may be a prime factor in the rapid—perhaps over-rapid—upturn expected in 1968. A speedup in the accumulation rate, with its concomitant stimulus to output, could come about partly because of the natural rebound from 1967's cautious buying policy and partly because of the strike hedge-buying expected in view of the midyear termination of the steel labor contract.

Even if inventory buying should expand only at the normal prosperity rate of (say) $5 billion a year, it could stimulate an excessively rapid pace when coupled with the recent ($15 billion per quarter) rate of growth of final demand. In the words of Economic Adviser Arthur Okun: "Inventory investment, which was the villain in the early 1967 slowdown, stands ready to play the villain's role in overheating the economy. The turnaround is enough in itself to make the difference between sluggish and vastly excessive rates of growth."

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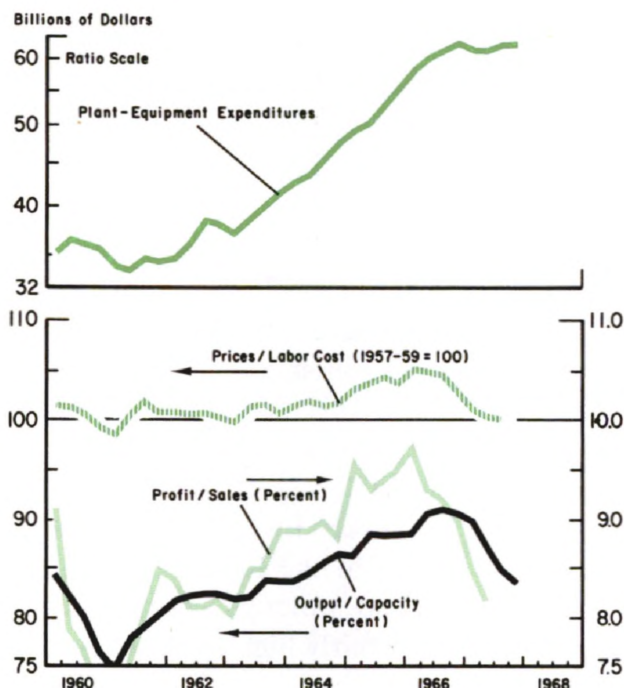
Falling profit and operating ratios dampen business-investment plans



Reluctant optimism?

The Business Council, a blueribbon group of corporate leaders, recently assessed all these developments and concluded that 1968 should be approached with "reluctant optimism". Given a post-strike acceleration in auto production, a pre-strike accumulation of steel inventories, continued growth of consumer spending, and expanded spending at all levels of government, GNP may rise 7 percent in 1968 to about $840 billion. Yet, the group fears, as much as half of that increase may be eroded by price increases even if Congress passes a 10-percent tax surcharge.

This top-level business group thus adopted the view of official Washington that the near-term future will witness unwelcome signs of inflation as well as the welcome signs of expansion, and that some dampening of the expansionary mood may be required in the form of a tax increase. Price pressures of course have already been widely noted: at the consumer level certainly, but also at the wholesale level, where stability had been evident throughout the early part of this decade.

Much of the recent pressure resembles the cost-push rather than the demand-pull variety of inflation. As inventory cutbacks created sluggishness in manufacturing activity and a year-long slide, from 91 to 84 percent, in the output-capacity ratio, unit labor costs responded to this uneconomic level of operations by jumping 6 percent after a 5-year long period of stability. Reflecting this development, wholesale prices of industrial goods rose last winter from 105.3 to 106.0, remained stable for about six months, and then edged up again to 106.7 in October (1957-59=100).

Feeding on each other

Now, with an expansionary Federal deficit staring it in the face, official Washington fears that a new burst of demand-pull inflation will accelerate the upward movement of prices and wages and thereby create new rounds of cost-push in the future.

Appearing before the House Ways and Means Committee in mid-September, Federal Reserve Chairman Martin said: "We already have clear and compelling evidence of a resurgence in inflationary pressures which, if unchecked, would curtail our domestic expansion, aggravate an already serious balance-of-payments problem, and bring severe strains in markets for credit, particularly the mortgage market."

The incentives and the opportunities to raise prices apparently have increased as markets have become more buoyant and as the costs of both labor and materials have risen. Already the rise in the wholesale-price index has reflected increases for such key materials as copper, steel, lumber, and oil, for such key producer products as metals and machinery, and for such key consumer products as tires, carpets, and TV's.

Thus, the possibility arises that cost-push

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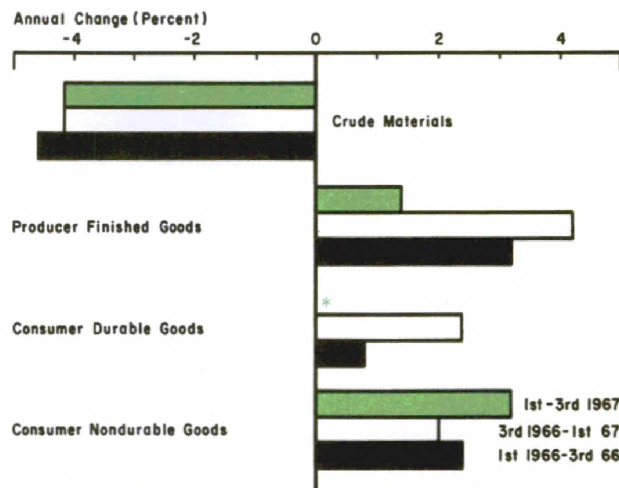
and demand-pull pressures will feed upon each other—that the rise in wage costs that is translated into higher prices will feed back into higher wage demands as price pressures pervade the economy. In Chairman Martin's view: "For a time, the individual firm may feel it is escaping the consequences of acceding to wage increases greater than gains in productivity by passing on the higher costs to its customers. But in time, it too becomes a customer, and finds a higher materials bill added to its higher wage costs. In the end, inflation hits all."

Do something!

The real growth of 3½-4½ percent expected next year would tend to use up the recent margin of slack, and a faster rate of expansion would simply put too much pressure on resources. Thus, in Economic Adviser Gardner Ackley's words: "The economy will be going up too fast unless we do something about it"—that something being the 10-percent tax surcharge. Even with the surcharge, in Mr. Ackley's view, consumer prices may rise by as much as 3 percent next year, but without the surcharge a 6-percent price increase would be easily possible.

Much of this discussion was lost from sight in this fall's Congressional debate over economy in government, which centered around demands for reduced spending on the scale of perhaps a $1-billion cut for every $1-billion increase in taxes. (Emphasizing his concern, Congressman Mills noted that the total tax bill for the Federal Government was about $9 billion when he entered Congress in 1939, but that $15 billion is needed today simply to pay the interest

Wholesale finished-goods prices rise despite weakness in materials prices



on the bill). But in arguing for the (administrative) budget which it submitted to Congress, the Administration pointed out that about $141 billion of the total was essentionally outside its control—defense, veterans, interest payments, and the like—and that the $21 billion in controllable expenditures included a number of fairly essential items ranging from school lunches to FBI payrolls.

On economic grounds, meanwhile, the tax-increase argument drew considerable professional support. In particular, a group of 260 leading economists expressed its concern that "Rapidly rising Federal expenditures will be injected into an economy where total expenditures are moving steadily upwards and where the interplay threatens renewed inflation." The surcharge consequently would be needed to restrain the economy in order to maintain orderly growth, to prevent the resurgence of inflation, and to forestall excesive reliance on tight money.

William Burke

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Money—and Taxes

MONETARY policy and fiscal policy continued to stimulate the national economy in the summer and early fall months, even as they did in the earlier part of the year. The net free-reserve position of the member banking system averaged $280 million in the third quarter, about the same as the second-quarter average.

The Federal budget meanwhile registered a deficit (on a national-income basis) of roughly $14 billion—almost as large as the preceding quarter's deficit. Thus, public policy fostered a most hospitable climate for the $14-billion increase in the output of final goods and services that took place in the third quarter. Monetary policy and Treasury debt-management policy also contributed to a large increase in bank credit during this period.

More credit . . .

Bank loans and investments grew at an average annual rate of 17.7 percent in the third quarter, well ahead of the 6.1-percent growth rate in the second quarter and comfortably ahead of the 13.7-percent rate in the first three months of the year. However, there were some distinctive changes in the composition of bank credit.

Total loans rose at an annual rate of 12.2 percent during the quarter despite a sharp slowdown in the pace of business lending. This slack in business loans was more than offset by increases in real estate, consumer, and security loans. Commercial banks also added substantially to their investment portfolios—particularly U.S. Treasury securities — during the quarter. In both July and August, banks acquired $3 billion of Treasury obligations, and in September, they recorded small net sales of Governments. And the banking system continued to be a net buyer of state-local government securities, although the amounts acquired were less than in the earlier quarters of the year. The money supply meanwhile grew at a 7.0-percent annual rate, with the expansion largely concentrated in the early part of the quarter.

. . . higher interest rates

Interest rates moved up in all maturity ranges during the third quarter, with the largest increases occurring in the short end of the market. Treasury-bill yields in 91-day and 182-day maturities rose by 89 and 116 basis points, respectively. This jump reflected the Treasury's third-quarter financing operations, wherein it tendered nearly $11 billion of new bills, either as April or June tax-anticipation bills or as additions to the regular weekly and monthly bill cycles. Commercial paper and bankers' acceptances, which did not undergo such sharp increases in the outstanding supply, recorded much smaller increases in yields, rising by about ⅜ of 1 percent during the quarter.

Long-term interest rates, which had risen by about 30 basis points in the preceding quarter, showed further advances in the third quarter. Then, as top-quality corporate bonds and long-term U.S. Government bonds came under increasing pressure in the first half of October, yields reached their highest levels in a generation. At 5.76 percent, the average yield on corporate bonds was about ¾ of 1 percent above the February low and ¼ of 1 percent above the high point reached in the 1966 tight-money "crunch." The average yield on long-term Treasury bonds reached 5.10 percent in mid-October, and this too was about ¼ of 1 percent above the 1966 peak. The yield on outstanding state-local government bonds reached a peak for the year in mid-July, at 3.87 percent, and remained in a range of 5-10 basis points

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below this peak through the middle of October. The yield on tax-exempts, unlike that on corporate and Treasury bonds, has not yet reached the 1966 high.

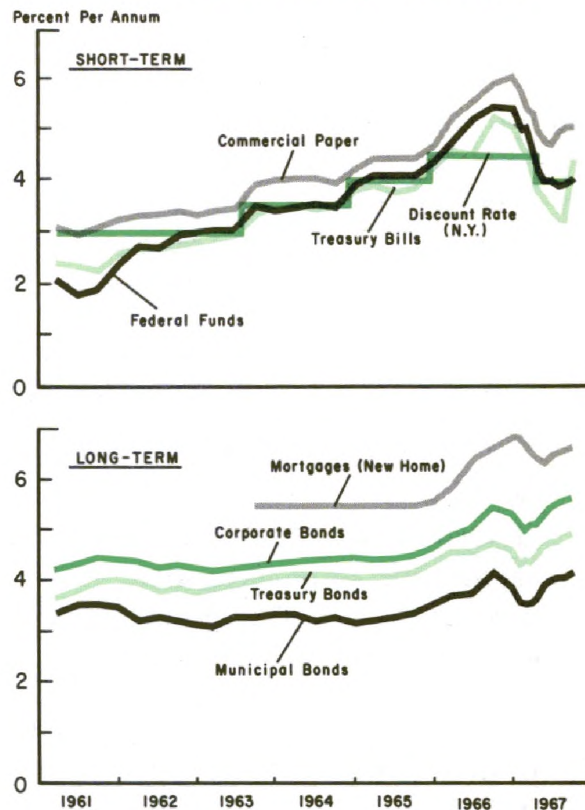
. . . and capital-market upsurge

The third-quarter upsurge in interest rates was directly related to the heavy volume of debt offerings during this period. New capital offerings by corporations exceeded $6.5 billion, bringing the January-September total to almost $18 billion, or substantially more than the total for the entire preceding year. But the tempo of new corporate flotations slowed considerably in September and October from the average $2.4-2.6 billion pace of June through August, thus offering some hope for an easing of the corporate demand for long-term funds.

While corporate demands on the capital market were building to a peak, the volume of tax-exempt offerings was gradually declining, so that the nearly $3 billion of new offerings represented a one-fifth decline from the second-quarter pace. This early summer lull, if it could be called that, helped to stabilize the yields on municipals at a level somewhat below the 1966 peak.

The Treasury, which had actually repaid debt in the second quarter, dominated the credit markets in the following months. Much of what it needed was raised through the tender of $8.5 billion of tax-anticipation bills maturing in March, April, and June 1968, and another $2.5-billion was raised through the sale of a 3½-year note which matures in February 1971. The two tenders of TAB's and the note all bore the TT&L privilege under which payment may be credited wholly or in part to the Treasury's Tax and Loan Accounts (deposits held with commercial banks); the banking system thus acted as underwriter for these Treasury debt issues. Also, in late October, the Treasury offered $12.2 billion of new 15-month and seven-year notes for the purpose of paying off $10.2 billion of maturing securities and borrowing new cash. The offer consists of $10.7 billion of 5⅝-percent notes to mature in February 1969, and $1.5 billion of 5¾-percent notes to mature in November 1974.

Interest rates move up everywhere, in some cases exceeding '66 levels



The impact of Treasury borrowing operations has been felt mostly in the shorter end of the market—from about six months out to about three years, since this is where most of the new debt was placed. But the entire structure of yields on Treasury securities has risen, with longer-term bonds reacting to rising yields in the corporate-bond market rather than to the increased supply of outstanding Treasury issues.

Rates—and taxes

The uncertainty surrounding the future of the proposed tax increase clouds the money and capital markets as well. If the Treasury is unable to reduce the deficit

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through increased tax revenues, it will, of course, have to borrow more money. The result may be higher interest costs not only for the Treasury itself but for other borrowers too.

In his statement supporting the Administration's tax proposal, Federal Reserve Chairman Martin said: "Financial markets cannot be insulated from the laws of supply and demand; market participants realize that a Federal deficit of record proportions on top of the loan demands generated by a booming private economy would add up to overall demands for credit far beyond the savings capacity of the economy. The resultant pressures in financial markets would necessarily be reflected in rising costs of credit, even with continued generous provision of reserves to the banking system."

Herbert Runyon

Another Budget

"The Budget," a new all-purpose model, was unveiled by a Presidential budget-reform commission last month as a suggested replacement for the several alternative measures now used by political and financial analysts. The Commission's basic recommendation was that "a unified summary budget statement be used to replace the present three or more competing concepts that are both confusing to the public and the Congress and deficient in certain essential characteristics."

"The Budget," by its comprehensiveness and consistency, thus is designed to remedy the "deficiencies" of the several alternative measures. It would include the activities of the Federal trust funds, which the administrative budget excludes. It would utilize the accrual method of accounting favored by major corporations, rather than the cash basis used by government accountants for the consolidated cash budget. And it would utilize this accrual method for all transactions, and in addition would include Federal lending operations, differing in both respects from the national-income-accounts budget.

The Commission, in an attempt to gain greater clarity, also proposes to change the format of the budget summary. In the new document, the Government would show on one page the appropriations requested from Congress, its planned spending and tax collections, and then a sub-total surplus or deficit. This should serve the same purpose as the NIA surplus or deficit in showing the Federal Government's impact on the economy.

The same sheet would then show Federal lending, loan repayments, and the resultant net lending. Next would be "total budget" receipts along with combined spending and net lending. This would produce the total deficit (or surplus), followed by a brief breakdown of how it is to be financed. The summary would show all necessary borrowing from the public, whether by the Treasury or other agencies, along with any reduction of the Treasury's cash balance.

As a result of all these changes, the new measure would have shown larger deficits in each of the last several years than any of the alternative measures. In fiscal 1968, it would show a $10.3-billion deficit, as against deficits of $4.3, $8.1, and $2.1 billion, respectively, on the cash, administrative, and NIA bases.

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Westward Expansion

WESTERN business activity speeded up in the summer and early fall months, despite strikes in copper, autos, and several other industries. Payroll employment, which had moved sideways during the first half of the year, increased about 0.5 percent in the third quarter—equalling the gain elsewhere—and the regional jobless rate meanwhile slid from 5.0 percent in the second quarter to a September level of 4.8 percent.

Mine employment was affected severely by the strike of 20,000 copper miners in Utah, Arizona, and other District states. Manufacturing employment was hurt also by the auto strike and by weather-delayed harvests. (California canning and preserving plants recorded a far-below-seasonal gain in August, but then turned around and posted a gain rather than the usual decline in September.) All other industries, however, recorded significant employment gains during this period.

The major manufacturing industry, aerospace, showed continued strength with a 2-percent quarterly gain in employment to 723,000. Budget reductions for the space program curtailed some projects, but the rising backlog of orders for commercial aircraft and the expansion of military orders imparted a strong tone to industry activity. Much of this strength resulted from the first-half '67 increase in the dollar volume (and the District's share) of defense contract awards.

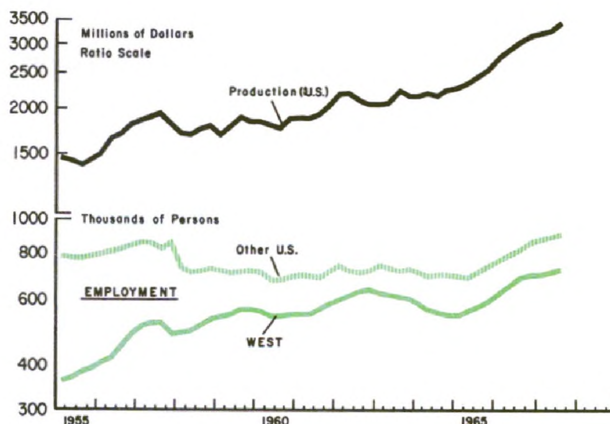
Construction and its suppliers

Housing construction also stimulated general business activity as it surged ahead on the comeback trail. In fact, the housing pace quickened even more in the West than elsewhere, as the regional industry benefited from the increased availability of mortgage credit and the sharp reduction in the inventory of vacant units. Housing starts in the West rose by about one-third over the quarter, to a 273,000-unit annual rate, and residential awards were half again as large as they were during the severe slump of late 1966.

But while housing moved upwards, other segments of the construction industry tailed off. Nonresidential and heavy engineering contracts both declined 9 percent during the quarter, reflecting a reduction in outlays for commercial buildings, hospitals, schools, and other public works. The dollar volume of construction activity still remained substantially above the levels reached prior to the 1966 peak, but the margin was smaller in real terms because of the sharp increases recently in labor and other costs.

The lumber supply situation tightened sharply in late summer, not only because of the improvement in the housing market but also because of shortages created by serious fire damage in the Northwest woods. Lumber and plywood prices rose as much as $15 per thousand board (or square) feet between early July and early September, but most of these increases disappeared dur-

Defense production jumps sharply, but jobs rise more slowly than in '66



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ing the following month as price quotations encountered stiff buyers' resistance.

Western steel producers escaped most of the impact of the nationwide auto and steel-haulers' strikes, but their output still lagged about 5 percent below year-ago levels because of the nationwide slowdown in industrial and heavy construction. Meanwhile, despite the reduced level of production and the continued import threat from foreign steel, domestic mills in August posted price increases of as much as 3.6 percent on products comprising about one-third of total industry shipments.

Aluminum potlines operated at peak levels during the third quarter, partly in order to supply demands that had previously been met from government stockpiles. Yet, by early fall, industry sources reported concern over the possibility of overproduction and general price weakness.

Other industry trends

Western oilmen produced more and also imported more crude in the aftermath of June's Middle East crisis. Consequently, sufficient supplies were available to support a moderate growth of refinery activity throughout most of the summer months. In fact, refinery activity eventually was curtailed in late September as excess inventories began to accumulate.

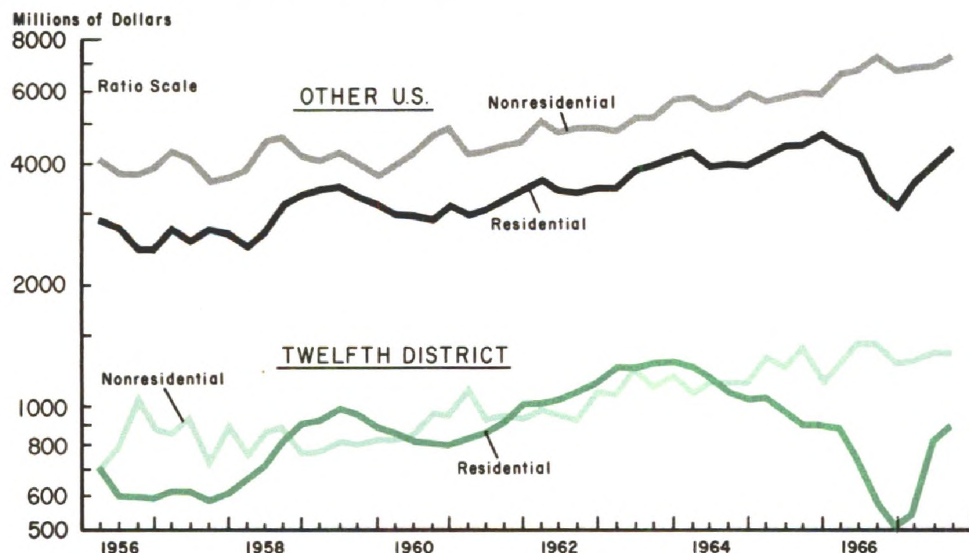
Part of the gap in crude supplies caused by the temporary loss of Mid-East production was filled by increased imports from Sumatra and (especially) Canada. The rest of the gap was filled by increased production from California and the new fields in Alaska and Arizona. Between mid-May and late-September, the production rate in Western oil fields rose from 1.02 million to 1.10 million barrels per day.

By summer's end, however, the most worrisome regional development was the prolonged 3½-month-long strike involving some 25,000 copper mine and smelter workers. The two sides were still far apart at the end of October, with the union holding out for a 98-cents-an-hour rise in basic pay over a three-year period and the industry standing by its original 51-cents package.

As strike losses mounted to about 450,000 tons, copper mine production for the year to date lagged about one-fourth below the comparable 1966 figure. Despite these losses, and despite the dim prospects for an immediate settlement, relatively few shortages developed until the latter part of October. At that point, however, the dealer price for refined copper shot up to 64 cents a pound — almost 20 cents above the pre-strike level.

Early third-quarter returns showed a strengthening of Western farm receipts, but total returns for the year to date—in Dis-

While housing moves upward, other segments of the construction industry level off



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trict states as well as elsewhere — lagged slightly behind the record 1966 pace. The good third-quarter performance was based on increased prices of some products and increased marketings of others. Thus, Arizona vegetable growers reported higher prices, Northwest wheat farmers reported larger marketings, and most livestock producers registered heavier sales despite declining prices of beef and poultry.

The cold, wet weather of last spring created harvest labor problems this fall, as the concentration of *plantings* during the brief periods of good spring weather led to a concentration of *harvests* within a relatively short timespan. In this situation, California tomato producers obtained Labor Department authorization to import 8,100 Mexican fieldhands to harvest tomatoes, but domestic farm-worker groups attempted to block this action and the harvest was inevitably delayed. Then, as shortages developed because of consequent crop losses, canners posted a 5-percent price increase on several tomato products.

Consumers and their costs

As business activity continued to surge ahead in most areas of the West, personal income at summer's end was running a respectable 6½ percent above the year-ago figure—roughly in line with the over-all national performance. Retail sales meanwhile increased faster in the West than elsewhere, especially in the durable-goods category. Among other reasons, late-model used car sales were quite strong during the summer period, and new-car sales held up much better in the West than in the rest of the country.

Consumer prices reflected this relatively good sales performance, as most Western cities posted increases greater than the 0.9-percent national increase over the quarter. In some cases, however, rising indexes indicated the pressure of both political tax measures and household buying decisions. California price indexes, for example, went up in tandem with the increases voted by the Legislature this summer in cigarette, liquor, and retail sales taxes.

Because of sharp gains in living costs over the past year, the Labor Department's recent estimates of the cost of a "modest but adequate" family budget were outdated as soon as they were published. But either before or after adjustment, these estimates—which represent the average cost of a moderate living standard for a family of four—show the Western cities clustered at the upper end of the spectrum. Honolulu, where budget expenses top $11,500 in 1967 prices, is the most costly city in the United States. Metropolitan New York and Boston are next (almost $10,400), followed by San Francisco and Hartford—both over $10,200—and Seattle (just short of $10,000). In contrast, Los Angeles' budget of slightly over $9,700 is about tenth on the list, and San Diego ranks about fifteenth, although both cities are somewhat higher than the national urban average of $9,430.

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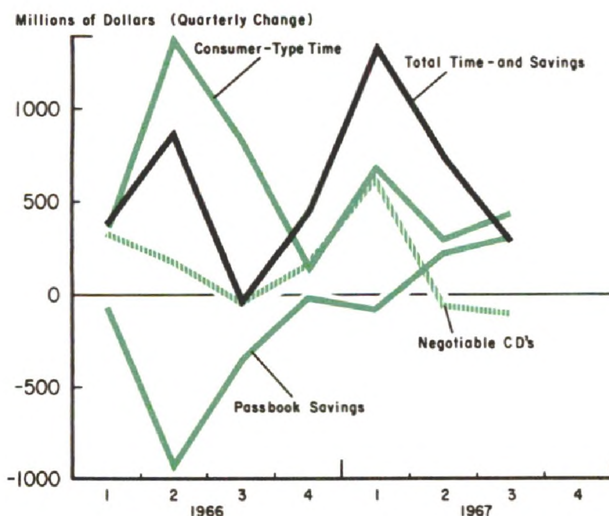
Accelerated Expansion

LARGE banks in the Twelfth District outpaced their counterparts elsewhere by recording a $1.4-billion expansion of credit during the third quarter. Despite this massive increase—which nearly equaled that of the entire first half of the year—Western banks were under less reserve pressure than in the more sedate second quarter. Largely because of a heavy deposit inflow during the June-September period, District banks were able to expand credit and at the same time reduce their reliance on borrowed funds.

Borrowing by District banks at the Federal Reserve discount window declined to $8.3 million in the third-quarter from the $16.0-million second-quarter figure, and their net free reserves (excess reserves less borrowings) rose to $19.5 million from $12.4 million. Major District banks meanwhile reduced their net purchases of Federal funds from other banks to $328 million ($63 million below the second-quarter average), and increased their Fed-funds sales (loans) to securities dealers to $399 million. These banks thus became overall net sellers of Fed funds—a reversal of their position in the first half of the year, when their net purchases on inter-bank transactions exceeded their sales of funds to dealers. (All data are on a daily average basis.)

Large inflows from household sector offset drop in business, public deposits



Deposit gain

At the end of September, total deposits of large District banks were up $1.1 billion from the mid-year level. In both demand and time-and-savings categories, their deposit performance was substantially better than in the comparable period of 1966.

Individual savings flows into these banks were quite large, both in the form of passbook savings and consumer-type time certificates. However, a seasonal reduction of $408 million in public time deposits and a run-off of $118 million in large negotiable CD's—mainly over the September tax date—limited the quarterly increase in total time-and-savings deposits to $285 million, a smaller gain than those recorded in the first two quarters of 1967.

On the asset side, large Western banks added $607 million in securities in the third quarter, further strengthening their liquidity positions. The gains were all in U.S. Treasury issues and Federal Agency participation certificates—mostly Treasury bills and short- and intermediate-term notes and bonds. These banks meanwhile reduced their municipal-bond holdings by $47 million, in sharp contrast to their record $1.6-billion expansion during the first half of the year. Tax exempts, however, still accounted for over one half of their total securities portfolios.

Loans: record September

Loans accounted for over one half—$813 million—of the third-quarter credit expansion. But the quarterly figures overstate the

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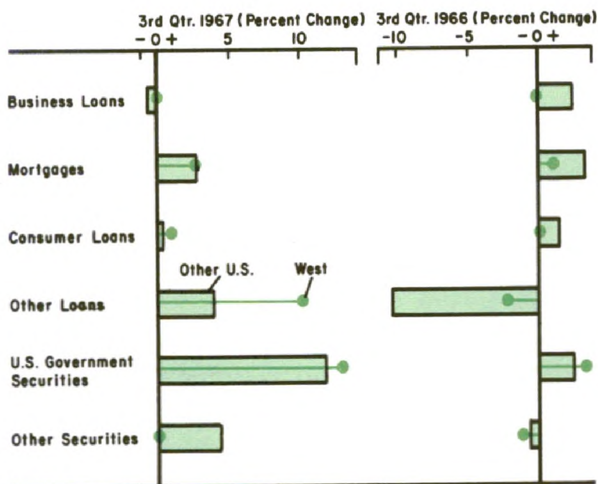
Jump in treasury-security holdings features third-quarter credit surge



strength of basic loan demand, since $484 million of the increase showed up in short-term credits to brokers, dealers and others for financing securities. The figures also obscure the slow pace of loan demand in July and August and the greater-than-seasonal demand in September. For that month, and for the quarter as a whole, loan expansion was relatively stronger at Western banks than it was elsewhere.

Over the quarter, large Western banks suffered a slight ($30 million) decline in their business-loan portfolios. The decline was almost reversed in September, however, when these banks extended a record $332 million of business credit over the September tax date, with almost all borrower categories sharing in that increase. (In September 1966, by way of contrast, banks were under considerable reserve restraint and increased their business credit by only $39 million.) In financing their longer-term credit needs, business borrowers relied more heavily on term loans and revolving-credit loans during this quarter than they did earlier in the year.

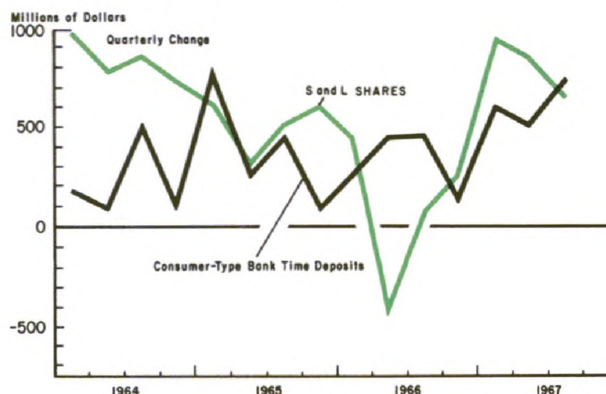
The average interest rate charged by District metropolitan banks varied only slightly over the quarter. Their average rate on all short-term business loans (loans maturing in one year or less) declined 5 basis points, from 6.00 to 5.95 percent, between the first half of May and the first half of August. The average rate on regular short-term loans remained at 6.05 percent, but the rate on loans extended under formal revolving-credit agreements averaged 5.88 percent—7 basis points lower than in May. The average rate on ordinary term loans, on the other hand, rose 5 basis points to 6.24 percent.

Consumer, mortgage gains

Consumer credit demand quickened in the third quarter—in contrast to the situation in the sluggish January-June period, when repayments actually offset new credit extensions. The $54-million third-quarter increase, which was relatively larger than the gain elsewhere, was stimulated by the inauguration of a major credit program by a group of large California banks.

Nonetheless, the major strength in bank loan demand came from the mortgage sector as the Western housing pace gained further momentum. While the turn-around actually came in the second quarter, the June-September increase ($272 million) was several times greater than the March-June gain—and it accounted for about one-third of the total increase in mortgage holdings reported by large banks nationally.

Heavy inflows of savings contrast sharply with 1966 experience



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The substantial inflow of individual savings served as a stimulus to renewed bank interest in mortgage lending. With a $297-million quarterly gain in passbook savings plus a $431-million increase in consumer-type certificates, the savings inflow was one-third above the second-quarter figure and nearly two-thirds greater than the depressed level of a year ago.

S&L expansion

District savings-and-loan associations posted a $636-million net gain in savings accounts over the quarter—a smaller gain than in the preceding quarter, in part because of some withdrawals induced by a July 1 rollback in maximum rates payable by S&L's in several District states. Despite this reduced inflow of funds, S&L's were able both to expand sharply their lending activity, by adding $514 million to mortgage portfolios, and to improve their liquidity, by repaying $160 million of borrowings from the Federal Home Loan Bank. Since the beginning of the year, S&L's have repaid about 40 percent of the borrowings outstanding at the time of last summer's "crunch" of savings withdrawals.

The acceleration in mortgage activity was accompanied by a continued firming of mortgage yields. Over the quarter, discounts on government-insured mortgages again increased, partly in response to a reduction in FNMA's secondary-market purchase price; yields on FHA 30-year 6-percent mortgages thus rose by 40 basis points, to 6.63 percent, while the conventional mortgage rate for new homes rose by 25 basis points, to 6.95 percent. (In the nation, the conventional mortgage rate reached 6.55 percent by the end of the quarter.) In all cases, yields lagged only slightly below those which prevailed during last year's "crunch."

Ruth Wilson and Verle Johnston

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		
		Net Change				Net Change	
		Third Quarter 1967		Third Quarter 1966		Third Quarter	
	Outstanding 9/27/67	Dollars	Percent	Percent	Outstanding 9/27/67	1967 Percent	1966 Percent
ASSETS							
Loans adjusted and investments[1]	$43,126	+1420	+ 3.40	— .10	$154,598	+ 2.98	— .36
Loans adjusted[1]	30,167	+ 813	+ 2.77	— .39	107,842	+ 1.08	— .78
Commercial and industrial	10,955	— 30	— .27	— .70	52,434	— .66	+ 2.57
Real estate	9,382	+ 272	+ 2.99	+ 1.22	18,955	+ 2.81	+ 3.37
Agricultural	1,234	+ 24	+ 1.98	— 1.26	655	— 2.38	+ 2.15
To non-bank financial institutions	1,611	+ 37	+ 2.35	— 5.86	8,573	— 1.40	—10.02
For purchasing and carrying securities	1,019	+ 489	+92.26	— 7.58	6,189	+ 1.77	—17.20
To foreign banks	243	— 15	— 5.81	+ 8.40	1,099	+ 1.76	— .56
Consumer instalment	4,412	+ 54	+ 1.24	— .25	11,743	+ .34	+ 1.47
To foreign governments, etc.	115	— 5	— 4.17	—18.57	1,011	+ 6.42	— 2.30
All other	1,700	+ 3	+ .18	+ 2.05	9,638	+ 3.57	— 6.74
Total securities	12,959	+ 607	+ 4.91	+ .72	46,756	+ 7.66	+ .73
U. S. Government securities	5,345	+ 621	+13.15	+ 3.80	21,697	+11.83	+ 2.65
Obligations of states and political subdivisions	6,471	— 47	— .72	+ 1.21	22,256	+ 4.92	+ .77
Other securities	1,143	+ 33	+ 2.97	—16.60	18,850	— .46	—11.57
LIABILITIES							
Demand deposits adjusted	14,620	+ 581	+ 4.14	+ 1.83	59,775	+ 1.08	— .84
Total time deposits	27,017	+ 285	+ 1.07	— .22	74,641	+ 3.50	+ .38
Savings	15,536	+ 297	+ 1.95	— 2.34	32,813	+ .96	— 2.46
Other time, I.P.C.	7,836	+ 345	+ 4.61	+14.82	29,337	+ 6.19	+ 3.49
States and political subdivisions	2,533	— 408	—13.87	—17.78	7,009	+ 4.24	+10.31
(Neg. CD's $100,000 and over)	2,830	— 118	— 4.00	— 1.97	17,164	+ 6.01	— 7.87

[1]Exclusive of loans to domestic commercial banks and after deduction of valuations reserves; individual loan items are shown gross.
NOTE: Quarterly changes are computed from June 28, 1967 — September 27, 1967 and from June 29, 1966 — September 28, 1966.

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