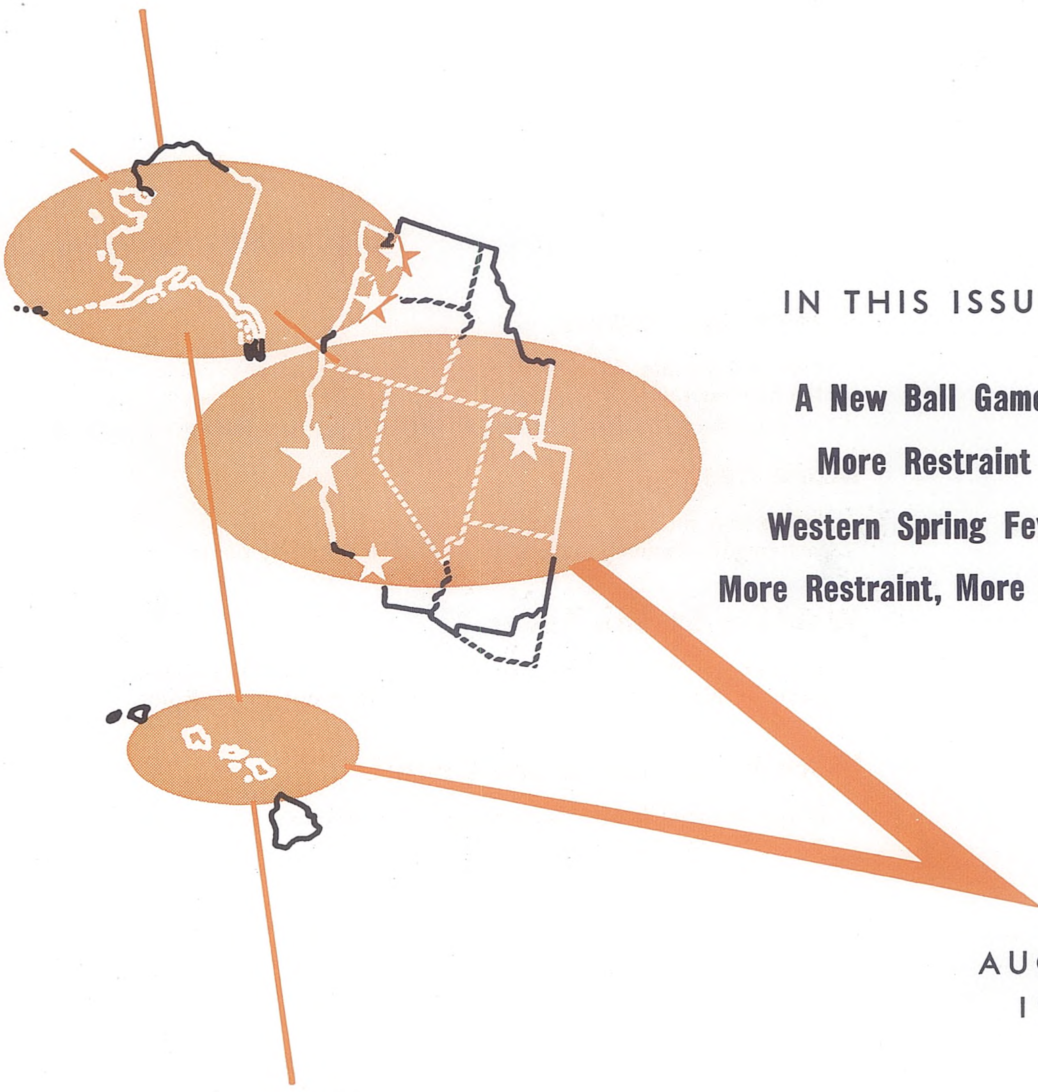
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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Editor: William Burke

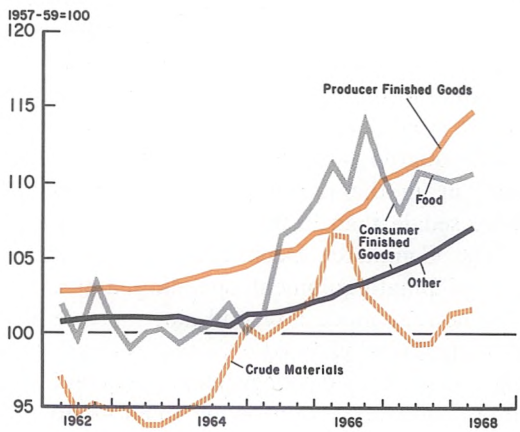
A New Ball Game

An exciting new season opened for football players and political candidates this August, with results which are still unpredictable. Perhaps just as important, an entirely new ball game opened for the nation's business community, as Congress with its fiscal package belatedly administered a bone-jarring tackle to the breakaway inflationary threat which has dominated the business scene throughout most of the past year.

Some foreshadowing of this new contest showed up in the mid-year statistics. The second quarter (like the past year as a whole) posted a price increase in the 4-percent range along with a 5-percent annual rate of increase in real output. Yet, at the same time, the mix of expenditures was different from that of the recent past, since roughly one-third of the $20-billion gain in GNP (to an $851-billion annual rate) showed up in expanded business inventories, while the continued upsurge in consumer final purchases was somewhat more moderate than in the first quarter.

At midyear, prices at retail and at wholesale still moved ominously upward, although scattered signs of easiness—for example, in copper, grain, and steel scrap—showed up alongside the price increases posted for such commodities as petroleum, tires, and livestock. Among industrial prices, there were major worries about such categories as producer finished goods, where continued price pressures created questions not only about the stability of the domestic price structure but also about the nation's competitive stance in foreign trade. Stable prices of producer finished goods during the early 1960's had encouraged heavy foreign orders which contributed substantially to the large foreign-trade surplus of that period, but the volatility of these prices during the past several years—witness the 5-percent (annual) price upsurge since last summer alone — has changed that situation radically. Finally, the steel industry's recent attempt to raise prices, in the face of declining demand, foreign competition, and official disapprobation, has created new fears about the stability of the industrial price structure.

Upsurge in industrial prices creates domestic, foreign-trade problems



And the question of how the late '68 contest will develop is even more problematical, in view of the new restraints of higher taxes and a slower Federal spending pace. A look at some of the major components of total spending may give some clues about the movement of the economy from the midyear starting point.

Less pressure than before

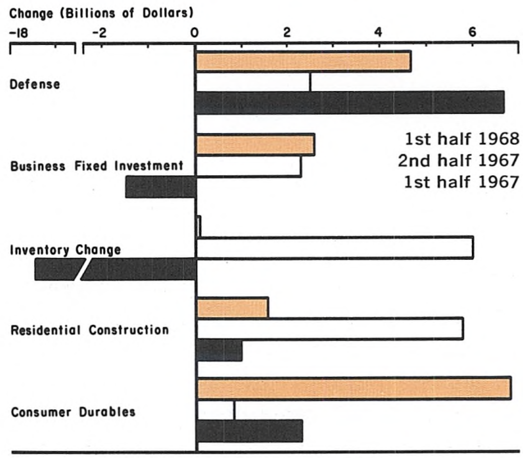
Defense spending, whose 50-percent increase over the past three years has contributed so much to today's inflationary pressures, remains difficult to evaluate. Pentagon expenditures jumped by $2½ billion to a $79-billion annual rate during the second quarter, but future trends will be determined by developments in the Hanoi-Saigon-Paris triangle as well as by Congress' recent attempt to reduce the scale of non-Vietnam defense spending.

The war of course goes on—U.S. battle deaths were greater in the first half of 1968 than in all of the preceding year—and the future toll in dollars as in men cannot easily be projected. Many analysts are appraising the economic consequences of a cessation of hostilities, and although they do not envision a post-Korea style downturn, their indicators suggest less pressure from this particular sector than heretofore.

Much the same can be said for the business fixed-investment sector, which has been another major contributor to the unsustainably rapid pace of recent years. Indeed, spending in this sector dropped $1 billion to an $87½-billion annual rate during the spring quarter, and the pace in the near future, as in the recent past, appears much more sedate than in the 1964-66 period.

The Commerce Department's spring survey of plant-equipment spending indicated a somewhat modest second-half increase in manufacturers' planned expenditures, reflecting the continued sluggishness in manufacturers' utilization of existing plant — down

Mixed spending patterns show up in first half of 1968



from 90 percent in late 1966 to below 85 percent during first half '68 — and the resultant year-long downtrend in appropriations for future capital spending. Other sectors showed much stronger spending plans, with airlines in particular posting a 50-percent gain in capacity over two years ago, but the overall picture suggests a continuation of the relatively small increases of the past year or so.

Inventories now up . . . then down?

Business inventory spending contributed a great deal to the second-quarter rise in GNP, with about a $10-billion rate of gain—as against a $2½-billion first-quarter figure—but much of this build-up came from the deliberate strike-hedge buying of steel users or auto dealers. Even so, the overall inventory sales ratio remained relatively low; at 1.51 in May, it was at the lowest level of the past year and a half.

Mixed trends showed up in the inventories of durable-goods manufacturers, where most major inventory movements usually get started. Machinery and transportation equipment —areas which have been under pressure because of the combination of heavy defense orders and relatively long production lead-times—continued over the quarter to post high ratios of goods-in-process inventories to order backlogs. But computations made at earlier or later stages of the production process—ratios of materials inventories to new orders and of finished-goods inventories to shipments — looked much better than they did during the worrisome period of early 1967.

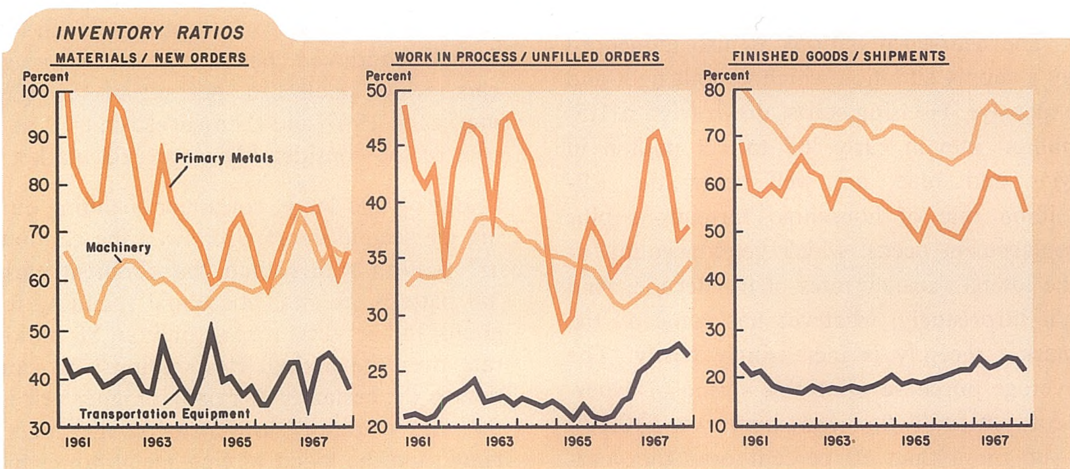
The late '68 inventory picture, nonetheless, will focus mainly on a single item—steel. By the July 31 labor-contract deadline, steel users had some 13 million extra tons of steel on hand, or about 60 days' more supply than their usual operating inventory. This massive stockbuilding, plus the easy availability of foreign steel, which could push imports 50 percent above the already high '67 level of 11½ million tons, indicates the size of the stockpile that must be chewed up over coming months. Thus, steel shipments may decline at least one-third below the January-July average level during the remainder of the year, or considerably more than they did in the aftermath of the three earlier strike-hedge episodes of this decade.

Whither the trade surplus?

For obvious reasons, too, the nation's trade balance has already felt the effects of labor difficulties in this and other major industries. Net exports in the nation's GNP accounts, reflecting the impact of heavy copper and steel inflows, held at only a $2-billion annual rate during the second quarter this year, as against a strong $8-billion rate achieved just three years ago.

Yet apart from the impact of such developments as strikes or strike threats in manufacturing activity, the foreign-trade statistics at midyear continued to show the eroding influence of a generally deteriorating price structure and a high and rising level of business activity. As the national economy continued to operate within an inflationary environment, it attracted more and more imports while exports lagged. All of this, of course, contributed to the balance-of-payments argument for the fiscal-restraint package.

Mixed trends appear in durable goods manufacturing, where most inventory movements usually get started



Whither housing?

The residential-construction sector, which has its own reasons for welcoming Congress' fiscal package, edged up slightly to a $30-billion rate during the second quarter of the year. Some housing experts expect little short-term strength in this sector, because of the delayed impact of the recent credit tightness on this credit-sensitive industry. For confirmation, they point to such indicators as the decline in housing permits from a 1.4-million to a 1.25-million annual rate between February and June, and the growing concentration of the industry on (low-priced) apartments rather than (high-priced) single-family units.

Still, the industry is favorably impressed with the long-run strength of basic demand and the near-term tightness of supply. On the demand side, there is a rising marriage rate, recently running at 10 per 1,000 as against 9 per 1,000 in the 1963-65 period, but at the same time there is a continued lag in the birth rate, now below 18/1,000 after a one-third decline from the early post-war peak. These cross-curents—more marriages and fewer children — buttress the heavy demand for apartment construction, which is now operating at a record pace after a sharp 60-percent upsurge over early '67 levels.

The near-term outlook is also influenced by a supply situation which is both tight and expensive. Housing starts, down from a 1.5-million rate in early '68 to 1.3 million in May and June, are well below the 1.7-million rate of household formations plus replacement needs, which helps account for the lowest vacancy rates of the decade. And not surprisingly, whatever has come on the market recently is increasingly costly. The average purchase price this spring of a new (conventionally financed) home was $30,500 —up more than 10 percent over the year-ago figure—and the average mortgage-interest rate, at 7.25 percent, was up 75 basis points over the year. But this tight, expensive situation should ease as other sectors of the economy take over some of the burden of restraint, and as credit flows are eased by such measures as the recent cut in savings-and-loan associations' liquidity reserves, which should free roughly $600 million in S&L cash for new mortgages.

Consumers and their savings

Consumer spending for autos and parts remained high, at about a $35-billion pace, during the second quarter. Judging from a heavy late-spring sales pace, new-car buyers were not only buying more in total but were also paying more and borrowing more on each new car. (The average note signed by new-car purchasers this spring jumped 4 percent over the year-ago figure, to about $2,900.)

At midyear, Detroit built up its dealers' stocks to a near-record 1.67 million autos, partly in anticipation of delayed '69-model introduction dates—but partly too in anticipation of a continued upsurge in sales. Yet some observers fear that too much borrowing has already been done from next year's sales, as evidenced by the massive (and profit-narrowing) dealer rebates used to clean out this year's models. And all observers tend to fear the continued challenge posed by foreign cars, which took 8½ percent of the U.S. market in 1967 and then carved out 10 percent of the considerably larger '68 market.

But by and large, consumer spending during the second quarter followed the cautious '67 pattern rather than the ebullient early '68 pattern, as total household spending for goods and services rose at only an $8-billion rate over the period. Responding with caution to the certainty of existing higher prices, the near-certainty of forthcoming higher taxes, and the mood of violence at home and abroad, the consumer in many markets simply maintained his existing spending patterns and thereby raised his savings rate from 7.1 percent to 7.7 percent of his increased disposable income.

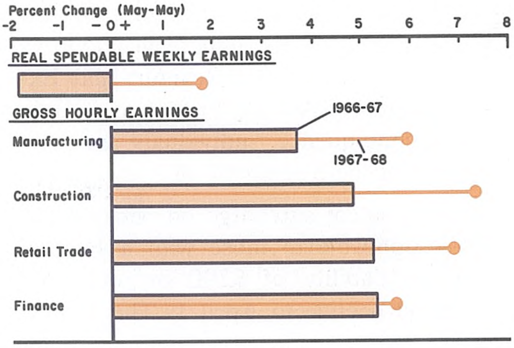
Workers and their earnings

Labor markets continued tight; nonfarm employment reached 67.9 million in June, on the strength of a 2.4-percent (annual) rate of growth over the first half of the year. And the jobless rate remained below 4 percent in June and July, despite the heavy incursion of teenagers into the market and the lack of opportunities for them in such traditional fields as construction and trade.

The uncertainty evident in consumer spending patterns may reflect a belief that the labor market will ease in the wake of the recent fiscal package. This easing could develop, however, not simply because of the targeted reduction in the economy's growth rate, but also because of the continued additions to the nation's stock of efficient new plant and the additions to the labor force resulting from the growing number of teenaged workers, returned servicemen, and training-program graduates.

Consumer budgets nonetheless will be bolstered by the whopping wage increases now being recorded because of 1968 (and earlier) wage negotiations. Over the past year, family heads in manufacturing have received a 2-percent increase in real spendable weekly earnings, thereby offsetting the real-income decline of the preceding 12-month period. The recent increase, which occurred even in the face of rising prices and rising taxes, reflects a sharp acceleration in

Improvement in real earnings reflects acceleration in hourly rates



hourly earnings, which over the year have jumped by 6 percent in manufacturing and finance and by 7 percent or more in trade and construction. Thus, in June, average factory earnings reached a new historical benchmark of $3.00 an hour—the $2.00 figure was reached in 1957 and the first $1.00 was earned in 1944.

The new ball game scheduled for business forecasters this fall will confront them with problems of uncertainty regarding the strength of government, business, and (especially) consumer spending. But they will be playing on a somewhat familiar field, and will not again encounter the difficulty of finding its boundaries, much less the difficulty of finding out what game is being played. Surveying the field recently, the London *Economist* commented: "The economy will go on at a rate of growth reduced by some unknown degree from the recent past. But what is important is that a sense of alarm, even of despair, has been removed."

William Burke

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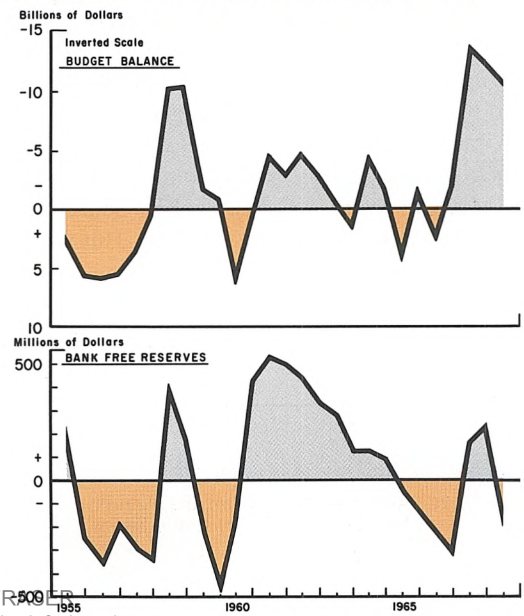
More Restraint

After many months of consideration, the Congress "bit the bullet" in late June and enacted into law the Revenue and Expenditure Control Act of 1968. And on July 15, as a consequence, individuals and corporations felt the first nibble of higher taxes.

The 10-percent surcharge on personal incomes—applicable to those with a Federal income-tax liability of $290 or more per year—is retroactive to April 1. The hike in corporate income taxes is a two-part package, containing both a 10-percent surcharge and an acceleration in the payment schedule from 70 to 80 percent of current liabilities. The corporate surcharge is retroactive to January 1. In both cases, the surcharge is scheduled to expire June 30, 1969. The surcharges and the speedup in corporate income-tax collections hopefully will bring in $10 billion in additional revenue in fiscal 1969.

Tax increase ends conflict between easy fiscal and tight monetary policy



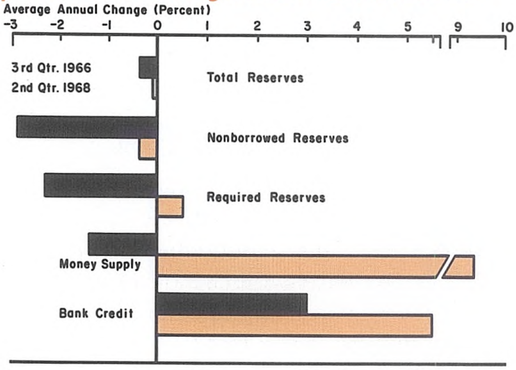
The tax increase is only a part of the $16-billion package of fiscal restraint, since the Revenue and Expenditure Control Act also incorporated three types of reduction in Federal spending. The first and most visible is a $6-billion reduction in actual outlays proposed in the January Budget, to $180.1 billion. Less obvious but not less important is a $10-billion cutback in new obligational authority—the authorization to appropriate and expend funds for fiscal 1969 and succeeding years—back to $191.7 billion. In addition, the President is directed to remove from the budget the sum of $8 billion which had been appropriated by Congress but not yet spent.

The manner in which the reductions in Federal programs are to be allocated was not specified by Congress, but was left to the Administration. However, one portion of the legislation afforded a certain amount of guidance. By placing a permanent limit on Federal civilian employment, this provision would (through attrition) reduce Federal jobs by almost one-quarter of a million persons to the level of June 30, 1966. Yet the fiscal limitations do not apply to the costs of Vietnam, debt interest, veterans and social security benefits—and, eventually, they may not apply to the costs of other activities, including the delivery of mail and the stacking of airplanes.

Still tight—but how tight?

The passage of the fiscal package took some of the pressure off monetary policy, which had carried the brunt of the anti-inflationary struggle recently in a manner sometimes reminiscent of 1966. In the second quarter, the member banking system's net borrowed reserves averaged $369 million and member-bank borrowings from the Reserve Banks averaged $715 million. These

Comparison of two tight-money periods shows significant differences



figures are roughly comparable to those recorded during the third quarter of 1966—the time of the now-famed monetary "crunch"—but there are striking differences as well as similarities in the comparison of the two periods.

In the most recent quarter of monetary restraint, total member-bank reserves declined at an average annual rate of 0.1 percent; non-borrowed reserves (banks' wholly owned reserves) fell 0.4 percent; and required reserves actually rose by 0.5 percent. (Most of the restraint came in the month of April, when the discount rate was raised to 5½ percent.) In each case, this year's figures reflected less tightness than prevailed in 1966. Moreover, the second quarter of 1968 was only the first full quarter of the past year to register net borrowed reserves, while July-September 1966 was the sixth consecutive quarter of increasingly firm restraint. This suggests that the duration of restraint is just as important as the degree of pressure against bank reserves in slowing down (or reversing) a monetary expansion.

Consideration of two traditional measures of the effectiveness of monetary policy—the availability and the cost of money—points up further similarities and differences. Money was fully as available in second-quarter '68 as in third-quarter '66; total bank deposits rose at a 1.0-percent annual rate in both periods. But money was somewhat more costly in this most recent tight-money episode.

Past the peak?

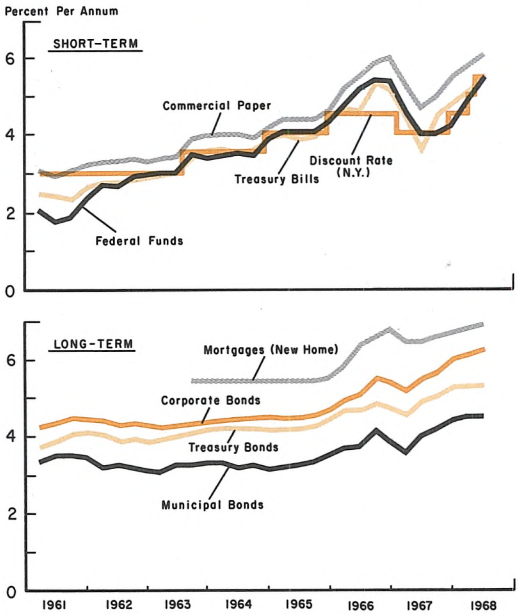
Interest rates (especially short-term rates) moved up sharply in the first five months of 1968, accompanied by two increases in the discount rate. Market yields fluctuated in response to rather wide swings in expectations with regard to the on-again/off-again developments in Vietnam and the on-again/off-again prospects for a tax increase. But yields on most money-and capital-market instruments declined after reaching their peaks in late May and early June.

In every case, the peak yields were above the highs reached in the 1966 squeeze, and some in fact were the highest attained in the past one hundred years. Though credit was equally as available as in the last period of tight money, it was nevertheless more expensive to obtain, in most cases by a margin of a half-percentage point or more.

The passage of the fiscal package had its greatest impact on yields for Treasury securities, since it indicated a substantial reduction in Treasury cash-financing needs in the months ahead. Accordingly, yields on Treasury issues declined throughout the list during June, the reductions ranging from about 60 basis points on 91-day Treasury bills to 27 basis points for long-term bonds. As the bill rate fell, it remained consistently below the discount rate for the first time since mid-1967.

Yields on corporate and municipal bonds were less affected by the tax increase because these securities continued to come into the market in fairly substantial volume. At mid-year the average yield on top-quality outstanding corporate bonds was 6.27 percent, down only two basis points from the peak of late May. The average yield on outstanding tax-exempt issues declined by about 27 basis points to 4.15 percent at the end of June.

Some interest rates reach all-time highs before mid-year turnaround



More loans, fewer securities

Commercial-bank loans and investments increased at a 5½-percent annual rate in the second quarter, down from nearly 7 percent in the preceding three-month period. But this diminished rate of growth in bank credit occurred simply because banks were reducing their security portfolios so as to expand their loans, as they typically do during tight-money periods. Banks increased their holdings of Treasury securities by 0.7 percent, only one-third of the first-quarter acquisition rate, and reduced their positions in other securities at a 0.6-percent rate, as against the first quarter's 13.7-percent increase.

Total commercial-bank loans meanwhile grew at an 8.2-percent rate, up from the first-quarter's 6.4-percent figure. Business loans supplied most of the impetus as they grew at a 12.3-percent annual rate, almost twice as fast as in the preceding period. A part of the increased business borrowing could be traced to the financing of expanded business inventories—but it might also have reflected the high level of rates in the capital market, as corporations borrowed from banks on a temporary basis while waiting for interest rates to decline on long-term debt instruments.

The 9.3-percent growth rate in the money supply—currency plus private demand deposits—was more than double the first-quarter rate, partly as a reflection of the Treasury's heavy borrowing operations during the spring months. (The build-up of private demand deposits was associated with a large decrease in U.S. Government deposits.) But the 2.8-percent growth rate in banks' time-and-savings deposits was less than the first-quarter growth. This reduced inflow of funds reflected the high and attractive level of yields on money-market instruments, relative to the return available from bank time-and-savings deposits.

How much is enough?

The dominant factor in the monetary-fiscal equation this summer is of course the tax increase and expenditure cutback, which promise to reduce the Federal deficit from $25 billion in fiscal 1968 to perhaps $5 billion or less in fiscal 1969. This swing of $20 billion or more in the Treasury budget is the most restrictive fiscal action taken since World War II. Opinions vary on the results of such a restrictive policy, with the more pessimistic observers arguing that a recession could result from a combination of a less-ebullient economy and a fiscal restraint of this magnitude.

Monetary policy, which has borne the bulk of the burden of restraint until recently, may now have to accommodate itself somewhat to the sharp shift in fiscal policy. But the direction and degree of any accommodation will depend upon how the economy responds to a policy of fiscal restraint in coming months.

Herbert Runyon

Discount Study

In late July, the Federal Reserve made public the results of an intensive three-year study of System lending policies. The document, "Reappraisal of the Federal Reserve Discount Mechanism," reaffirms several long-standing principles of Federal Reserve lending, but it also proposes some significant changes in lending policies and procedures aimed at providing more liberal member-bank access to Federal Reserve lending facilities. Thus redesigned, the "discount window" is expected to play a more active part in enabling commercial banks to meet their communities' credit needs more effectively.

Basic Principles Reaffirmed

- Federal Reserve System lending is to accommodate bank asset and liability adjustments over limited time periods and to meet essentially short-term fluctuations in member-bank needs for funds. But individual member banks shall not be continuously and permanently in debt to the Federal Reserve.
- Federal Reserve Banks always stand ready, however, to lend to any of their member banks caught in special regional or local adversities—such as droughts, drastic deposit drains, or other emergencies—for as long as reasonably needed for the bank to work out of these circumstances.
- The Federal Reserve serves as "lender of last resort" to buttress the entire financial system in the event of widespread emergency. Within the limits of existing law, and lending primarily through the conduit of member banks, the Federal Reserve is prepared to supply liquid funds to other groups of financial institutions when such assistance is not available elsewhere and is necessary to avoid major economic disruption.

New Proposals

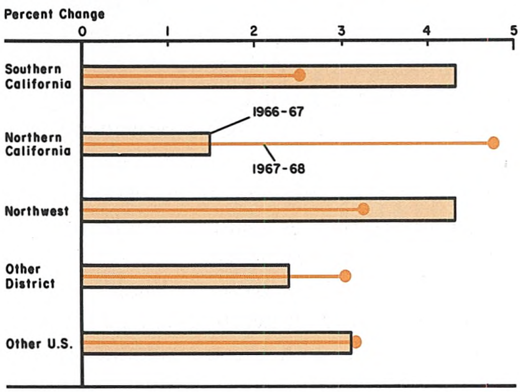
- To provide more clear-cut access to Federal Reserve lending facilities, each soundly operated member bank should be given a "basic borrowing privilege," enabling it to borrow limited amounts of funds from its Reserve Bank upon request in as many as half of its weekly reserve periods.
- Any member bank foreseeing large seasonal bulges in its needs for funds should be able to arrange for loans from its Reserve Bank to help meet all such needs in excess of a specified minimum ("seasonal borrowing privilege").
- Member banks experiencing drains of funds that are not of a seasonal or emergency nature—but that cannot be accommodated under the "basic borrowing privilege"—should not be precluded from short-term borrowings from their Reserve Banks pending a prompt reversal of their fund outflows or an orderly adjustment of their assets and liabilities. The applicable administrative procedures would be roughly the same as those that now apply to member-bank borrowings.
- The discount rate—the interest rate charged by Federal Reserve Banks on their loans to member banks—should be made more flexible than heretofore, through more frequent changes which keep it more closely in line with the movements in other money-market rates.

Western Spring Fever

A touch of spring fever characterized Western business activity during the spring and early summer months. Mixed trends appeared in the second-quarter statistics, as the aerospace and heavy construction industries lagged somewhat, offsetting the strength in homebuilding, farming and other industries.

Nonfarm employment in the West remained unchanged during the spring quarter, partly as a result of strikes in manufacturing and construction and a slow recovery in mining employment. Nationally, nonfarm jobs increased at a 2-percent annual rate over this period. Measuring the job increase over a longer (12-month) timespan, Northern California, the Pacific Northwest, and the Mountain states all at least matched the 3.2-percent gain recorded elsewhere, while Southern California advanced at a slower pace.

Southland expands at slower rate than other regions over past year



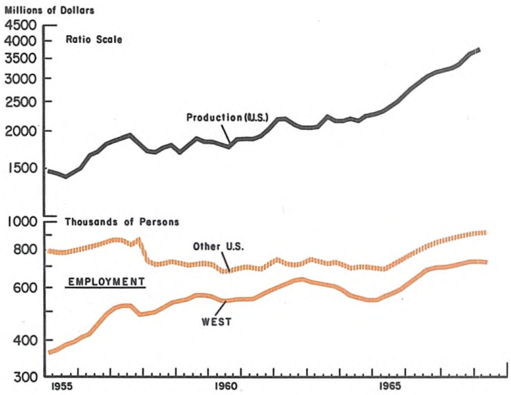
Unemployment rose slightly this spring in the Coast States while holding level in the nation. The jobless rate rose from 4.4 to 4.6 percent of the West Coast labor force and the national rate was unchanged at 3.6 percent, although it too began to move upward by midyear.

This spring consumers in most Western cities experienced a slight easing of the upward trend in retail prices, although the national index rose at a 4.8-percent annual rate over this period. (San Francisco moved with the national trend.) But despite the recent improvement at the regional level, by midyear retail prices were sharply above their mid-1967 levels. Upward pressures were most evident in higher costs for food, women's apparel, and health and recreation. (Also, in June, home-owners' costs reflected rising mortgage interest rates.) The loss of purchasing power amounted to about 4 percent in the nation as a whole, a bit less in the Pacific Northwest and Los Angeles, but more in California's other major urban centers.

Aerospace sags, housing rises

District aerospace employment declined by 14,000 during the second quarter, with reductions in payrolls centered in California. This weakness reflected a decline in military and space-agency contracts, as well as increased efficiency in the production of commercial aircraft. One major questionmark in the industry's outlook was settled in late July, however, when several major aerospace firms signed new three-year labor contracts,

Growth of defense jobs lags behind growth of defense production



which in each case provided for a 6-percent wage increase in the first year and 3-percent boosts in each of the next two years.

In the construction sector, the West outpaced the rest of the nation in both housing starts and the dollar volume of residential awards during the second quarter. Western housing starts rose 6 percent over the quarter to a 290,000-unit annual average—a sharp contrast to the 9-percent decline in the rest of the nation.

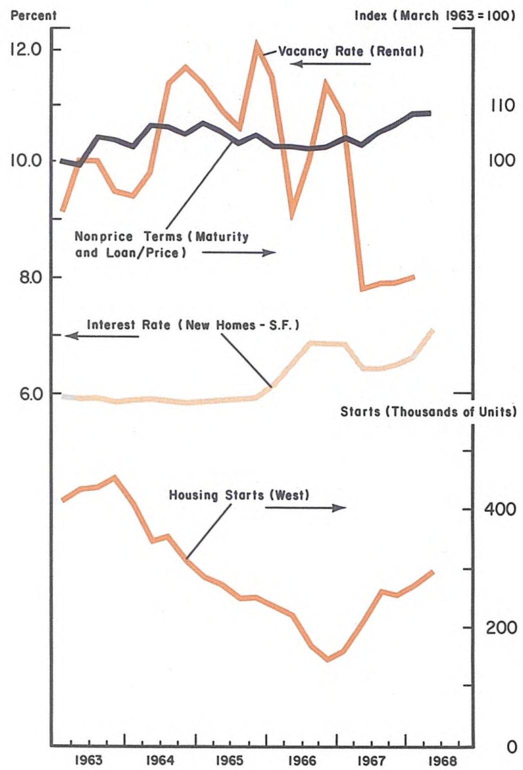
Starts for the first half of the year increased 50 percent above the year-ago level —well over double the gain elsewhere. This sharp gain in District housing activity occurred on the strength of a continued decline in vacancy rates and continued stability in non-price terms of mortgage lending, and in spite of a continued firming in mortgage interest rates.

In other construction activity the District showed a mixed performance. Awards for the construction of non-residential buildings rose by about 28 percent, far surpassing the gain outside the District. On the other hand awards for heavy construction projects dropped sharply from their first-quarter level, and, in contrast to the rest of the nation, trailed their year-ago volume by about 15 percent. This sharp decline in awards, along with some labor stoppages, helped account for the lag in construction employment during the second quarter.

Raw material highlights

The Western lumber industry raised its production sharply during the second quarter. But a June upsurge in orders—reflecting customer hedge-buying against the possibility of a strike at British Columbia mills, upcoming vacation shutdowns at many domestic mills, and heavy defense and construction requirements—sent prices for many items soaring to unprecedented highs. Prices for green Douglas fir reached a range of $99 to $101 per thousand board feet, a gain of $31 from year-ago levels.

Housing improves as vacancies drop —despite rise in mortgage rates



Petroleum refining activity rebounded from a first-quarter seasonal decline. Crude petroleum production also increased; Alaska's daily production at mid-year was 128,000 barrels higher than a year earlier, and California's output rose by 50,000 b/d over the same period of time. And Alaskan oil hit the headlines in July, with the announcement of a major oil find—reportedly one of the world's half-dozen richest fields—on the desolate Arctic slope.

The Western steel industry, responding to steel users' strike-hedge demands for inventories, poured a record quantity of the metal during the spring quarter. The industry's total output for the first half of the year exceeded the comparable 1967 figure by almost 10 percent. However, the industry noted with concern the prospect of late '68 customer inventory liquidation as well as a rising tide of imports. Foreign steelmakers increased their shipments to the Western market by almost 50 percent during early 1968, on the basis of price quotations which in some cases were one-fifth below U.S. mill prices.

In aluminum, an industry-wide strike was averted when most Pacific Northwest producers reached an agreement with the United Steelworkers just before the June 1 contract deadline. The pact calls for a 6.5-percent annual increase in wage and fringe benefits, totalling 97 cents an hour, over a three-year period. But failure to reach a contract settlement with other aluminum-worker unions sent 750 workers out on strike at the reduction facility at Wenatchee, Washington, and another 16,000 at plants outside the District.

Western copper producers by midyear had restored their operations to normal following a prolonged 9-month strike. In June, mine production reached a level only fractionally below the June '67 pre-strike mark, but deliveries of refined copper to fabricators remained 20 percent below a year ago. In early June, brass-and-wire mills reduced prices by 12 cents per pound to reflect the increased availability of raw metal and the post-strike slump in copper prices on outside markets.

For the first four months of the year, District farm returns were 4 percent above the comparable '67 figures, and prospects for the full year looked increasingly good. Crop production is expected to increase somewhat as a result of more favorable growing conditions, including better weather. Cotton acreage is up, and the crop should be considerably larger than last year. The sugar-beet crop may increase by 29 percent, and the rice crop by 38 percent. Declines, however, are foreseen in wheat and hay production. Meanwhile, California tomatoes, deciduous fruits and processing vegetables are all expected to show an increase in output this year.

At midyear, then, the regional economy faced the same basic uncertainties which confront the national economy, in the areas of defense (and space) spending, homebuilding, steel buying (and steel imports), crop prospects, and the like. Similarly, the West's near-term prospects may depend to a striking degree on the consumer's buying decisions in an environment of rising prices, rising taxes, and continued political uncertainty.

Regional Staff

More Restraint, More Credit

Banks in the West, as elsewhere, were subject to increased monetary pressure in the second quarter of 1968. Nevertheless, credit at large weekly-reporting District banks expanded about one-third faster during this period than at other large banks—and twice as fast as in the comparable 1967 period. To meet loan demands, District banks increased their borrowings and made a small reduction in their security holdings, mostly through sales of Treasury bills. Added funds also were supplied by a net inflow of deposits. The second-quarter expansion followed a better-than-national performance in the first quarter—so, for the first half as a whole, Western banks easily outpaced other large banks in the growth of total credit, loans, and deposits. (Data are not seasonally adjusted.)

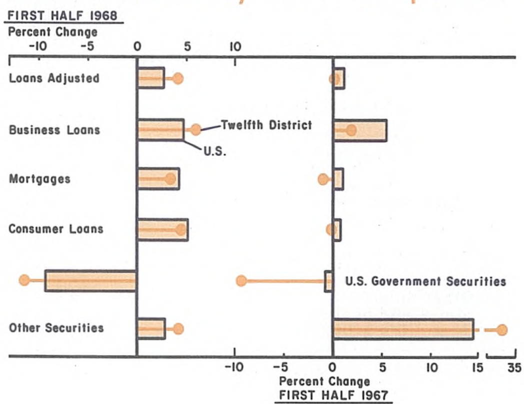
The District loan expansion was made at some cost to bank liquidity. The ratio of loans to total deposits tightened by midyear, rising 2 percentage points to 71.7 percent, the highest figure since January 1967. The ratio of short-term U.S. Government securities to deposits meanwhile declined to 2.8 percent from the December '67 level of 3.0 percent, and there was no offsetting increase in holdings of short-term municipal warrants and bills. In addition, bank borrowings financed an ever-larger proportion of loan and investment portfolios. Thus, large Western banks at midyear felt the pinch of monetary restraint as they confronted both an anticipated increase in corporate credit demand to cover surtax payments and continued strength in credit demand from other sectors of the economy.

More borrowing

Required reserves of District member banks were $45 million higher during the second quarter than in the first three months of the year, due to increases in both time and demand deposits. The volume of borrowing at the Federal Reserve Bank's discount window rose to $100 million, and net borrowed reserves (excess reserves less borrowings) were $67 million—three times greater than in the preceding quarter.

Large banks in the District shifted from a net purchase to a net sales position on their interbank Federal funds transactions, but their Fed-funds sales to Government securities dealers meanwhile fell to less than one-third of the first-quarter average. On *total* transactions, therefore, these shifts resulted in a 50-percent reduction in net Fed-funds sales (that is, loans of unused reserves). Increased reserve pressure also showed up in very heavy borrowings under corporate re-

Faster loan pace, greater decline in securities shown by '67-'68 comparison

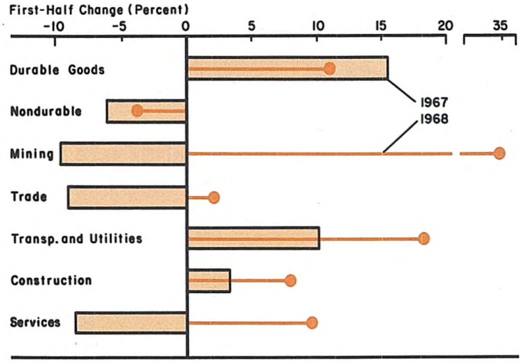


purchase agreements—at twice the first-quarter volume. Altogether, then, total borrowings by major District banks in the April-June period were significantly greater than in the earlier months of the year. (All data on reserves and Fed-funds are on a daily-average basis.)

More business, consumer loans

The second-quarter loan expansion was general throughout Twelfth District states. Business demand for credit was the strongest element in the expansion, as it had been earlier in the year, yet the pattern of commercial-industrial borrowing differed between the two quarters. Durable-goods manufacturers (except for primary metals) made net repayments, following a large volume of borrowing in the preceding quarter; non-durable-goods firms meanwhile reduced their borrowings in both periods. On the other hand, public utilities sharply increased their bank loans, and higher borrowings were also posted by wholesale and retail trade, mining, and service industries.

Most major business categories borrow more heavily in first-half '68



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	
		Second Quarter 1968		Second Quarter 1967		Second Quarter 1968	Second Quarter 1967
	Outstanding 6/26/68	Dollars	Percent	Percent	Outstanding 6/26/68	Percent	Percent
ASSETS							
Loans adjusted and investments[1]	$44,759	+1,313	+ 3.02	+ 1.48	$163,151	+ 1.97	+ 1.45
Loans adjusted[1]	32,214	+1,392	+ 4.52	+ 1.33	115,516	+ 4.33	+ 2.52
Commercial and industrial	12,285	+ 535	+ 4.55	+ 2.54	56,895	+ 3.89	+ 2.99
Real estate	9,924	+ 235	+ 2.43	+ .53	20,275	+ 3.58	+ 2.03
Agricultural	1,335	+ 114	+ 9.34	+ 3.68	671	− 4.01	+ 2.13
To non-bank financial institutions	1,553	+ 188	+13.78	+12.11	8,944	+11.33	+ 5.93
For purchasing and carrying securities	656	+ 68	+11.56	−33.50	6,434	+ 3.98	− 5.56
To foreign banks	229	+ 5	+ 2.23	− 2.64	1,179	+ 1.46	− 4.42
Consumer instalment	4,730	+ 179	+ 3.93	+ .76	12,469	+ 4.61	+ 2.33
To foreign governments, etc.	113	+ 9	+ 8.65	0	984	+ 3.04	− 1.24
All other	1,942	+ 71	+ 3.79	+5.13	10,327	+ 2.34	+ 3.72
Total securities	12,545	− 79	− .63	+ 1.84	47,635	− 3.34	− 1.09
U. S. Government securities	4,916	− 252	− 4.88	−14.88	20,616	− 5.85	− 8.53
Obligations of states and political subdivisions	6,443	+ 151	+ 2.40	+14.86	24,114	− .89	+ 6.12
Other securities	1,186	+ 22	+ 1.89	+23.07	2,905	− 4.82	+ 4.10
LIABILITIES							
Demand deposits adjusted	15,048	+ 91	+ .61	+ .88	62,879	+ 1.91	+ .36
Total time deposits	28,149	+ 39	+ .14	+ 2.84	75,703	− 1.71	+ 2.81
Savings	15,558	− 200	− 1.27	+ 1.43	33,099	− .79	+ 4.14
Other time, I.P.C.	8,528	+ 107	+ 1.27	+ 3.45	30,888	− 1.18	+ 3.09
States and political subdivisions	2,891	+ 262	+ 9.97	+ 8.79	7,188	− 3.93	+ 2.75
(Neg. CD's $100,000 and over)	3,034	− 256	− 7.78	− 2.90	16.237	− 5.95	− .47

[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 March 27, 1968 — June 26, 1968 and from March 29, 1967 — June 28, 1967. Data are not seasonally adjusted.

Over the entire first half, large Western banks added $731 million to their business-loan portfolios—three times greater than the first-half '67 increase. In California, large tax-related borrowing by corporations helped to accelerate business-loan demand in both April and June. But the pace was even faster in Nevada, as the tourist industry boomed, construction increased, and strike-bound mining operations reopened. In Utah, business borrowing also rose sharply following the April settlement of the copper strike. On the other hand, the pace of loan demand in Washington slackened somewhat by mid-year, reflecting the slowdown from last year's rapid expansion in aerospace.

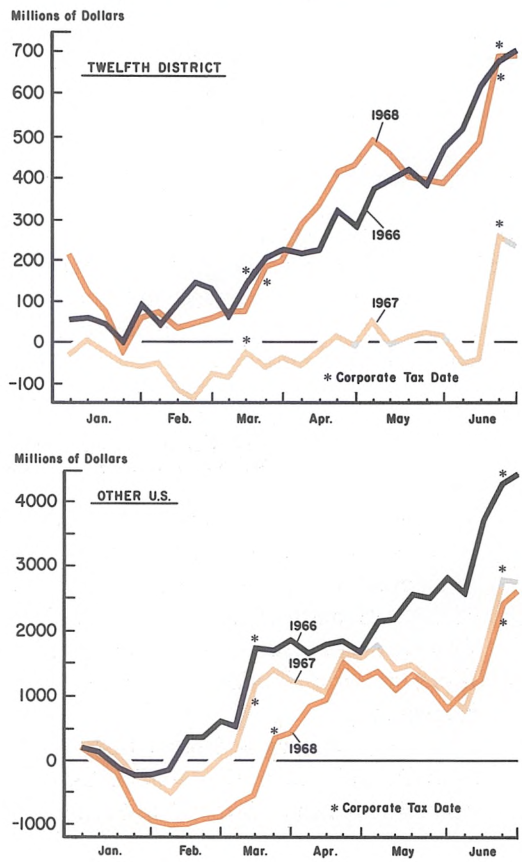
In the consumer sector, second-quarter loan demand increased by $179 million—almost five times greater than the spring '67 expansion. Financing increased substantially for both automobiles and other consumer goods. Credit granted under credit-card and related plans also rose during this period, as credit-card programs expanded further throughout District states.

Accelerated mortgage lending

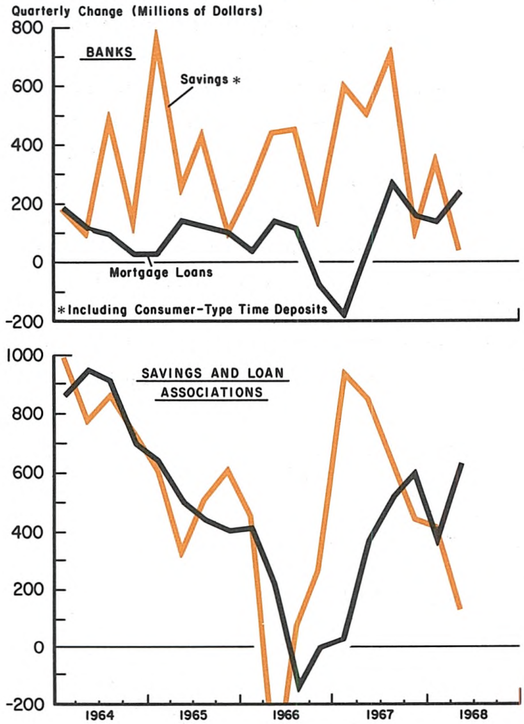
In spite of a sharp reduction in the flow of savings into both District S&L's and commercial banks, mortgage lending by these institutions increased substantially during the second quarter. The net gain in savings at District S&L's dropped from $410 million during the first quarter to only about $100 million during the April-June period, due to a combination of higher withdrawals and reduced inflows of new savings. Nonetheless, the mortgage portfolios of District S&L's expanded by about $600 million — almost double the previous quarter's gain — and associations in every District state participated in the increase. (But in several cases the increase was financed by additional borrowings and advances from the Federal Home Loan Bank, which in total rose by about $275 million over the quarter.) At the same time, commitments for future loans rose by about $20 million to $530 million—the highest level in the District since mid-1965—primarily because of increased mortgage activity in California.

For their part, District commercial banks added a substantial $254 million to their mortgage portfolios—almost double the previous quarter's increase—despite a reduction in their savings inflow. District banks thus accounted for over one-third of the national increase in bank mortgage portfolios. Large-bank mortgage lending increased in all District states except Idaho, with Arizona and Washington recording the largest gains.

Western banks, unlike others, match fast '66 business-loan pace this year



Banks, S&L's increase mortgage loans despite slowdown in savings inflow



Attrition in savings and CD's

In the second quarter, large District banks posted a $91-million increase in demand deposits adjusted, which more than offset a decline in U.S. Government demand deposits.

But a substantial slow-down occurred in the inflow of time-and-savings deposits; the quarterly gain was limited to $39 million, in contrast to a $733-million net inflow in the preceding quarter and a similarly large increase in the year-ago period.

The poor deposit performance centered in passbook savings (down $200 million) and in large-denomination negotiable CD's (down $256 million). The April attrition in savings deposits reflected the large withdrawals of funds for income-tax payments; withdrawals from California banks were particularly heavy because of a sizable increase in state income-tax rates. However, the quarterly rise in consumer-type certificates exceeded the reduction in passbook savings accounts. Public time deposits rose by $262 million, so that banks recovered some of the funds withdrawn from savings accounts in the form of state-local government deposits.

Large District banks lost $256 million in large CD's during the quarter—about evenly divided between certificates held by individuals, partnerships and corporations, and certificates of foreign banks and governments. This attrition, however, followed a $385-million first-quarter gain. Large banks elsewhere posted declines in CD's in both the first and second quarters.

Ruth Wilson and Verle Johnston

Western Farm Lending

"On the survey date, almost 100,000 Western farmers were in debt to District banks to the tune of over $1.8 billion. These borrowers represented only 5 percent of all borrowers in the national survey, but their borrowings amounted to 16 percent of the national total of $11.7 billion." . . . These and other findings of the Federal Reserve's 1966 survey of commercial-bank farm lending are found in the booklet, *Western Farm Lending,* published recently by the Federal Reserve Bank of San Francisco.

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