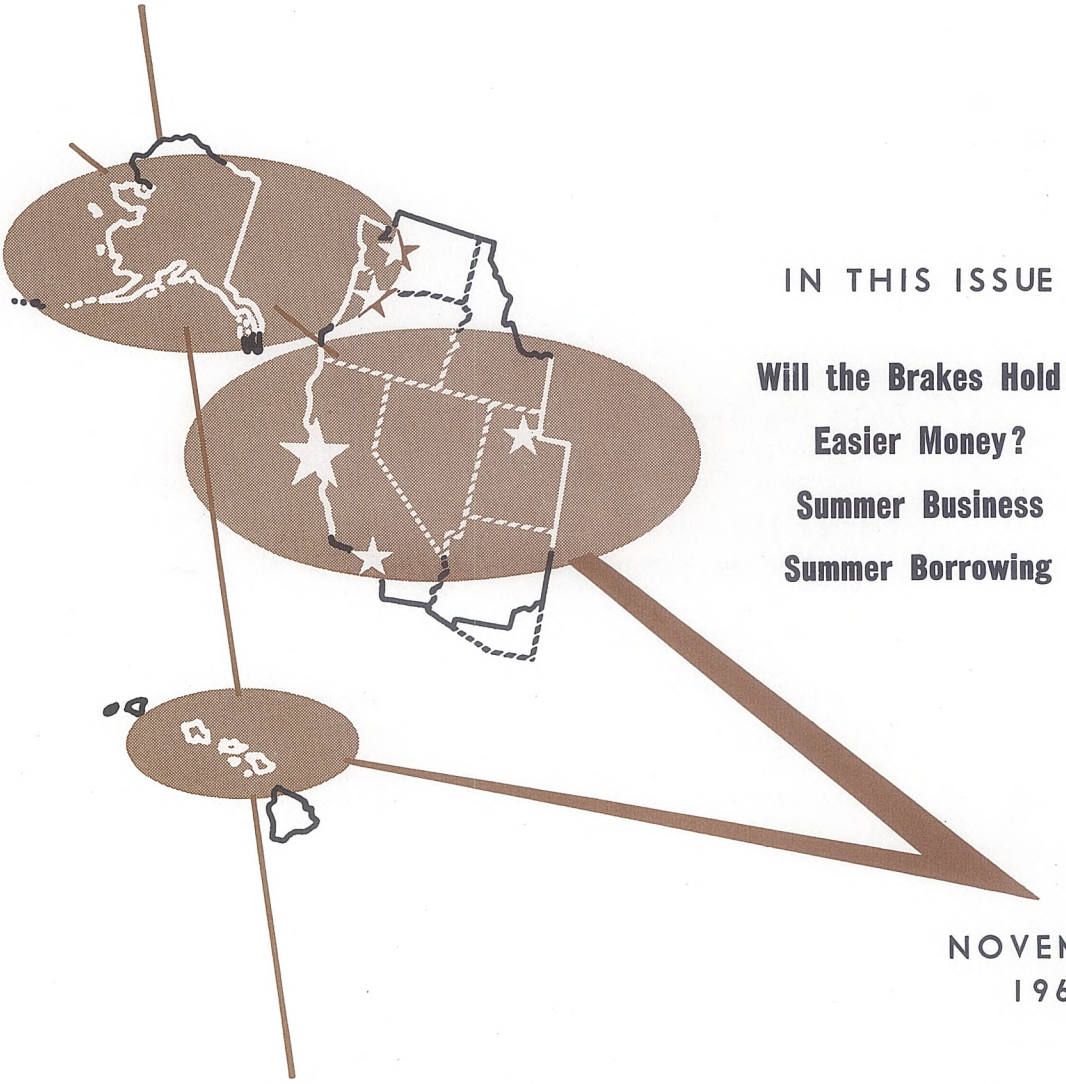
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



IN THIS ISSUE

NOVEMBER
1968

Will the Brakes Hold?

. . . "Wait 'til next year" is now the cry of the pundits who predicted in June that Congress' braking action would have immediate results.

Easier Money?

. . . The third quarter showed a modest but distinct shift in monetary policy away from the rather stringent posture of early 1968.

Summer Business

. . . The Western economy, in line with the national pattern, remained generally healthy during the summer and early-fall period.

Summer Borrowing

. . . Twelfth District banks channelled about three-fourths of their third-quarter increase in total credit into security purchases.

Editor: William Burke

Will the Brakes Hold?

Most business pundits expected in early summer that Congress' heavy foot on the brake pedal would have immediate results, but now that summer has turned into fall, they are still waiting for the brakes to hold. Indeed, in most forecasting circles, it seems agreed that the test lies ahead sometime in early 1969. Meanwhile, the business indices, including the price indices, continue to rise rapidly. And Wall Street, which spent most of the early summer adjusting uncomfortably to the tax impact on earnings estimates, has spent the rest of the summer and early fall adjusting its sights upward again.

During the third quarter, GNP rose by about $18 billion to an $871-billion annual rate. Although this was somewhat below the $22-billion rate of rise of the preceding quarter, much of the difference resulted from the smaller (and healthier) rate of inventory increase. Summer-quarter statistics showed continued strength in spending by and for consumers—on the part of both individual households and (collectively) state and local governments — and renewed strength in spending by businesses for new capital goods. Other sectors showed a little less buoyancy—residential construction, for example — and Federal Government spending, as it was supposed to, grew at a somewhat slower pace. But, just as in earlier quarters, roughly half of the GNP increase was due to an uncomfortably high and rising level of prices.

Reasons for restraint

The consumer-price index increased at a whopping 6-percent annual rate in June and July, but then showed smaller increases in August and September. Yet, in September, the index was 4.4 percent above the year-ago level for the largest year-to-year increase since the Korean War period.

Over the past year, prices of consumer services have increased 6 percent. Medical costs jumped sharply over this entire period, partly because of Medicare and partly because of the 1967-68 increases in the minimum wage, which especially benefited poorly-paid health workers. The third-quarter increase was also characterized by a jump in housing costs, specifically by a rise in mortgage-interest costs generated by money-market pressures and by legislative increases in mortgage-rate ceilings.

Prices of durable and nondurable goods also increased sharply over the year — much more at retail than at wholesale, incidentally. These boosts reflected heavy demand (as in autos), supply restrictions (as in fruit and vegetables), and marketing-cost pressures (as in everything, because of even higher wage boosts in distributive industries than in manufacturing).

The wholesale-price index fluctuated during the third quarter, but still by late summer showed a 2.7-percent increase over a year ago, largely because of last spring's strong price upsurge. Industrial commodity prices —up 2.7 percent over a year ago—have increased only 1.5 percent at an annual rate since last spring. This shift to moderation reflected improvements in supply—in particular, the drop in copper prices following the strike settlement in that industry—reduced price pressures for imports, and weak market anticipations in some areas. But then, in the early fall, pressures on industrial prices began to build up again in such sectors as machinery and construction materials.

Continued price pressures during the summer quarter, however, lent some substance to the comment found in the annual report of the International Monetary Fund, that it is

"necessary" for the U.S. economy to be held "well below" its 4-percent potential growth rate through the workings of the fiscal package. Most observers, in fact, here as well as abroad, have seen the necessity of consciously sacrificing some output and employment in the near term in order to gain extra output and employment over the longer run. But whether the strong pressure on the brakes—that is, the shift from a $25-billion to a $5-billion (estimated) Federal deficit between fiscal 1968 and 1969—will have a major effect within the near future can only be guessed from an analysis of the major components of the late '68 economy.

Defense: slackening

Defense spending rose by almost $1 billion, to an $80-billion annual rate, during the summer quarter, and other federal spending was up slightly to a $21½-billion rate. These increases amounted to roughly half the size of recent quarterly gains, as the spending curbs included in the fiscal-restaint package went to work.

In keeping with the intentions of the fiscal-restraint program, the Federal Government may well be a major force for moderation as the economy moves into 1969. Moreover, Federal pruning may affect the inexorable growth of state-local government spending, since Federal grants to these second-level governments will rise considerably more slowly than heretofore.

Military prime-contract awards, a major indicator of future defense spending, have moved practically sideways over the past two years after a two-thirds increase during the first eighteen months of the Vietnam build-up. Contract awards, moreover, have weakened slightly this year, running 3 percent below the year-ago level during January-August 1968. Nonetheless, the $30-billion annual cost of Vietnam will not disappear even if that conflict tapers off; the need to rebuild military inventories, to make up for postponed projects (such as military housing), and to develop new weapon systems, could keep the military budget close to its present level for years to come.

Investment: spotty

Business investment spending rose to a new high during the third quarter, increasing by $3 billion to a $90-billion annual rate through heavy purchases of producers' durable equipment. Spending for bricks and mortar remained below earlier peaks.

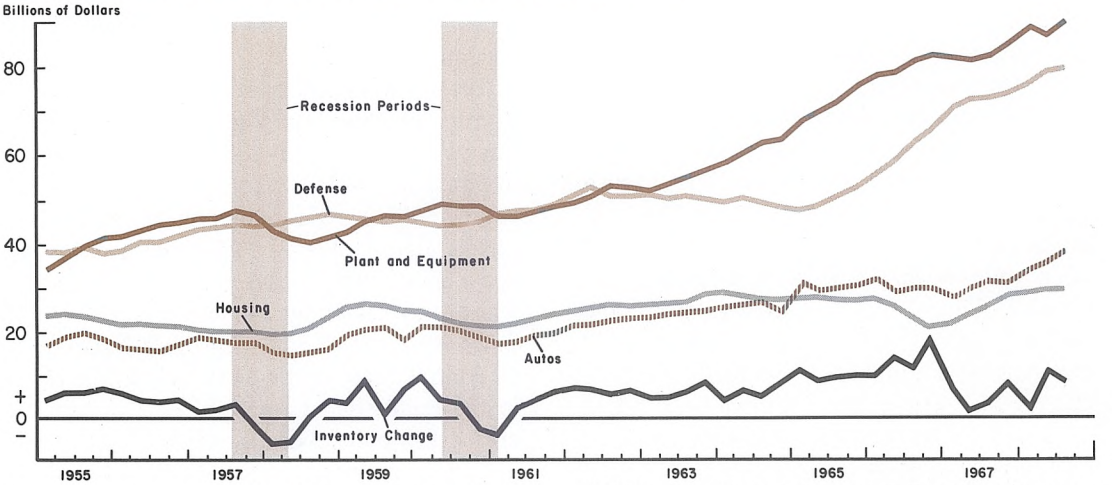
The Commerce Department's quarterly survey of business spending plans projects a modest advance for the entire second half and for 1968 as a whole. Still, because of sharp price increases, 1968's projected 4½-percent increase in dollar spending translates into a zero increase in real spending. (Last year also failed to post any real increase in spending.)

Several recent private surveys anticipate that 1969 will, like 1968, show a modest gain in dollar spending for fixed investment, but at this point no one forecasts any boom comparable to that of the 1965-66 period, when increases of 15 percent or more were recorded for two years in a row.

Indeed, business capital spending right now looks somewhat spotty. Some industries are still spending heavily; airline, trucking, and utility firms are all expanding their facilities sharply, with 1968 expenditures roughly one-third above the levels of two years ago. On the other hand, manufacturers are cutting back on their spending, both in current and real terms, evidently because they see no need to expand their facilities at the present time. Manufacturing firms are utilizing their present facilities at less than 83 percent of capacity (down from 91 percent two years ago) and expansion needs are reported by firms holding only 41 percent of total manufacturing assets (down from 51 percent two years ago).

Business inventory policy continued its seesaw trend during the summer quarter as the accumulation rate slid to roughly $8 bil-

Some GNP sectors move sideways during third quarter, but most show continued (and unexpected) growth



lion on an annual basis. (Over the past four quarters, accumulation has shifted from $5 billion up to $8 billion, down to $2 billion, up to $11 billion, and now down to the present level.) This sector is now strongly influenced by steel consumers' enforced reduction of inventories, but the possibility of only modest spending increases in defense and business investment suggests that stock building also may proceed at a modest pace in coming months. And even if consumer markets remain strong enough to require expanded inventories, the cost of carrying such stocks remains strikingly high.

Consumers: splurging

Nonetheless, most of these uncertainties have recently been overshadowed by the third-quarter upsurge in the massive consumer sector. Spending rose by more than $13 billion to a $541-billion annual rate, and this increase was eclipsed only by the sharp gain in the first quarter of this year.

This surprising increase in consumer spending, carried out in the face of the stronger tax bite, was made possible largely by increased borrowing and reduced saving. During the summer, instalment-credit extensions ran almost 15 percent ahead of the 1967 pace. The savings rate dropped by over one percentage point from the high 7.5-percent figure of the preceding quarter, and this $7-billion shift nearly offset the increase in consumers' withheld taxes.

Moreover, payrolls continued to expand during the summer quarter, as a Federal pay boost occurred at midyear and as strong gains continued in most components of the private economy except steel. Employment continued to expand, even though the monthly gains lagged behind those recorded in the early part of the year. (Trade, services, and state and local governments showed substantial increases, while manufacturing employment was relatively stable.) Besides, the labor market exhibited continued tightness as the labor force grew slowly in the face of heavy labor demand. Thus, the jobless rate, averaging 3.6 percent for the third consecutive quarter, remained at the lowest level of the last fifteen years.

In coming months, consumer incomes probably will reflect less substantial wage increases—and, hopefully, price indexes will reflect reduced labor-cost pressures. In 1969 there will be a smaller number of major wage negotiations than this year, and the

wage increases already provided for in previously negotiated contracts will tend to be smaller than in the initial years. Moreover, there will not be a significant increase in the minimum wage in 1969, as there was in each of the two preceding years.

Consumer incomes will also feel the tax pressure that is slated to increase early next year. Consumers will first have to absorb an increase in social-security taxes amounting to about $1½ billion, and will then have to pay out roughly $1½ billion (in addition to withholdings) to meet their final income tax bills for 1968. Thus, it is still possible that consumer purchases, especially for durable goods, will reflect the continued fiscal pressures on discretionary incomes.

Detroit: speeding

In the sunny summer of 1968, however, this possibility was only a cloud on the far-distant horizon. In the rip-roaring auto market, in particular, total sales of autos and parts rose more than $2 billion to a $38-billion annual rate. For the year to date, unit sales of Detroit's products were 10 percent above the 1967 figure and import sales were 32 percent over a year ago. August and September especially were a sales manager's dream, as new cars (including imports) rolled out of the showrooms at a 10-million unit annual rate.

The fast cleanup of the '68 models was followed by an equally fast start on the '69s. Accordingly, automakers this fall scheduled a record rate of production: almost one million cars for October, and 2.5 million cars for the entire fourth quarter. October traditionally is a heavy production month because of the need to fill dealers' inventories and to meet fleet orders, but the recent activity in the showrooms suggests that buyers are waiting for every car coming off the production line.

Detroit, however, will now have to combat both the slowdown in consumer disposable incomes and a speed-up in its own price activity. Car buyers can expect to pay somewhat more for the new models than for the '68s, and they may get somewhat less for their money because of a major roll-back in warranty coverage.

To the statisticians in Washington, a $41 average increase in suggested retail prices this year includes only a $1 net improvement in "quality" —safety, reliability and the like —since this year's reduction in warranties offsets almost all of a $24 gross quality improvement in the average car. (General warranties covering 24 months or 24,000 miles were cut in half with the '69 models.) In contrast, last year's $116 average increase in the retail sticker price included a $58 increase in quality because of new safety and pollution-reduction features.

The average new-car buyer — someone turning in a '65 model, say—will see a sticker price $325 higher than what he paid several years ago, as a result of five rounds of price increases over the past three years. Still, the early shoppers seemed willing to pay the tab; in fact, one automaker reported that half of his customers were anxious to spend another $500 each for air-conditioned models.

Housing: mortgaging

Another consumer-oriented industry, residential construction, held steady during the summer quarter at a $29½-billion annual rate. This sector, although advancing only slowly since last winter, operated at a considerably healthier pace than two years ago. Housing starts this summer, as during the first half of the year, remained in line with the 1962-65 annual average of about 1.5 million units.

Builders generally expect some further growth during 1969, not only because of the underlying strength of consumer demand, but also because of their belief that mortgage funds will become more abundant and thereby offset some of the depressing fiscal impact on consumer incomes.

The industry ardently believes that a great underlying strength for housing exists, especially in view of the sharp drop in vacancies in recent years. At midyear the rental vacancy rate was 5.7 percent and the owner-occupied rate was 1.0 percent—the lowest figures of the past decade. But effective strength in 1969 may also depend upon an adequate flow of funds into mortgage-lending institutions and upon the ability of buoyant consumer attitudes to offset the tax impact on consumer incomes.

Brakes: holding?

If the brakes of fiscal restraint should take hold in early 1969, the annual growth of the economy, in real (price-adjusted) terms, should slow down to somewhere between zero and 4 percent. According to the official arithmetic, the economy should slacken just enough to assure that prices and wages decelerate, but should also run fast enough to avoid recession and the excessive costs associated with substantial unemployment. Of course, the growth rate conceivably could fall below 4 percent even without the application of these fiscal brakes, partly because of the gradual effects of the earlier period of monetary restraint, the expected slowdown in capital spending, and the present cutback in steel output and inventories. When, in addition to those factors, fiscal policy is tightened more suddenly than it has ever been before, the prescription of the experts, both here and abroad, should be amply fulfilled.

Still, at this stage, the business pages are full of the controversy over whether the brakes will actually hold. For those who "read the monetary tea leaves" (in Professor Walter Heller's phrase), this past year's rapid increase in the nation's money stock implies a continued increase in spending. For those who follow the leading indicators of manufacturers' new orders, Wall Street indexes, and the like, the slowdown is not yet in sight. Yet for those who swear by the memory of John Maynard Keynes, 1969 should surely testify to the efficient braking action of fiscal restraint. *William Burke*

Easier Money?

In early summer, there was a modest shift in monetary policy away from the rather stringent posture that had characterized policy earlier in the year. But then, much of the earlier ease was wiped out by mid-September, and the banking system was still recording net borrowed reserves in October.

Still, the Federal Reserve did reduce the discount rate by ¼ of 1 percent in August, and commercial banks did cut their prime rate on business loans from ¼ to ½ of 1 percent in September. The commercial banks—and other financial institutions as well—were under less pressure as the level of money-market yields declined and the threat of disintermediation waned.

One of the major reasons for the somewhat easier tone in the money and capital markets was the marked improvement in the Treasury's cash position. The Treasury's estimated deficit for the third quarter was in the neighborhood of $3 billion, compared with $9 billion for the same three months last year. (Happily, the outlook for the months ahead is for more of the same; after raising an additional $3 billion through the issue of tax anticipation bills in October, the Treasury later announced that it would need no more new cash on a net basis for the remainder of 1968 and only $1½ billion in the first half of 1969.) In perspective, this summer period witnessed a shift in the mix between monetary policy and fiscal policy subsequent to the June enactment of the fiscal-restraint package.

Policy . . . and problems

By many of the usual measures, monetary policy appeared to be less restrictive during the third quarter. The average level of net borrowed reserves was just under $200 million (compared with about $350 million in the second quarter), and the average level of member-bank borrowings from the Reserve Banks was $531 million (compared with $715 million in the preceding quarter). The average effective rate on banks' Federal-funds transactions dropped from as high as 6¼ percent in July and August to just above 5¾ percent in September.

The total reserves of the member banks increased at a 9-percent annual rate in the third quarter, which was about in line with the 1967 pace but was considerably above the performance of the second quarter, when reserves remained unchanged. On the other hand, the money supply (narrowly defined) increased at a 4.5-percent annual rate in the third quarter—just about half the preceding period's 8.7-percent rate.

The timing and magnitude of the reduction in the discount rate in August argues against the interpretation of this action as a significant shift in monetary policy. Most money market rates had already fallen sharply in late July, prior to the cut in the discount rate. The decline in interest rates was simply a reflection of the change in market expectations brought about by the fiscal-restraint program's expected impact on financial markets. The estimates of the Federal deficit for fiscal 1969 were scaled down drastically from around $25 billion to a more manageable figure of $5 billion or so.

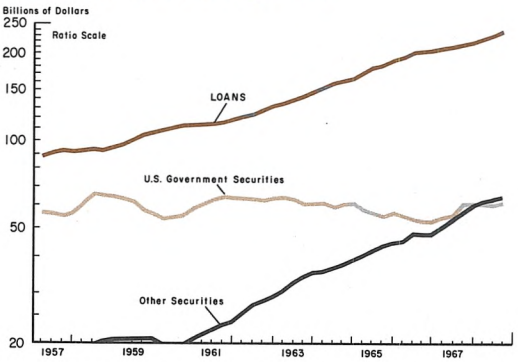
There were wide swings in bank reserves, bank credit, and the money supply in the third quarter. A good part of these variations can be explained by Treasury financing operations. In the third quarter the expenditures of the Federal Government ran well ahead of receipts, as usual, and this drain was met by drawing down cash balances and by borrowing to raise the bulk of the needed cash. The Treasury, conducting major financing operations in July and August, raised a total of about $7 billion of new cash for the entire quarter. The banking system was the principal underwriter for these financing operations, and deposits and required reserves of the banks rose as payment was credited to the Treasury's account.

The money supply grew at an annual rate of 12.8 percent in July and fell at an annual rate of 5.8 percent in September. Here again, a part of these swings can be traced to the ebb and flow of the Treasury cash position. The cash balances of the Treasury are not included in the money supply, which consists of demand deposits of the public and currency outside of banks. Federal expenditures in July drew heavily upon Treasury deposits, and the transfer of ownership of deposits to the public thereby increased the money supply. Conversely, as Federal taxes were paid in September, the deposits of the public declined (as did the money supply) and Treasury balances were replenished.

Security blanket?

Commercial-bank credit (total loans and investments) rose at a 17-percent annual rate in the third quarter, or nearly three times the preceding quarter's rate of increase. A large part of this expansion was due to bank acquisition of U.S. Government and

Security purchases help spur rapid bank-credit growth



municipal securities. During the summer period, banks expanded their holdings of Governments and tax-exempts at annual rates of 19 percent or more, in contrast to second-quarter increases of 1 and 14 percent, respectively, in those two categories.

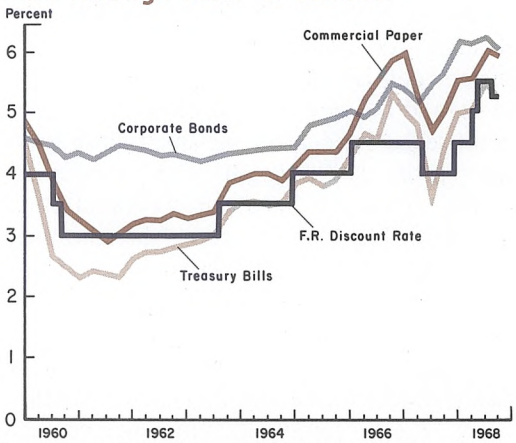
The banks held on to a good share of the issues that they obtained in underwriting Treasury and state-local financing operations during the quarter, and they also increased their Treasury-bill holdings, adding to the bills acquired in the July financing. They were persuaded to keep these issues in their portfolios because of the general expectation of declining interest rates, which would be reflected in higher prices of securities and capital appreciation.

Meanwhile, banks were able to support their increased purchases of securities because of a sharp increase in time-and-savings deposit inflows, which jumped from 3 to 18 percent (anual rates) between the second and third quarters. The change in the trend of interest rates helped explain this stepped-up inflow, for as the yields on money-market instruments declined, the rates paid by banks on these deposits became relatively more attractive. Large-denomination negotiable certificates accounted for well over one-third of the increase in total time-and-savings deposits. Changes in the level of outstanding CD's also reflected the availability and cost of Eurodollars, which the larger banks regard as an alternative source of funds.

Total commercial-bank loans increased at an annual rate of over 15 percent in the third quarter, nearly double the second-quarter rate. This gain was attributable in part to a very large ($3.5 billion) rise in loans to security dealers. Large speculative positions in securities—mostly Governments—were built up and carried through most of the quarter by securities dealers, banks, and other investors in anticipation of capital appreciation.

The third-quarter demand for business

Downtrend in interest rates lasts through most of summer



loans was less than it had been earlier, rising at a 9-percent annual rate as against the 12½-percent pace of the second quarter. Improved corporate liquidity was a factor here, since tax borrowing was very small over the July tax date and not much stronger over the September tax date. The reduction of borrowing to carry steel inventories in anticipation of a steel strike at the end of July also helped diminish the business demand for bank accommodation.

Rates down . . . then up

The term most often—and appropriately—used to describe the course of interest rates in the third quarter was "indecisive," particularly in view of the absence of a clearly defined trend. Money-market rates, after peaking in May, declined through the first half of August, because of the prospect of a declining trend of interest rates. By early August, the market yield on 91-day Treasury bills had fallen by just over one percentage point from the May high of 5.92 percent, and the decline for other types of short-term instruments was also fairly large. Yet the trend was soon reversed, and much of the euphoria that characterized mid-summer expectations was dissipated by mid-October, when most yields were back to where they were at the beginning of July.

Meanwhile, several exceptions to the general direction of rates became apparent. Even as the bill rate was dipping below 5 percent in early August, the Federal-funds rate remained consistently at or above the 6-percent level, and the rate on bank loans to Government-securities dealers remained close to its May peak. The strength in these rates reflected the heavy demand for Federal funds and securities loans to carry the unusually heavy inventories of Government securities that overhung the market during most of the quarter. Dealers were forced to balance off the prospects of capital gains in the event of falling interest rates against their "negative carry," represented by the difference between the yield on bills and other security holdings and the day-to-day costs of financing these issues. They could of course have sold securities to reduce borrowing costs, but this would have put downward pressure on security prices and thereby reduced the prospects of capital appreciation on their remaining holdings.

The course of interest rates in the long-term markets differed by the type of borrower. The yield on seasoned top-quality corporate bonds fell by 34 basis points between May and early September, and then recovered about a third of that decline by the middle of October. The average yield on long-term Treasury obligations decreased by 44 basis points between the end of May and the first half of August, and then climbed about half of the way back by early October. The average yield on outstanding municipal bonds declined the most between late May and early August (62 basis points) but also rebounded the most, regaining nearly three-quarters of its decline by the first half of September.

The rather different behavior of corporate-bond yields and tax-exempt yields can be explained in great part by the supply conditions in the two markets. Public offerings of new corporate bonds in the third quarter ($2.6 billion) were down almost $0.5 billion from the second-quarter figure, while offerings of municipal bonds ($4.4 billion) were up nearly $0.6 billion. A large share of the municipal securities coming onto the market were industrial-revenue issues, which at year-end will lose their tax-exempt status for new issues larger than $5 million.

The third quarter was one of those awkward moments in time in which developments do not unfold in the neat sequence in which they are written into the script. A crucial development was the failure of consumers to pay heed to the "conventional wisdom" and reduce their expenditures in the face of higher taxes. The absence of the anticipated slowdown in total spending in the third quarter dispelled fears of "fiscal overkill" that might lead to recession, but it also introduced a note of uncertainty about the ultimate effects of the July fiscal package and thereby complicated the formulation of a complementary monetary policy.

Monetary policy makers also had a number of technical problems to cope with, mostly as a consequence of their support of the Treasury's efforts to raise $7 billion of new cash in the securities markets. The buildup of dealer inventories of Treasury securities imposed certain constraints upon Federal Reserve actions. If money were to be made easier, borrowing costs would become cheaper and the prospects for capital appreciation would become greater; conversely, if money were to become tighter, dealers would have had to make very large sales of securities and put a great deal of upward pressure on interest rates. In either event, there was the possibility of the emergence of a disorderly market in Government securties. Then, in addition to all those complications, the Federal Reserve had to contend with the September changeover in the method of bookkeeping for reserve purposes.

Herbert Runyon

Summer Business

In line with the national pattern, the Western economy seemed generally healthy at the end of the third quarter. Construction, raw-material production, and agriculture posted good gains, but aerospace manufacturing continued to be rather sluggish.

Total employment in District states increased by 0.5 percent over the second quarter—more than double the increase in the country as a whole. Nonagricultural employment gains were somewhat larger, and agricultural employment decreases somewhat smaller, than in the nation. (There were some mixed trends—construction jobs rose in the West while declining elsewhere, and the reverse was true in the field of Federal employment.) At the same time, the District unemployment rate edged up slightly to 4.6 percent, while the national rate remained unchanged at 3.6 percent of the civilian labor force.

Partial data on retail sales suggest that the West kept up with the fast national pace in this category. Consumers in major Western cities meanwhile saw no let-up in the upward trend of retail prices, although early autumn brought hints of future relief. California's major metropolitan areas recorded a 4.4 percent annual rate of price increase—somewhat below the overall national increase—while Seattle posted its largest quarterly increase since the Korean War era. Consumers encountered higher price tags in every major budget category, but the most significant increases this summer were in homeowner costs, particularly mortgage interest rates.

The key industries

District aerospace employment continued to weaken during the third quarter, as the industry's workforce was reduced by 9,000 to a total of 724,000. The bulk of the decline was in California, but losses were also felt in Washington. In contrast, aerospace employment generally strengthened elsewhere in the nation.

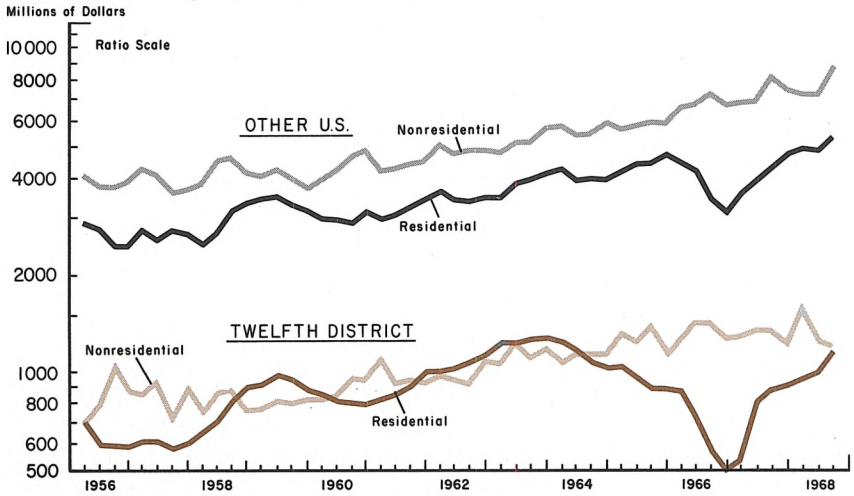
Thus far in 1968, District aerospace employment has declined by 33,000—wiping out much of the 48,000 gain in 1967—and the present order inflow does not suggest any significant improvement by year-end. The third quarter ended on one high note, however, as 26 stewardesses sent 26 champagne bottles hurtling toward the fuselage of the first 747 jumbo jet — the massive plane capable of carrying 490 passengers non-stop for 6,000 miles at 625 miles per hour. About 100 of these transports will be built over the next two years, and orders are on hand for more than double that number.

Construction activity expanded in the District during the summer months, and housing activity showed particular strength as the quarter came to a close. Actually, third-quarter housing starts failed to exceed the second-quarter rate, but the direction of activity was strongly upward after a sluggish early-summer period.

Successive strong gains in August and September carried starts to a 330,000 annual rate in the West—about 25 percent above the year-ago figure, in contrast to an 8-percent year-to-year gain in the rest of the nation. This strength of housing activity was fairly wide-spread throughout the District, and was particularly notable in view of the continued climb in mortgage interest rates to new record highs. (But some easing in borrowing costs was reported in California as the quarter came to a close.)

Other regional construction activity showed some let-up, however, in contrast to fairly sharp gains in the rest of the nation. Combined awards for the construction of nonresidential buildings and for heavy engineering projects dropped about 3 percent below

Construction activity expands in District, but at slower pace than elsewhere in nation



the previous quarter's level, but the strength in housing contributed to a gain in District construction employment. Less encouraging, however, was a continued rise in construction costs, as both construction wage rates and construction material prices showed substantial increases.

The basic industries

The Western lumber industry was hard pressed to keep up with the heavy demand for its products emanating from all sections of the country. Mills succeeded in raising production slightly above high second-quarter levels, but prices nevertheless spiralled upward to new yearly peaks under the pressure of tight supplies. Prices of Douglas fir, Ponderosa pine, and softwood plywood all rose sharply above year-ago levels.

The Western steel industry began to cool its furnaces in July in preparation for a possible steel strike, and it cut back production further following the labor settlement at month-end, as customers began to liquidate excess inventories accumulated as a strike hedge. Western steel production nevertheless declined by only 4 percent during the summer quarter, compared with a 25-percent decline in steel production nationwide as a result of the inventory run-off. The July 30 agreement between the United Steelworkers of America and 11 of the nation's major steelmakers, including two District producers, called for a 90-cent hourly increase in wage and fringe benefits over a three-year period. This increase, about 6 percent annually, was similar to recent settlements in the automobile, can, and aluminum industries, but it was the largest steel wage boost since 1956's 7½-percent increase.

Aluminum production in the Pacific Northwest was affected by a strike at the Wenatchee (Washington) reduction plant, which lasted through July. Shipments of ingot and aluminum mill products dropped below their record second-quarter pace, but still remained above the year-ago figures. Despite the loss of production and the relatively high level of demand, prices reportedly weakened somewhat because of strong import competition.

The Western copper market was healthy during the third quarter, and relatively free of the wild fluctuations characteristic of the past year or so. Shipments of refined copper to fabricators picked up after the vacation lull, but in September were slightly below the level of shipments reached in April (immediately after the strike settlement) and a full 20 percent below their pre-strike level of June 1967. As a result of the improvement in U.S. and foreign demand, the spot quotation on the London Metal Exchange rose from 47 to 50 cents a pound between June and September.

Petroleum refining activity continued strong during the third quarter. In fact, for short periods of time the area's refineries operated above their rated capacity—a rare occurrence in the West. But to add to the area's refining capacity, a $100-million, 100,000 barrel/day refinery was announced for construction near Bellingham, Washington, in a move related to the rich oil strike on Alaska's North Slope. Also on the drawing boards are a railroad and a pipeline to tap the new Arctic oil field; these facilities, as well as the Bellingham refinery, should be in operation by late 1971.

District farm returns rose about 4 percent above the year-ago level during the third quarter, while cash receipts elsewhere just matched their year-ago performance. Resurgence of crop marketings in California were primarily responsible for the year-to-year advance in District cash receipts, although the comparison was affected by the fact that 1967 was a poor crop year in that state. Crop returns were boosted by large harvests of deciduous fruits, processing tomatoes, cotton, rice, and sugar beets; livestock returns meanwhile were boosted by increased prices for beef cattle, milk, and eggs. In particular, sharp increases in acreage and in crop yield led to a whopping 50-percent increase in California's processing-tomato crop.

On balance, the buoyancy of the regional economy matched that of the national economy during the summer and early fall months. Minor weaknesses developed in the key aerospace industry, and potential weaknesses could be envisioned as the fiscal-restraint medicine worked its way through consumer markets and business activity generally, but the overall pattern of healthiness persisted as 1969 approached.

Regional staff

Summer Borrowing

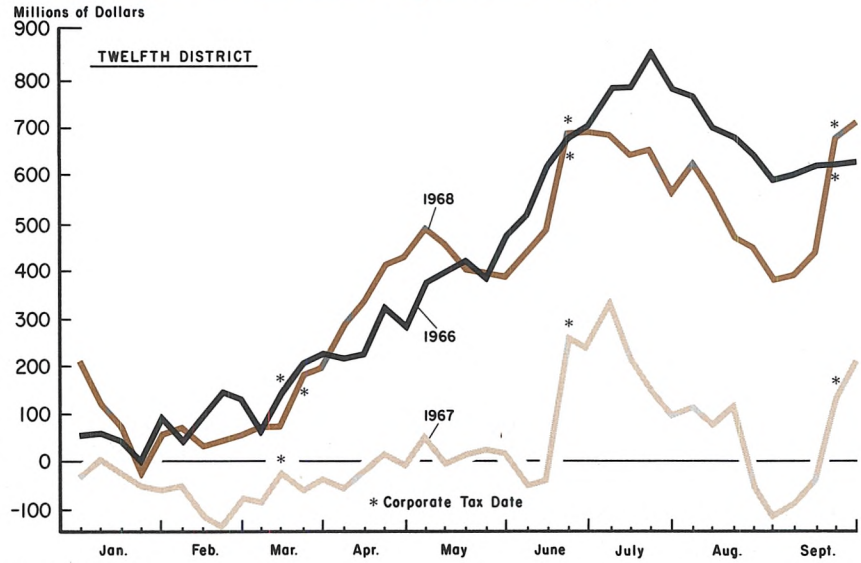
Large Twelfth District banks channeled about three-fourths of their third-quarter increase in total credit into security purchases, in large part because they had access to ample funds and were faced with a seasonal lull in business-loan demand. The 4.7 percent ($2 billion) expansion in total credit over the quarter was somewhat greater than the rate recorded by large banks elsewhere, and was substantially above the District's performance in the comparable quarter of 1967. The credit expansion occurred against a background of higher average deposits and a shift in member-bank borrowing from the discount window to the Fed-funds market.

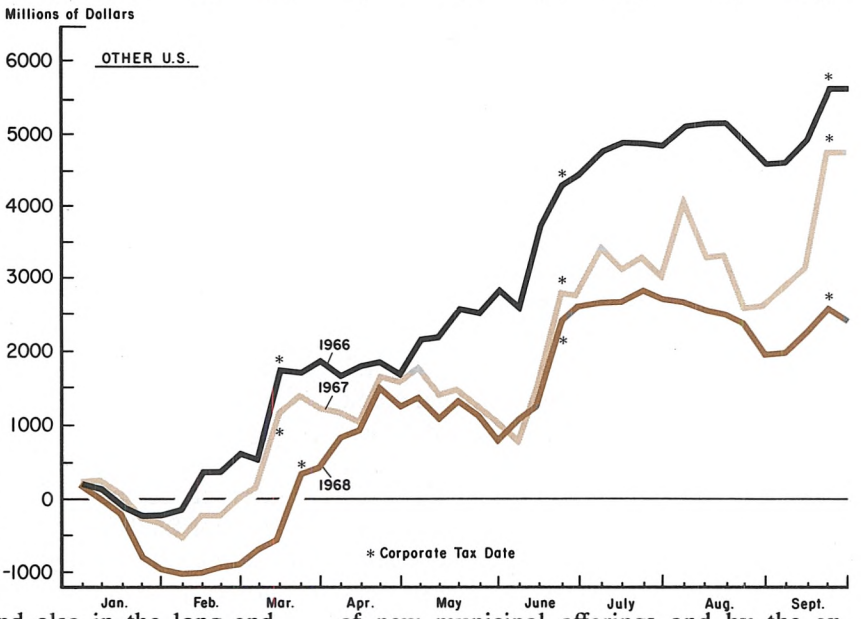
Required reserves of Twelfth District member banks were $106 million higher than in the second quarter because of substantial gains in both net demand and total time deposits. Excess reserves changed little over the three months, but borrowings from the Federal Reserve Bank fell $60 million to an average of $39 million for the quarter. As a result, net borrowed reserves shifted from the second quarter's $67-million average to only $3 million during the summer period.

Throughout the third quarter, large District banks were heavy net purchasers of Federal funds on interbank transactions—in sharp contrast to their net sales position during the preceding three-month period. (Fed-fund "purchasers" are borrowers of unused reserves of other member banks, and "sellers" are lenders of such reserves.) Net sales of funds to Government securities dealers more than tripled, but did not quite offset net interbank purchases. On total Fed-funds transactions, therefore, District banks shifted

from a net sales position of $224 million to a net purchase position of $24 million in the summer quarter. Borrowings under corporate-repurchase agreements remained at the high level prevailing in the second quarter. So despite a decline in activity at the discount window, District banks increased their total borrowings, and at least some of these funds were used to finance the substantial expansion of their security portfolios.

Western banks exceed their '66 business-loan growth, but large banks elsewhere lag behind '66 pace





Buying securities

Large District banks added $1.5 billion in securities to their portfolios during the third quarter of 1968—more than double the third-quarter '67 increase. In the Government-securities category, they invested in the short end ($730 million in Treasury bills) and also in the long end ($235 million in 5-year-and-over maturities).

These banks also added $635 million to their holdings of municipals, with the heaviest concentration being in short-term warrants and bills. Bank interest in municipals was kindled by this summer's large volume of new municipal offerings and by the expectation of future price appreciation. (In contrast, banks reduced their holdings in the July-September period a year ago.) The sharp gain in new municipal offerings was sparked by the possible enactment of restrictive legislation relating to bonded indebted-

ness. Over the quarter, District-bank holdings of municipals increased by 10 percent, as against an 8-percent gain nationally; in short-term maturities, the increases were 57 and 26 percent, respectively.

Financing securities . . . and business

Loans to finance Government securities dealers accounted for about one-third of the third quarter's $589-million increase in total loans, while business loans showed only a nominal rise. Furthermore, business demand for bank credit was somewhat weaker in the West than nationally—in sharp contrast to the situation prevailing in the first half of the year. Nevertheless, business borrowing over the September tax date exceeded borrowings in mid-June. This was a reversal of the normal District pattern (and the pattern elsewhere this year), which shows a heavier concentration of tax borrowing in June than in September.

Large District banks witnessed a decline (for the second successive quarter) in credit demand from the durable-goods sector, but machinery and transportation-equipment manufacturers still remained among the heaviest borrowers over the September tax date. Food, liquor and tobacco firms were the single largest borrower-group in this period, coming in with a greater-than-usual demand for bank financing in September, and trade and service firms also registered increased demand for credit during the quarter.

According to the Federal Reserve's quarterly business loan survey, borrowers paid a slightly higher (9-10 basis points) average rate of interest on short-term business loans in mid-summer than in mid-spring, despite the relative slackness of business-loan demand in the first half of August, the survey period. But some downward adjustment in rates is now a possibility, since Western banks followed the national trend in reducing their prime rate by ¼ percent—to 6¼ percent—in late September.

Consumer lending helped offset some of the summer sluggishness in business lending, as District banks posted a $148-million gain in installment loans during the third quarter —three times the gain in the comparable period of last year. Increased automobile financing and credit-card financing contributed to the quarterly rise in consumer debt.

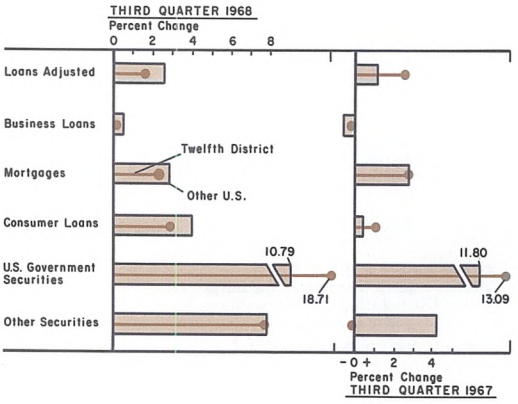
Financing mortgages

The pace of activity in the Western mortgage market maintained its momentum during the third quarter. This situation reflected a pickup in the flow of funds into District commercial banks and savings-and-loan associations, but also reflected a continuing high level of borrower demand in the face of a slight further rise in mortgage interest rates.

District banks expanded their real estate loans by $255 million, surpassing their previous quarter's gain, while District S&L's added about $458 million to their mortgage portfolios, for a moderately smaller gain than in the spring quarter. At the quarter's end, the volume of S&L commitments for future loans stood at $586 million—an increase of about $70 million from mid-year and the highest level since 1965.

The increase in mortgage lending was ac-

Bank-credit growth centered in security purchases



companied by a further rise in the general level of mortgage interest rates to new record highs. However, a slight easing in rates occurred as the quarter came to a close, and there were scattered reports that some prospective borrowers were holding off in anticipation of a possible decline in borrowing costs.

Saving money

The continued expansion in mortgage lending was facilitated by an improved inflow of savings funds into both commercial banks and S&L's—and by a reduction in the latter's "liquidity" requirement, as set by the Federal Home Loan Bank. District banks showed a modest gain in their passbook savings and a very substantial increase in their "other time" deposits, as total time-and-savings deposits rose by over $1 billion. The S&L's, too, recorded a larger net inflow of savings — about $297 million, or almost triple that of the spring quarter. The improved flow of savers' funds into both the banks and S&L's apparently reflected the general decline in market rates of interest and an attendant increase in the attractiveness of the yields obtainable on time instruments.

In their savings behavior, Westerners apparently were less affected than others by the surtax and by the summer spurt in consumer expenditures—at least as far as their bank savings were concerned. Large District banks posted an $81-million increase in passbook savings during the third quarter, in contrast to a $384-million decline at large banks elsewhere. Furthermore, other consumer-type deposits rose by $475 million — a faster rate than nationally. Meanwhile, large District banks posted a relatively stronger increase in large negotiable time certificates, partly because of the absence of a run-off in the District over the September tax date.

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	
	Outstanding 9/25/68	Third Quarter 1968 Dollars	Third Quarter 1968 Percent	Third Quarter 1967 Percent	Outstanding 9/25/68	Third Quarter 1968 Percent	Third Quarter 1967 Percent
ASSETS							
Loans adjusted and investments[1]	$46,870	+2,111	+ 4.72	+ 3.40	$170,522	+ 4.52	+ 4.25
Loans adjusted[1]	32,803	+ 589	+ 1.83	+ 2.76	118,515	+ 2.60	+ 1.08
Commercial and industrial	12,235	+ 9	+ .07	− .27	57,190	+ .52	− .69
Real estate	10,194	+ 255	+ 2.57	+ 2.98	20,824	+ 2.71	+ 2.80
Agricultural	1,352	− 2	− .15	+ 1.98	667	− .45	− 2.53
To non-bank financial institutions	1,416	− 86	− 5.73	+ 2.35	8,757	− 2.09	− 1.39
For purchasing and carrying securities	1,000	+ 344	+52.44	+92.26	8,072	+25.46	+12.83
To foreign banks	192	− 37	−16.15	− 5.81	1,186	+ .59	+ 1.76
Consumer instalment	4,911	+ 148	+ 3.11	+ 1.23	12,968	+ 4.00	+ .37
To foreign governments, etc.	118	+ 5	+ 4.42	− 4.17	978	− .61	+ 6.41
All other	1,953	− 32	− 1.61	+ .18	10,546	+ 2.11	+ 3.31
Total securities	14,067	+1,522	+12.13	+ 4.90	52,008	+ 9.18	+ 7.64
U. S. Government securities	5,774	+ 910	+18.71	+13.09	22,841	+10.80	+11.80
Obligations of states and political subdivisions	7,096	+ 653	+10.14	− .72	26,126	+ 8.34	+ 4.91
Other securities	1,197	− 41	− 3.31	+ 2.96	3,040	+ 4.65	− .46
LIABILITIES							
Demand deposits adjusted	15,440	+ 392	+ 2.60	+ 4.13	61,064	− 2.89	+ 1.08
Total time deposits	29,238	+1,089	+ 3.87	+ 1.06	79,414	+ 4.90	+ 3.50
Savings	15,639	+ 81	+ .52	+ 1.95	32,715	− 1.16	+ .96
Other time, I.P.C.	9,505	+ 977	+11.46	+ 7.60	33,934	+ 9.86	+ 6.19
States and political subdivisions	2,823	− 68	− 2.35	−13.84	7,938	+10.43	+ 4.24
(Neg. CD's $100,000 and over)	3,615	+ 581	+19.15	− 3.87	18,645	+14.83	+ 5.41

[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 26, 1968 — Sept. 25, 1968 and from June 28, 1967 — Sept. 27, 1967. Data are not seasonally adjusted.