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Monthly Review

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FEDERAL RESERVE BANK OF PHILADELPHIA

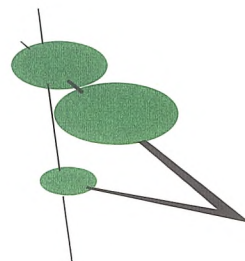
In this issue

Waiting . . . Waiting

Plenty of Restraint

Growing . . . Growing

Even More Restraint



April 1969

Waiting . . . Waiting

. . . Business continued booming, prices continued rising, and policy became tighter as the anti-inflation fight neared its climax.

Plenty of Restraint

. . . A major element in the policy picture in early '69 was a hitherto-missing balance between monetary and fiscal policy.

Growing . . . Growing

. . . The West participated fully in the nation-wide employment upsurge of the past half-year, despite sluggishness in aerospace.

Even More Restraint

. . . In the first quarter's tight-money atmosphere, District banks had to cut sharply into security holdings to expand their loans.

Editor: William Burke

Waiting . . . Waiting

During the early spring months, the world awaited a showdown between the still-surging U.S. economy and the still-stiffening policy stance of the nation's economic policymakers. On the one hand, recent GNP data revealed the continued growth of the national economy, as the first quarter witnessed a 7-percent annual rate of gain, to over \$903 billion, in the production of goods and services. On the other hand, April's policy announcements — a substantial Treasury budget surplus for fiscal 1970 and increased Federal Reserve credit restrictions—revealed the determination of policymakers to destroy inflationary expectations and to hold the economy within the bounds of its real growth potential.

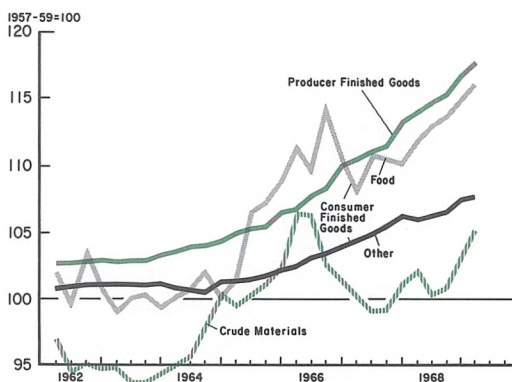
GNP expanded mostly because of a continued strength in today's consumer markets and of a strong upsurge in business spending, which looks to the expanded markets of the 1970's. With inventories growing only at a modest pace, final demand (total GNP less inventory change) jumped by roughly \$20 billion, as against a \$13-billion rate of gain in the preceding quarter. This was fully as surprising in the present atmosphere of fiscal and monetary tightness as was the comparable spending upsurge which followed on the heels of the restrictive tax surcharge of mid-1968. Not so surprising, but more worrisome, was the news that more than half of the GNP increase was swallowed up by rising prices. Understandably, then, policymakers moved this spring to tighten the screws once again.

Action against inflation

On the fiscal front, the Federal budget continued to move sharply toward surplus. Over the past twelve-month period, it has shifted from a \$10-billion deficit (national-income basis) to a surplus in the neighborhood of \$6 to \$8 billion. On the monetary front, Federal Reserve policy stiffened again in early April. Reserve banks lifted the discount rate from 5½ to 6 percent, and the Federal Reserve Board raised member-bank reserve requirements on demand deposits by ½ percent. Thus, by mid-April, the period when the signs of taxpayers' revolts annually appear, policymakers were moving relentlessly against the cruellest tax of all—inflation.

The need for further action on the anti-inflation front was quite evident during the first quarter of 1969. The consumer price index (and the GNP price index) rose at a

Continued rise in all price sectors provides rationale for tighter policy



4½-percent annual rate in the early months of the year. Wholesale prices for industrial commodities rose at almost the same rate, and thereby helped reduce further the competitive position of American products in world markets. Indeed, the upsurge in the inflation-stimulated domestic economy, with an assist from the East Coast dock strike, helped account for a zero reading in the national accounts' net-export column, for the first time in a decade.

But these developments only emphasized the cost-price indicators that businesses and consumers have begun to take increasingly into account in making their purchasing decisions over the past several years. From the middle of 1965, when a war boom was superimposed upon a business-investment boom, to the end of 1968, the consumer and wholesale price indexes rose 3½ percent and 2 percent annually — more than doubling their respective rates of increase of the preceding 3½-year period.

Action on wages

At the same time, pressures have re-

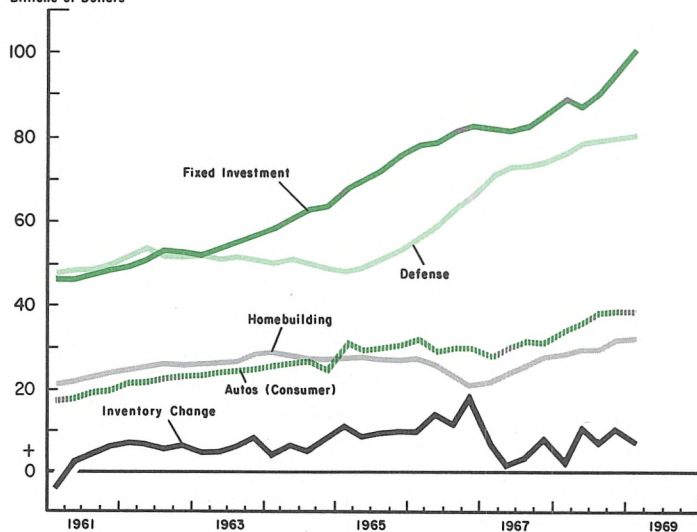
mained rather taut in the U.S. labor market. Continued tightness has been evidenced by the very low unemployment rate, and by a substantial upsurge in employment over the past half-year or so. (March, however, posted a modest rise in the jobless rate, to 3.4 percent, as well as a slowdown in the rate of growth of nonfarm employment.) The 2 million workers added to payrolls in the past half-year matched the rapid rate of growth recorded in the opening stages of the Vietnam buildup.

Labor-market pressures — and labor-cost pressures — continue to be quite strong. Even though only 2.7 million workers are involved in major industry contract negotiations this year, as against 4.9 million workers in 1968, the economic climate all but guarantees problems in reaching satisfactory wage agreements. Although steel, autos, rubber, and trucking negotiations are not on the agenda, as they were last year, there will be negotiations aplenty in the transport sector (air, sea, and rail), electrical manufacturing, lumber, construction, and public enterprises. (The year has already witnessed strikes on the docks and in the oil fields, plus an abortive nationwide rail strike.)

Over 6 million union workers will receive deferred wage increases in 1969. The median increase—4 percent—that will be obtained in the organized sectors should help dampen the average increase in the total wage bill, especially in contrast to the first-year contract gains of close to 7 percent recorded in 1968 and early 1969. Even so, wage increases for those not covered by long-term contracts will probably continue large until the pressures generated by a tight labor market

Most cyclical sectors of GNP move sideways—except business investment

Billions of Dollars



and rising consumer prices begin to moderate.

Some moderation in those pressures may yet arise from the supply side, since the babies who were born in record numbers after the war are now moving rapidly into the adult labor force. This development was overshadowed in recent years by a 300,000 growth in the armed forces, which took up the bulk of the rapid rise in male employment in the 20-24 year age bracket. With continuation of the growth in the labor force (with or without a reduction in the size of the armed forces), labor-market pressures could ease in rapid fashion.

Wages spell spending

Still, in early 1969 the tight labor market, with its rising labor-cost pressures, also spelled a continued upsurge in personal income which soon showed up in a higher volume of buying. Family spending, in true cyclical fashion, responded rather late but ebulliently to the investment boom of the mid-60's and the defense boom of the late-60's, and it has since continued quite strong, even in the face of restrictive tax and credit policies. During the first quarter, consumer spending rose by more than \$11½ billion to a \$558-billion annual rate. (Fast-spending '68 chalked up quarterly gains of \$10½ billion, on the average.) Sales of consumer durable goods continued to edge into higher ground, while sales of nondurable goods and services moved sharply upward.

This consumption gain developed in the face of a rather modest rise in disposable income. (Wages and salaries advanced sharply during this period, but much of this was offset by rising social-security and income taxes.) Just as in the third quarter of 1968, consumers showed their willingness to sacrifice savings in order to maintain a spending rate to which they had increasingly become accustomed. The savings rate in the first quarter fell below 6 percent of disposable

income, as against the high 7½-percent rate which prevailed before the imposition of the tax surcharge last summer.

Detroit against the world

Probably the best example of the high but potentially unstable level of consumer spending was the auto market. Sales of autos and parts edged up to almost a \$40-billion rate during the quarter, as Detroit with its heavy sales efforts attempted to offset the problems caused by increased tax deductions from consumer payrolls and by increased rates on auto loans.

Detroit started the 1969 model year at a fast pace—perhaps too fast for auto dealers' comfort. The hard sell was in evidence as early as February, in the form of rising advertising budgets and heavy sales-incentive campaigns, as dealers were forced to deal with a record level of new-car inventories for that early in the model year. Even with the help of sales contests and a slowdown in production rates, the industry still had 1.75 million new cars on hand on the eve of the spring season. (One industry statistician figured that those cars would fill 4,300 football fields.) Much of the problem was simply due to a significant drop in the new-car sales pace, from a 9.0-million-unit annual rate in third quarter '68 to an 8.4-million-unit rate in first quarter '69.

The industry, of course, had to contend with a strong import challenge as well as the challenge of increasingly restricted consumer budgets. During the first quarter, imports continued to take over 10 percent of the U.S. market, despite the lack of supplies occasioned by a two-month dock strike. But over the rest of the year, imports must face the competition of a new U.S. scaled-down compact, although they will not have to face a widespread Detroit response until the 1971 models come out with several more domestic entries in the sub-compact class.

Past history provides few answers to the

domestic industry's dilemma. Detroit successfully withstood the import challenge during the 1960-65 period, so that U.S. compacts had about a 3-to-2 edge over imports by 1965. That ratio, however, has since been reversed as Detroit has lost control of the bottom segment of the market, and the domestic industry may face some difficult problems in attempting to regain its foothold in this market segment.

Housing and money

Another consumer-oriented sector, residential housing, increased at a fairly rapid pace during the early months of this year. New construction rose by about \$1 billion to a \$33-billion annual rate during the first quarter, which was quite strong in view of the restraints on both housing demand and mortgage availability. On the demand side, buyers had to run the gauntlet of rising costs; on the monetary side, they had to find acceptable credit terms in the face of the reduced inflow of funds into savings institutions, the basic source of mortgage money. But these restraints are less binding on multi-unit construction than on single-family housing — which helps explain the dominant role of apartment construction in the building upsurge of the past two years.

Housing starts during the first quarter reached a rather respectable 1.7-million-unit annual rate, but they have trended downward since the January peak as builders have begun to scale down their operations from their original 1969 plans. The major question mark thus centers around the problem of mortgage money. The demand for funds is growing faster than the level of housing starts because of the rapid rise in housing costs, and the supply of mortgage money is under pressure because of the tight-money impact on the availability of funds.

On balance, then, this year may see a further addition to the backlog of housing demand created since the beginning of the

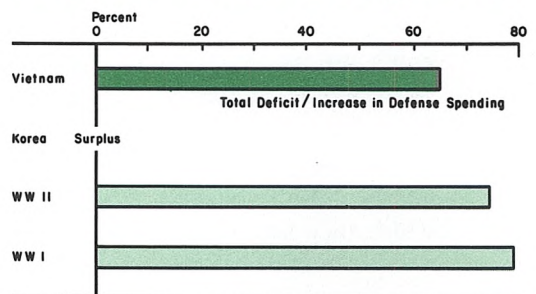
Vietnam crisis. Basic demand, as measured by the rate of household formations, has increased by one-third since mid-1965, and vacancy rates have dropped sharply in the face of the industry's failure to keep up with rising demand. By the end of 1968, the rental vacancy rate had dropped from 7.7 to 4.9 percent, and the single-family rate from 1.4 to 1.0 percent.

Efficient stockroom

The inventory sector, where any imbalance between business ebullience and policymakers' restrictiveness should show up first, remained relatively healthy during the first quarter of 1969. Business inventories rose at perhaps a \$6-billion annual rate during this period, in contrast to the sharp buildups that developed during the second and fourth quarters of the preceding year. Inventory-sales ratios, although too high for some retailers (such as auto dealers), were substantially below the 1968 average for durable goods' manufacturers and were roughly in line with traditional ratios for other businesses.

In the auto sector, as noted above, record inventories in the face of a sluggish sales rate created some warning signals. But elsewhere, many purchasing agents erred in the other direction, feeling that rising materials prices left them no alternative than to buy now instead of later. (Even so, inventories of

Inflation during Vietnam, as during two world wars, traceable to budget deficit



materials were not out of line with the level of final demand.)

This inventory accumulation was largely voluntary, in response to the rapid rise of sales volume and to the heightened expectations of purchasing agents. Still, if sales should flatten out and if some involuntary accumulation of inventories occurs, businessmen may quickly see the divergence between their own bright calculations and policymakers' more conservative views, and they may then assess their '69 expansion plans more realistically.

Pentagon and inflation

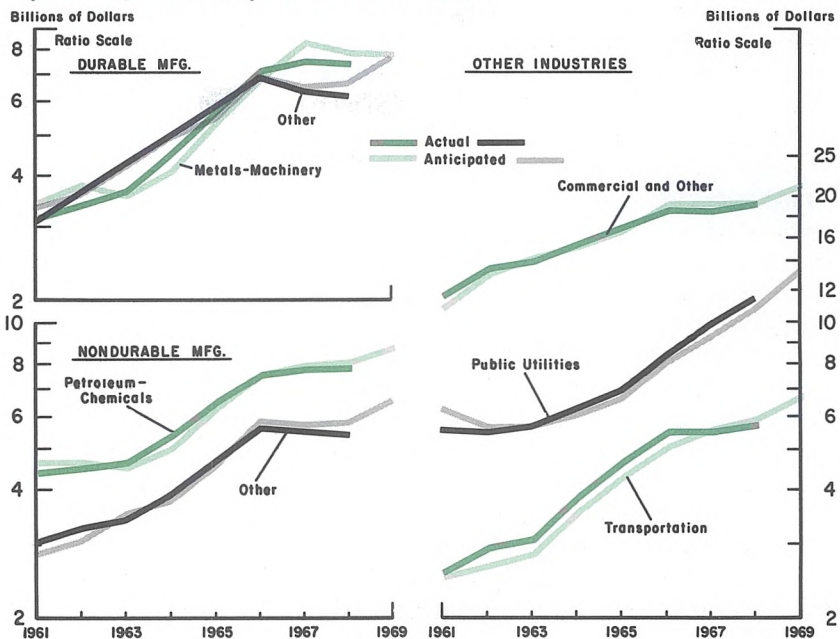
Nonetheless, the business spotlight during the first quarter continued to focus on those two sectors which first generated the boom and the super-boom of the mid-60's—business investment and defense spending. On the latter score, the Pentagon, which created much of the excess demands of the last several years, increased spending less than \$½ billion during the first quarter to an \$80½-billion annual rate. According to revised budget figures, the slowdown in this growth sector should continue now throughout fiscal 1970.

Much of today's inflationary pressure can be traced to our attempt to fight a large-scale war without raising sufficient tax revenues to finance it, as was noted recently by Federal Reserve Governor Brimmer in a speech at the City University of New York. Accord-

ing to his calculations, deficit financing of the Vietnam conflict, until mid-1968, was relatively almost as large as in World War I and World War II, and was in sharp contrast to the budget surplus posted during the Korean conflict. (In the fiscal 1965-68 period, the total Federal deficit amounted to 64½ percent of the increase in war-related spending, as against a 79-percent ratio during World War I and a 74-percent ratio during World War II.) Now, only in fiscal 1969, has a major effort been made to reduce the purchasing power in the hands of the private sector, thus lessening this sector's claims on the real resources needed for the war effort.

The April budget revisions, incidentally, showed several changes from the \$79-billion spending figure proposed by Defense Secretary Clifford for fiscal 1970 last January. Secretary Laird by early April reduced the 1970 figure to \$77.9 billion—in contrast to 1969's projected \$78.4 billion — mostly through the cancellation or deferment of

Sharp gains likely in plant-equipment spending, even if plans are off target



certain aircraft, shipbuilding, and munitions programs.

Business and inflation

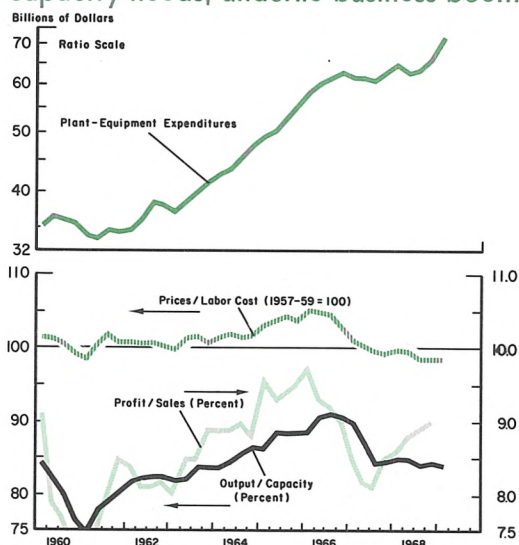
The dominant 1969 question, however, centers more on the intentions of business investors than on the intentions of military purchasers. During the winter quarter, fixed-investment spending jumped almost \$6 billion, to a \$100-billion annual rate, and thus set the stage for what may well be the second investment boom of this decade. In early spring, according to the periodic Commerce-SEC survey, businessmen announced plans to increase their plant-equipment spending by 14 percent this year — which suggests a whopping increase even if spending falls below target, as it did in 1967-68.

Federal Reserve Chairman Martin, in Congressional testimony late last month, suggested some possible reasons for these heavy spending plans: “With wages increasing at rates still beyond the growth of productivity, with the costs of capital goods rising, and with expectations developed over the past several years that higher costs can sooner or later be passed on in the form of higher prices, why shouldn’t we expect businesses to do what they can to introduce cost-cutting methods and to put new capital in place at today’s prices?”

Manufacturing firms, after slowing down their plant-equipment spending for two straight years, plan to increase their expenditures by about 16 percent this year. Other major industries as a group plan a 12½-percent increase—and each of these industries (except public utilities) has scheduled a substantially larger increase than in either 1967 or 1968. The magnitude of this proposed expansion, taken in the face of already restrictive monetary and fiscal policies, helps account for the Administration’s late-April decision to ask for the repeal of the 7-percent tax credit on business equipment.

Moreover, economic reality may yet force a downward revision of these spending plans.

Inflationary cost expectations, not capacity needs, underlie business boom



In a somewhat similar situation during the 1955-57 inflationary boom, the supply situation fairly rapidly caught up with demand, as measured by a sharp decline in manufacturing capacity-utilization rates. The decline in utilization rates then helped bring about an end to the price spiral—by stimulating increased competition, and by bringing cost reduction back into style.

At this stage, businesses, consumers, and governments alike may do well to heed the prescription of “disinflation without deflation,” in Chairman Martin’s phrase. The problem and the cure are summarized in Economic Adviser McCracken’s recent speech to the New York Economics Club: “The casual price decision which reflects the extrapolation of past trends will make for some uncomfortably soft markets in this new environment; and wage bargains which assume continued inflation at recent rates will court the risk of less employment. . . . But one responsibility of those managing policies is not to keep validating private decisions which would make sense only if inflation were to continue unabated.”

William Burke

Plenty of Restraint

Public policy on the whole was far more restrictive in the first quarter of 1969 than in many, many years—and the outlook for the second quarter promised even more of the same. Significantly, a major element in this picture was the presence of a hitherto-missing balance between monetary policy and fiscal policy. The recent gains in final sales of goods and services, even in the face of tightening credit and tax policies, simply served to emphasize the strength of aggregate demand and the necessity for sustained restraint.

The present tight-money period invariably invites comparison with the major “credit crunch” of the late summer of 1966. The parallels are obvious, but there are also some dissimilarities — principally the extent to which fiscal policy reinforced (or failed to reinforce) monetary policy.

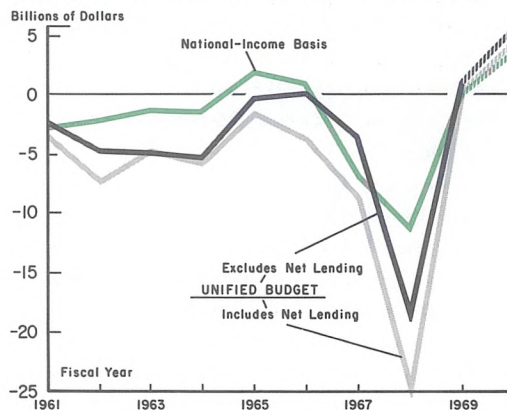
Between the second and the third quarters of 1966, the Federal budget on the national-accounts basis moved from a surplus of nearly \$4 billion (annual rate) to a \$½ billion deficit. Thus, while monetary policy was exerting continued pressure on bank reserves, the Treasury on its part was moving rapidly from a fairly restrictive to a modestly expansive posture. Conversely, in the more recent period, the Treasury moved from a \$10-billion deficit in second-quarter '68 to a surplus of almost \$8 billion in the initial quarter of this year. On balance, then, 1969 marks a far more restrictive atmosphere, with both monetary policy and fiscal policy mov-

ing toward restraint, in contrast to the fiscal stimulus and monetary restrictiveness of the earlier episode.

Monetary policy fosters restraint . . .

Between December 1968 and April 1969, the monetary authorities used all of their instruments of control to bring pressure to bear upon the reserves of the banking system. Federal Reserve Banks raised the discount rate (the cost to member banks of borrowing additional reserves) from 5 to 5½ percent in mid-December and then to 6 percent in early April. The Federal Reserve Board raised reserve requirements against demand deposits by ½ of 1 percent in April, imposing an estimated \$650 million of bank reserves. The System, moreover, was a net seller of securities in the open market, re-

Fiscal policy (not only monetary) moves toward restraint in '69 setting



ducing its securities portfolio by \$900 million in the first quarter and absorbing a like amount of bank reserves.

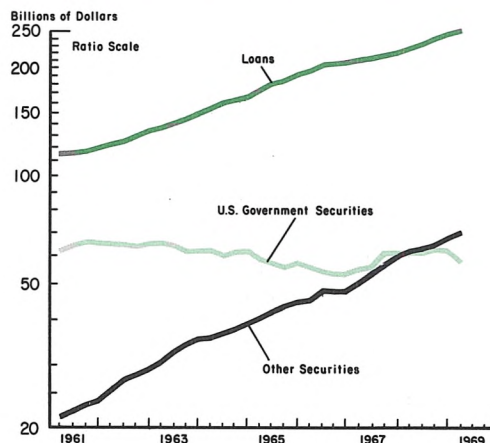
Interest-rate ceilings on time-and-savings deposits (Regulation Q) were not increased from the levels in effect since April 1968. In this case, the failure to lift Regulation Q maximums must be regarded as another significant policy action. As interest rates on competing money-market instruments exceeded the maximums on large negotiable time-certificates (CD's), the failure to renew maturing certificates resulted in the conversion of these time deposits into demand deposits, which of course are subject to higher reserve requirements. Hence, the loss of \$5 billion or more in CD money since early December represents a *de facto* increase in required reserves, inasmuch as the deposit-mix of demand and time deposits was altered, raising average reserve requirements against total deposits outstanding.

... and monetary expansion slows

The growth of total member-bank reserves dropped sharply between the fourth quarter and the first quarter, from an 8.8-percent annual rate of gain to a 0.4-percent rate. Banks were forced into the discount window to support their outstanding deposits, and the average level of member-bank borrowing from the Reserve Banks thus rose from \$580 million in fourth-quarter '68 to nearly \$800 million in first-quarter '69. Net borrowed reserves (total borrowings less total excess reserves) deepened from a \$284-million average to a \$600-million figure over the same period.

The money supply (demand deposits plus currency) increased at roughly a 2-percent annual rate in the first quarter—far below the 7.6-percent rate of the preceding period. More strikingly, time-and-savings deposits turned around sharply between the fourth quarter and the first quarter, from a 15.7-percent rate of growth to a 6.7-percent rate

Banks, in typical tight-money move, sell off securities to expand loans



of decline. Most of the decrease developed because of the runoff of CD's at major money-market banks. A similar reversal occurred in total bank credit, which shifted from a 12.2-percent rate of growth to a 5.1-percent rate of decline over the same time-span.

Adjusting to tight money

The sharp change in bank-credit expansion during early 1969 reflected the efforts of commercial banks to accommodate themselves to a climate of harsher monetary restraint. Since the demand for loans tends to be strongest in such an environment, banks generally alter the composition of their assets in order to provide funds to meet such demand. The most typical response is the sale of various assets, chiefly securities.

Between December and March, commercial banks reduced their holdings of U.S. Government obligations by about \$4.5 billion and their holdings of "other securities" (principally municipals) by \$0.4 billion. A substantial part of this reduction was in short-term maturities, which may be sold or allowed to mature without renewal. (Short-term securities may also be the first to go

because they generally entail smaller capital losses in a declining securities market.)

The second major response to tight money involved the borrowing of funds to replace losses from the CD runoff and from the diminution of the growth rate of bank reserves. Many banks borrowed in the Federal-funds market (utilizing uncommitted reserves of other banks), borrowed from a Federal Reserve Bank, or even tapped the Euro-dollar market.

There are limits to the amount of funds that can be raised in the Federal-funds market, since as money grows tighter, excess reserves of the banking system decline. Borrowing from Reserve Banks now costs member banks 6 percent, which is relatively cheap when compared with other rates, but this type of borrowing naturally subjects the borrowing bank to the scrutiny of Reserve-Banks' discount officers. Thus, some banks have increasingly turned to foreign sources, by transferring funds to the home office from foreign branches or, where foreign branches do not exist, by borrowing directly in the Euro-dollar market. American banks have recently drawn heavily upon this source of funds; liabilities to foreign branches of domestic banks increased by about \$2.6 billion in the first quarter, to a level of \$9.5 billion in March.

Interest rates . . . up

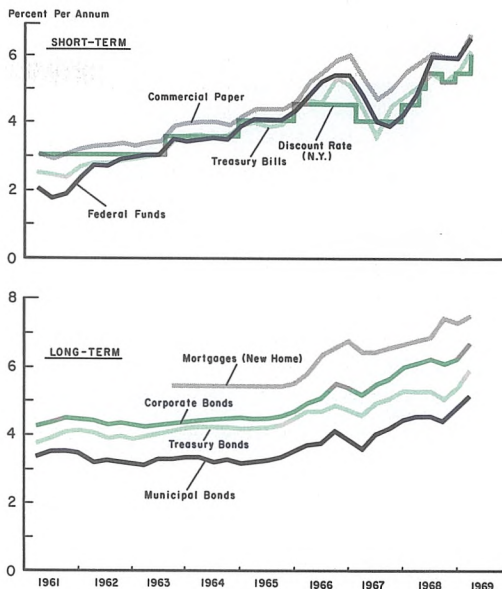
There was no place for interest rates to go but up when monetary policy became more restrictive. Yields were already at record levels in many instances in 1968, so new highs were established in the first quarter of 1969. There were exceptions, however; yields on 91-day Treasury bills dropped over 20 basis points over the first three months of the year, dipping below the 6-percent level in the process — primarily because of the prospect of heavy Treasury debt repayment, perhaps as much as \$12 billion, during the second quarter. (Some of the demand for

bills resulted from holders shifting out of CD's, reflecting the strong demand for liquidity during this period.) But the behavior of Treasury-bill yields was not typical of short-term interest rates in general; commercial-paper rates rose by more than 60 basis points and bankers' acceptance rates increased by nearly 30 basis points in the first quarter.

Long-term securities came under severe pressure during this period. Yields on corporate (and municipal) issues were up about 50 basis points from December levels, and the yield on top-quality outstanding corporate bonds reached 6.99 percent at the end of March, rising by 27 basis points in that month alone. Yields on new issues rose accordingly; top-rated issues carried 7½-percent coupon rates, while somewhat lower-rated issues were priced to yield well over 8 percent.

The municipal market was particularly vulnerable to this pressure, since the com-

Interest rates had no place to go but up when policy became tighter



mercial banks, which typically underwrite about four-fifths of new tax-exempt securities, reduced their net holdings of municipal issues during this period. The 5-percent statutory limit on many state-and-local bond issues forced the postponement or withdrawal of many offerings, sometimes because of a lack of bids, as the average yield on outstanding municipal bonds reached and exceeded 5 percent in mid-March. Altogether, market conditions forced the postponement or withdrawal of roughly \$1 billion of offerings during the first quarter.

The Federal budget should show a substantial surplus this quarter, and the Treasury

will use this to repay debt and to build up its cash balances. (Treasury financing efforts will be confined to the retirement of \$8.8 billion of tax-anticipation bills maturing in April and June and to the refinancing of \$6.8 billion of notes and bonds maturing in mid-May and mid-June.) Since the Treasury will be making substantial debt repayments, its operations should contribute to some easing of upward pressure on short-term interest rates. For that matter, a quite recent easing tendency in long term rates suggests that anti-inflationary policies are beginning to take hold in that sector as well.

Herbert Runyon

Presidential Tax Message

President Nixon in late April sent Congress a far-ranging tax message which proposed the immediate repeal of the 7-percent investment tax credit, the halving next January of the 10-percent income-tax surcharge, and the enactment of a number of reforms designed "to lighten the burden on those who pay too much, and increase the taxes of those who pay too little." The proposed reforms included a 50-percent limitation on tax preferences available to affluent taxpayers and the lifting of the tax burden from "poverty level" taxpayers. The revenue gains and losses of the package, taken as a whole, would balance out at \$4 billion a year.

Treasury officials expect that roughly \$1.8 billion in tax revenue would be saved in fiscal 1970—and roughly \$2.8 billion each year thereafter—from the repeal of the investment tax credit. A major factor underlying their proposal is their expectation that this step would dampen the inflationary strains resulting from the present plant-equipment boom.

Officials also expect that about \$1.9 billion in revenue would be lost in fiscal 1970 from the reduction of the surtax to the 5-percent level over the January-June period. (In his budget message two weeks earlier, the President asked for retention of the 10-percent surtax but, then as now, he proposed dropping the surcharge "if economic and fiscal conditions permit" at the end of June 1970.) Thus, these two major budget changes would practically balance each other off, and would not appreciably affect the \$5.8-billion surplus projected for fiscal 1970.

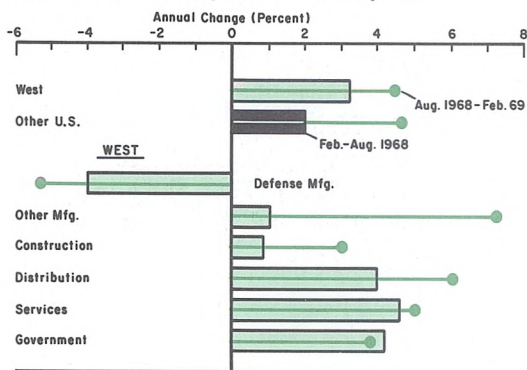
Growing . . . Growing

The Western economy weathered the storms of winter remarkably well and entered spring with signs of growth in nearly all sectors. The expansion of employment kept in line with the surging national pace, even though the District's aerospace-manufacturing industry continued to post declines. Much of the West suffered from prolonged winter storms which had a dampening effect on the lumber, agriculture, and construction industries, but all of these industries began to rebound in early spring.

The West participated fully in the nationwide employment upsurge of late '68-early '69, with a 4.6-percent annual rate of gain over that period. (In the preceding six-month period, District nonfarm employment grew at a 3.2-percent annual rate.) The West showed gains in all major sectors except aerospace over the past six months, with particular strength in non-aerospace manufacturing, which experienced a 7.4-percent rate of gain.

The unemployment rate in California increased slightly in the first quarter, to a seasonally-adjusted rate of 4.6 percent. The rest of the District, however, showed an easing—

Job expansion accelerates in West—except for aerospace



from 4.3 to 4.1 percent—as did the rest of the U. S.—from 3.2 to 3.1 percent.

Severe winter weather—particularly in the Pacific Northwest and Southern California—dampened retail-sales activity during the first quarter. Nevertheless, District consumers began the year by spending at a faster-than-'68 pace, with few weaknesses evident except in some durable-goods lines.

Shoppers were faced with a continuation of last year's trend toward higher price tags. First-quarter boosts in Western living costs equaled, and in some cases exceeded, the 4.8-percent annual rate of increase nationwide. The greatest strains on consumer budgets came from rising food and housing costs.

Aerospace — earthbound

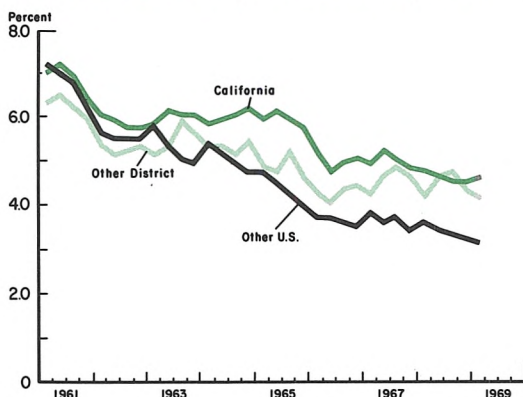
Aerospace-manufacturing employment weakened, both nationally and regionally, during the first quarter of 1969. The District decline over this period—8,200—was fairly modest when compared with the 13,000 reduction during the last quarter of 1968. The recent decline was centered in Washington, with some easing also in California plants. District aerospace employment now stands about 6 percent below the peak of 755,000 workers reached in December 1967.

Declines in orders for both government and non-government products, along with stretchouts on several projects, were primarily responsible for the employment decline. Space-agency contracts also continued to drift downward and, in the commercial sector, deliveries of current models of jet aircraft started to taper off.

Construction — rebounding

Housing activity in the West fell off sharply during the first quarter from the vigorous pace achieved during the closing months of

Jobless rate in West remains above national rate, despite faster expansion



1968. The exceptionally bad weather apparently accounted for a considerable part of the slowdown. Housing starts dropped 18 percent from the fourth quarter of 1968 to the first quarter of 1969, reaching a 225,000-unit annual rate in February. But the industry then rebounded sharply in March to a 332,000-unit annual rate—only slightly below the peak reached late last year. By contrast, home starts in the rest of the nation posted an overall gain of about 12 percent for the first quarter, in spite of a fairly sharp decline in March.

While Western housing starts fluctuated considerably during the quarter, both the number of permits and the dollar volume of construction awards showed less volatility and a smaller decline—about 10 percent in the case of the latter. In any case, the major depressants on the housing market seemed to be the severe weather and, to some extent, the continuing rise in costs. Even so, demands for funds by builders and buyers appeared strong, and vacancy rates continued to decline in most major metropolitan areas except Seattle.

In other District construction activity, non-residential and heavy engineering contracts posted a 6-percent gain (in dollar volume) during the initial quarter of 1969. This gain

lagged slightly behind the pace in the rest of the nation. Both regionally and nationally, awards for the construction of commercial buildings and manufacturing facilities showed considerable strength, underscoring business' plans for a sharp increase in plant-equipment spending this year.

Lumber — snowed under

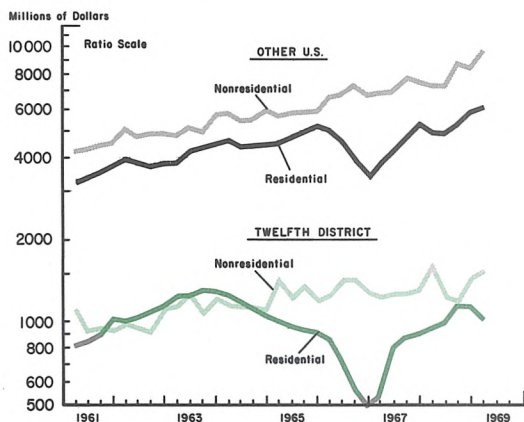
Snowstorms—dumping up to 30 inches of new snow on Pacific Northwest lumber-producing areas in January—created severe production problems for the industry and sent prices soaring to record highs. In February, Douglas-fir prices were at least one-third above year-ago levels, and softwood-plywood prices were double early '68 quotations. But the situation turned quickly around in March, as production returned to normal and as customers began to resist sky-high plywood prices.

The ensuing price decline was accentuated when President Nixon — acting upon the recommendations of a special Cabinet-level task force and the urgings of the National Association of Home Builders—instructed the Agriculture and Interior Departments to make more timber available from Federal lands. By early April, key plywood prices were 50 percent below the peak levels of late February, despite the closing of more than a dozen small mills, while Douglas-fir lumber prices were off about 15 percent.

Metals — soaring

Copper and base-metal prices were raised on a broad front as demand remained heavy in the face of several supply problems — severe weather conditions at the mines, along with the reduced flow of imports resulting from strong European demand and the East and Gulf Coast dock strike. In early January major producers raised their price for refined copper from 42 to 44 cents a pound, and in late March fabricators raised their prices to reflect an average price for

Western construction activity lags behind pace in rest of nation



copper from all sources (including dealer and exchange markets) of 48 cents a pound. Zinc producers raised the price of their metal from 13½ to 14 cents a pound, and lead producers upped their quotation from 13 to 14½ cents a pound in half-cent increments.

Pacific Northwest aluminum production reached record levels during the first quarter of 1969. But heavy demand enabled the industry to raise ingot prices from 26 to 27 cents a pound—the highest level in over a decade—and fabricated-product prices by an average of 5 percent.

Western steel production increased sharply as the prolonged period of sluggishness that followed the mid-1968 labor-contract settlement came to an end. In March, regional production neared the record pace achieved in May 1968. The industry benefitted both from a pickup in total demand and from a slowdown in the import boom resulting from the adoption of voluntary quotas by Japanese and European producers. In mid-February most producers raised prices of hot-rolled sheets by \$12 a ton, in effect cancelling all of the reduction posted last November, and in mid-March they raised tubular-product prices by almost 4 percent.

Petroleum refining activity during early 1969 surpassed year-ago levels despite interruption by the first industry-wide strike in 17 years. By the end of the quarter, however, striking workers had returned to work at most District facilities. But most of the major industry news came from January's massive oil leak in the Santa Barbara Channel—which prompted at least a temporary ban (until April) on drilling on Federal offshore leases—and from the continued development of Alaska's North Slope bonanza.

Agriculture — holding steady

Western agriculture during early '69 showed little change from year-ago levels, as increased livestock returns were offset by reduced crop receipts. In contrast, cash receipts in the rest of the country were up somewhat, as a sizable increase in sales of livestock and products more than offset a decline in crop receipts.

Some expansion in District field-crop acreage is in prospect for 1969, despite a sharp reduction in food-grain acreage. Plantings of other field crops are generally higher than last year, with sugar beets and cotton leading the field, and processing vegetables lagging.

Agricultural losses from flood damage have been extensive in some areas of the District. Floods covered large areas of Central and Southern California's farmland early in the year, and further flood damage could occur in the southern portion of the San Joaquin Valley when the record snowpack melts. Citrus growers have been hardest hit to date, with considerable amounts lost, quality of fruit downgraded, and trees washed out. Peach growers are afraid that saturated soils may reduce the size of their forthcoming crop. And, in addition, growers of field crops and early spring vegetables have been forced to postpone some plantings because of soggy farmlands.

Regional staff

Even More Restraint

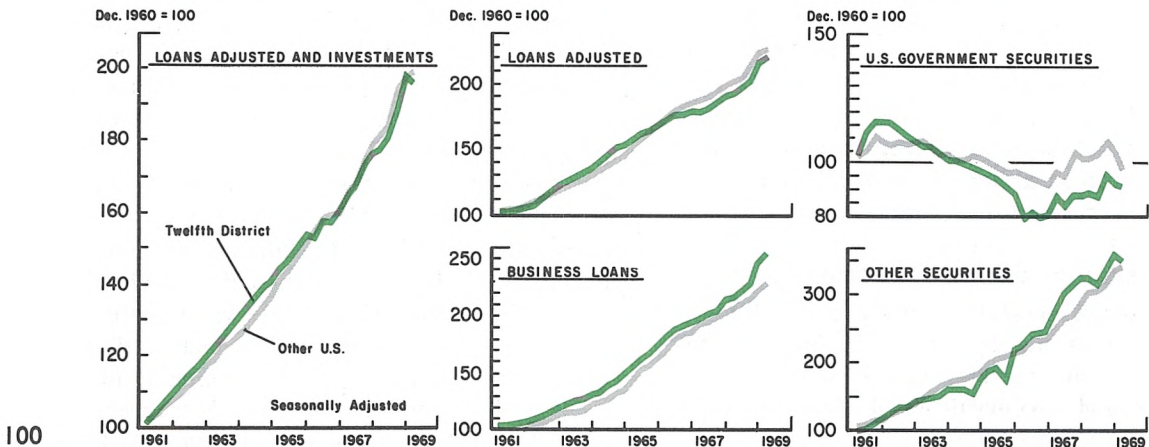
Early 1969 was a period of mixed blessings for Twelfth District commercial banks. During the first quarter they expanded their loans by \$592 million, on a seasonally adjusted basis, with business loans pacing the gain as they had throughout most of 1968. Moreover, with their record loan revenues, many Western banks posted first-quarter operating earnings well above year-ago levels. But an increasingly restrictive monetary policy brought about a \$688-million (seasonally adjusted) contraction in total bank credit during this period. Thus, the first-quarter loan expansion was made at the expense of a \$1,280 million reduction in bank holdings of securities—mostly short-term Treasury issues, although all maturities

and all types of securities suffered in the decline.

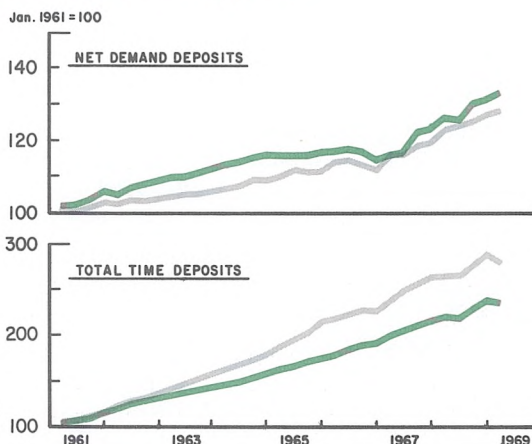
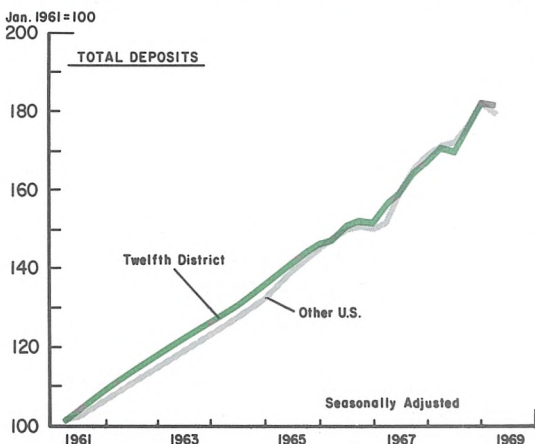
The impact of a firmer monetary policy on Western banks also showed up in a (seasonally adjusted) first-quarter decline in total deposits. Attrition in large-denomination CD's and a greater-than-seasonal loss of public funds reduced time-deposit totals by an amount which more than offset the banks' gains in demand deposits.

Western banks' first-quarter performance, in comparison to that of other commercial banks, was somewhat mixed. The loan expansion was relatively smaller and the reduction in securities greater than at other banks, but the decline in total deposits in the West was relatively less than elsewhere.

Western banks post first-quarter decline in total bank credit, because of slowdown in lending and large reduction in security holdings



Western banks experience smaller time-deposit attrition than other member banks during first-quarter tight-money period



As a result of these first-quarter developments, Western banks suffered a fairly sharp decline in the ratio of liquid assets to total liabilities (less capital accounts), since they were left with fewer short-term assets for conversion as a source of lendable funds. On top of that, the April 4 increase in the discount rate, from 5½ to 6 percent, raised the banks' cost of obtaining funds from the Federal Reserve discount window, while rates for borrowed funds from other sources continued at record or near-record highs. Furthermore, the increase in required reserves against demand deposits, effective April 17, idled an additional \$90 million in the form of reserves for District member banks. Thus, banks entered the second quarter with their maneuverability substantially reduced—partly because of the first-quarter reduction in deposits and security holdings, and then because of their higher borrowing costs and increased reserve requirements.

Reliance on discount window

District member banks borrowed \$90 million (daily average) from the Federal Reserve during the first quarter of 1969. This volume of discounting was 43 percent greater than in the preceding quarter, and it far ex-

ceeded the amount of discounting in 1966's tight-money period. Further, net borrowed reserves of District banks averaged \$87 million—more than double the preceding quarter's figure and four times greater than in third-quarter 1966. But District banks recorded relatively smaller increases, in borrowings and in net borrowed reserves, than other member banks did between the final quarter of 1968 and first-quarter '69.

Despite the intensified reserve pressure, major District banks were net interbank sellers of Federal funds (idle balances of banks on deposit with Federal Reserve Banks). Their sales (loans) of funds to banks averaged \$157 million, in contrast to net purchases (borrowings) of \$575 million in the fourth quarter of 1968. However, District-bank Fed-funds sales to Government securities dealers dropped to \$75 million during the January-March period, compared with \$500 million in the fourth quarter.

District banks' overall position as net sellers of Fed funds appears paradoxical in view of the general tightening of reserve pressure. It should be noted, however, that many individual District banks were net purchasers of funds in this three-month period. Moreover, most of the net-selling banks more than offset

FEDERAL RESERVE BANK OF SAN FRANCISCO

their Fed-funds sales by borrowing funds from corporations under repurchase agreements and/or by increasing their reliance on the Euro-dollar market.

Expansion in loan portfolios

Western commercial banks recorded a decline in loans in January and an increase in February on a seasonally adjusted basis; then, in March, they scored a sharp \$578-million gain. The pace of business lending accelerated over the quarter, from \$89 million in January to \$168 million in March, when corporations borrowed heavily to meet their mid-March corporate tax payments. Corporate borrowing at District banks outpaced the rest of the nation during March, although it lagged behind the rapid national pace during the quarter as a whole.

The strength in business credit demand was largely centered in the durable-goods sector, particularly machinery, transportation and other fabricated-metal producers. Other heavy borrowing came from petroleum refineries and from the transportation sector of public utilities. Despite record borrowing costs, business term loans (loans with maturities of over one year) increased by \$89 million in the first quarter as most categories of durable-goods manufacturers increased their long-term bank credits. Several sizable loans to service firms also boosted the term-loan total.

The rise in business borrowing occurred against a background of two increases in the prime rate—on January 7 and March 17—which brought this key loan rate to 7½ percent, a record high. The latest quarterly

SELECTED ASSET AND LIABILITY ITEMS OF WEEKLY REPORTING LARGE BANKS

Data Not Seasonally Adjusted
(Dollar amounts in millions)

	TWELFTH DISTRICT				U. S. MINUS TWELFTH DISTRICT		
	Outstandings	Net Change			Outstandings	Net Change	
		March 26, 1969	First Quarter 1969			March 26, 1969	First Quarter 1969
	Dollars	Percent	Percent		Percent	Percent	
Total loans and investments	\$49,343	- 461	- .93	- .86	\$177,075	- 3.51	- 1.32
Loans adjusted and investments ¹	47,934	-1,533	- 3.10	- .53	173,341	- 4.09	- .66
Loans adjusted	34,964	- 389	- 1.10	+ .05	123,471	- 2.39	- 1.34
Commercial and industrial loans	13,816	+ 112	+ .82	+ 1.69	61,231	+ 1.29	+ .71
Real estate loans	10,642	+ 116	+ 1.10	+ 1.39	21,950	+ 1.66	+ 1.91
Agricultural loans	1,263	+ 16	+ 1.28	+ 1.07	700	- 4.24	- 2.49
Loans to nonbank financial institutions	1,424	- 244	-14.63	-16.46	8,933	-12.46	-13.56
Loans for purchasing and carrying securities							
To brokers and dealers	261	- 519	-66.54	-12.61	3,436	-42.07	-15.51
To others	278	+ 12	+ 4.51	+ 5.76	2,611	+ .97	- 3.64
Loans to foreign banks	265	+ 6	+ 2.32	-13.85	1,377	+ 2.30	- 1.02
Consumer installment loans	5,223	+ 71	+ 1.38	+ 1.02	13,551	+ .81	+ 1.32
All other loans	2,388	+ 47	+ 2.01	+ .10	12,583	- 3.14	- .70
Total investment	12,970	-1,144	- 8.11	- 1.94	49,870	- 8.04	+ .90
U. S. Government securities	4,903	-1,026	-17.30	- 7.47	19,908	-15.04	- 3.36
Obligations of states and political subdivisions	6,885	- 151	- 2.15	+ 1.99	26,496	- 1.88	+ 4.95
Other securities	1,182	+ 33	+ 2.87	+ 4.10	3,016	- 9.67	+ 1.76
Total deposits (less cash items)	47,555	-1,892	- 3.83	+10.33	157,904	- 9.33	- 2.79
Demand deposits adjusted	16,019	- 999	- 5.87	- .57	63,465	-11.72	- 4.11
Time and savings deposits	30,237	- 483	- 1.57	+ 2.67	78,171	- 4.05	+ 2.13
Savings deposits	15,581	- 326	- 2.05	+ .80	33,086	- .56	+ 1.04
Other time deposits IPC	10,186	+ 438	+ 4.49	+ 8.65	32,982	- 6.64	+ 2.31
Deposits of states and political subdivisions	3,356	- 488	-12.70	- 6.26	7,357	-10.32	+10.17
(Neg. CD's \$100,000 and over)	3,538	- 338	- 8.72	+13.25	15,255	-19.47	- 1.02

¹Total loans less loans to domestic commercial banks and net of valuation reserves

survey of borrowing costs, conducted in the first half of February, showed Western business borrowers paying an average of 7.35 percent on short-term loans (excluding revolving credit) from District metropolitan banks. This average rate was 73 basis points higher than in November and, of course, did not reflect the most recent increase in the prime rate. The rate on loans made under revolving-credit agreements rose by about the same amount, to an average of 7.22 percent. About 50 percent of the dollar volume of regular short-term loans was made at (or below) the prime rate, and nearly 70 percent of revolving-credit loans carried this rate—the rate applicable to borrowers with top credit ratings.

Western consumers meanwhile continued to expand their instalment debt at banks during the first three months of 1969. The rise in loans at large banks was twice the volume of a year ago. Early '69 data indicate a higher volume of financing of automobiles and other consumer goods than in the year-ago period, as well as an increase in credit extended under credit-card and related plans.

Slowdown in mortgage markets

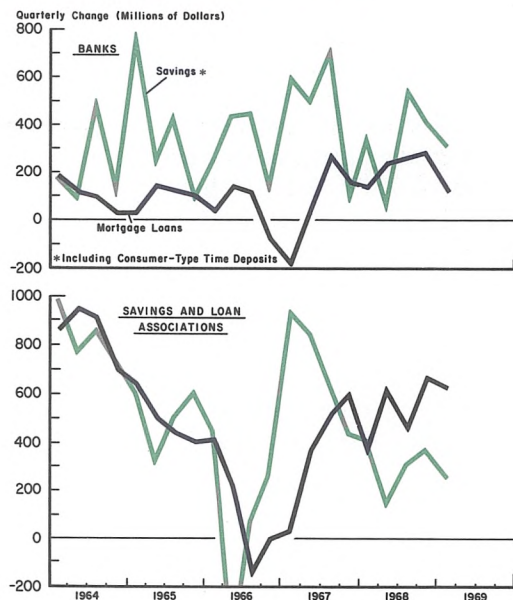
Activity in Western mortgage markets showed reduced momentum during the first quarter, as declines occurred in both the rate of net savings inflows and the rate of mortgage lending. For their part, District banks posted an increase in their passbook savings and consumer-type time deposits of somewhat over \$300 million, while savings-and-loan associations had a net savings gain of \$430 million—roughly 25 percent below and 10 percent above the respective gains posted during 1968's closing quarter. Then, during the first half of April, both the banks and S&L's experienced a net outflow of savings as households and businesses alike drew down their balances to meet increased tax obligations. The loss of savings may also have reflected the overall rise in market rates of

interest and the attendant decline in the competitive attractiveness of savings in fixed-rate passbook and certificate form.

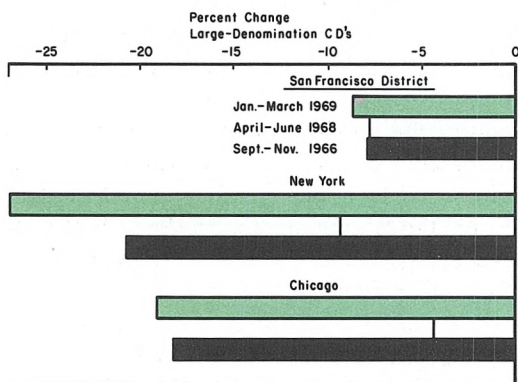
On the other side of the ledger, District banks increased their outstanding mortgage loans by \$116 million—less than half the gain of the previous quarter—but the S&L's increased their mortgage portfolios by \$515 million, only about \$150 million less than during the closing months of 1968. The continued high volume of S&L mortgage financing—maintained in the face of a reduced savings inflow—was financed in part by further borrowings from the Federal Home Loan Bank, which reached \$2.74 billion at the end of March. (This represented one-half of the total of such borrowings for the entire nation.) S&L commitments for future loans rose slightly, to \$623 million at the quarter's end, but the total was still moderately below the peak reached late in 1968.

All these indicators of reduced mortgage activity were accompanied by a further rise in mortgage interest rates to new record

Mortgage activity slows down with fall-off in savings inflow



New York banks suffer greatest CD attrition in each tight-money period



highs. By March, the effective yield on conventional new-home loans in the West reached a level just under 8.00 percent—50 basis points above December and some 35 basis points above the national average. (April’s reduced inflow of savings, in the face of a continued strong demand for loanable funds, then contributed to a further rise in mortgage yields.) On the other hand, non-price terms of lending—such as maturities and loan-to-price ratios—generally showed little change from previous months and continued to be somewhat more liberal than the average nationally.

Attrition in time deposits

Over the first quarter, District member banks posted a \$135-million daily average reduction in total deposits (seasonally adjusted). A \$327-million loss in total time-and-savings deposits more than offset a \$38-million rise in private demand deposits and a \$154-million gain in U. S. Government demand deposits.

Large Western banks recorded a number of significant changes in the composition of

their time-and-savings deposits during this period. In an attempt to retain existing individual deposits and to attract additional savings funds, a number of major California banks began to offer a “passbook-type” open-account instrument paying 5-percent interest, and this action soon led to a substantial transfer of funds from regular 4-percent passbook accounts into the new deposit instrument.

Largely as a result of these transfers, large Western banks in the first quarter experienced a \$326 million decline in regular passbook savings—but also a \$600-million increase in consumer-type time deposits. The total consumer-savings inflow at Western banks was about one-fourth below the fourth-quarter volume, but this was still better than the savings performance of large banks elsewhere in the nation.

Large Western banks also recorded a \$488-million reduction in public time deposits in the first quarter, double the rate of the comparable year-ago period. However, this substantial decline was not unexpected, because it followed an unusually large increase in public deposits in the last quarter of 1968. Major Western banks also experienced substantial disintermediation in large-denomination negotiable CD’s, as money-market rates continued to exceed legal CD ceilings. Nevertheless, the San Francisco District’s 9-percent rate of attrition (\$338 million) was well below the declines posted by the New York and Chicago Districts—27 percent and 19 percent, respectively. Still, reductions of such magnitude in Western banks’ time deposits, coming during this period of monetary restraint, placed pressure on them to run-off or sell securities to meet continued heavy loan demand.

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