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# Monthly Review

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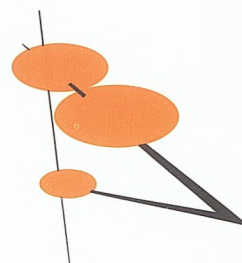
FEDERAL RESERVE BANK OF PHILADELPHIA

*In this issue*

**Midsummer Problems**

**Beginning of Expansion?**

**Slowdown of Expansion**



*August 1971*

### **Midsummer Problems**

... The economy continued to grow in recent months, but although the pace was modest, price pressures remained too strong.

### **Beginning of Expansion?**

... In the West, signs of increased activity appeared even in the face of continued problems in aerospace and other industries.

### **Slowdown of Expansion**

... Western banks posted a slower rate of deposit growth, amid an atmosphere of fast-rising money-market rates.

**Editor: William Burke**

## Midsummer Problems

At midsummer, the business indicators painted a picture of modest expansion. But although most signposts pointed upward, the housing sector was the only really booming sector in the national economy, and industrial production still lagged about 5 percent below its pre-recession high point. In August, then, the President unveiled a broad-gauge program to cure the problems of slow growth, high prices and a weakened dollar. (Details on page 143.)

GNP increased by about \$20 billion in the second quarter to an annual average rate of \$1,041 billion. This was substantially below the \$32-billion gain of the first quarter, which was dominated by the rebound in spending from last fall's auto strike. After price adjustment, GNP increased at a 4.0-percent annual rate in the spring period — considerably below the first-quarter rate, but otherwise the largest increase of the last three years.

On the plus side, residential construction boomed during the April-June period at a \$40-billion rate, and business expenditures for new equipment also advanced to \$69 billion. In addition, state-and-local government spending increased strongly, albeit at a decelerating rate, to \$134 billion, while consumer spending on a wide range of goods and services continued rising even in the face of the highest saving rate of the past twenty years. (This catch-all category alone recorded a \$16-billion gain, to a \$661-billion annual rate.) On the other hand, defense spending declined somewhat further, to \$72 billion, while Federal non-defense expenditures and business spending for new structures moved side-ways, at \$24 billion and \$38 billion, respectively.

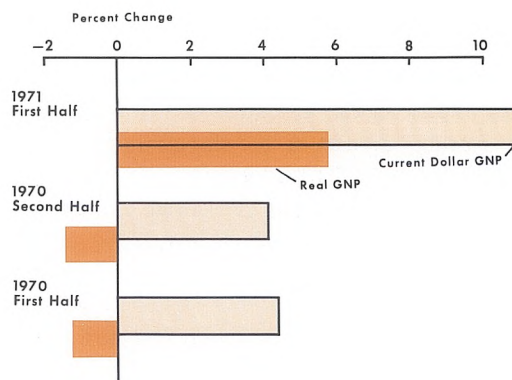
The pattern of activity so far in 1971 has been strangely uneven, and the rest of the year may follow the same path. The first quarter may rank as the strongest quarter of the year, on the basis of such factors as the rebound in the auto industry and the strike-hedge inventory build-up in steel. The second quarter performance was

buoyed by the steel-inventory situation and by the sharp increase in payments to social-security beneficiaries, but it lacked the stimulus of the earlier auto rebound. The present quarter may be even weaker, however, reflecting the rundown in inventories which will be as extensive without a steel strike as it would have been with one. The October-December period should be decisive for the 1972 economy, for with the special influences of earlier quarters out of the way, there should be a chance for the economy's real growth trend to demonstrate its strength.

### Turnaround?

In coming months, defense spending may begin to rise again as a result of anticipated rising prices for defense products and rising pay for defense personnel. This should reverse at least part of the \$7-billion (10 percent) drop which has occurred over the past year or so, largely because of personnel cutbacks and a two-fifths reduction in the output of military hardware. In other government sectors, an increase in Federal civilian outlays has been budgeted, while continued growth in public (largely non-Federal) construction seems assured.

### Real GNP begins to grow, after posting decline in 1970





An improvement in business fixed-investment spending may also be in the works, although not too much of this shows up in the Commerce Department's spring survey, which indicates only a modest second-half gain in spending plans overall. Manufacturers expect a 1-percent gain over the first-half level, and non-manufacturing firms anticipate a more substantial 8-percent increase.

Behind these estimates are heavy long-term commitments by utility firms — electric, gas and communications firms — and increasing strength in commercial building. In addition, liberalized depreciation rules may add to spending totals. Manufacturers' spending plans may be stimulated by the recent improvement in business profits and cash flow, but some projects in this sector undoubtedly will be hindered by high interest rates, rising prices, and the very low capacity-utilization rate in manufacturing. Now, however, this sector may show more strength on the basis of the President's tax package, which includes such measures as the restoration of the investment tax-credit.

### Inventories?

Inventories increased at a \$6-billion annual rate in the second quarter — somewhat higher than most other quarters of the past year but considerably below the 1968-69 average. Despite this relatively modest level of accumulation, inventory surpluses probably will have to be worked off in the second half, and not only in such obvious areas as steel. But this weakness could be offset by any strengthening in the trend of final demand.

Inventory accumulation generally has trended downward for the past two years, thus helping to account for part of the sluggishness in both 1970 and 1971. The adjustment has been relatively moderate; there has been no overall liquidation of inventories as in past inventory cycles. In 1970, the adjustment reflected declines in new orders, backlogs and sales. In 1971, the modest rate of accumulation has reflected a continued attitude of business caution and a general weakness of orders and final demand, despite

recent improvement in consumer buying. (Large inventory buildups have occurred, for special reasons, only in autos and steel.) In the second half, a further drag may develop because of the expected reduction in steel inventories, plus the need to work off record inventories of 1971-model cars.

The steel industry shipped a record 29 million tons in the second quarter, but shipments may drop by about one-third in the summer period. Production actually peaked early in May and then declined 17 percent by mid-July, reflecting not only the sluggishness of steel consumption but also the heavy inflow of imports, which have been running about 60 percent above year-ago levels. The strike-hedge accumulation probably totaled about 11 to 12 million tons, which means that roughly a 60-day supply was on hand when the new labor contract was signed at the beginning of August.

### How much support?

The Federal Government has provided considerable stimulus to consumer purchasing power through a number of measures whose overall impact probably equals two 1964-size tax cuts. These measures include gradual reductions in income taxes, major increases in social-security and welfare benefits, and increases in both civilian and military pay. Nonetheless, consumer attitudes remain cautious, as evidenced by the second quarter's 8.4-percent consumer saving rate, a twenty-year high. (Bunching of social-security benefit payments in June helped boost the rate.) The rate has averaged over 8.0 percent ever since early 1970, in contrast to the 6.5-percent average figure of the preceding half-decade.

Consumers purchased new cars at a 10-million clip during the January-June period, thanks to stable sales of domestically produced autos and soaring sales of imports. Domestic sales began to slip early in the year after the initial recovery from last autumn's strike. Imports accounted for a record 18 percent of the U.S. market in July, largely because of the popularity of Japanese cars. (Sales of Japanese models doubled between

the first half of 1970 and the comparable period of 1971.) Domestic new-car inventories meanwhile reached a new high of 1.6 million units on August 1, so that Detroit is faced with a substantial overhang of 1971 models at new-model introduction time.

Residential-construction spending continued to boom in the second quarter, at a level fully one-third above the first-half 1970 level. Basic strength in housing demand seemed to support that level of activity, except perhaps in the West, which has been troubled by high levels of unemployment and low levels of in-migration. At mid-year, however, financial factors appeared less favorable than they did earlier in the year. Nonetheless, inflows of funds to private mortgage lenders may be sufficient to finance current levels of activity.

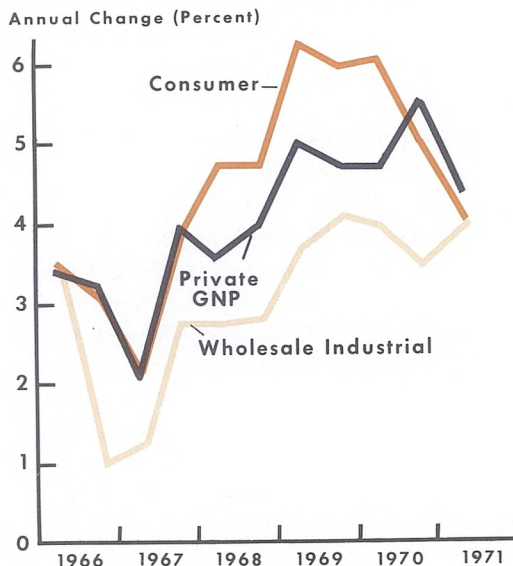
### How many jobless?

Labor markets continued sluggish during the spring months. For the third consecutive quarter, the average jobless rate amounted to roughly 6 percent of the civilian labor force. Also, disappointingly, non-farm employment still remained below the levels of early 1970.

The labor scene was somewhat tumultuous in mid-summer, with major walkouts occurring in communications, the West Coast docks, several major railroads, and the copper industry — and with a close call in steel. These labor conflicts reflected employers' efforts to control the rising cost of labor and employees' parallel attempts to offset the rising cost of necessities. Wage settlements reached in major contract negotiations so far this year have followed a certain standard pattern: roughly a 31-percent three-year increase in wages and fringe benefits. The pattern was set early in the year in the relatively small can-manufacturing industry, and it has since been repeated in such major industries as aluminum, telephones, copper and steel.

Throughout recent months, arguments continued over what constituted a reasonably satisfactory level of unemployment. For the Admin-

### Price indexes, although easing, fail to show solid improvement



istration, Treasury Secretary Connally described as a "myth" the use of a 4-percent unemployment rate as a full-employment standard, largely because this rate has been reached only in war-time periods.

In one contribution to this discussion, the Brookings' Institution's George Perry argued that the trade-off between unemployment and inflation has worsened because of changes in the composition of unemployment. Indeed, he has concluded that a given unemployment rate is associated with an inflation rate  $1\frac{1}{2}$  percentage points higher than the inflation rate with which it was linked 10 to 20 years ago. Relatively tight labor markets for adult males have created persistent wage and price pressures, at a time when women and young people — whose employment has less impact on wage levels — have flooded the labor markets and boosted the jobless rolls.

### Persistent inflation

Some signs of de-escalation appeared on the price front during the spring period. A 4.7-percent rate of increase in the (fixed weight) GNP

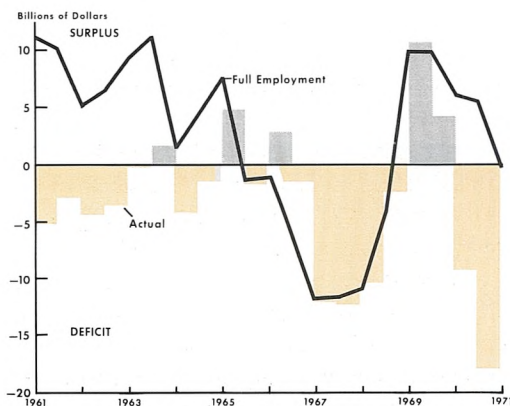


price deflator was the lowest of the past year. At the same time, other price indexes exhibited worrisome trends.

Wholesale prices increased at a 7-percent annual rate in the first quarter and at a 5-percent rate in the second quarter. Recently, prices have advanced in a broad spectrum of industrial goods, such as steel, copper, coal, and lumber. (The 8-percent price hike posted by steelmakers after the recent labor settlement, and the 4-percent increase posted by automakers at new-model time, were particularly disturbing.) Moreover, the stability in agricultural prices that characterized 1970 has now disappeared.

Consumer food prices were only about 3 percent above the year-ago level at midyear, but all of that increase occurred just this spring. Moreover, price tags at food counters this summer may have been affected by the first-half rise in wholesale food prices — up at a 10-percent annual rate. Last year's stability in consumer food prices was due to heavy supplies of meat and other products. Now, however, with recent cut-backs in farm output and increases in farm costs, declines in farm prices no longer offset the constant advances in processing and distribution costs, and household budgets feel the full impact of the turnaround.

### Actual budget deficit deepens, with full-employment balance



### Persistent deficits

While the nation has scored at least a few successes in meeting the goals of domestic policy so far this year, it has encountered great difficulty in meeting its balance-of-payments target. On the official-settlements basis, the deficit reached a whopping \$22-billion annual rate in the first quarter and a \$23 billion rate in the second.

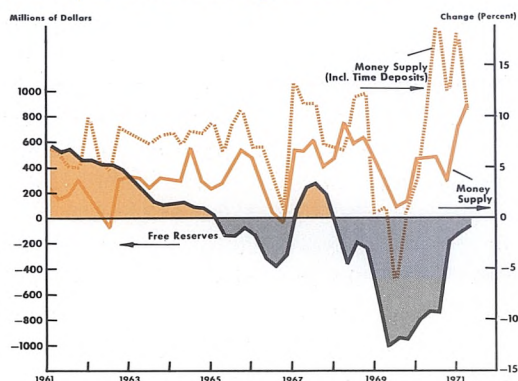
This situation reflects the huge outflow of short-term funds caused by the out-of-phase movement of the economies on the two sides of the Atlantic. The U.S. over the past year has shifted from an anti-inflationary policy to an expansionary policy, while West Germany and other European nations have adopted tight monetary and fiscal policies in order to curb an accelerating inflation. The outcome was predictable — relatively low short-term rates in this country and high rates in Europe in recent quarters led to a huge eastward flow of capital.

This movement of short-term funds largely represented a reflow of money that had shifted to this side of the Atlantic during tight-money 1969. In that year, American monetary and fiscal policies both had been aimed at combating excess demand, while in Europe, most policymakers had adopted a more expansionary stance. U.S. commercial banks, finding their deposits running off as short-term market rates rose above the Federal Reserve's Regulation Q ceilings, had borrowed some \$10 billion in funds from branches abroad to meet domestic credit demands. The branches in turn had bid for funds in the Euro-dollar market, and interest rates offered there had led Europeans to shift into dollars. As a result, pressures on European interest rates had increased and dollar reserves of European central banks had declined.

However, this entire process then was reversed as cyclical policies last year went out of phase in the opposite direction. As a result, the liabilities of U.S. banks to their foreign branches have dropped from \$14 billion to \$2 billion within two years' time.

More recently, policymakers have acted to off-

## Monetary aggregates expand faster than planned during first half



set the balance-of-payments deficit and the attendant buildup of dollars in foreign central banks. Federal Reserve open-market activities, plus Treasury debt-management policies, have worked to moderate the downward pressure on U.S. short-term rates in recent months. In addition, the Treasury and the Export-Import Bank this spring issued \$3 billion in securities to foreign branches of U.S. banks, and these issues intercepted funds that would otherwise have landed in foreign central banks.

Yet all these efforts were nearly swamped by the massive currency speculation this spring, which affected mostly the German Deutschmark. Among other options, West Germany could have placed controls on the inflow of dollars or could have changed its exchange rate, in an attempt to combat the domestic inflationary impact of those speculative flows. It took the latter course and let the Deutschmark float, so that by early August the mark was 6 percent above its earlier dollar parity.

## Trade imbalance

Much of the deficit over the past year reflected the flow of short-term funds responding to cyclically different monetary conditions and to speculation, but it came on top of a series of persistent balance-of-payments deficits, and was deepened by a substantial deterioration in the nation's trade balance.

The export balance was over \$5 billion annually during most of the decade prior to 1965, but thereafter it began to shrink. It was less than \$1 billion in 1968 and 1969, recovered somewhat in 1970, and disappeared completely this spring. According to Commerce Department projections, imports are rising this year faster than domestic business is expanding, while exports are falling in line with the reduced activity of our major trading partners abroad, so that the balance for the year may be negative, for the first time since 1893.

U.S. exports grew at a 10-percent annual rate during the 1965-70 period — a respectable rate, although not fast enough for the U.S. to maintain its share of world markets. U.S. imports rose at a 14-percent rate, increasing from three to four percent of GNP. This reflected the overall situation of excess demand, plus a shift in the character of imports represented by a sharp rise in finished manufactured goods.

In future periods, short-term outflows may become less likely because of the decline in the stock of Eurodollars. More help may come from increased returns from investments abroad, increased foreign investment in Wall Street, and smaller outflows of funds for military purposes. But more important than any specific measure is the restoration of domestic price stability, without which no permanent improvement can be seen in the nation's underlying trade balance.

## "Strongly expansive"

The Administration's major policy decisions at mid-year centered around the fiscal measures required to fight inflation and yet provide sufficient stimulus to bring about full employment. On a hypothetical full-employment basis, the Federal budget was set to yield a small surplus in both fiscal 1971 and fiscal 1972. But the actual deficit exceeded \$20 billion in fiscal 1971, and the actual deficit for fiscal 1972 could approach that level too — about two-thirds above the figure estimated last January. This was a "strongly expansive" policy in the Administration's view.

These substantial deficits reflect the heavy



stimulus provided the consumer sector through Congressional actions affecting social-security benefits, Federal pay, and tax revenues. Transfer payments have increased 20 percent above year-ago levels. In addition, reductions in taxes have helped account for a \$4-billion *decline* in Federal income-tax liabilities in the face of a \$50-billion increase in disposable personal income.

### "Moderate firming"

For its part, the Federal Open Market Committee at its April meeting voted to seek "moderate firming" of money market conditions, so as to achieve a less rapid growth of the money supply, as well as a narrowing of the gap between domestic and foreign interest rates in order to curb capital outflows. Even so, the money supply grew at an 11.1-percent rate in the second quarter, as against the first quarter's 8.9-percent rate. Growth in time-and-savings deposits slackened from the first quarter's very high rate, with a fairly even pace of inflows during the April-June period. Then, in July, the Federal Reserve moved to bring the discount rate into better alignment with short-term market rates by raising the rate from  $4\frac{3}{4}$  percent to 5 percent. This move also reflected the System's concern over the continuation of cost-push inflation.

Money-market rates continued to gyrate this spring and summer. The bellwether three-month Treasury-bill rate, which had soared as high as 8-percent at the beginning of 1970 and had dropped as low as  $3\frac{1}{4}$  percent in March of this year, by late July was back up to about  $5\frac{1}{2}$  percent. The bank prime business-loan rate, which had risen as high as  $8\frac{1}{2}$  percent in mid '69 and had dropped as low as  $5\frac{1}{4}$  percent earlier this year, has now risen to 6 percent.

Financial intermediaries, such as banks and savings-and-loan associations, benefitted early in 1971 from the spread between fast-falling short-term rates and slowly-falling long-term rates, since they generally supply short-term assets and make longer-term investments. In the second quarter, however, the spread narrowed despite increases in rates in both ends of the market,

and the banks felt impelled to raise their prime rate to offset their rising cost of funds.

The bond market too continued to fluctuate sharply. The gyrations in bond prices — and hence in bond yields — have been almost without precedent. Over the past year, for example, the rate on top-grade corporate bonds has risen as high as  $8\frac{1}{2}$  percent and fallen as low as 7 percent and is now back to almost  $7\frac{3}{4}$  percent. The recent climb in long-term rates reflects a continuing demand for liquidity by corporate treasurers, despite the fact that corporations have been piling up liquid assets and repaying bank loans with the proceeds of stock and bond issues, even in the face of limited needs for external funds.

Some increasing signs of stability appeared in the capital markets around midyear. After all, it would be difficult to imagine any further increase in pressures; in the January-June period alone, corporate-bond sales amounted to two-thirds of the volume sold during the entire record-breaking year 1970, and the same held true for municipal-bond sales.

Heavy demand is still evident in the municipal-bond market, and any decline in rates there may bring in those claimants who went to the sidelines earlier. On the other hand, the corporate calendar finally is showing signs of tapering off, partly because the gap is now narrowing between internally generated funds and capital needs. On the demand side, high yields during the spring period's setback proved attractive to a wide range of investors and brought in a heavy volume of long-term funds.

Nonetheless, many pressures still impinge on the money and capital markets. In the long-term end of the market, the process of unwinding deferred demands and restoring desired levels of liquidity may still not be complete, despite the less-insistent nature of these demands. In the short-term sector, the markets must be prepared to service the anticipated rise in business and consumer borrowing because of the economic expansion, as well as the record-high level of Treasury borrowing.

William Burke



## President's Message

In mid-August, President Nixon unveiled a multi-faceted action program in an effort to transform the ailing national economy. The various measures imposed by the Administration (or requested from Congress) were aimed at halting the inflationary spiral, improving the economy's laggardly growth performance, easing the Treasury's financing problem, and curing the international woes of the dollar.

On the price front, the President ordered an immediate 90-day freeze on wages, rents, and all prices except those of unprocessed foods and farm commodities. He set the legal price ceiling on each product equal to the highest level substantially effective in the month ending August 14, and stopped previously negotiated wage increases from being put into effect during the next three months.

On the growth front, the President asked Congress to repeal the 7-percent excise tax on autos and to restore the investment-tax credit on U.S.-produced machinery and equipment at a temporary 10-percent rate. He would also have Congress advance to January 1972 the personal income-tax cuts scheduled for January 1973, by boosting the individual tax exemption to \$750 (from the current \$650) and raising the standard deduction to 15 percent with a \$2,000 maximum (from 13 percent with a \$1,500 maximum).

To ease the fiscal problem, however, the President acted to cut \$4.7 billion from the fiscal-1972 budget, more than offsetting the \$4.2-billion net revenue loss from other measures. He ordered a 5-percent reduction in Federal employment, deferral of the scheduled Federal pay boost from January to July 1972, and postponement of the proposed revenue-sharing and welfare-reform programs.

On the international front, the President cut the dollar loose from the historic \$35-an-ounce gold price, and thus permitted it to float in accordance with supply-and-demand considerations. Formally, the U.S. notified the International Monetary Fund that it "no longer freely buys and sells gold for the settlement of international transactions." (The program also involved suspending the Federal Reserve's use of its swap network for converting dollars into foreign currencies.) To curb the inflow of imports, the President imposed a 10-percent surcharge on most imported goods, and to stimulate U.S. exports, he asked Congress to provide tax deferral for export earnings through the creation of "domestic international sales corporations."

## Beginning of Expansion?

The Western economy greeted summer with a spurt of activity in the home building, lumber and agricultural sectors. These signs of increased activity appeared even in the face of continued employment problems, caused largely by the District's faltering aerospace industry. The region's problems then were compounded in July and August by a prolonged dock strike, which reduced farm exports and increased the jobless totals, especially in Hawaii and Alaska.

Nonfarm employment (held down by the now-routine aerospace layoffs) failed to retain its first-quarter gains during the spring period. Payrolls declined at a 2.2-percent annual rate, to 10.45 million workers, as gains in the service, finance and government categories failed to offset losses in other industries. Elsewhere in the nation, nonfarm employment increased at a modest pace.

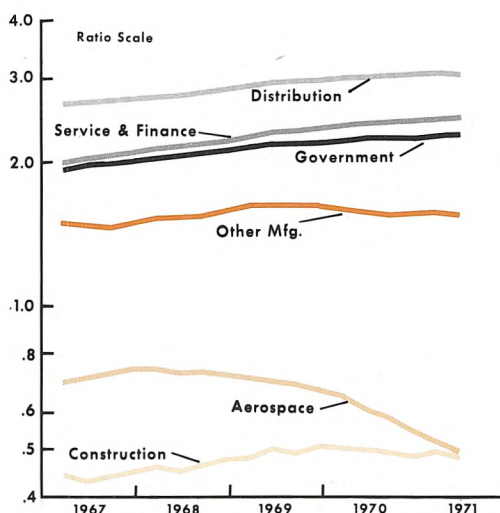
This development was also reflected in the unemployment figures. The first-quarter reduction in the ranks of the unemployed could not be sustained in the second quarter, and the West's jobless rate rose from 6.9 to about 7.6 percent. Elsewhere in the nation, the jobless rate hovered around 6.0 percent in both quarters. Seattle again topped the scale for major metropolitan areas with a rate of 15.7 percent in June. The Los Angeles situation, with a 7.2-percent rate in June, suffered a further setback in early July when a major auto producer closed its Los Angeles plant and idled some 1,200 workers. In light of these statistics, California will receive \$100 million of the \$600 million total soon to be made available under the public-service jobs legislation signed by President Nixon in early July.

### Slump in aerospace

Aerospace employment continued to slump in the District during the second quarter, as layoffs of 12,000 more workers reduced District employment to 509,000. This quarter showed a slowing in the pace of the decline when compared with the first-quarter reduction of 26,000 workers. However, almost a quarter-million Western aerospace workers have lost their jobs since the December 1967 peak of 755,000 employees.

Employment in Washington suffered as a result of the halt of Boeing's supersonic-transport project. This decline was offset in part by Lock-

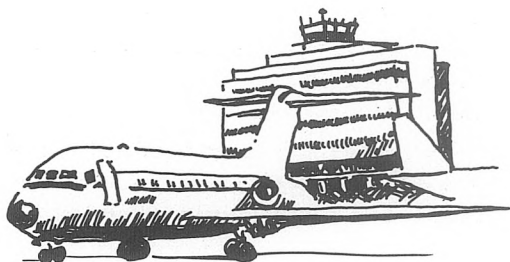
### Job markets reflect weakness in aerospace and other manufacturing industries





heed's rehiring of about 1,200 employees in California to work on the L1011 airbus, even before Congress approved the Administration proposal to guarantee a \$250-million loan to Lockheed.

California firms recently obtained some sizeable defense and space contracts—\$200 million to Lockheed for continued production of the Poseidon missile and \$500 million to North American Rockwell for space-shuttle engines. These contracts will not provide an immediate boost to employment but will help maintain payrolls at their present levels.



### Strength in housing, lumber

Home building in the West continued to boom in late spring, as new starts exceeded even the soaring first-quarter pace to reach a record 461,000-unit annual rate. With a few exceptions—most notably Seattle—home building in the District surpassed the low year-ago levels by very substantial margins. It is questionable, however, whether the current rate of population growth is sufficient to sustain this level of housing activity.

While residential construction maintained its momentum during the second quarter, non-residential and heavy construction increased moderately. The volume of awards for commercial and office buildings, hospitals, educational facilities and streets and highways increased, while awards for the construction of electric-power systems, bridges, dams and reservoirs declined from their first-quarter levels.

Lumber and plywood prices resumed their upward movement after a brief period of weakness during early spring. Orders at the mills rose sharply as wholesalers and retailers replenished inventories which had been severely depleted by the strong pace of home building. The Pacific Coast dock strike also stimulated orders by creating fears of possible shortages. By June the wholesale price index for softwood lumber was 23 percent above the year-ago level. However, plywood prices were up only 3 percent, because of large supplies created during a period of overproduction earlier this year.

### Strife in metals markets

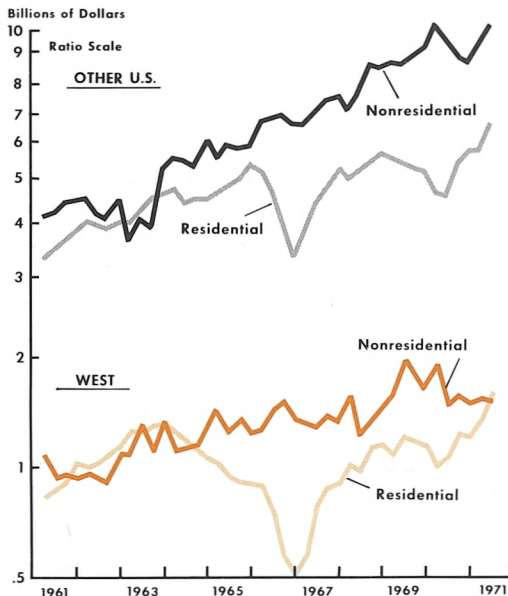
Western steel production was off 6 percent from a year ago, reflecting a slowdown in regional demand and a sharp influx of foreign imports. Production elsewhere in the nation remained well ahead of the year-ago level. However, national production slowed during the quarter as the auto industry and other major steel users, in an attempt to beat price increases, completed their hedge buying well in advance of the industry's August 1 strike deadline.

Demand for aluminum was bolstered temporarily by strike-hedge buying, but when a settlement was reached before the May 31 strike deadline, demand again weakened. One major producer responded to the slowdown by closing down a 35,000 ton-per-year potline at its Wenatchee, Washington reduction plant. This and other cutbacks scheduled since last fall have now reduced primary-aluminum production in the Pacific Northwest to 88 percent of capacity.

Labor-contract settlements in aluminum and steel provided for roughly a 31-percent increase in wages and fringe benefits over three years' time. Aluminum producers responded to the wage increase by announcing a 6-percent average price increase on fabricated aluminum products, and steelmakers followed suit with 8-percent higher price quotations in their industry.

Copper prices declined during the second quarter, despite the threat of a July 1 strike

## Housing boom strongest element in Western construction picture



deadline, because of ample supplies on hand at producer plants. Between late March and late June the price of refined copper on the London Metal Exchange slid downward from 55¾ to 47½ cents a pound. The situation changed, however, when more than 30,000 copper workers walked off their jobs at the strike deadline, claiming they had not received contract offers matching the recent aluminum settlement. The strike idled about 85 percent of the domestic

industry's mine capacity, 98 percent of its smelter capacity and 75 percent of refining capacity.

The severe reduction in output caused copper prices on the exchange to rebound almost to their March levels, but the quotation then headed downward when one producer after another signed new labor contracts. By late July the price in London had dropped to 48¼ cents a pound, 4½ cents below the U.S. producer price of 52¾ cents a pound.

Western farmers enjoyed a relatively prosperous first half as their farm receipts increased 5 percent from a year ago. This contrasted with the rest of the country's 1-percent decline, which was due to lower returns from livestock marketings, primarily hogs. The boost in District receipts was centered in California.

A bountiful harvest stemming from a wide variety of crops now appears in prospect for District farmers. Deciduous-fruit production is expected to rise, despite drastic efforts to limit the output of California cling peaches through "green drop" and "tree pulling" program. Output of field crops, such as wheat, cotton, sugar beets, and corn, is also expected to rise, while an increase is planned in acreage planted for processing tomatoes. Increases also are indicated in the livestock sector, since the number of cattle on feed at midyear was up 7 percent from a year ago.

*Regional Staff*

Publication Staff: Karen Rusk, Editorial Assistant; Janis Wilson, Artwork.

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## Slowdown of Expansion

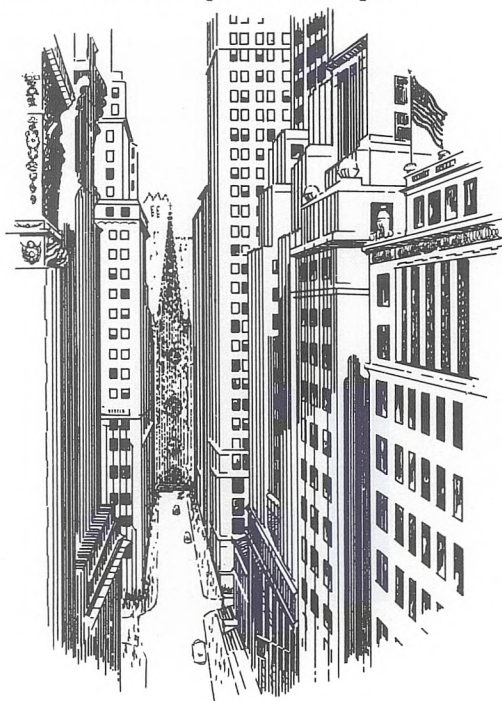
In an atmosphere of swiftly rising money-market rates, deposit growth slowed considerably at Twelfth District commercial banks this spring. Total deposits increased at an 8-percent annual rate during the second quarter, in contrast to the high 17-percent rate of the January-March period. Growth of total credit also tapered off to a 4-percent annual rate from the rapid 22-percent pace of the preceding three-month period. District banks adjusted their loan rates upward to counteract the rising cost of borrowed funds, but they were also forced to offer higher rates on time deposits to remain competitive in bidding for individual and corporate savings.

Increased security holdings accounted for the entire \$215-million second quarter gain in Western bank credit; outstanding loans on banks' balance sheets remained unchanged at the March level. However, there were diverse movements among loan categories. Business loans declined \$122 million and loans to dealers and others for financing securities by \$694 million, while mortgage lending expanded by a sizeable \$485 million. In addition, lending to consumers and to nonbank financial institutions rose significantly. (All data seasonally adjusted.)

### Slowdown in deposit growth

The deposit pattern shifted in the second quarter (seasonally adjusted) as demand deposits rose at a faster rate than time deposits. Member-bank net demand deposits rose at a 12-percent annual rate, on a daily-average basis, despite a low level of U.S. Government deposits. On the other hand, the net growth in time-and-savings deposits slowed to less than a 6-percent annual rate, well below the extremely high 24-percent first-quarter rate. Attrition was high in both passbook savings and large-denomination negotiable time certificates.

The runoff in passbook savings in April reflected householder's greater than usual reliance on these accounts to meet tax bills, and also reflected withdrawals resulting from the reduction in the rate paid on savings deposits (from 4½ to 4 percent) which most District banks made at the beginning of the month. Some of the outflow in mid-June represented transfers of passbook accounts accelerated in June, and for the quarter account deposits following the reinstatement (in early June) of ceiling rates on these consumer-type savings instruments by many District banks. The increase in these small CD's and open accounts accelerated in June, and for the quarter much more than offset banks' loss in regular passbook savings. The runoff in large negotiable CD's, which occurred in the face of higher offering rates by the banks, was just about offset by a seasonal increase in public time deposits.



## Squeeze on income

Although District banks tried to improve their cost position this spring by lowering the rate of interest paid on passbook savings, they still experienced a profits squeeze because of rapidly rising costs of other funds. To offset this squeeze, major banks began quoting a  $5\frac{1}{2}$  percent (up from  $5\frac{1}{4}$  percent) prime rate in early May, and in early June raised mortgage rates to  $7\frac{1}{2}$  from  $7\frac{1}{4}$  percent.

A move toward a higher 6-percent prime rate began in late June, but most banks did not move to this level until early July. They accompanied this step with a further increase in mortgage rates, to  $7\frac{3}{4}$  percent. However, banks then added to their costs by raising rates, to ceiling levels, on consumer-type time certificates and open-account savings in early June, and by returning to the  $4\frac{1}{2}$ -percent ceiling rate on passbook savings in July and August.

Published reports of Western banks generally showed smaller year-to-year gains in net earnings and income in the second quarter than in the preceding period. This shift was particularly evident in the net income figures; in the first quarter, these had reflected substantial capital gains from security trading and from banks' own security investments. Substantial differences developed among individual banks this spring, and a few major banks showed sizeable declines from the year-ago period.

## Shifts in reserves, credit

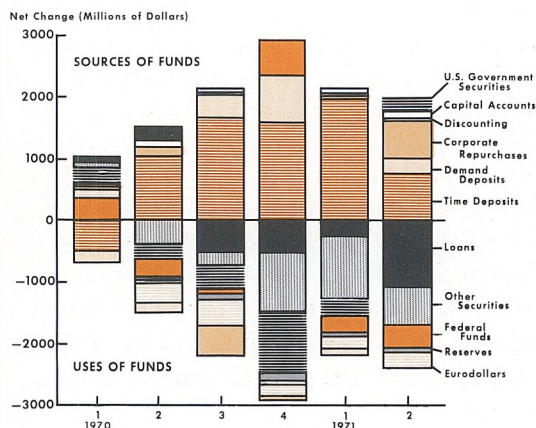
Required reserves of District member banks increased by \$77 million in the second quarter, because of higher levels of deposits — both demand and time — than in the January-March period. Despite a \$9-million increase in borrowings from the Federal Reserve Bank, District banks posted net free reserves of \$10 million,

## Sources and Uses

In the first half of 1971, the relative importance of various sources and uses of Twelfth District bank funds generally followed the traditional pattern, with domestic deposits as the major source and loans and securities as the major use. In each quarter, large banks in the District increased their funds by \$2 billion on a daily-average basis. (Data unadjusted for seasonal variation.) Time deposits contributed over 90 percent of these additional funds in the first quarter, with the remainder coming from increases in capital accounts and in borrowings under corporate repurchasing agreements. In the second quarter, time deposits and demand deposits together were responsible for only one-half of the increase. A further increase in borrowings under repurchase agreements contributed another third, and the remainder came from sales of U.S. Government securities and from an increase in capital accounts.

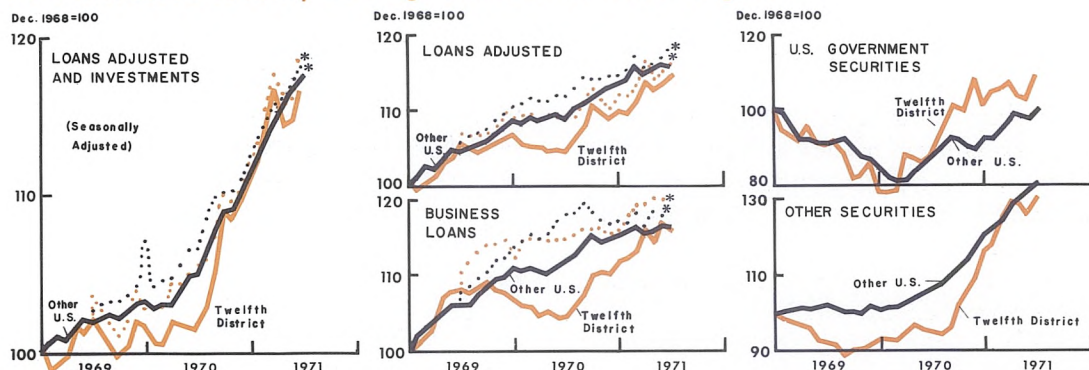
In the first quarter, banks used about one-fourth of the \$2 billion in additional funds to expand their loan portfolios; in the second

quarter, this share rose to almost one-half. In contrast, funds invested in securities accounted for one-half of the use of funds in the first quarter, but for only one-fourth of the total in the second quarter. In both quarters, some of the additional funds were used to meet higher reserve requirements and to reduce further the bank's Euro-dollar and Fed-funds borrowings.





## Western bank credit fluctuates widely in second quarter ... increased security holdings account for most of gain



\*Includes loans sold outright

double the first-quarter figure. Member banks elsewhere reduced their borrowings but still had net *borrowed* reserves of over \$100 million. (Data are on a daily-average basis.)

Major District banks borrowed substantially less in Federal funds in the April-June period than in the preceding three months. Net Fed-funds purchases from banks declined by two-thirds, and about 70 percent of these borrowed funds were resold to brokers and dealers. Thus, on *total* Fed-funds transactions, District banks were net purchasers of \$136 million, down from \$512 million in the January-March period. However, this reduction in Fed-funds borrowing, and a parallel reduction in Eurodollar borrowings, was just about offset by an increase in borrowings from corporations and others under repurchase agreements.

Bank credit, seasonally adjusted, fluctuated widely in the second quarter, ranging from a decrease of \$1.4 billion in April to a gain of like magnitude in June, and with a modest gain in May. Loans and securities both contributed to the April decline in total credit, while in May, a \$445-million loan increase more than offset a decrease in security holdings. The large June increase was mainly from securities. Throughout the quarter, lending strength was concentrated in loans to home buyers and to nonbank financial institutions.

### Weaker business-loan demand

Business loans declined slightly over the quarter, with only May in the plus column. June's decrease in business loans occurred in spite of very large borrowing over the June 15 tax date.

Some strength in loan demand was evident in durable-goods manufacturing, mainly primary metals and transportation, but demand from the nondurable-goods sector was weak. Loans to public utilities were well below year-ago levels except for communications firms, which borrowed heavily in the latter part of the quarter. Loans to both wholesale and retail firms also rose sharply in May and June. Construction loans remained at a high level, reflecting the upturn in home building, and service industries continued to increase their demand for bank credit.

Individuals discarded some of their wariness in the second quarter and increased their consumer instalment debt, with the pace accelerating as the quarter progressed. Automobile financing was a major factor in the high level of consumer borrowing. The use of credit cards to borrow money for tax payments also contributed to the April increase in consumer loans.

### Accelerated mortgage demand

Mortgages were the major source of loan demand at Western banks in the second quarter, following a rather dull first quarter. During the

# FEDERAL RESERVE BANK OF SAN FRANCISCO

spring months, banks rapidly expanded their real-estate lending, particularly on residential properties, with increases of \$100 million in both April and May, and then a \$280-million gain in June (seasonally adjusted).

For their part, savings-and-loan associations in District states registered a \$1.8-billion net savings gain — about 15 percent below the first quarter's increase, but still the second largest quarterly gain on record. With their sources of funds continuing to expand, the S&L's increased their mortgage portfolios by about \$1.4-billion — a record — while substantially reducing their borrowings from the Federal Home Loan Banks. At the same time, they increased their commitments to make mortgage loans by some \$550

million, to a record \$1.5 billion at mid-year, thereby assuring a continuing high level of home financing in the months ahead.

The step-up in housing activity, plus the improvement in consumer spending, should serve to stimulate business activity and strengthen bank-loan demand in the second half of the year. In addition, the higher loan rates put into effect in early July should help widen the margin between banks' return on loans and their cost of funds. In the West, however, banks again will be adversely affected on the expense side by the increase of 1/2-percentage point in rates they pay on their large volume of passbook deposits.

*Ruth Wilson and Verle Johnston*

## SELECTED ASSET AND LIABILITY ITEMS OF WEEKLY REPORTING LARGE BANKS

Data Not Seasonally Adjusted

(dollar amounts in millions)

	TWELFTH DISTRICT				OTHER U.S.
	Outstandings	Net Change			Net Change
		March 31, 1971 to June 30, 1971	March 25, 1970 to July 1, 1970	March 31, 1971 to June 30, 1971	
		Dollars	Percent	Percent	Percent
Loans gross adjusted <sup>1</sup> and investments	57,235	+ 714	+ 1.26	+ 1.47	+ 2.91
Loans gross adjusted <sup>1</sup>	40,514	+ 722	+ 1.81	+ 1.27	+ 3.54
Commercial and industrial loans	15,258	— 86	— 0.56	+ 0.69	+ 1.74
Real estate loans	11,774	+ 464	+ 4.10	+ 0.10	+ 2.62
Agricultural loans	1,537	+ 183	+ 13.52	+ 6.23	+ 5.76
Loans to nonbank financial institutions	2,593	+ 349	+ 15.55	+ 19.11	+ 11.16
Loans for purchasing or carrying securities:					
To brokers and dealers	458	— 710	— 60.79	— 20.09	+ 4.83
To others	275	+ 20	+ 7.84	— 10.29	+ 5.15
Loans to foreign banks	237	+ 82	+ 52.90	+ 45.90	+ 27.98
Consumer instalment loans	5,997	+ 270	+ 4.71	+ 0.31	+ 4.52
All other loans	2,385	+ 150	+ 6.71	+ 0.47	+ 3.54
Total investments	16,721	— 8	— 0.05	+ 2.06	+ 1.43
U.S. Government securities	6,020	— 230	— 3.68	— 1.22	— 5.63
Obligations of states and political subdivisions	8,790	+ 98	+ 1.13	+ 5.53	+ 5.87
Other securities	1,911	+ 124	+ 6.94	— 6.18	+ 3.73
Total deposits (less cash items)	56,358	+ 1,072	+ 1.94	+ 3.55	+ 3.11
Demand deposits adjusted	18,297	+ 498	+ 2.80	— 1.34	+ 1.33
Time and savings deposits	36,090	+ 224	+ 0.62	+ 4.59	+ 2.67
Saving deposits	16,862	— 253	— 1.48	+ 0.99	+ 2.62
Other time IPC	13,261	+ 154	+ 1.17	+ 6.02	+ 1.97
Deposits of states and political subdivisions	4,566	+ 349	+ 8.28	+ 22.53	— 1.43
(Neg. CD's \$100,000 and over)	4,015	— 395	— 8.96	+ 6.85	+ 6.05
Capital accounts	4,557	+ 184	+ 4.21	+ 1.04	+ 1.51
Total assets/liabilities and capital accounts	73,013	+ 1,786	+ 0.28	+ 4.25	+ 0.19

<sup>1</sup>Total loans minus loans to domestic commercial banks