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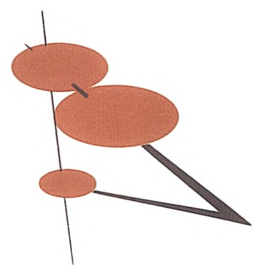
Monthly Review

In this issue

Entering the New Era

Coping with Problems

Encountering Loan Demand



November 1971

Entering the New Era

. . . Recent statistics provided a somewhat limited foretaste of what seemed to be in store for the national economy in 1972.

Coping with Problems

. . . The Western economy benefited from a building boom and a farm boom, but suffered from a dock strike and aerospace problems.

Encountering Loan Demand

. . . For banks, the first effects of the New Economic Policy were a crisis-related upsurge in borrowing and a decline in money rates.

Editor: William Burke

Entering the New Era

As the new economic era got under way this fall, the Administration's aggressive response to the problems of a sluggish economy, continued inflation, and a weakened dollar created a burst of confidence which, although not sustained in Wall Street, at least generated a more favorable set of 1972 forecasts than could have been foreseen earlier in the year. In the wake of the new program, a poll taken at the annual meeting of the National Association of Business Economists indicated a strong gain of about 5½ percent in real (price adjusted) GNP in 1972, along with a moderate 3-percent gain in prices. A few hardy forecasters, in fact, projected a $100-billion increase in total GNP for the coming year.

In contrast, the third-quarter GNP statistics gave only a partial foretaste of this bright new world. The $18 billion rise in GNP, to a $1,061 billion rate, was disappointing but not entirely unexpected, in view of such factors as the anticipated slashing of steel inventories during the late summer months. Real GNP thus rose at about the same pace as before, in line with the 3.6-percent rate of the second quarter. With the price freeze in effect for half of the summer quarter, the overall price index (implicit deflator) increased at a 3.0-percent rate, as against the spring period's 4.2-percent rate and even higher rates in preceding quarters.

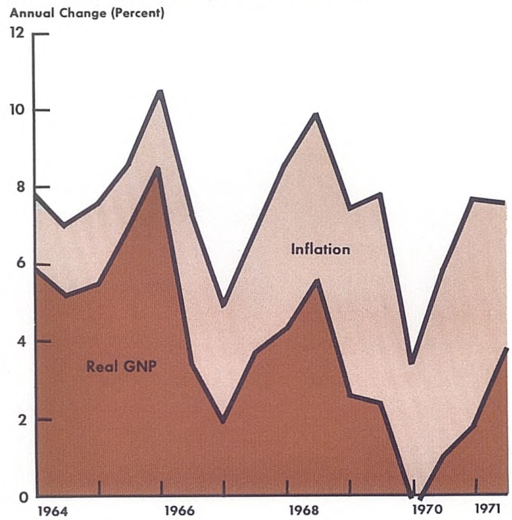
Statistics mixed

The July-September GNP statistics reflected a continuation of the housing boom, an upsurge in consumer-durables spending, and fairly substantial increases in the business fixed-investment and Federal nondefense sectors. At the same time, there were significant weaknesses in the defense, inventory, and foreign-trade sectors.

Industrial production, despite a September upturn, weakened during the third quarter as a whole, largely because of the decline in steel. Indeed, steel shipments were lower during this quarter than in any other period of the past decade. In September, total output was no higher than it was last January, and was 6 percent below the 1969 peak. A weakening of new durable-goods orders in August and September was also worrisome — as was a decline in manufacturing productivity, which contrasted with a sharp improvement in the first half of the year.

Nonfarm employment remained near the second-quarter level of 70.7 million, again despite a September upturn, and the average workweek dropped in the manufacturing sector. The third-quarter unemployment rate averaged close to 6 percent, as in the several preceding quarters, but the rate dipped slightly as summer turned into fall. However, the labor market also had to con-

More growth, less inflation recorded over year to date



tend with a substantial increase in the labor force, unlike the situation earlier in the year, and this made the task of pulling down the jobless rate doubly difficult.

Personal-income growth moderated during the third quarter — understandably, since incomes were held down by the freeze during half of that period, and since windfall increases such as retroactive social-security benefits were lacking from this quarter's figures. Consumer spending meanwhile rose fairly substantially, at least in the durable-goods lines, and the personal saving rate thus dropped from 8.2 to 7.7 percent during the quarter.

Consumers buying

The President's economic proposals helped set off a sales boom in both domestic and foreign cars. Domestic sales had averaged 8⅓ million units (annual rate) during the January-August period, but the rate jumped to 9½ million units in September and early October. (Yet in the face of this high sales rate, Detroit failed to reduce its unusually high inventory of older cars during September.) Import sales averaged more than 1½ million units (annual rate) through August, but sales were reduced in September and October, largely because of a depletion of stocks brought about by the West Coast dock strike.

Consumer budgetmaking appeared more favorable in September because of an actual decline in food prices and a relatively modest increase in other consumer prices. The price freeze, plus favorable growing conditions, gave promise of reversing the unfavorable early-1971 trend in food prices. Nonetheless, the indexes this fall will still reflect pressure from certain areas. Prices of some foods (and sales and property taxes) are not covered by the freeze, and some index items that haven't been priced since before the freeze should show up higher in later surveys.

Farm crop output in 1971 may be 8 percent above the previous (1969) record, according to the September crop survey, and the output of livestock and products should exceed even the strong 1970 performance. Although food prices may fluctuate somewhat this winter, bumper crops of major commodities (especially corn) are bound to have long-term anti-inflationary consequences, because of the increased production of hogs, poultry, eggs and beef expected eventually as a consequence of the improved feed situation.

Residential-construction spending continued rising during the third quarter, until it stood almost 50 percent above the year-ago level. New starts exceeded a 2.1-million rate — the highest level of the past two decades — and the boom in mobile homes also kept rolling along.

The high level of building-permit activity and the continued availability and lower cost of mortgage funds suggest that the boom will be maintained for a while yet. Nonetheless, the specter of overbuilding — especially in the West — began to be raised as the boom continued into the fall months. Basic housing demand resulting from new household formations, demolitions, and growing desires for seasonal shelter would probably not justify a 2.1-million rate over the longer term.

Business cautious?

Business fixed-investment spending rose moderately during the third quarter, and a fairly strong 7-percent gain for 1972 may be in prospect on the basis of early reports on spending plans for that year. In the latest purchasing-agents survey, moreover, two-thirds of the respondents reported intentions to increase purchases of equipment in 1972 because of the new investment tax credit.

Still, the low rate of capacity utilization in manufacturing has continued to act as a drag on spending; the rate fell to 73 percent during the third quarter, several points below the already low figure posted during the first half of the year. Optimism was bolstered, however, by rising levels of sales and cash flow, lower interest rates, and the fiscal stimulus from the new economic policy.

The rate of inventory accumulation slumped sharply during the third quarter, as a reflection of the runoff of steel stockpiles which had been built up earlier in the year. But except for steel and possibly autos, industry's close attention to stock control has kept the inventory situation well balanced for the past year or so, with the accumulation rate during 1970-71 falling to less than half the 1968-69 average, on a book-value basis. Inventory-sales ratios recently have been at the lowest levels of the past two years, so that any surge in final sales could stimulate an appreciable increase in inventory investment. Detroit, for example, is now using up a 60-90 day steel supply built up last summer, and automakers thus would be forced to beef up their inventories this winter if their sales remain high.

Corporate cash flow has been rising sharply, based upon a substantial increase in depreciation allowances and a turnaround in profit flows. Liberalized depreciation rules are a major factor in this upswing, although the Administration's original proposals are being challenged in the courts and are in the process of being scaled down in Congress. The increase in depreciation funds (whatever it may be), plus the administration's pressure to hold down dividends, may leave corporations with more cash than expected, so that the ratio of cash flow to GNP might soon return to the high levels of a decade ago.

Governments spending . . .

In the government sector, defense spending continued to edge downward during the third quarter, while other federal spending rose strongly and state-and-local spending continued on its uptrend. In physical terms, defense output is off about one-third from its peak, or back at about the pre-Vietnam level.

House and Senate conferees recently agreed on a $21.3 billion shopping list for military hardware in fiscal 1972, and the list included all of the major items requested by the Pentagon. Included were funds for further work on the trouble-plagued C5A transport plane, plus funds for procurement of the F-14 carrier-based fighter and the P3C anti-sub patrol plane, plus money for continued deployment of the ABM in Montana and North Dakota and for preparation of new missile sites in Wyoming and Missouri. Some uncertainty meanwhile was injected into the spending picture by, on the one hand, the Senate's rewriting of a $2.9-billion foreign-aid bill, and on the other, by the jump in farm subsidies implicit in the Agriculture Department's efforts to slash feed-grain production.

. . . and losing revenue

The House passed a revenue bill in October designed to cut individual income taxes and restore the 7-percent investment-tax credit. The House bill would reduce tax liabilities by $7.8 billion in 1972, as against the $9.2-billion reduction involved in the original Administration proposal, largely through the scaling down of depreciation allowances and the use of a 7-percent instead of a 10-percent tax credit.

The overall impact of the new House bill, plus the 1969 tax legislation and the 1971 depreciation regulations, would be a $14.7-billion cut in tax liabilities in 1972 and an even larger reduction in 1973. (This ignores the effect of the "temporary" import surcharge.) Tax reductions are concentrated heavily in the personal sector, thanks to the present House bill as well as the 1969 legislation. This emphasis on personal tax cuts should give a strong impetus to the 1972 economy, since past history suggests that reductions of this type exert their impact immediately, in contrast to the delayed response of corporate-oriented measures such as the investment credit.

The budget deficit for fiscal 1972, originally estimated at less than $12 billion, may be more than double that figure at the final accounting, as the revenue reductions associated with the new economic policy accentuate the depleted revenue picture resulting from the sluggish 1971 economy. The budget deficit would soar even more if there should be a postponement of the sharp increase in social-security taxes scheduled for January 1972. Present law would bring in $3.0 billion annually from a rise in the wage base, and legislation passed by the House would bring in $4.1 billion more from a further rise in the base plus an increase in the tax rate.

Tight incomes policy

While Congress worked this fall to complete a budget policy that would stimulate the economy, the Administration set in place the machinery for an anti-inflationary incomes policy, built around the new Pay Board and Price Commission as well as the existing Cost of Living Council. The President meanwhile asked for power to control interest rates and dividends in requesting the extension (to April 1973) of the Presidential authority over wages and prices, and he also proposed legislation which would establish a temporary emergency court to handle appeals from the Pay Board and the Price Commission.

The pay and price agencies, with their small enforcement staff, of course will monitor closely only the major wage and price decisions in the economy. Companies with over $100 million in annual sales must have advance approval from the Price Commission before raising prices, and labor contracts involving more than 5,000 workers will need prior clearance from the Pay Board. Delays of proposed increases will be almost inevitable under this procedure, but such delays would tend to have an anti-inflationary impact, since an increase delayed is (temporarily) an increase denied.

Even before the imposition of the new economic policy, a decelerating rate of wage increases began to show up in new labor contracts. During the first half of the year, settlements of contracts covering over 1,000 workers provided an average first-year increase of 10 percent in hourly earnings, as against the 1970 average of 12 percent. This largely reflected the small number of new agreements in construction as well as the slowdown of large awards in that key industry — the first to be brought under an incomes policy, through the operations of the Construction Industry Stabilization Commission.

In its first major decision, the Pay Board voted to set a limit of 5.5 percent a year for wage and benefit increases in post-freeze contracts. This "initial" pay standard will be applied to "annual aggregate" increases in all labor agreements signed after the end of the freeze, but the 5.5-percent guideline will be reviewed periodically to take account of productivity and cost-of-living trends. The Board made clear that contract raises could be made retroactive only on a case-by-case basis with Board approval, but it introduced considerable flexibility into this decision by stating that retroactive payments could be made to remedy "severe inequities." In an earlier decision, the Committee on Interest and Dividends proposed that a 4-percent limit be placed on annual increases in dividends.

The Price Commission for its part promulgated a 2.5-percent guideline for annual price increases, based on the 5.5-percent wage guideline and on an allowance for a 3-percent average gain in productivity. This price guideline was designed to offset cost increases, but not to raise profit margins above the average level of the best two of the last three years.

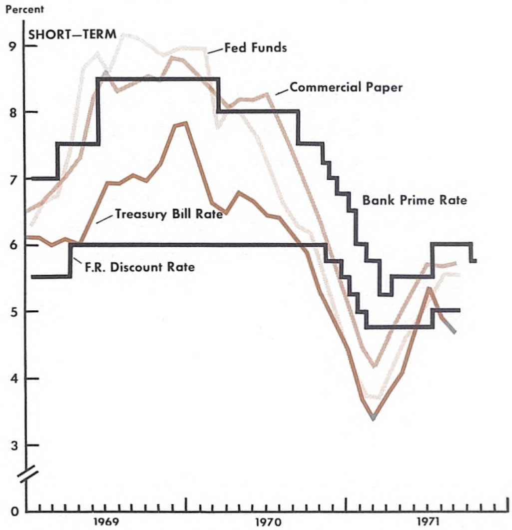
Easier monetary policy

The new economic policy meanwhile took a great deal of pressure off of monetary policy in recent months. The wage-price freeze, along with Phase II planning, helped out on the anti-inflation front, and the depreciated dollar and the import surcharge did their part in stopping the dollar outflow.

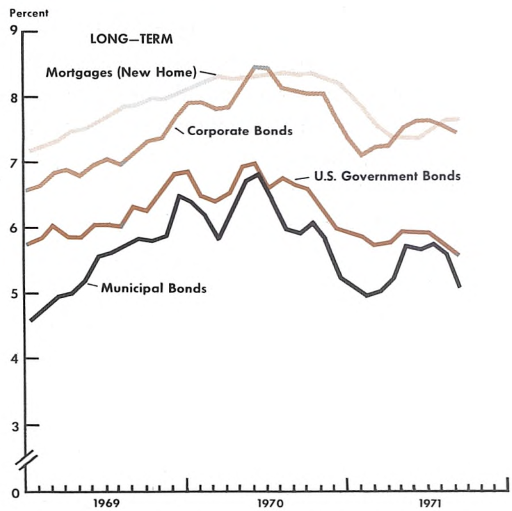
Against this backdrop, the late summer and early fall months witnessed a reversal of the upsurge in money-market rates which marked the spring and early summer period. (Commenting on this drop in market rates, the Committee on Interest and Dividends pointed out that lenders do not need as large an inflation premium as they formerly did.) Short-term market rates have dropped as much as 3/4 of a percentage point since mid-August, and long-term rates have fallen as much as a full percentage point.

Commercial banks responded to these money-market developments by lowering their prime business-loan rate this fall from 6 to 5 1/2 percent, in a two-step reduction. In addition, several major banks adopted a floating prime rate,

Policy shift brings drop in short-term interest rates . . .



. . . as well as decline in most long-term rates



with one bank tying its rate to the 90-day commercial-paper rate and others adopting somewhat different formulas. The drop in the prime reflected a less-than-seasonal increase in loan demand as well as a decline in the cost of bank funds, as measured by a 62-basis point reduction since July in the secondary-market rate on large corporate certificates (CD's). Then, in early November, the Federal Reserve lowered its discount rate from 5 to 4¾ percent, as a means of bringing this rate into better alignment with short-term rates generally.

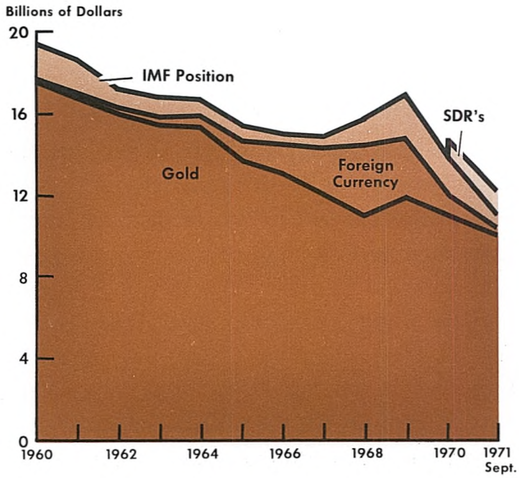
Commercial-bank credit rose at a 10-percent annual rate during the third quarter, on the basis of a strong increase in loan demand. Business loans expanded substantially during August's currency crisis, because of the activity of foreign borrowers. But with that exception, the demand for short-term bank funds has been generally sluggish for more than a year, since corporations have been funding their liabilities through a large volume of stock and bond financing, while economizing on their working-capital needs.

The money supply increased at only a 3-percent rate during the third quarter, as against an 11-percent rise during the preceding quarter. Indeed, the money supply actually declined in September and October. Bank time deposits grew at an 11-percent rate during the July-September period, versus a 13-percent rise during the spring period. Consumer-type time deposits grew at a slower pace than before, but large corporate deposits increased sharply, especially during September and October.

International turning point

The third quarter witnessed a major turning point in international affairs, climaxed by a major attack on the dollar. As a result, U.S. reserve assets dropped from $14.5 billion at year-end 1970 to $12.1 billion at the end of August. In addition, Federal Reserve swap arrangements were utilized heavily to absorb foreign official dollar gains that might have been converted into reserve assets, so that the debt under swap lines rose from $810 million to $3,045 million between the beginning of the year and August 13.

Attack on the dollar means run on U.S. reserve assets



But then came August 15, with the suspension of dollar convertibility and the imposition of the import surcharge.

A new structure of floating exchange rates thereupon developed, but with a system of "dirty" instead of "clean" floats — that is, with foreign central banks intervening in the market on an ad hoc basis to help maintain desired parity levels. Moreover, the market was strongly influenced by the U. S. surcharge, by a variety of exchange controls abroad, and by conflicting appraisals of the appropriate realignment of parities. In any event, by early November the mark stood 9.8 percent, the yen 9.4 percent and the pound 3.9 percent, above their previous parities.

Treasury spokesmen argue that the realignment of major currencies needed to end the extended period of U.S. payments deficits would raise the value of a number of foreign currencies, some of them sharply. They say also that certain barriers to U.S. trade should be lifted, and that foreign nations should shoulder more of the financial burden of U.S. military and foreign-aid commitments.

The leading trading nations have protested the U.S. surcharge as a hindrance to an eventual settlement, and as noted above, they have not only balked at outright revaluation of their currencies but have intervened in the markets to keep their currencies from floating too high. U.S. officials have not been specific in stating the conditions under which the surcharge would be removed, although Treasury Secretary Connally, speaking at the annual meeting of the International Monetary Fund, expressed his willingness to remove it "if other governments will make tangible progress toward dismantling specific barriers to trade and will be prepared to allow market realities freely to determine exchange rates for their currencies for a transitional period." Separately, in accordance with U.S. legislation, the U.S. removed the surcharge on man-made fiber and woolen textiles, in response to an agreement by major Asian producers to limit their textile shipments to this country.

Foreign nations have responded to the U.S. trade initiative in varying ways. For example, Denmark imposed its own 10-percent import surcharge, and West Germany established a credit-guarantee program for exporters, designed to protect them against exchange-rate fluctuations of more than 3 percent during long-term contracts stated in non-German currencies.

In recent months, foreign leaders have turned their attention increasingly to the spreading problems of stagnant production and unemployment. Germany responded to the slowdown of activity in mid-October, by reducing bank reserve requirements by 10 percent and lowering its bank rate from 5 to 4½ percent, and Italy and France later reduced their rates also. (Great Britain had lowered its rate from 6 to 5 percent more than a month earlier.) Canada, in response to a 7.1-percent unemployment rate in September, scheduled corporate and personal tax reductions as well as a large public-works program, and Japan meanwhile readied plans to bolster *its* sagging economy. Just as in earlier decades, the fear grew that an American sneeze would lead Europe (and other trading nations) to catch pneumonia.

William Burke

Coping with Problems

Entering fall, the Western economy was enjoying a boom in homebuilding activity and record marketing receipts in agriculture. At the same time, it had to cope with a lengthy dock strike, now suspended by the Taft-Hartley injunction, as well as with the ramifications of the nation's new economic policy — all in addition to its older problems arising from the prolonged aerospace slump.

Nonfarm employment in Twelfth District states fell off slightly, to 10.45 million, during the third quarter. Increases in the service, finance, and government categories helped to maintain the total in the face of declines in manufacturing and construction. In the rest of the nation also, employment declined modestly during the summer period.

The unemployment rate levelled off at 7.4 percent in the District in the summer period, and similarly levelled off at 5.7 percent in the rest of the nation. Most major labor markets, however, continued to suffer from higher jobless rates than a year ago. Seattle, hardest hit by the aerospace slump, posted a 13.8-percent rate in midsummer, as against a 10.7-percent rate a year ago. But San Francisco-Oakland also recorded a sharp increase over the year, from 5.6 to 6.5 percent. Southern California aerospace centers generally posted higher rates, but by a minor amount; thus, the rate for Los Angeles-Long Beach rose from 6.6 to 6.8 percent over the year.

Aerospace employment in the District dipped slightly during the third quarter, to 507,000, but was turning up again by September. This was the first indication of an advance in payrolls since the December 1967 employment peak, but it came about as the result of rehirings for the newly-financed L-1011 project and did not stem from basic strengthening in the aerospace industry.

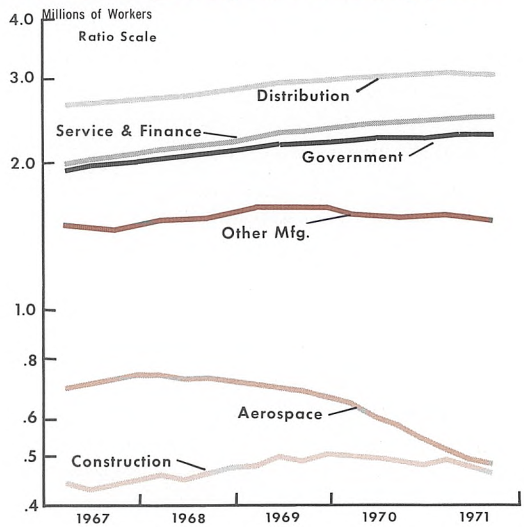
New orders for commercial jet aircraft continued at an extremely low level and were nonexistent for some models. In addition, during the second quarter California firms received the lowest volume of defense contracts for this period since 1957. Space-agency awards received by District firms also dropped sharply in recent reporting periods.

Homebuilding booms

A vigorous pace of homebuilding continued in the West during the third quarter. Housing starts set a new record at a 510,000-unit annual rate, or 10 percent over the former peak reached during the preceding quarter. In addition, Western mobile-home sales rose to an annual rate of 89,000 units — almost 50 percent above the high sales level of 1970.

Non-residential and heavy construction activity posted a 5-percent gain during the quarter, as

More jobs in government, services, but fewer factory and building jobs



measured by the dollar volume of construction awards. Although the volume of awards let for the construction of dams, electric power facilities, and streets and highways declined from the previous quarter, contracts for commercial buildings, educational facilities and hospitals increased substantially over earlier levels. However, because of the exceptional strength in District homebuilding, the pace of total construction activity has remained about 15 percent above a year ago.

Lumber and plywood prices rose in early summer, as customers increased their orders to keep up with housing demand and to gain protection against possible shortages arising from the dock and railroad strikes. Prices dropped somewhat

Dock Strike

West Coast docks began coming back to life October 9 after being closed down by a 98-day strike of the International Longshoremen and Warehousemen's Union (ILWU). The back-to-work order came as President Nixon invoked the Taft-Hartley Act, forcing the striking longshoremen to work during an 80-day cooling-off period. The move came on the heels of a walkout at Eastern and Gulf ports at the beginning of October.

It took nearly a week for all 15,000 strikers to return to work at the 24 shut-down West Coast ports. Work was resumed under the terms and provisions of the contract in effect June 30, before the strike began. If the conflict remains unsettled after 60 days of the cooling-off period, within 15 days the National Labor Relations Board will take a secret ballot of longshoremen on the final offer by the Pacific Maritime Association. If they refuse the shipper's last offer they will be free to resume their strike after five more days.

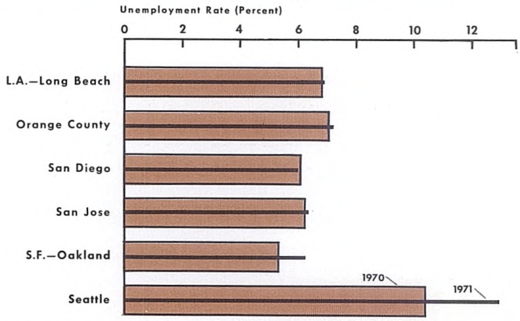
One of the main issues involved in the strike, aside from wages and benefits, was a dispute as to whether longshoremen or teamsters should have jurisdiction over loading and unloading containerized cargo "in any new or expanded container freight-station or facilities." After examining the dispute a White House-appointed board of inquiry described the strike as an "uncommonly difficult dispute."

Nearly 250 ships were tied up during the course of the strike, and some areas of the West, particularly Alaska and Hawaii, began to get into serious straits. By the strike's end, fresh meat and produce were in short supply in Hawaii, with prices climbing about 13 percent for whatever supplies were available. In Hawaii also, hospitals ran short of medical supplies and drugs, construction firms laid off workers as building materials were used up, and staple grocery items such as rice, salt, and toilet paper disappeared from shelves. The impact on the sugar industry was felt both in Hawaii and on the mainland, where a major refinery was forced to close temporarily, laying off 1,000 workers. Alaska was also hard hit by the lack of supplies, particularly in the building industry, where the construction season lasts only three months.

In the Pacific Northwest, agricultural and forest-products communities suffered from the inability to export wheat, logs, lumber and woodchips. In many cases, shippers feared that foreign buyers who have been forced to turn to other sources for their supplies will not return to the U.S. markets.

California officials estimated that total losses (farm and non-farm) in that state could amount to as much as $1 billion. Auto importers felt the effects of the strike, as did merchants waiting for Christmas merchandise and farmers waiting to ship their crops.

Most major labor markets continue to suffer from higher jobless rates



following the rail strike settlement in August, but in September the wholesale-price index for softwood lumber still was 34 percent above a year ago, while the softwood-plywood index was up almost 14 percent.

Metals weaken

Steel producers averted a strike on August 1 by reaching an agreement with the steelworkers' union on a new three-year contract. Western steel production thereupon slumped as customers liquidated excess inventories, and by early fall had recovered only partway. By mid-October Western production remained 10 percent below the level of a year ago, while production elsewhere lagged the year-ago pace 23 percent. In early August, steelmen raised prices about 8 percent on about half of total shipments in an effort to offset rising labor costs. Further increases scheduled for September and October were prohibited by the price freeze.

The domestic copper industry was hit by a strike by 30,000 workers on July 1. Some properties remained closed until late September, but shortages were not a threat as ample amounts were available from world supplies. The price of refined copper on the London Metal Exchange rose briefly in response to the strike, then headed downward under the influence of slow demand worldwide. By mid-October the exchange quotation was back down to 48¼ cents a pound, 4½ cents *below* the U. S. producer price.

Aluminum prices remained under severe downward pressure as a result of lagging demand and excess capacity. One large producer announced in September that it would go ahead with earlier-scheduled price increases because the new selling prices were below levels of May 25, 1970 and thus permissible under the price freeze. But this exercise was largely academic because of the industry's serious problem of excess capacity. Indeed, in early October a smaller producer acknowledged the chaotic discounting of prices by reducing its list price for primary ingot from 29 to 23 cents a pound.

Refiners, farmers, expand

Petroleum refining activity increased in the West during the third quarter, to about 2 percent above the year-ago level. Refining capacity of about 100,000 barrels per day was added during the quarter, and facilities operated at 87 percent of capacity. Refineries increased their dependence on imports of crude oil, primarily from non-Canadian sources.

Additional supplies of crude petroleum are available from District resources, but petroleum firms are having difficulty moving these supplies to market. Pipeline construction in Alaska continues to be delayed by legal problems. In Southern California, four major oil companies have gone to court to force the Federal government to allow another drilling platform in the Santa Barbara Channel, although the Secretary of the Interior has issued an order stopping installation of the platform.

District farmers received a record flow of $4.6 billion in marketing receipts during the first eight months of 1971. Returns thus were 5 percent higher than a year ago, primarily on the basis of higher prices and heavier volume of crop marketings. Elsewhere in the nation, receipts were about the same as a year ago.

A bumper wheat crop in the Pacific Northwest helped boost third-quarter crop receipts, but the dock strike blocked the movement of wheat into export markets. In the livestock sector, marketings during the quarter were slightly heavier than during the comparable period last year.

Regional staff

Encountering Loan Demand

The mid-August announcement of the New Economic Policy shattered the usual summer lull for Western banks. The immediate effects were, first, a surge in borrowing related to foreign-exchange transactions and, second, a decline in money market rates, which removed the mounting pressure on loan rates and led to the two reductions in the prime rate.

In the third quarter, total credit at Twelfth District commercial banks expanded at a 4-percent annual rate ($676 million), representing some acceleration from the low 1.3-percent (revised) rate of the preceding three months. Total deposits, with an 11-percent rate of gain, also expanded at a faster pace than in the second quarter.

In the June-September period, loans rose $1.9 billion — a 16-percent annual rate of growth — in contrast to no expansion at all in the preceding three-month period. The increase included large gains in business loans ($695 million) and in real-estate loans ($622 million), but the expansion in consumer instalment loans trailed the rate in the prior quarter.

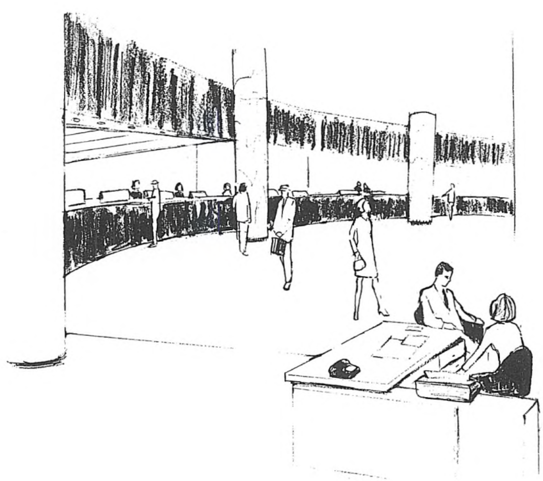
The growth of bank credit was held down, however, by the large reductions made in bank investment portfolios. Heavy run-offs in Treasury bills in July and August brought about a $1.3-billion decline in portfolios of U.S. Treasury issues. Other securities rose only $46 million during the quarter, even though banks were heavy purchasers of short-term municipals in September. (Data are seasonally adjusted.)

Slowdown in savings flows

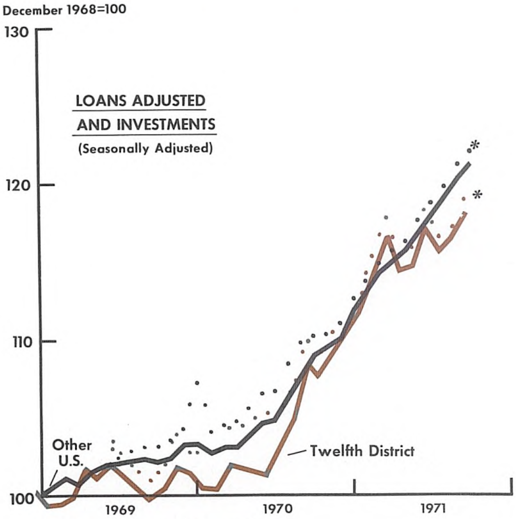
For the second consecutive quarter, net demand deposits grew faster than time deposits at District member banks — a 16-percent rate versus an 8-percent rate, on a daily average basis. This reflected the unusually large increase in U. S. Government deposits, as a consequence of the acute situation in the foreign-exchange markets. On the other hand, private demand deposits, with a 9-percent rate of gain, grew more slowly than in the preceding quarter.

The slowdown in the flow of individual savings, which began in April, continued into the third quarter. Large Western banks suffered an attrition in regular passbook savings in both July and August, despite the reinstitution of a $4\frac{1}{2}$-percent rate by most of those banks that had lowered their rate to 4 percent in April. While September's increase offset the outflow of the two prior months, most of that month's gain was attributable only to crediting of quarterly interest. Other consumer-type time deposits rose at less than half the pace of the prior three months.

District banks recorded their usual seasonal withdrawals of public time deposits in the July-September period, but they attracted an inflow of over $1 billion in large corporate CD's, bringing outstandings to a record high. This upsurge



Bank-credit expansion fueled by upsurge in bank lending



**Includes loans sold outright*

reflected an increase in available short-term corporate funds, but also the active bidding by banks for such funds.

Mixed income reports

In contrast to the first-half pattern, a number of District banks recorded lower third-quarter income than a year ago, both before and after securities gains or losses. As in the earlier part of the year, the income pattern of individual banks varied widely.

On the revenue side, District banks benefitted by the early July increase in the prime business loan rate and by the August increase (by some banks) in mortgage rates. However, the rate of return on securities declined after mid-August.

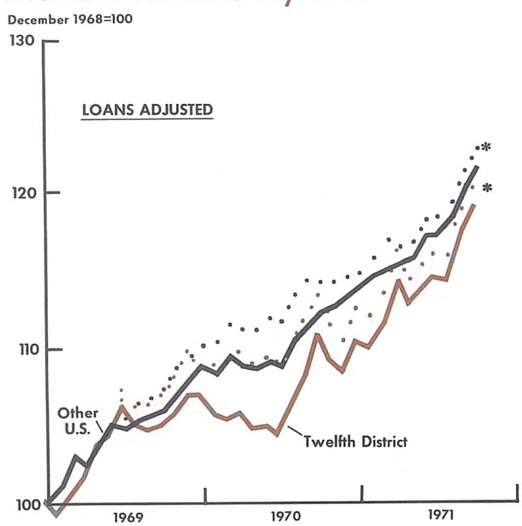
At the same time, a substantial increase in bank costs came about because almost all District banks again paid the 4½-percent ceiling rate on passbook savings in the third quarter. In the latter part of the period, however, banks were able to obtain large CD's at somewhat lower rates than heretofore. But there was little or no relief on non-deposit borrowing costs; the discount rate rose from 4¾ to 5 percent early in the quarter, the Federal-funds rate stayed within a relatively high range for most of the quarter, and the rate on Eurodollars skyrocketed during the foreign-exchange crisis.

Shift to borrowed reserves

Because of the increases in both demand and time deposits, District member banks' required reserves were $140 million greater in the third quarter than in the preceding period. Their borrowings from the Federal Reserve Bank also were relatively high, at $61 million (daily average), or four times the average in the first half of the year. As a result, District banks had net borrowed reserves of $45 million during the quarter — a shift from the small net free reserve position maintained earlier in the year.

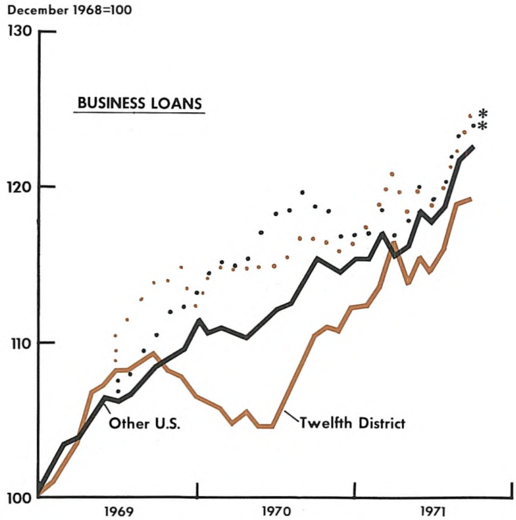
On their total Federal-funds transactions, on the other hand, large District banks were net borrowers (purchasers) of only $57 million, or less than half the amount of the preceding quarter. They were net purchasers of $185 million from banks, and were net sellers of a small volume of funds to dealers in U.S. Government securities. Large District banks also reduced their borrowings from their own foreign branches (mainly Eurodollars) and from corporations and others under repurchase agreements.

Loans rise sharply, reflecting international monetary crisis



**Includes loans sold outright*

Business-loan growth lags in September after earlier surge



**Includes loans sold outright*

Mixed loan statistics

Business borrowing rose $256 million (seasonally adjusted) in July, and then spurted another $390 million in August as metropolitan banks experienced credit demands related to the international financial crisis. In September the gain in business loans tapered off to $49 million, despite the usual substantial tax borrowing in mid-September.

Most categories of business loans rose during the July-September period. The late August bulge in bankers acceptances, however, was substantially reduced by the end of September. Increased credit demands by nondurable goods manufacturers centered in the seasonal credit needs of food, liquor and tobacco dealers.

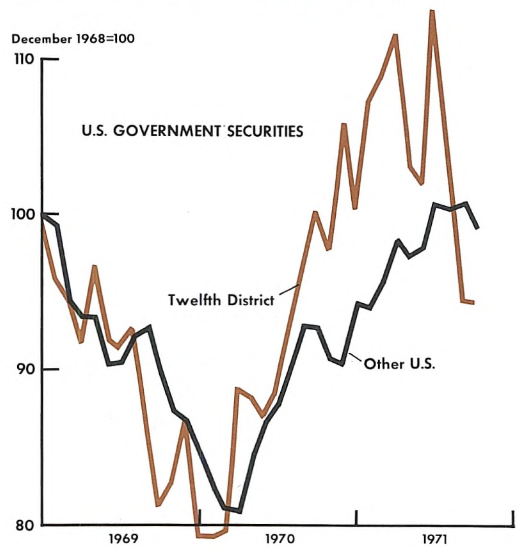
Individuals meanwhile displayed some hesitancy about adding to their instalment debt. Large banks reported a $135-million increase in consumer loans during the third quarter, or only half the second-quarter gain. While automobile loans rose at District banks, there was no substantial increase as had originally been forecast. Credit card outstandings rose in July, but then dropped in August, although the volume of new credit extensions continued to expand. The Western consumer still appeared to be waiting for a clearer reading of the economic situation before embarking on a spending spree.

Strong mortgage statistics

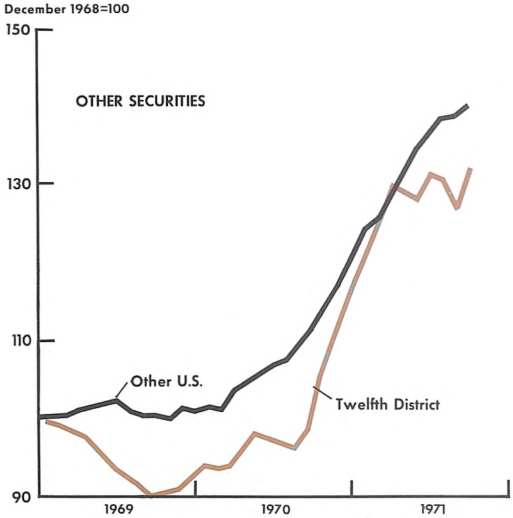
Mortgage financing increased more than seasonally during the third quarter, with commercial banks and savings-and-loan associations expanding their mortgage portfolios by $556 million and $1.4 billion, respectively. (However, the September increase at banks was only half of the two preceding months.) At the same time, both the banks and the S&L's reduced their large volume of mortgage commitments, although to levels which still promised a high level of mortgage financing in the months ahead.

This slowdown of commitments, plus a slower pace of mortgage financing in the late summer period, in part reflected a slowdown of savings inflows as well as the threat of overbuilding in some regional centers. The banks' $200-million

Runoff in Treasury securities most evident at District banks



Other banks outpace District banks in acquisitions of municipals



net savings inflow was only a fraction of the very heavy inflow recorded last winter, while the S&L's $1.4-billion gain was also well below the early-year gain.

The slower savings pace, in conjunction with the high level of mortgage loan demand, contributed to some firming of regional mortgage rates early in the quarter, with conventional loan rates on new homes rising about 15 basis points to approximately 8 percent. However, some easing in rates was again evident as the quarter came to a close; moreover, a number of major lenders posted reductions in their prime home-financing rates during October. Non-price terms of lending in most major markets also eased, with slight increases in both average loan maturities and loan-to-price ratios.

Uncertain fourth quarter

Apart from seasonal fluctuations, bank-loan portfolios will probably not show too much movement during the current quarter, since businesses and consumers appear to be marking time until the uncertainties of Phase II are resolved. On the deposit side, demand-deposit growth may moderate as U.S. Government deposits move down to a more normal level. The November payout of Christmas Club accounts and other savings withdrawals to meet holiday-connected expenditures should have their usual adverse effect on individual savings flows. However, corporate funds may continue to be available to Western banks in sizeable amounts during coming months.

The October and November reductions in the prime rate may result in a scaling down of other loan rates which are tied to the prime. Such reductions would mean lower revenues for District banks, but since they reflect a reduction in the cost of funds from corporate sources, the impact on profit margins should be offsetting. Still, profits may be held down by the continued high cost of funds from non-corporate sources, such as the 4½-percent rate on passbook savings and similar ceiling rates on other consumer-type deposits.

Ruth Wilson and Verle Johnston

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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
	Sept. 29, 1971	June 30, 1971 to Sept. 29, 1971		July 1, 1970 to Sept. 30, 1970	June 30, 1971 to Sept. 29, 1971
		Dollars	Percent	Percent	Percent
Loans gross adjusted[1] and investments	58,270	+ 993	+ 1.73	+ 6.86	+ 0.60
Loans gross adjusted[1]	41,761	+1,235	+ 3.05	+ 4.16	+ 1.52
Commercial and industrial loans	15,570	+ 312	+ 2.04	+ 2.64	+ 1.36
Real estate loans	12,333	+ 565	+ 4.80	+ 0.43	+ 4.24
Agricultural loans	1,445	— 91	— 5.92	— 4.49	— 4.09
Loans to nonbank financial institutions	2,464	— 138	— 5.30	+ 13.75	— 9.07
Loans for purchasing or carrying securities:					
To brokers and dealers	781	+ 328	+72.41	+255.03	— 0.12
To others	251	— 33	—11.62	+ 2.29	— 0.37
Loans to foreign banks	351	+ 142	+67.94	— 0.56	+48.02
Consumer instalment loans	6,134	+ 135	+ 2.25	+ 0.92	+ 3.67
All other loans	2,432	+ 15	+ 0.62	— 1.44	+ 0.50
Total investments	16,509	— 242	— 1.44	+ 14.88	— 1.59
U.S. Government securities	5,614	— 421	— 6.98	+ 27.27	— 5.43
Obligations of states and political subdivisions	8,935	+ 157	+ 1.79	+ 5.90	+ 1.42
Other securities	1,960	+ 22	+ 1.14	+ 24.48	— 6.11
Total deposits (less cash items)	57,394	+1,055	+ 1.87	+ 6.99	— 1.10
Demand deposits adjusted	18,300	— 3	— 0.02	+ 3.22	— 2.85
Time and savings deposits	37,020	+ 945	+ 2.62	+ 9.81	+ 3.49
Saving deposits	16,865	+ 2	+ 0.01	+ 1.50	— 0.95
Other time IPC	14,290	+1,045	+ 7.89	+ 20.05	+ 5.05
Deposits of states and political subdivisions	4,214	— 352	— 7.71	+ 15.59	+10.64
(Neg. CD's $100,000 and over)	5,043	+1,026	+25.54	+ 41.10	+14.21
Capital accounts	4,542	— 17	— 0.37	+ 1.98	+ 1.94
Total assets/liabilities and capital accounts	73,753	+ 713	+ 0.98	+ 4.07	— 1.11

[1]Total loans minus loans to domestic commercial banks