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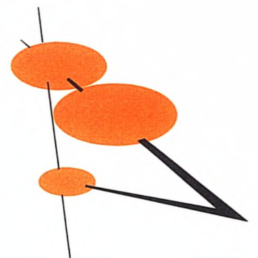

August 1972

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Widespread Advance

. . . Consumers, businesses and governments all contributed to the second-quarter upsurge — and helped spur inventory building too.

Regional Advance

. . . The West expanded roughly in line with the national pace, despite the first signs of weakening in the housing boom.

Brisk Loan Expansion

. . . Bank lending expanded much faster in the West than in the rest of the nation in recent months, but security holdings fell.

Editor: William Burke

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Widespread Advance

The national economy grew rapidly and broadly during the spring and early summer months, with GNP rising to an $1,139-billion annual rate during the second quarter. Current-dollar GNP grew at a more moderate pace because of a substantial slowing in the rate of inflation — but in real terms, growth increased from a 6.5-percent annual rate in the January-March period to an 8.9-percent rate in April-June. Consumers, businesses and governments all contributed to the rapid pace of recovery, and their increased buying plans helped stimulate a long-awaited buildup in inventories. The only minus sign in the national accounts was the continued deficit in the foreign-trade sector.

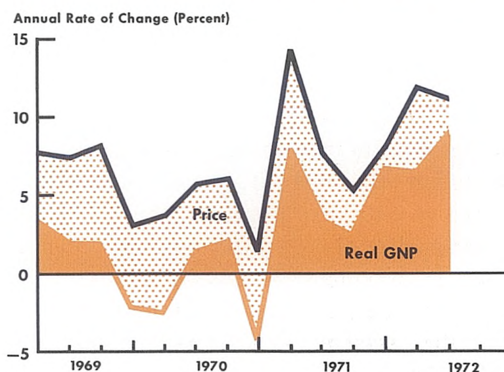
Industrial production finally (April) surpassed the peak first reached two and a half years earlier, and it continued to advance during May and June. The production indexes showed the impact of heavy business spending in the increased production of producers' durable goods; the impact of the housing boom in the higher production of construction materials, furniture and household goods; and the impact of the auto boom in the high level of new-car assemblies, especially in the early part of the quarter. However, the upsurge in overall demand has not yet bumped up against the economy's ability to expand supply. During the second quarter, almost 6 percent of the labor force remained unemployed, and over 23 percent of manufacturing capacity remained unused.

Inventories to rise?

The growth in inventories was up from practically zero in the first quarter to a $4.3-billion annual rate in the April-June period. This may be only the beginning, since past relationships suggest that inventory buying could rise to $12 billion or more, as the economy expands further. During the early spring period, producers holding 15 percent of manufacturing inventories described them as too high; this contrasts with a 20-percent rate through most of 1971, and a 23-percent rate in 1970.

Inventory-sales ratios in manufacturing and trade have fallen sharply during the past year and are now relatively low — below the level of 1968, the last strongly prosperous year of the past half-decade, though not necessarily too low considering technological changes in inventory control. The ratio fell to 1.51 this spring as against a peak of 1.70 in late 1970. The upturn in durable-goods orders and the end to earlier weakness in the defense and capital-goods sectors have brought heavy orders for such items as aircraft, computers and electronics, which involve many complex components with long production lead times. Inventories

Real GNP strengthens as recovery expands, while prices rise less rapidly



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of this type have been liquidated over the last two years, so the turn-around should boost inventories at all levels, especially goods in process.

Defense spending turns around

Government spending in the GNP accounts continued to strengthen during the second quarter. Defense expenditures rose by $1.9 billion to a $78.6-billion rate; this gain was in line with the first-quarter expansion after adjustment for changes in pay schedules. (Defense spending overall is up sharply from last summer's low, in the fastest increase since the 1966 Vietnam buildup.) Federal non-defense spending was up $0.7 billion to a $29.6-billion rate, and state-and-local government spending was up $2.7 billion to a $146.4-billion rate. In the latter case, however, the gain was below the historical uptrend.

Further increases in Pentagon spending appear to be in the cards, because of rising prices, rising procurement to replace stocks used up in Vietnam, and a $2-billion pay increase scheduled for next January. Already, the statistics show substantial increases in defense-industry backlogs and in Defense Department obligations.

Secretary Laird, testifying before Congress on fiscal 1973's $83.4-billion defense budget, claimed that the Vietnam escalation could add $3 billion to $5 billion to budgeted spending, because of increased requirements for munitions, fuel, equipment and aid to the South Vietnamese. On the other hand, the strategic-arms pact should cut $550 million net from the budget, because of the reduction in ABM sites from the original twelve to only two. However, the actual size of the budget also depends on how Congress votes on procurement of certain bargaining-chip items, such as the B1 long-range bomber and the Trident missile-firing submarine, which the Administration feels should be developed to spur the USSR into further limitations on strategic offensive arms.

Government construction spending showed some strength in early 1972, after a prolonged period of sluggishness. Some of this increase represents a delayed response to the heavy borrowing by state-and-local governments in the last two years, the proceeds of which were first used to rebuild liquidity before new construction programs were undertaken. This year should see heavy spending by local units for roads, bridges, sewers and water-supply facilities. In addition, new Federal legislation could lead to a $1-billion increase in Federal building programs over the next two years, in a program designed to reduce the backlog and streamline the financing of previously authorized buildings.

New forces on business spending

The business-spending boom continued with a $4.0-billion second-quarter increase to a $120.1-billion annual rate, concentrated mostly in the durable-equipment sector. In real terms, however, the increase was somewhat slower than in the fast-expanding January-March period.

The spending boom began last year with the help of Administration tax incentives, and it has been stimulated further by the sharp improvement in corporate profits and the rising needs of a rapidly expanding economy. The upsurge has been supported by the rise in internally-generated funds and by the relatively favorable cost of borrowing — and also by the lower effective cost of new equipment because of the reinstatement of the investment tax credit.

Business-construction spending has shown divergent trends, in contrast to the upsurge in the durable-equipment sector. This year so far has witnessed a sharp rise in construction of stores and health facilities, related mainly to the housing boom, but somewhat less strength in other areas such as office-building construction.

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Producers' durable-equipment spending has been boosted by heavy truck sales, helped by the general economic expansion and by the repeal of the 10-percent excise tax. Truck sales in the spring of this year were running about one-third above the year-ago level. However, much of this may be consumer demand — although the figures show up in the business statistics — because consumers have been buying large numbers of lightweight pick-up and panel vans for use as second or third cars.

Corporate spending, according to this spring's Commerce Department survey, is expected to grow at a slower pace during the second half of 1972. Manufacturers and non-manufacturers alike expect a 4-percent annual rate of increase in the second half, as against their first-half increases of 10 percent and 20 percent, respectively. Some sectors which recorded very substantial gains during the first half (such as the aircraft industry and the airlines) expect declines as deliveries taper off, but the prolonged boom in public-utilities spending seems destined to continue. However, second-half spending may be stronger than anticipated because of the recent turnaround in business sentiment, with actual outlays exceeding earlier expectations in each of the last several quarters. In the past, such a development has always signaled a strong cyclical growth in capital outlays.

Consumers support the upturn

Consumer spending was up strongly this spring, although with some shift in the contents of the market basket. Durable-goods spending increased \$2.6 billion to a \$113.6-billion annual rate — about one-half as large as the previous quarter's advance. Nondurable spending increased \$8.0 billion to a \$296.3-billion annual rate — the strongest quarterly gain in years. Spending on services meanwhile increased \$5.9 billion to a \$302.6-billion annual rate, in line with the usual uptrend.

The upswing in retail sales this year has been broadly based, with strength apparent in furniture, appliance, apparel, and particularly auto sales. The upswing has been backed by a very sharp expansion in consumer credit, with outstanding instalment credit increasing at a \$15-billion rate — double the 1971 pace — in the spring period.

The auto boom, which began a year ago under the stimulus of the excise-tax repeal, continued this spring and early summer as new car sales reached 10.7 million units, at an annual rate — 10 percent above the year-ago level. About 9.2 million of the second-quarter sales represented domestic-type units. Imports have fallen below earlier peak levels, but are still surprisingly high at a 1.5-million rate, inasmuch as prices of imports have risen roughly \$250 over the past year, while prices of competing domestic subcompacts have increased hardly at all.

Detroit has witnessed record sales of luxury cars this year, but also a broad shift from standard-size to mini cars. For the first time, the bottom of the line — intermediates, compacts and subcompacts — has accounted for over one-half of all cars sold. The industry has built up substantial inventories of new cars — about 1.8 million units, or a 52-day supply — but strong third-quarter production plans indicate Detroit's faith in the continuation of heavy consumer demand.

The housing boom began to falter this spring as spending increased only \$0.8 billion to a \$52.4-billion annual rate — and increased not at all in real terms. Housing starts, although reaching a very high rate of 2.2 million units, were off substantially from the previous quarter's peak, and housing permits also declined. Yet with the continued high level of housing starts and the usual lag of construction activity behind

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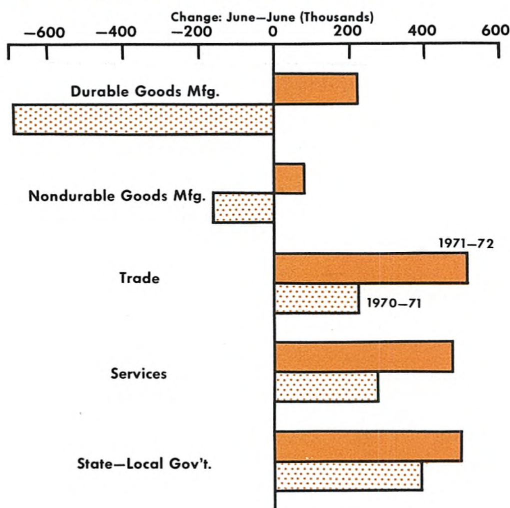

starts, dollar spending seems bound to remain strong for the rest of the year. Even so, builders have cause to worry because of the record number of units now reaching completion, especially since the market has been slower and slower over the past year in absorbing the new homes and apartment units being placed on the market.

How much saving?

The consumer saving rate fell considerably below the unusually high (8.1 percent) average rate of the last two years, declining to 6.6 percent in the second quarter on the heels of the first-quarter drop to 7.2 percent. This resulted partly from the strong upsurge in spending, but also from some temporary influences affecting consumer income. As sharp swings in income take place, fluctuations in spending may not be precisely equal, so that the brunt of the lags is borne disproportionately by consumer saving. Without the special factors impacting on income, the saving rate in the second quarter probably would have been considerably closer to the earlier peak rate.

Over-withholding of income taxes, by affecting consumer take-home pay, reduced the amount available for discretionary household disbursement throughout the first half of 1972. This situation will be reversed next spring, since the Treasury Department estimates that tax refunds then will be almost twice as large as in early 1972. The overwithholding, indeed, has acted as a form of temporary savings, but one on which the saver earns no return. Hurricane Alice, meanwhile, by sharply reducing property and proprietors income in East Coast flood areas, cut back income gains somewhat during the month of June.

Future income trends may be influenced by the repercussions of a Federal Court decision in July, which enjoined the Cost of Living Council from exempting only workers making $1.90 an hour or less from wage controls. Several major unions brought the suit, charging that the cutoff point should be $3.35, which is equivalent to $6,960 annually — the Labor Department's standard in 1970 for a "lower level" budget for a family of four. (Actually, the latest official estimate was about 4 percent higher, at $7,214.) Soon thereafter, the Council boosted the wage cutoff for its poverty exemption to $2.75 an hour. This increase, along with an earlier decision to exempt employees of most small businesses, means that 56 percent of the nearly 58 million private nonfarm workers are exempt from the Pay Board's 5.5-percent wage guideline.

How much unemployment?

Nonfarm payroll employment rose by 700,000 in the second quarter to a total of 72.5 million workers, in its second consecutive quarter of very rapid advance. At that level, employment was almost 2 million (3 percent) above the year-ago figure. Trade, services and state-local government each added roughly one-half million new workers, and durable manufacturing added a

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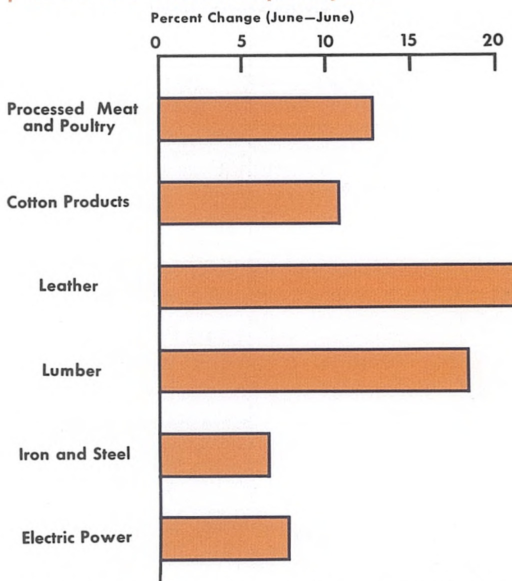
quarter-million more, during this year-long upturn.

Labor-force growth slowed somewhat during the spring months, but the unemployment rate still remained near the 6-percent level, before declining sharply to 5.5 percent in the June-July period. (Moreover, the average duration of unemployment increased from 12.2 to 12.8 weeks during the second quarter.) Administration spokesmen now count on a continued decline in unemployment, under the impact of rising employment and an expected slowdown in the growth of the labor force. Over the past year more than one-sixth of the labor-force increase has been due to a reduction in the armed forces, which is not likely to be repeated in the next year.

The problem of a sticky unemployment rate in the face of strong employment growth was highlighted by T. Aldrich Finegan in the *Monthly Labor Review* of February 1972. Finegan contends that the rapid increase in the adult population over the last decade, at roughly 1.7 percent a year, will continue for several years yet. He further expects, in contrast to official projections, that the rise in the female labor-force participation rate will also continue, because of such factors as a declining birth rate, a declining percentage of women with preschool age children, and the rising importance of the service industry and other industries which are dominated by women workers.

This analysis implies that an unprecedented growth in employment would be required to cut the unemployment rate to 4.5 percent by the end of next year. An increase of between 5.9 and 7.1 million workers would be needed between the second quarter of 1971 and the fourth quarter of 1973 to bring this about — far ahead of the record of most postwar expansions. Indeed, the only period when growth of



this kind occurred was the demobilization period of 1945-47. Unemployment might be lowered, of course, with a slowdown in productivity improvement, but that would tend to create new problems for the nation's inflation fighters.

Better price news . . .

During the spring and early summer months, the inflation news was generally good. In particular, the price deflator in the private economy rose at only a 2.0-percent rate in the second quarter, in contrast to the 4.2-percent rise of the January-March period.

The consumer-price index decelerated during the spring period with a 2.2-percent rate of increase, partly because declines in meat and vegetable prices from last winter's stratospheric levels held food prices stable, while apparel prices rose at a slower pace than heretofore. Since the beginning of Phase II, the CPI has risen at a 2.7-percent rate, in contrast to the 3.8-percent increase of the pre-freeze period of 1971. Much of

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the recent increase has come from items exempt from Price Commission regulations, such as raw agricultural products, used cars, houses, mortgage rates and taxes.

The wholesale price news has been less cheery, however, and has had serious implications for the future of the consumer-price index and for the international competitiveness of the dollar. Over the course of Phase II this index has risen at a 5.7-percent rate, even faster than during the pre-freeze period of 1971. Looking over the past year as a whole, a lengthy list of disturbing price signs can be compiled from the wholesale-price index: livestock, plus 26 percent (and meat, poultry and fish, plus 14 percent); hides and skins, plus 86 percent (and leather, plus 21 percent); lumber, plus 13 percent; cotton products, plus 10 percent; electric power, plus 8 percent, and so on.

. . . except meat, hides, lumber

Meat prices again were in the news at mid-year after their earlier decline. At that time a potentially explosive increase developed because of heavy consumer demand, sluggish retail supplies of red meat, and the build-up of cattle on the feed lots instead of in the butcher shops. To combat the supply problem, the President removed quotas on meat imports for the rest of the year and the Defense Department cut in half its normal meat inventories. Little could be done, however, about another major consumer item — coffee — since frost damage in Brazil has already led to sharp increases in the wholesale price of the national beverage.

Price increases in hides developed because of increased world demand, Argentine export quotas, and lower-than-expected beef kills in this country resulting from the concentration of cattle in feed lots. Heavy exports of hides then developed because of price controls in this country and heavy overseas demand. But then the Commerce Department imposed a ticket system of export controls, effective September 1, in a move designed to reduce hide exports to year-ago levels.

The Cost of Living Council meanwhile moved to get control of lumber prices, which have been rising steeply under the stimulus of strong housing demand and strike-caused supply problems. The Council reimposed price and wage controls on all manufacturers and dealers with annual sales in excess of $100,000. These concerns had raised their prices rapidly during the period of exemption, and thus in some cases may be forced to roll back their prices to the levels of last May.

In view of their expanding role, the control agencies this spring boosted their combined staff by one-third to a total of 770 employees, and also assigned one-half of the 3,000 Internal Revenue agents involved in the program to the monitoring of large-firm price compliance. Moreover, the Price Commission began to think in terms of the "impact test" and the "basket clause," in its desire to control the gyrations of the wholesale and consumer price indexes.

Under the impact criterion, the Commission may apply stricter-than-normal rules for processing price-increase applications whenever a rise threatens to lift the index more than 0.1 percent. The Commission already has moved in the shoe industry, by ruling that shoemakers may pass on leather-cost increases only on a dollar-for-dollar basis. The auto industry may be another candidate for this test, since the major producers have applied for price increases of 1.9 percent or more on 1973 models to cover the cost of government-required equipment, although a rise of 1.5 percent would serve to generate a 0.1-percent rise in the overall wholesale-price index. (However, much of the requested 1.9-percent increase may not affect the index, because of being defined

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as "quality improvement.") The "impact test" tends to act as a trigger for application of the "basket clause" — which involves whatever is necessary to hold the overall economy-wide increase within the guideline of 2.5 percent a year.

What size deficits?

On the fiscal side the Administration released new budget figures in June, which indicate that a strong fiscal stimulus will continue for some time yet. (In the fiscal year just ended, the stimulus as measured by the full-employment deficit amounted to $3.6 billion.) The figures indicate a $27-billion overall deficit in fiscal 1973 (unified basis), but later developments suggest a far higher deficit figure, perhaps on the order of $37 billion. Moreover, unofficial observers argue that the full-employment deficit might approach the highly inflationary figure recorded in 1967-68.

Major expenditure increases which were not included in the June budget figures include expanded Defense Department outlays (especially those related to Vietnam), flood-relief spending, and the major part of the recently enacted 20-percent social-security benefit increase. The latter alone should boost the 1973 deficit by at least $4 billion.

Treasury financing was eased this spring by a sharp improvement in the Treasury's cash position, as the $39-billion (1972) deficit projected in January became transformed into an actual $23 billion at the end of the fiscal year. Some improvement in the Treasury's cash balance developed because of smaller-than-expected spending, but more of it came about because of the unexpectedly large tax intake resulting from the expanded economy and the over-withholding phenomenon. In addition, there was an extra inflow of foreign funds, as central banks which had taken in dollars in exchange-support operations invested part of those proceeds in Treasury special issues.

During the second quarter, debt managers paid down the debt instead of borrowing heavily as they had been expected to do. This condition of ease has extended into the third quarter — partly because of the issuance of roughly $3 billion in special issues to foreign central banks who have recently been soaking up dollars. But the large size of the projected deficit for fiscal 1973 indicates very heavy financing in the fourth quarter and thereafter. However, total cash needs during the July-December period may fall below the $21.5 billion raised in the like period of 1971.

As a reflection of its continuing strong cash position, the Treasury in late July offered a 3½-year note priced to yield 5.96 percent, a 7-year 6.25-percent note at par, and a 12-year bond priced to yield 6.45 percent, in exchange for notes and bonds maturing during the remainder of 1972. The longer note and the bond also were made available in an advance-refunding operation designed to help the Treasury level off the large amounts maturing several years hence. The public's good response to this offering exceeded the Treasury's initial expectations.

Slower growth, higher rates

As the economy strengthened, the Federal Open Market Committee decided at its April meeting to seek somewhat more moderate growth of the monetary aggregates. (The Committee noted that the moderation probably would be associated with "some further tightening of money-market conditions.") As it turned out, the money supply (demand deposits plus currency) grew at a 5.1-percent rate during the second quarter — as against the 9.3-percent rate of the preceding quarter — despite an especially fast

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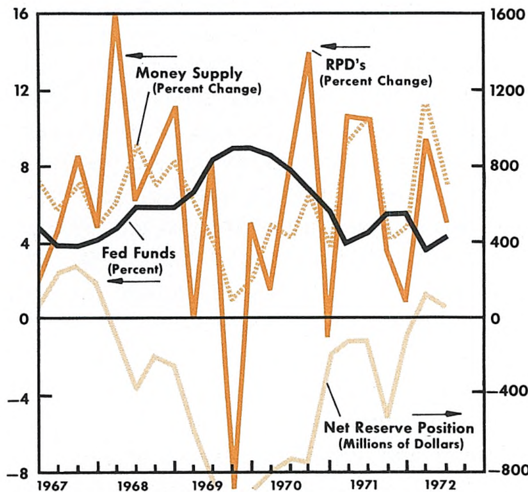
Monetary indicators point to moderation in growth path



growth occurring during April. Also, time deposits advanced strongly, with large corporate CDs increasing rapidly in the early part of the quarter and other time-and-savings deposits accelerating later in the period.

Commercial bank credit increased at a 7-percent rate during the spring period — as against a 15-percent rate in the first quarter — as security investment slackened but loan expansion continued strong. Business-loan demand strengthened at least during May and June (except at the large New York banks), while demands for consumer and mortgage loans increased very rapidly on the basis of the auto boom and the housing boom.

Money-market rates advanced (except during April), continuing the uptrend evident early in the year. The 90-day Treasury-bill rate exceeded 4 percent early in July — a full percentage point above its February level — and the Federal-funds rate increased to 4½ percent in the same period. On the basis of this rise in market rates and the stronger loan demand, bank business-loan rates moved up in the same fashion, and reached a range of 5¼ to 5½ percent in July. Loan demand was very heavy outside of New York as many large firms went to regional banks for their working-capital financing. By early August, however, short-term rates began to soften.

In the long-term sector, Treasury bond rates dropped temporarily because of the Treasury's easing cash position, but then stiffened and held at around 5½ percent in July. Corporate Aaa bond rates remained high, at over 7 percent in July, as investors remained relatively timid because of inflation fears, the international situation, and the prospect of a very large Treasury deficit in fiscal 1973. But external financing by corporations was fairly light, since firms had ample cash flow to support their heavy spending on new plant, equipment and inventory.

Even with the sharp rise in short-term rates and the relatively stable level of long-term rates, a wide spread between money-market and capital-market rates still existed at midyear. Apparently, investors remained unconvinced of the likelihood of wage-price stability or balance-of-payments equilibrium, and therefore continued to demand an inflation premium.

Yet another crisis

Yet another international crisis developed in late June when the United Kingdom floated the pound in response to a speculative attack, even though it held a record level of reserves at the time. The major causes of the crisis were the U.K.'s falling balance of trade, its chronic inflation problem, and labor turmoil which climaxed in late July with a nationwide dock strike. To combat the resultant movements of capital funds, a number of nations then resorted to expanded exchange controls. The U.K. itself extended its existing controls to cover flows to the overseas sterling area, limiting banks in their foreign-exchange dealings to investment pur-

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poses, and permitting firms to buy foreign currency only for import-export purposes or for approved investment abroad.

West Germany, the major recipient of the unwanted inflow of weaker currencies, imposed a series of controls, although at the cost of the resignation of Economics and Finance Minister Schiller. The government ordered German-based nonbank corporations to deposit with their banks, at zero interest, 50 percent (up from 40 percent) of the funds they borrowed abroad; also, it raised further the marginal reserve requirements on Deutschemark-denominated deposit liabilities to nonresidents. The Japanese government steeply increased reserve requirements on yen deposits that have been converted from dollars and held by non-resident foreigners. Switzerland prohibited non-resident foreigners from buying Swiss real estate or securities, imposed a negative-interest charge of 8 percent on nonresident Swiss franc deposits, and banned all borrowings abroad by Swiss firms without central-bank approval.

To help restore order in foreign-exchange markets and to help uphold the Smithsonian agreement, the Federal Reserve intervened in the market in mid-July, purchasing dollars with Deutschemark balances held by the Treasury. According to Federal Reserve Chairman Burns, the operation will continue on whatever scale and whenever such transactions are deemed desirable. At the same time, the Chairman said that last August's suspension on the use of swap lines was now lifted.

Trade breakthrough

On the foreign-trade front, most of the big news recently came from Eastern Europe instead of Western Europe, as the U.S. became involved in both a major wheat deal and a major technical-assistance project with the USSR. The U.S. agreed in July to sell $750 million of wheat and other grains to the USSR over a three-year period, with standard financing by the Commodity Credit Corporation. (This would amount to a 17-percent increase in total U.S. grain exports over the average exports of the 1969-71 period.) Also in a multi-firm deal, U.S. participants announced that they would become involved inside the Soviet Union in the exploration and production of natural gas and crude oil, the design and building of hotels, the production of agricultural fertilizers and chemicals, and various other projects.

The net balance on foreign transactions in goods and services continued at a record deficit level during the second quarter. In the GNP accounts, imports exceeded exports at a $4.9-billion annual rate during this period, slightly worse than in the January-March period. Imports of goods recently have remained on a high plateau, reflecting partly the rising demand for industrial foreign products from an expanding domestic economy and partly a slowdown in imports of nonfood consumer goods other than autos. Exports have also remained fairly flat, as demands for U.S. goods have not responded to the slow upturn in foreign economic activity. U.S. shipments of agricultural commodities, however, held at a very high level in the second quarter.

Despite considerable arguments as to the timing and magnitude of future changes in American foreign trade, practically all observers expect an improvement in the poor trade showing experienced so far this year. However, the overall improvement resulting from devaluation may not be fully realized before late 1973 or early 1974.

William Burke

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Regional Advance

The Western economy expanded roughly in line with the national pace during the spring and early summer months, even in the face of a slackening in the housing boom and the continued low level of activity of the aerospace-manufacturing industry. But the vast regional economy, which recently has been generating $140 billion in income annually, had other sectors which took up the slack and kept the recovery moving along.

Nonfarm payroll employment rose at a 4-percent annual rate — somewhat faster than the first-quarter rate — and exceeded 10.7 million on average during the spring period. The gains were broadly based, with all major sectors — manufacturing, construction, distribution, services, and government — advancing at the same pace.

Despite this improvement, the unemployment rate in Pacific Coast states declined only slightly, from 6.6 to 6.5 percent, between the first and second quarters. (The California rate actually edged up slightly, to 6.2 percent, but in Washington the rate fell a full percentage point over the quarter, although to a still high 9.2 percent.) Yet because of the sharp declines in joblessness in late 1971 and early 1972, the regional rate is now considerably below the 7.8-percent peak figure reached a year ago.

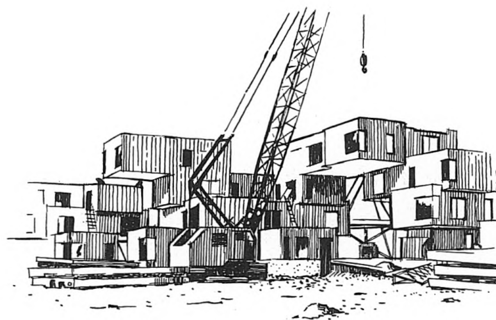
Recovery: government finance

The Western economy benefitted this spring from the fiscal stimulus arising from the Federal budget deficit. State-government finances also benefitted, as income and sales-tax receipts advanced strongly. California in particular received a stimulus not only from rising incomes associated with the recovery but also from the initiation of its own income-tax withholding system, so that the state found itself at the end of fiscal 1972 with a $256-million budget surplus. And despite an expected rise in state spending from $6.9 billion to $7.7 billion between fiscal 1972 and fiscal 1973, California authorities project a $550-million surplus in the new fiscal year on the basis of current trends.

Western governmental units issued about $1.2 billion in bonds during January-May 1972, or one-fifth less than in the comparable 1971 period, when they had borrowed heavily to rebuild their liquidity. The average yield on these borrowings was 5.23 percent, as against an average of 5.63 percent in last year's more crowded market. Local governments accounted for over one-half of the total bonds issued in the 1972 period, and state governments and special districts accounted for most of the rest.

Mixed trends: housing, aerospace

The boom in residential construction slackened this spring from the exceptionally high levels reached in late 1971 and early



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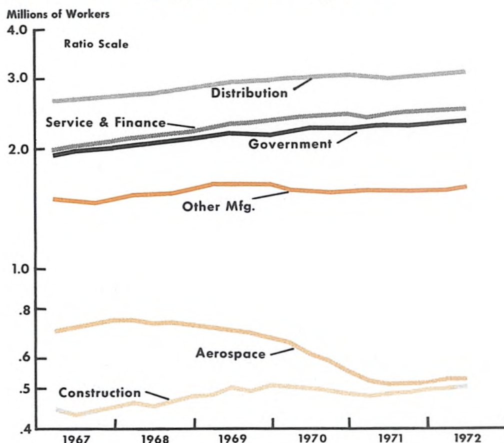
Employment in all major sectors rises at roughly the same pace



1972, as housing starts dropped 20 percent from the phenomenal first-quarter figure to 488,000 units at an annual rate. However, this was about equal to 1971's record annual figure. Residential construction awards also fell steeply to a $7.4-billion rate, but this was still ahead of the peak annual figure ($6.5 billion) recorded last year. In addition, the pace of mobile-home sales (shipments) remained far ahead of last year's record 79,000 units.

Activity also declined in the nonresidential and heavy construction categories, with awards dropping from the record first-quarter pace to a $6.4-billion rate. But here again, the second-quarter figure was ahead of the strong 1971 pace. Awards increased for educational and hospital facilities, as well as for water and electric-power facilities, but awards fell for manufacturing plants, commercial buildings, streets and highways.

Employment in aerospace manufacturing increased modestly during the second quarter, rising by 3,000 to 523,000 workers. This relative standoff reflected mixed trends in defense contract awards during the previous quarter, with Washington gaining a substantial number of new contracts but California falling off considerably. It also reflected mixed trends in the commercial aircraft sector, with heavy demand developing for Boeing 727s — and some Chinese interest reported in 707s — but with relatively weak demand for the wide-bodied jumbo jets.

The space agency awarded a $2.6-billion development contract on the space shuttle to North American-Rockwell in late July. The award means a 9,000 increase in jobs at North American's facilities over the next three years, but it also means cutbacks by some firms that lost out in the competition. Vandenberg Air Force Base in California has already been chosen as one of the two launching sites for the shuttle.

Rising trends: extractive industries

Because of supply difficulties as well as the demand generated by the still-strong housing boom, prices rose sharply this spring for Pacific Northwest lumber products. For Phase II to date, wholesale prices of softwood lumber and softwood plywood have risen by 13 and 21 percent, respectively. Recently, a new labor contract provided for a 9-percent first-year wage increase for mill workers, adding pressures on the cost side, and shortages threatened because of vacation shutdowns at domestic mills and a strike in British Columbia forests.

Prices rose sharply in early 1972, because of the absence of controls on raw timber and the loopholes in the term-limit-pricing agreements affecting major lumber producers — and they rose even faster this spring, after the Cost of Living Council lifted wage and price controls for small firms in all sectors of the economy. Because these firms — manufacturers and dealers with 60 employees or less — account for a large share of the total lumber sales, they were able to push up prices substantially during the period they were decontrolled. To overcome this problem, the COLC eventually reim-

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posed controls on producers with annual gross sales of $100,000 or more.

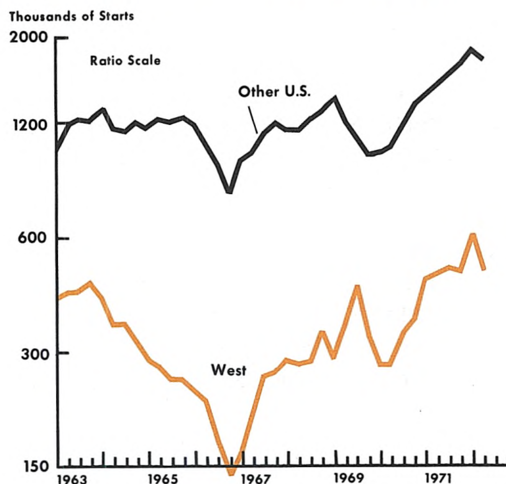
Western steel producers boosted output sharply this spring to meet the economy's growing demand and to make up for losses sustained in a six-week strike early this year at Kaiser Steel's plant at Fontana, California. By July, production was running well ahead of year-ago levels. Steel imports meanwhile surged during the January-May period to a record volume in Pacific Coast states, while declining elsewhere in the nation. However, producers expect that the new quota agreement signed this May will now reverse this trend. The agreement provides for foreign producers to reduce their imports to the U.S. in 1972, and also calls for Japan to hold its Pacific Coast shipments to no more than one-third of its total imports into the U.S.

Pacific Northwest aluminum producers brought some of their idle capacity back into production, as demand improved and inventories fell to more normal levels. But somewhat paradoxically, the industry this spring lowered the list price of aluminum ingot — the primary form of the metal — from 29 to 25 cents a pound. This was done because of the unrealistic nature of the list price, which was considerably out of line with the lower market quotation, but a major consideration was the industry's commitment to pay the list price in purchasing 350,000 tons from the government stockpile by 1973.

After midyear, copper producers lowered their price for the refined metal by 2 cents to 50½ cents a pound — about one-sixth below the peak figure reached in 1970. This move primarily reflected the lagging demand for copper in sluggish industrial markets overseas.

Western oil-refining activity increased slightly during the second quarter to a point 6 percent above the year-ago level. But since new capacity increased even faster over this interval, refineries continued to operate considerably below their rated capacity in most spring months. With the continued downtrend in crude output from domestic sources, refineries increased their dependence on Canadian and other foreign sources to meet rising consumer demand.

Housing starts remain high, despite fall from record first-quarter pace



The development of Alaska's North Slope would eventually deliver two million barrels/day of crude to Western refineries — a volume far in excess of the current level of foreign imports. Interior Secretary Morton has announced himself in favor of the pipeline that would bring the oil to market, but development is three years or more away, because of the legal disputes still surrounding the project.

Farming: boom, drought, freeze

Marketing receipts of Western farmers were 5 percent above year-ago levels during the winter and early-spring months, as the livestock boom brought about a sharp year-to-year gain in prices received by farmers. But judging from prices paid by farmers, expenses were also up, so that farmers may encounter difficulty in matching their 1971 net income this year.

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Persistent drought conditions in the Pacific Southwest stimulated the movement of cattle off the range into feedlots. Yet despite heavy feeding activity, marketings from Western feedlots now appear to be little above year-ago levels, which suggests the continuation of recent upward pressures on beef prices. Meanwhile, untimely frosts this spring led to a sharp drop in output of deciduous fruits, especially in the Mountain states, which suffered almost complete failure. Current estimates suggest that the West's total deciduous fruit output will drop 20 percent below the 1971 figure, to the lowest level of the postwar period.

On balance, the Western economy appears solidly based for at least the remainder of 1972. Even if the housing boom continues to taper off, other sectors should come forward to take up the slack — perhaps the aerospace industry, as new orders develop out of the now-rising Pentagon budget, or perhaps the extractive industries, responding to the increasing demands of a stronger national economy. The quickening pace of consumer spending also should provide solid support to the regional economy in the months ahead.

Verle Johnston, Yvonne Levy, and Donald Snodgrass

Western Economic Association

The Annual Conference of the Western Economic Association, celebrating the Association's fiftieth anniversary, will be held on August 23-25 at the University of Santa Clara. Governor Andrew F. Brimmer of the Federal Reserve Board of Governors will discuss "Recent Developments in U.S. Monetary Policy" at a plenary session. Other sessions will feature discussions of economic theory and econometrics, economics of health and pollution, money and banking, international economics, industrial organization, labor and human capital, and regional and urban economics.

For details of the conference program, write to W.E.A. Local Arrangements Committee, c/o Department of Economics, University of Santa Clara, Santa Clara, California 95053.

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Brisk Loan Expansion

As the Western economy continued to improve in the second quarter, credit at Twelfth District commercial banks expanded $1.2 billion — a 6.8-percent annual rate of increase (seasonally adjusted), or about one percent below the national rate. But the loan component expanded $1.9 billion for a 14.5-percent annual rate — far exceeding the national pace. The loan expansion was broadly based, with strength evident throughout the business, mortgage and consumer sectors. Business demand for credit was somewhat stronger in the West than in New York, as District banks increased their commercial and industrial loans at double the first-quarter rate. In addition, mortgage lending accelerated further, and consumers finally discarded their long-held reluctance to expand instalment debt.

Although the second quarter as a whole was buoyant, by mid-year the banks began to feel the effects of the April firming in monetary policy. In June, District banks recorded the first monthly decrease in total credit so far this year, as the loan expansion slowed from the rapid pace of preceding months and security holdings declined at an accelerated rate.

Some of the funds for loan expansion were obtained from a reduction in banks' holdings of securities, in contrast to the national pattern. Both U.S. Government securities and municipals declined; however, most of the reduction in Treasury issues was in maturities over 5 years, while the decrease in tax-exempts was in short-term warrants and bills. The run-off in the latter securities more than offset the additions to short-term municipal issues acquired during the first quarter.

Rapid time-deposit growth

Sustaining the second-quarter bank-credit expansion was a $2-billion increase in total deposits (daily average basis). This 13.2-percent annual rate of gain was well above the first-quarter rate, after seasonal adjustment. Deposit growth was heavily weighted toward time deposits, which increased at a 16.3-percent annual rate, two and a half times the first-quarter pace. Private demand deposits, on the other hand, grew at only a 7-percent annual rate, less than half the preceding quarter's pace.

Time deposits rose in each month of the quarter, but more than two-thirds of the gain occurred in May, when California banks received extraordinarily large amounts of public time deposits as a consequence of the newly instituted withholding of State income taxes. (These funds were invested in relatively short-term maturity certificates.) In addition, rate differentials were favorable to investment in corporate-type time certificates at that time.

Passbook savings decreased seasonally in April, when individuals withdrew funds to pay income and property taxes, and they increased only modestly in May and June. Nevertheless, Western banks held their rate on regular passbook accounts at 4 percent — the reduced rate which became generally effective last February. On the other hand, other consumer-type time deposits expanded in volume during the March-June period, as some banks that had previously lowered rates or discontinued offering longer maturities again began to offer long-term certificates at ceiling rates. Large-denomination certificates also increased during the quarter, as offering rates on these corporate-type deposits moved upward in line with other money-market rates.

Mixed borrowing pattern

The reserve position of District banks re-

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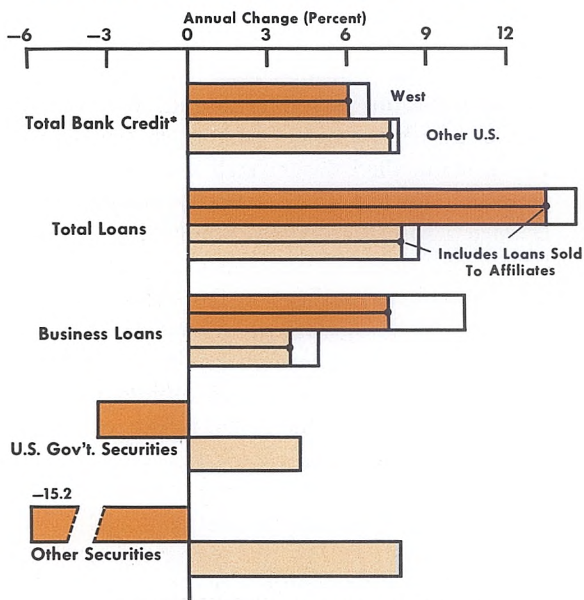
Loan upsurge dominates 2nd quarter statistics . . . security holdings decline



*Adjusted to exclude domestic interbank loans

flected the second quarter's somewhat firmer policy stance. Still, the increase in total deposits was heavily weighted by time deposits, which carry lower reserve requirements than demand deposits, so that the total reserves maintained with the Federal Reserve Bank increased by only $109 million (daily average) from the first quarter's level. But banks reduced their excess reserves to roughly $12 million, from $15 million in the preceding three-month period, while their borrowing from the Federal Reserve Bank rose slightly, to roughly $5 million from $2 million. Thus, their net free-reserve position dropped to about $6 million from the previous quarter's $14-million average figure.

In contrast, large District banks became net interbank sellers (lenders) of Federal funds, with their net sales of $568 million being about two-thirds larger than the January-March figure, on a daily-average basis. In a reverse pattern, they became net borrowers from U.S. securities dealers, and this narrowed their net sales of funds on total transactions to $393 million. (Disaggregated data disclose, however, that many District banks remained net Fed-funds purchasers during the quarter.) The swing to a net sales position may appear paradoxical, but it should be considered against the large increase in funds borrowed by banks under repurchase agreements with public agencies and corporations. Borrowing from this source increased more than one-sixth above the first-quarter figure to reach nearly $2 billion, and a large portion was resold in the Fed-funds market as banks took advantage of arbitrage possibilities.

Stronger business demand

Loans at Western commercial banks rose in each month of the April-June period. Most major loan categories contributed to the expansion, and the increases were widely distributed geographically as well.

Business demand for credit was strong in April, slackened in May and then strengthened again in June. Altogether, business loans increased $473 million during the quarter (seasonally adjusted) — a 10-percent annual rate of growth, nearly double the national rate. Public utilities accounted for the largest increase in business borrowing, in contrast to the first quarter, when a major public utility repaid bank debt with the proceeds of a capital offering. Increases were also registered by wholesale and retail trade, mining, construction and foreign commercial firms. In manufacturing, borrowing by the durable-goods sector declined because of net repayment of debt by transportation-equipment manufacturers, and the nondurable-goods sector also generally reduced its borrowing except in the textile and apparel industries.

While demand strengthened for short-term business credit, demand weakened for term loans (maturities of one year or more).

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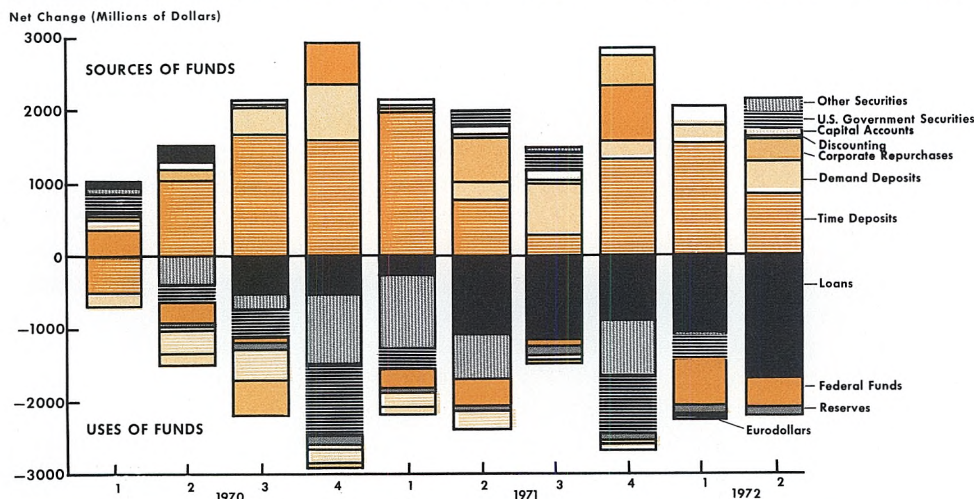
Sources and Uses

Large Twelfth District banks registered an expansion of slightly over $2 billion (daily average) in their sources of funds in each of the first two quarters of 1972. (Data unadjusted for seasonal variation.) While these gains were well below the $2.7-billion expansion of fourth-quarter 1971, they equalled the average quarterly increase for 1971. Time deposits, demand deposits, and capital accounts were the major sources of additional funds in the first quarter, with time deposits accounting for 76 percent of the total. Sources of funds were more varied in the second quarter, with time deposits accounting for only 39 percent of the total increase.

Net demand deposits contributed 20 percent of the April-June increase — about double the proportion in the first three months. Also, District banks raised substantially less funds through capital issues during the spring period, although the amount was still relatively high, accounting for 6 percent of the gain. The major change from earlier in the year was the large amount of new funds (15 percent of the total) obtained through borrowing under corporate and other repurchase agreements, mainly from public agencies. Banks also made net reductions in their holdings of both U.S. Treasury and other securities, and this produced 19 percent of their additional funds for the quarter.

In the first half of 1972, a much larger proportion of new funds was channeled into loans than in the comparable 1971 period. Regular loans absorbed 48 percent of banks' expanded funds in January-March, and this rose to 78 percent in the second quarter. (When net loans in Federal funds are added, these figures rise to 75 and 96 percent, respectively.) Also, banks used 16 percent of their funds to expand holdings of U.S. Treasury issues in the first quarter, but reduced their holdings in the second quarter. In both quarters, as deposits expanded, banks allocated some funds for higher required reserves and some funds to repay Eurodollar borrowings.



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A second-quarter reduction of $100 million in term loans at large District banks followed the national pattern.

Reflecting April's ¼-percent increase in the prime rate, the average rate paid by business borrowers in major West Coast cities rose to 5.60 percent on regular short-term loans and 5.57 percent on revolving credit loans in early May. These rates represented increases of 21 and 44 basis points, respectively, from the average rates paid three months earlier.

Farm, consumer demand

Western farmers continued to expand their borrowing activities during the spring period. Loans outstanding at Production Credit Associations increased above the year ago level in practically all District states, and were up considerably in California. Short-term commercial-bank lending was also heavier than a year earlier, although lagging behind the pace set by the PCA's. Mortgage lending of Federal Land Banks also increased further.

Western consumers finally cast off their hesitancy toward incurring instalment debt during the spring period. At large District banks alone, instalment loans rose $441 million in the April-June period — a record quarterly rise, and more than three times the first-quarter rate. Preliminary data indicate relatively large gains in auto loans and in loans for other consumer goods, whether under credit-card plans or direct-loan terms.

Active mortgage markets

Commercial banks and savings-and-loan associations alike experienced a moderation in savings inflows during the second quarter, but the pace of their mortgage lending still accelerated. Large commercial banks increased their savings deposits (passbook savings plus other consumer-type deposits) by about $369 million, only about one-half the previous quarter's gain, while the S&L's recorded a $1.7-billion net increase, more than one-fourth below the winter period's record inflow.

Nevertheless, commercial banks expanded their mortgage portfolios by a record $722 million, and the S&L's increased their outstanding real estate loans by a record $1.6 billion. At the same time, both the banks and S&L's increased their volume of loan commitments to levels which promised a continuing high volume of mortgage financing in the months ahead, and the S&L's made further repayments to the Federal Home Loan Banks on earlier borrowings.

The moderate slowdown in savings, in conjunction with a continuing high level of mortgage-loan demand, contributed to a slight firming of mortgage interest rates in the West, as the average rate on a conventional new-home loan rose by 15 basis points over the quarter to 7.70 percent. Concurrently, average loan maturities in most Western markets remained fairly steady, while average down payments decreased slightly, apparently reflecting a growing proportion of 5-percent-down loans made by savings-and loan associations.

Wide variations in income

Earnings of individual District banks varied widely in the second quarter, just as they had earlier in the year, with declines as well as increases being widespread. Profit margins generally widened somewhat in early April, when Western banks followed the national trend by adjusting their prime rate on business loans to 5 percent from the 4¾-percent rate which had prevailed since late January. (The further increase to 5¼-percent at the end of June was too late to affect first-half income results.) The rapid expansion in loans also was a favorable factor on the revenue side.

On the other hand, bank costs for funds edged up slightly, as money-market rates increased and general bank expenses continued

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their inexorable rise. Also, most banks did not realize securities gains in the first half of 1972, as they had in 1971, and this too was a limiting factor on net income.

Strong credit demand?

Most Western banks held their prime rate to 5¼ percent in July — although a few banks elsewhere in the nation moved at mid-month to 5½ percent before retreating to 5¼ percent in early August. Banks can expect somewhat higher loan revenues as the effect of the June increase in the prime rate is reflected throughout the loan rate structure.

Business loans increased in June and expanded further in the first half of July, but then weakened during the remainder of the month. (However, business demand for credit could accelerate in coming months if the expected upsurge in inventories materializes.) Also in July, real-estate loans expanded at the high second-quarter rate, and consumer instalment loans held at the accelerated June pace.

The net inflow of savings and consumer-type time deposits continued at the slower rate evident in the second quarter. Public time deposits were reduced in July, following the normal third-quarter seasonal pattern of withdrawals, so District banks in coming months may have to rely more heavily on large negotiable CD's as a source of funds.

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
	June 28, 1972	March 29, 1972 to June 28, 1972		March 31, 1971 to June 30, 1971	March 29, 1972 to June 28, 1972
		Dollars	Percent	Percent	Percent
Loans Gross Adjusted[1] and Investments	63,475	+1,434	+ 2.31	+ 1.33	+ 2.66
Loans Gross Adjusted[1]	45,984	+2,136	+ 4.87	+ 1.88	+ 4.26
Federal Funds Sold[2]	2,464	− 393	−13.76	−21.80	− 4.00
To Commercial Banks	2,166	− 452	−17.27	+36.40	− 5.46
To Brokers and Dealers	186	− 53	−22.18	−77.94	+47.45
Other Loans—Total	45,910	+2,060	+ 4.70	+ 3.81	+ 4.37
Commercial and Industrial Loans	16,628	+ 579	+ 3.61	− 0.56	+ 1.35
Real Estate Loans	13,708	+ 722	+ 5.56	+ 4.17	+ 5.36
Consumer Installment Loans	7,017	+ 441	+ 6.71	+ 4.72	+ 5.10
Agricultural Loans	1,614	+ 101	+ 6.68	+13.44	+ 5.32
Loans to Nonbank Financial Institutions	2.501	+ 16	+ 0.64	+15.95	+ 8.25
All Other Loans	4,442	+ 201	+ 4.74	+ 9.69	+ 8.96
Total Investments	17,491	− 702	− 3.86	+ 0.04	− 1.15
U.S. Government Securities	6,310	− 284	− 4.31	− 3.43	− 6.88
Obligations of States and Political Subdivisions	9,131	− 460	− 4.80	+ 0.99	+ 1.44
Other Securities	2,050	+ 42	+ 2.09	+ 7.57	+ 3.60
Total Deposits (Less Cash Items)	62,185	+1,498	+ 2.47	+ 1.90	+ 1.72
Demand Deposits Adjusted	19,165	− 288	− 1.48	+ 2.81	+ 0.64
U.S. Government Demand Deposits	1,121	+ 175	+18.50	+54.53	− 0.71
Total Time and Savings Deposits	40,817	+1,466	+ 3.73	+ 0.58	+ 3.16
Savings Deposits	18,174	− 90	− 0.49	− 1.47	+ 0.81
Other Time Deposits IPC	15,381	+ 847	+ 5.83	+ 1.05	+ 5.70
Deposits of States and Political Subdivisions	5,451	+ 658	+13.73	+ 8.26	+ 1.36
(Negotiable CD's—$100,000 and over)	5,240	+ 366	+ 7.51	− 8.93	+ 7.38
Capital Accounts	5,102	+ 85	+ 1.69	+ 4.27	+ 1.88
Total Assets/Liabilities, Reserves and Capital Accounts	81,744	+2,717	+ 3.44	+ 2.55	+ 1.68

[1]Total loans minus loans to domestic commercial banks
[2]Including securities purchased under resale agreements

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