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In this issue

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Editor: William Burke

Competitive Outlook in Banking

By John J. Balles, President
Federal Reserve Bank of San Francisco

Remarks at the Annual Intermountain Banking Seminar, Utah State University, Logan, Utah, November 9, 1972.

The management of the American Bankers Association undertook an opinion survey at its recent Dallas convention to ascertain what business problems are uppermost in the minds of bankers. President Eugene H. Adams reports that the most often-mentioned problem was the competitive climate facing the banking industry. More specifically, bankers are concerned about the structure of the banking industry, competition between large and small banks, competition between banks and thrift institutions, and the implications of the Hunt Commission's recommendations.

Your program committee obviously is attuned to these problems, since they have designated the competitive outlook for banking a major subject for this seminar. They may not have been so wise in inviting me to handle the subject, since this is a tall order, and I don't pretend to have all of the answers. Nevertheless, I welcome the opportunity to share my thoughts on this most important topic with you. Hopefully, this will stimulate further discussion and consideration on your part.

Profound forces for change are at work in our financial system. Today I would like to review with you the nature and implications of some of the key developments that are bound to alter existing competitive relationships within banking, and between commercial banks and their principal nonbank competitors:

. . . The vital thrust within the commercial banking system itself for innovation;

. . . The drive by other financial institutions increasingly to share the functions and markets of commercial banks;

. . . The technological revolution occurring in the payments system;

. . . The emerging change in social values which is likely to impact on financial institutions.

Taken individually, the existence of these trends is not unknown to any of us. But as I began to think about the interrelations and the combined impact of them on the competitive outlook for banking, it seemed to me that many of us have underestimated the degree of synergism at work. Hence my belief that they constitute a profound change when viewed as a package.

Thrust for Banking Innovation

First, as to the vigorous thrust toward greater innovation within the commercial banking industry itself, several leading examples are worth reviewing.

New Financial Instruments — Nondeposit Funds. One innovation represents a response to movements in general credit conditions in the economy. A case in point is the development of new or modified financial instruments during the past decade; witness the massive recourse taken by commercial banks in the nation to nondeposit funds in 1969 and early in 1970. This was a result of the impact of intensive borrowing demands in a situation in which bank access to deposit funds was limited by Regulation Q. Thus, in spite of a net loss of $4 billion in deposits in 1969, banks were able to extend credit by about $16 billion—$12 billion through loans and investments on their own books and $4 billion through sales of loans to affiliates. This was made possible largely by tapping some $20 billion in funds from non-deposit sources, including Eurodollars and sales of commercial paper by bank affiliates. At present, increasing use is being made by bank holding companies of notes and debentures as a source of funds.

The Growth of Bank Holding Companies. A second type of innovation centers on the proliferation of bank affiliates through the creation and active use of bank holding companies. Part of this movement was generated by the search for ways of cushioning the impact of tight money, to which allusion was just made; part, by the search for ways to escape the geographic limitations on branching imposed by some states; and part, by the search for new and profitable ways to offer services to the public that commercial banks are not permitted to provide directly.

The number of bank holding companies is likely to grow, particularly in states where sharp restraints exist over branching. The reason for this stems from economic advantages of the holding company form of organization, as demonstrated by its success in those states where it has had an extended period of operation, and from the greater range of services, closely related to banking, that holding companies can offer. The inevitable result will be to bring about a significant change in banking structure and competition.

Colorado furnishes a good illustration. At the end of last year, the seven multiple-bank holding companies operating in that state held 47 banks with $2,727 million in deposits, representing some 54 percent of all Colorado bank deposits. This was up from roughly 23 percent five years before and from less than 7 percent at the end of 1962. Altogether, there were 58 holding companies headquartered in Colorado on December 31, 1971. Already, in that state, overtures have been made for mergers of holding companies to gain even further advantages. Moreover, I understand that two requests have been placed before the Colorado Bankers Association seeking broad banking legislation, and increasing numbers of bankers are becoming restive for change in the existing geographical restraint.

Other New Services. Commercial banks have also pioneered in the widespread provision of new services both to business, in the form of corporate cash management services and other matters, and to consumers. A prime example of the latter is bank credit cards. Contrary to some beliefs, credit cards are not in the direct line of evolution toward a paper-less financial system; indeed, they generate even more paper than before in the provision of payments convenience to the public. In so doing, however, they helped precipitate the introduction of technology that will be giving a further boost to bank competition.

Expanding International Business. Finally we should note the vast expansion in international services and overseas banking activity of some of the nation's leading banks. Induced largely by a desire to follow their customers abroad in an era of development of major multinational companies, this trend not only has been profitable but also has given a competitive edge to those banks which have engaged in expanded international activity.

The Drive by Nonbank Institutions—Implications of the Hunt Commission

Late last year, the President's Commission on Financial Structure and Regulation issued its report and recommendations. This group, more commonly known as the Hunt Commission, proposed sweeping changes in the powers, functions, and regulation of banks and competing financial institutions. To a considerable extent, the recommendations are said to be aimed at providing more competition among the nation's financial institutions, and less regulation of them, to the extent consistent with safety; and at providing equal ground rules for various classes of competitors. One of the major proposals is to offer commercial bank-type powers to thrift institutions (mutual savings banks, savings and loan associations, and credit unions) if they also assume approximately the same regulatory and tax burdens as commercial banks.

Thus far, the banking industry has not taken a position on the Hunt Commission recommendations, probably because the industry faces a dilemma regarding them. If adopted pretty much in toto (which appears highly unlikely), the recommendations would entail major changes in competitive relationships affecting banks. On the other hand, if adopted only in part through piecemeal legislation at the Federal or state level (which appears more likely), the results may be even more profound for commercial banking. Why do I say this? Because the ability of the heretofore specialized thrift institutions to compete against banks would likely be increased if their lending and fund-raising powers were broadened and made more comparable to those of commercial banks but if their tax burdens, reserve requirements and regulatory structure were not.

Suppose, for example, that savings and loan associations in various states succeeded in getting consumer loan powers and the authority to offer checking accounts to individuals and non-business entities. Also suppose that they were not required to maintain the same reserves against checking accounts as member banks must do, but at the same time were permitted to continue benefitting from preferential Federal tax treatment. In that case, their ability to provide services at advantageous rates vis-a-vis commercial banks would be increased, since the ability of any intermediary to compete for deposits reflects the return it can earn on its assets. Hence, to the extent that differing reserve requirements, regulatory limitations, and tax burdens influence asset mix and earnings, the ability of the various types of institution to compete for deposits will also vary.

Thus, if thrift institutions are to be provided with broader lending, investment, and deposit powers (including checking accounts) that are more akin to those enjoyed by commercial banks, it will be vital, in the interest of competitive equality, that they assume in commensurate degree the same burdens as commercial banks — i.e., reserve requirements, ceilings (if any) on interest rates payable on deposits, regulatory constraints, and tax treatment.

Changes Now Taking Place—Thrift Institutions

But while the debate on the Hunt Commission report goes on, a number of changes in the powers and functions of thrift institutions are even now taking place, and it is to these that I wish to call your attention.

Regulatory Actions of the FHLBB. The first development which I would like to emphasize involves the numerous regulatory changes implemented over the last year or so by the Federal Home Loan Bank Board, which were designed to strengthen the position of savings and loan associations.

1. Broadened Lending Authority. These changes not only embrace substantially broadened lending powers in the field of real estate financing, but also permit savings and loan associations to make loans for major home appliances and built-in equipment (up to 5 percent of assets, as authorized by the HUD Act of 1968). Included in the latter group are loans for the financing of wall-to-wall carpeting, central air conditioning, food freezers, lawn sprinkler systems, water systems, and installed workshop equipment—items that comprise a large portion of consumer-durables financing.

2. Third-Party Payments. Still other regulations, adopted in 1971, authorize savings and loan associations to make non-negotiable transfers from savings accounts to third-party payees for a wide range of transactions more or less related to housing and home occupancy. They cannot, however, arrange such payments for food, clothing and automobiles.

(Similarly, although not subject to the FHLBB regulations, mutual savings banks and credit unions in a number of states are now offering, or are seeking to obtain authority to offer, a wide range of third-party payments services—including checking accounts.)

3. Capital Structures. Through yet another regulatory action the Federal Home Loan Bank Board has proposed approval for savings and loan associations to issue subordinated debentures, and has lifted the moratorium on conversions from mutual to stock associations, in order to provide increased flexibility in the raising of funds.

4. Branching Regulations. Finally, branching regulations have been adopted that will give savings and loan associations a number of new possibilities to serve the public. These are worth reviewing in greater detail in view of the competitive implications for commercial banks.

Limited Facilities and Satellite Offices. The new regulations will permit the establishment by savings and loan associations of so-called "limited facilities" and "satellite" (or "mini") offices. A "limited facility" is subject to the branching regulations, but differs from a branch by having specific restrictions placed upon it as to personnel, physical size, capital investment, and/or functions permitted. However, the only practical such constraint is simply "what the market will bear," according to Federal Home Loan Bank Board Director Thomas Clarke. Such facilities are envisioned as a particularly powerful vehicle for penetrating low-density rural areas.

"Satellite" offices, on the other hand, are provisionally approved entities that offer full service within restraints of other sorts. For instance, they must be located within five miles of an existing S&L office, and are limited in number. No more than five satellites can be established in total, and also no more than two can be installed in any one year. One type of "satellite," the "counter in a store," will be confined to retail establishments and may not occupy more than 500 square feet, with a maximum of four teller stations. At these offices, customers may deposit their paychecks, make mortgage payments, or obtain cash — right in the store where they have come to shop.

The second type of "satellite" is the "fully automated" facility, an electronic device operated by a special card given to customers. These machines may be located in a wide range of places such as in retail stores, shopping center malls, office buildings, or transportation depots. Open 24 hours a day, 7 days a week, 365 days a year, such facilities will receive deposits and accommodate cash withdrawals.

The characteristic shared by each of these three new types of offices is that they will enable an S&L to pinpoint and accommodate small, local markets in both rural and urban areas at a fraction of the cost involved in the establishment of a full-scale branch. As Federal Home Loan Bank Board Director Thomas Clarke has claimed, "An S&L can now be just as convenient—even more convenient—than a commercial bank, and so there is no longer any reason to settle for commercial bank passbook savings rates." The key to the great promise of the automated facility in particular is its "kinship with the new breed of electronic and data processing technology which will transform financial transactions in this country . . . to an electronic funds transfer system." "Such a system," he notes, "is absolutely inevitable." Consequently, the FHLBB is urging the savings and loan industry to "begin laying the groundwork for conversion to an electronic funds transfer system at the opportune moment. This means developing present third-party payment authority to its full capacity."

Let me now turn to the subject of computer technology and the payments system, as it affects the competitive outlook for banking.

The Impact of Computer Technology

Until the advent of the computer, the banking business was little affected by technological change, but these changes are now occurring with the prospective impact "on the figurative order of a megaton bomb," to use the words of Governor George W. Mitchell of the Federal Reserve Board. The technology for a completely integrated and automatic payments system is known, is being developed, and is becoming operational. Obviously, this has major implications in the competitive outlook for banking.

First Steps: Regulation J and RCPC's. This month, for example, with the implementation of the revisions in Federal Reserve Regulations D and J, you will feel the effects of one step of the sweeping changes which are to take place. As you know, the new Regulation J has the twin objectives of helping to expedite and rationalize the check-collection process while at the same time reducing Federal Reserve Float. The simultaneous lowering of reserve requirements under the new Regulation D is intended to minimize the transitional impact on member banks.

Another significant development in Federal Reserve activities affecting the payments mechanism over the past year has been in the area of Regional Check Processing Centers. Each Federal Reserve Bank has either proposed, planned, or implemented one or more "RCPC's" in its District. At the Federal Reserve Bank of San Francisco, we expect to have RCPC's operational at each of our five offices by early 1973.

As you know, the basic function of an RCPC is to provide the manpower and equipment, geared to later deposit deadlines, at locations where large concentrations of check volumes can be expeditiously processed and collected. Our goal is to furnish the earliest practical availability of funds to our depositors and ultimately to the public. Furthermore the Federal Reserve System is beginning to look ahead to the next steps in improving the payments mechanism.

SCOPE. Ancillary changes in the payments system, which are in the early process of development or in the implementation stage, include the much-publicized SCOPE project in California, initially conceived and promoted by ten major banks in the state. The system provides for pre-authorized paperless entries to effect payments in lieu of checks. The nerve center of this project lies in two automated clearing houses, located in the San Francisco and Los Angeles offices of the Federal Reserve Bank of San Francisco. For the bank customer, the system involves both credit entries to his checking account in the form of payroll depositing, and debit entries in the form of regularly recurring payments of such items as utility bills, mortgage loans, and insurance. Now in the process of being implemented by some 145 banks which account for 90 percent of the banking business in California, SCOPE-type projects are under active consideration by banks in some 20 or more other areas in the nation. Significantly, the possibility of participation in such programs by departments and agencies of the Federal Government is being carefully studied.

The Atlanta Project. Other significant developments in the electronic funds transfer area include the Atlanta payments project, which, in addition to the automatic deposit of payrolls and a pre-authorized, paperless system for paying bills, has proposed to offer "bill-checks." These bill-checks will use machine-processable documents on which the payor endorses a bill and stipulates the amount and date on which his bank is to debit his account and effect payment to the creditor or the vendor-payee.

Computer Terminals in Retail Stores. Going beyond these projects is the point-of-sale computer terminal in retail stores, activated by a consumer's card, and providing a direct hookup with a bank's computer and authorization terminals. Indeed, as envisioned by a number of observers, what these arrangements eventually will entail is a system of computerized telecommunications linking home and business with the market, including vendors and those institutions which administer the payments mechanism. These institutions — commercial banks and possibly other financial and non-financial institutions —will be grouped into a series of local systems, with access to a central data bank containing a variety of information on customers. The local systems will be linked into regional centers which in turn will be linked to an integrated national system of computerized telecommunications.

Implications for Banks of Electronic Payments System

In assessing the implications of an electronic payments system for the competitive outlook in banking, the first and basic consideration to you as bankers must be the great opportunity it will afford for expanding the scope and variety of your services. There is little doubt that banks (or their competitors) will be in a position to accommodate a very wide range of bill-paying and account-keeping functions of consumers, businesses, and governments alike.

Larger Banks and Fewer Banking Offices. At the same time, the era of less-checks and instant communications between businesses, consumers, vendors and bank computers is likely to witness at least some tendency towards the concentration of business in large or regional banks. The reason is that such banks will be able to serve customers that are not in close geographical proximity to them, and hence will offer more competition to small local banks.

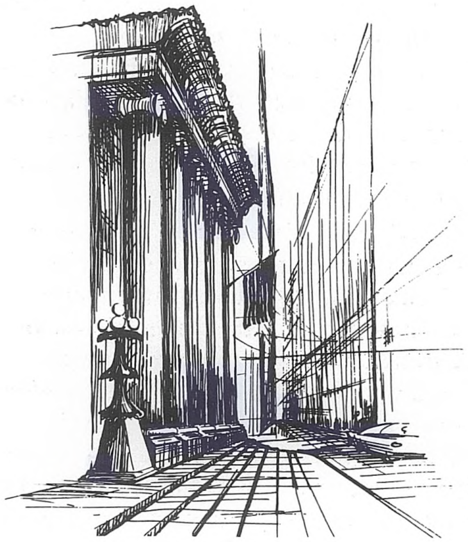
Consequently, the development of an electronic payments system may be a force working toward a decline in the number of small banks and of branch offices. An electronic transfer system reduces the need for the bank customer to visit his bank office, either in the capacity of a depositor or borrower. If the customer can bank through his telephone and have his bills paid and funds deposited automatically, proximity to a bank office *per se* will become less relevant. By the same token, an electronic payments system is certain to break down geographical barriers, and in the process render obsolete many existing legal barriers to competition such as branch restriction and home-office protection laws.

Changing Role for Correspondent Banks. What, then, of the correspondent banker? Clearly, a very important function of the correspondent today—clearing checks and other cash items—will greatly diminish in importance. Yet, the new and varied services that are likely to develop in connection with an electronic payments system could result in new correspondent ties in the way of specialized services. Consequently, one key to the survival of the small bank may depend upon its ability—perhaps through pooled facilities and leasing arrangements—to work out with its city correspondent the means of participating in the new services and markets offered by an electronic system, without independently having to undertake the costly investment involved in the necessary hardware and personnel.

Competition from Non-Banks. The electronic funds transfer system is also likely to impinge upon commercial banks as competitive nonbank financial institutions enter the third-party-payment field and utilize the latest technological developments in the process. It is the view of some observers that nonbank firms increasingly will attempt to move into the payments system, which has long been the nearly exclusive domain of commercial banks. These potential entrants include not only savings and loan associations and mutual savings banks but also data processing firms, specialized service bureaus, large retail firms, and possibly some elements in the communications industry itself. Not overlooking the advantages of modern technology in their own operations, they will deny to the banking industry the luxury of doing business just the way it was done before.

Changing Social Values

Finally, there is another fundamental force for change which is increasingly evident in our body politic and which has an important bearing on the competitive outlook for banking. I caution you against underestimating the potential impact of it. For better or worse, some groups in society are raising questions as to the appropriate balance between social ends and means. More specifically, questions are being raised regarding the consistency of traditional economic goals—high and rising levels of income, output and consumption — and considerations regarding environmental and ecological balance.



Effect on Financial Institutions. This growing concern has important implications for the nation's financial institutions as well as for economic policy. As examples I would cite the growing support for construction moratoria in some areas, and the increasing antagonism towards development.

This is, of course, a matter of concern both to financial institutions and to policymakers simply because economic growth — which means more jobs and more income—is related to the pattern of real-resource allocation, which is affected by the pattern of financial flows. The latter, in turn, is influenced by the structure of financial institutions and the rules under which they operate.

The outcome of the growing debate is not certain. However, it would appear that, partly under the impact of the environmental movements, a stabilization—and even decline—in homebuilding and other forms of construction already is occurring in some areas. If environmental concerns become more pervasive, then types of activity which involve a heavy throughput of materials (such as construction) will be viewed with progressively less favor. If so, this clearly has implications for the likely course of action by heretofore specialized thrift institutions which have been primarily engaged in financing these types of activity. More specifically, pressures on their part for diversification into other fields—including several fields dominated by or reserved to commercial banks—can be expected to increase.

Need for Flexibility. It is partly for this reason—the fact that the social priorities of the future may well differ from those of today—that the increased flexibility in operations envisioned for banks and their nonbank competitors by the Hunt Commission would appear to some observers to have considerable merit. In their view, such a system would be preferable to the present one, which induces thrift institutions to specialize in real estate lending and which offers less freedom of action to commercial banks. In any event, it is clear that maintenance of the *status quo* is not one of the options open to commercial banks.

Summary and Conclusion

With these remarks, I have attempted to identify the nature and the implications of some of the major forces in the competitive outlook for banking. Stemming from innovations within the banking industry itself, from the drive by thrift institutions for bank-type powers, from the technological revolution in the payments system, and from changing values in our society, these forces for change are certain to exert an increasingly powerful influence upon the competitive environment in which you, as banks, are going to live.

More specifically, the changes now in the air suggest an increasing reliance by banks on non-deposit sources of funds; a growing importance of bank holding companies, both in banking and in "closely-related" fields; a continued proliferation of new and imaginative services by banks to business, consumers, and governmental bodies; a further growth in importance of international banking; a major drive by thrift institutions (mutual savings banks, savings and loan associations, and credit unions) in directions that have the potential of sharing increasingly in the functions and markets of commercial banks; a major revolution in the payments mechanism of the country and in the role of banks in that mechanism, with an inevitable impact on the functions of correspondent banks; and changing social values which may have an important effect on banks and other financial institutions. I urge that you be prepared to cope with these changes when they come.

A famous economist and former banker, the late Joseph Schumpeter, once described the capitalist system as one characterized by "a perennial gale of creative destruction." The assessment may seem a little severe to those seeking solace, but certainly changes are in the air, and most assuredly, they are not just of a seasonal nature.

Rapid Expansion (U.S.)

Business activity continued expansive in the summer and early fall months, although the pace was not up to the unsustainably rapid pace of the second quarter, which was just about the fastest growing period of the last 13 years. During the July-September period, GNP rose to a $1,164 billion annual rate on the strength of a 6.3-percent increase in the real rate of growth and a quite moderate 2.4-percent rate of inflation.

Most sectors of the economy contributed to the rapid third-quarter advance, with strength being most apparent in housing, autos and other consumer durables. Business spending for new equipment rose rapidly, and business inventory expansion continued at a somewhat accelerated pace. On the other hand, the year-long recovery in defense spending received a temporary check during this period. Meanwhile, purchasing agents reported a higher level of confidence in future business prospects than they had at any other time in the ten years of this survey.

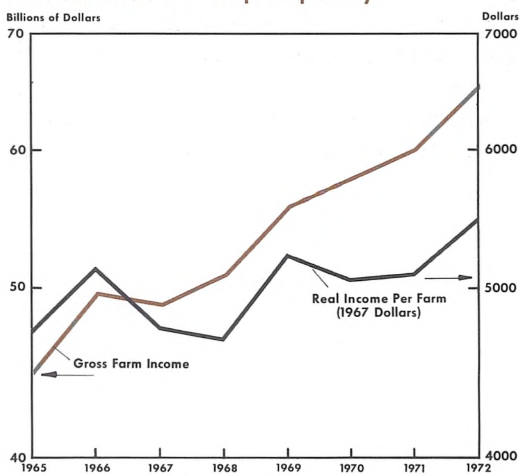
Industrial production rose at a 5-percent rate—a somewhat slower pace than in earlier quarters of this year. Output gains were meager in the early-summer period because of East Coast floods, but production strengthened in late summer. Gains were widespread in such areas as steel, business equipment, and defense equipment, but auto assemblies were below the early-spring peak. Future strength in output seems assured, since new orders for durable goods (except defense equipment) have increased at a 26-percent rate—double the year-ago pace—to date in 1972.

The farm boom has contributed substantially to the nationwide air of prosperity. Gross farm income in the third quarter was 10 percent higher than a year ago, and net income per farm (in real terms) was 6 percent higher. These gains reflected the upsurge in grain sales to the drought-stricken U.S.S.R. and the rise in meat sales to the increasingly prosperous U.S.A. The farm boom has supported other sectors as well; for instance, unit sales of farm tractors have jumped 31 percent over the past year.

Equipment buying spree

Business firms continued on a buying spree for new equipment, as spending rose to a $79.0-billion annual rate in the July-September period. But spending on business structures eased to $41.8 billion; in real terms, the

Farm boom contributes to nationwide air of prosperity



investment in bricks and mortar was no higher than a year ago and was below the 1969 peak. This discrepancy reflects in part the availability of the investment tax credit for equipment but not for business structures.

The latest Commerce Department survey of plant-equipment spending plans (mostly taken in September) indicates a 9.6-percent rate of increase in the current half-year, on top of a 12.2-percent annual rate of gain in the January-June period. Manufacturing investment, which had actually declined for several years, began to recover in early 1972, and is now expected to jump 17.8 percent (annual rate) in the current half-year, with heavy spending by nonferrous metals, nonelectrical machinery, petroleum and food manufacturers. Outside manufacturing, a modest pace of expansion is anticipated on the heels of very heavy spending during the first half by electrical utilities and transportation and communications firms.

Increased expenditures by industrial firms are indicated by the rising number of firms reporting inadequate facilities and by the rising dollar volume (up one-third in one year) of new starts on manufacturers' investment projects. The data also show a strong rise in the carryover of expenditures on projects started previously, especially in the utilities field.

New orders for capital goods, which generally lead capital-goods spending by some months, have been in a strong uptrend for the past year. Considerable manufacturing capacity is still unused, with the utilization ratio at about 83 percent in the third quarter, but the continuing rise in real output should create pressure on resources and bring about further new investment. As for financing, corporate cash flow could rise 20 percent this year over 1971's $78.2-billion figure (net of dividends), on the basis of a rapid rise of profits and an expansion of depreciation allowances. As in past business recoveries, this rise in cash flow should provide a solid underpinning to the ongoing investment upsurge.

Business inventories meanwhile increased strongly in the third quarter, at an $8.0-billion annual rate. But with stock-sales ratios at relatively low levels, the accumulation rate should rise as final sales expand during the current quarter, thereby adding to GNP growth.

The increase in factory inventories has not been evenly distributed among stocks at all stages of fabrication. Inventories of materials and supplies actually have trended down over the past year, while finished-goods stocks have been increasing. The unwillingness to add inventories at the initial stage of production underscores the caution (or cost consciousness) still evident among many manufacturers.

Government: mixed trends

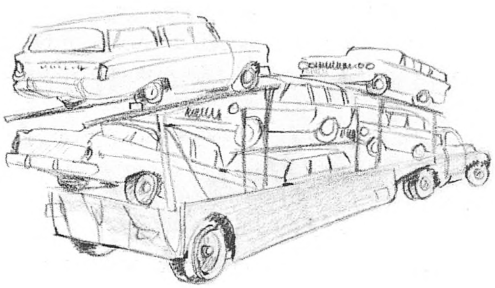
In the government sector of GNP, defense spending fell significantly to a $75.1-billion rate in the July-September period, representing a continuing decline in the number of men in uniform and a fall-off from the heavy bunching of purchases in the January-June period. Spending on goods and services by Federal non-defense agencies reached a $30.2-billion rate, and state-and-local government spending reached $150.4 billion, both increases being in line with their usual uptrends.

State and local governments are enjoying a respite from their prolonged financial squeeze, because of growing federal grants, rising revenues from the economic recovery, and a significant slowdown in wage increases. Spending in this area should now rise further in response to the bounty of revenue sharing. Some 39,000 localities will receive an initial $2.6-billion pay-out in early December, and will then receive an equal sum a month or two later, representing retroactive payments covering the two halves of calendar year 1972. For the most part, the recipients will use these funds for tax relief (mainly to property owners), for salary increases, and for capital improvements.

Congress recently passed a $74.4-billion defense appropriation bill for fiscal 1973—the highest total since World War II. The final figure was still $5.2 billion below the Defense Department's request, because of Congressional cuts for manpower, research and certain weapons systems. However, the Administration won most of its requested funds for big-ticket procurement items, such as the B1 bomber, the Trident missile submarine, and a new nuclear-powered aircraft carrier. Early planning for fiscal 1974 suggests further spending increases, but with partial offsets through the closing of unneeded military bases and the reduction of support troops.

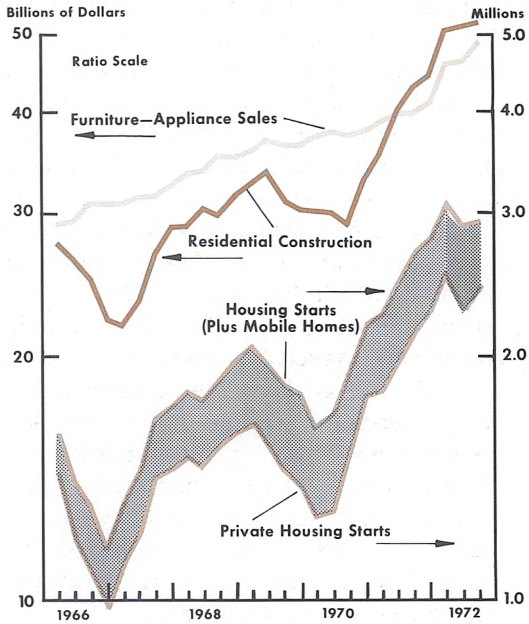
Auto buying spree

In the consumer sector, durable-goods spending rose sharply to a $118.6-billion rate in the third quarter; expenditures for services ($308.0 billion) were also strong, but spending for consumer nondurables ($302.0 billion) was up only modestly. Auto sales dominated the news, but furniture and appliance



sales also expanded rapidly during recent months in line with the continued high rate of new housing completions. Backing up this spending spree was a rise in consumer confidence—evident in surveys of consumer attitudes and spending intentions—as a consequence of the slowdown in the inflation

Housing and furniture
sales continue to expand



rate and the pickup of jobs and incomes over the past year.

Auto sales were helped by the smooth transition from the hot-selling 1972 models to the equally attractive '73s, as sales rose about 10 percent in the third quarter. The continuing boom was fueled by liberal credit terms, with some easing of downpayment requirements on auto loans.

The auto boom got underway about a year ago, with the introduction of new '72 models sold at frozen prices along with expectations of elimination of the auto excise tax. Thus, in the '72-model year, sales of domestic models jumped 20 percent — and perhaps would have increased more but for some end-year shortages — while import sales fell off slightly. Altogether, Detroit sold 9.2 million '72-model cars, and in addition reported very heavy sales of 2.5 million trucks. The '73 models got off to a good start, partly reflecting the Price Commission's refusal (at least initially) of a price-boost request from the big automakers.

Residential construction continued to rise in the third quarter at a $54.4-billion rate, which is about 75 percent above the recession low of two years ago. Housing starts, at a 2.28-million rate, remained on the high plateau maintained throughout most of the past year, and in addition, mobile-home shipments held at about a 600,000-unit rate this summer.

The housing boom continued to receive help from an exceptionally heavy inflow of funds into thrift institutions. During the first half, this inflow supported a very strong expansion in mortgage commitments, and this has practically guaranteed the availability of funds for the immediate future. Even so, rising inventories of unsold single-family homes and a decelerated growth of multi-unit construction have been marked in recent months, suggesting some weakening of the basic demand factors involved in the boom.

Income and jobs

Personal income flows accelerated during the third quarter, reflecting continued increases in employment and hours. Take-home pay advanced at an even faster pace as tax deductions rose only modestly, but only a relatively small share of this income increase went into savings, most being allocated instead to consumer spending. The personal-saving rate amounted to 6.4 percent of disposable income for the second consecutive quarter, marking a return to the saving pattern of the 1960s and a shift away from the very high rate of 1970-71.

Expanded consumer spending plus excessive tax withholdings recently have cut sharply into the savings rate, but the rate should rise during the present quarter to the extent that the substantial increase in social-security payments is (at least temporarily) held out of the stream of consumption spending. This jump in social-security benefits and early 1973's refund of overwithheld taxes, each amounting to about $8 billion at an annual rate, should raise the level of savings and also give an added fillip to the consumer spending boom.

The expansion has continued to generate new jobs, although not quite so rapidly as earlier in the year, with nonfarm employment rising from 72.5 million to 73.0 million during the third quarter. (To date this year, nonfarm employment has increased at a 3.8-percent annual rate, or triple the 1971 pace.) The unemployment rate meanwhile has continued on its slow downward track, falling slightly to 5.5 percent during the third quarter. The rate has now dropped slightly in each of the last four quarters.

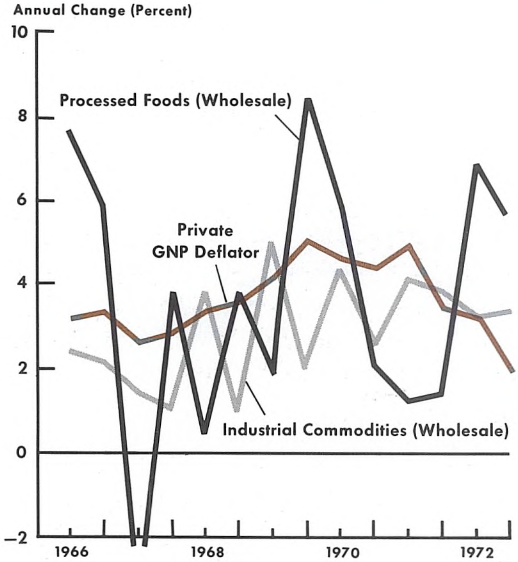
Job market strength

The 2.4-million growth in civilian employment over the past year represents a larger relative rise than during any previous economic recovery of the post-war period. The growing strength of the labor market is also seen in the sharp year-long decline in the layoff rate in manufacturing, as well as the substantial rise in factory new-hires. The factory workweek, although roughly stable since last spring, is about one hour higher than a year ago, at 40.7 hours in September.

Labor market analysts are now looking with some caution at the 1973 calendar, in view of the scheduled sharp increase in major labor-contract negotiations. Overall, these contracts will affect over 4.1 million workers —more than twice the 1972 figure—in such major industries as autos, trucking, construction and electrical equipment.

Yet, with the recent subsidence of inflation pressures, rank-and-file demands for outsized wage settlements may diminish next year, especially in view of the growing use of wage-escalator clauses in labor contracts. Moreover, even in the face of a decelerating trend in compensation per man-hour, the prolonged downtrend in real earnings has been reversed over the past year. Average weekly earnings in manufacturing (adjusted

Inflation pace decelerates, but wholesale price trends worrisome



for rising prices) increased by 6 percent between September and September.

Prices: the food impact

The news was generally good on the price front — at least according to the broadest measure of prices, the implicit GNP deflator. This index rose at a 2.4-percent annual rate in the third quarter, roughly in line with the previous quarter's experience and less than one-half the rate of advance of the 1969-71 period.

On the other hand, consumer prices accelerated during the third quarter on the heels of an upsurge in food prices. Thus, to date in Phase II, the CPI's 3.5-percent rate of increase has approached the 3.8-percent rate of the pre-freeze period of 1971. (During Phase II, food prices have risen at a 4.9-percent rate and other commodity prices at a 3.0 percent rate, roughly in line with the pre-freeze trend, but price increases for services have decelerated significantly to a 3.5-percent rate.) Wholesale prices also accelerated in the third quarter because of the rocketing price of food. Consequently, the wholesale price index has increased at a 5.2-percent rate over the Phase II period, matching the increase in the pre-freeze period of 1971.

The food problem has centered in the two categories of meat-poultry-fish and fruits and vegetables. Over the past year, retail prices in these two categories have increased by 9.9 percent and 7.8 percent, respectively. Some easing of beef prices, perhaps temporary, may now occur because of the 10-percent year-to-year increase in the number of cattle on feed, largely attracted out of pastureland by the highest prices of the last two decades or pushed out of pasture by drought in the Southwest grazing areas. But now a sharp rise in flour prices has occurred as a by-product of the mammoth grain sales to the U.S.S.R., and has threatened to end the past year's stability in retail prices of cereal and bakery products. Just between July and September, the farm price of wheat jumped by about 30 percent.

Prices: controls and trends

Meanwhile, with wholesale lumber prices running about 13.2 percent above a year ago, the Cost of Living Council moved this summer to extend its reporting requirements to lumber firms with sales over $5 million annually. With the revocation of an earlier small-business exemption, the Council extended the controlled section of the industry from 10 to 30 percent. Auto prices also got into the news as the Price Commission turned down price-boost requests from General Motors and Ford—designed to cover the cost of mandated safety and emission equipment—on grounds of possible violation of profit-margin limitations. (But the automakers then returned to the Commission with new price proposals in November.) Despite the rejection of the initial request, however, retail new-car prices this September averaged 3.8 percent higher than a year ago, reflecting the strength of the auto-spending boom.

In industry generally, lessened price pressures have shown up in a reduced rate of increase of unit costs, both fixed and variable. With the rebound in output following the cyclical trough, fixed costs have been spread over a growing volume of production, so that unit-nonlabor costs have tended to stabilize or even decline following the very rapid rise during the sluggish 1969-70 period. Unit-labor costs have moved in similar fashion, reflecting mainly a speedup of private nonfarm output per man-hour—up at a rapid 5.6-percent rate in the past half-year. Indeed, unit labor costs in the private nonfarm sector have actually declined for two successive quarters, for the first decline of the past seven years.

Fiscal deficit

In the fiscal arena, Federal-government spending declined below the spring-period pace during the third quarter, mostly because of the above-mentioned setback in defense spending, and the Federal deficit (national-accounts basis) thus narrowed somewhat. However, there should be a different story in the current quarter, because of the first payout of revenue-sharing funds and the sharp boost in social-security payments, along with normal increases in spending for goods and services. The budget deficit thus is expected to be substantial, giving rise to a danger of overheating the national economy.

Congress adjourned in mid-October after rejecting the Administration's request for authority to impose a $250-billion ceiling on budget spending for the current fiscal year. A compromise bill specifying areas for possible reduction was passed by the House but then voted down by the Senate. After Congress adjourned, Administration experts set to work to cut about $6 billion from budgeted expenditures, so as to meet the self-imposed $250-billion spending limit and presumably to avoid a tax increase next year.

Also in the adjournment rush, Congress increased social-security taxes to help pay for a large number of new social-security and medicare benefits—all on top of the major 20-percent boost in benefits voted just last June. (The June legislation also included a tax increase.) In 1973, the social-security tax rate will rise to 5.85 percent on the first $10,800 of a worker's income, for a maximum tax of $632 as against this year's $458. With both the tax rate and the wage base rising over time, the maximum payment in 1978 will rise to at least $720—probably more, because last June's legislation involves a tax escalator clause tied to the consumer-price index.

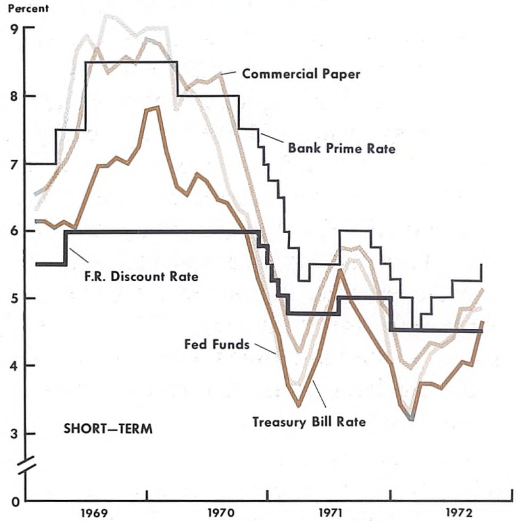
Congress, as noted, passed a scaled-down $74-billion Defense Department appropriation bill before adjourning. In addition, it appropriated $30 billion in revenue-sharing funds over a five-year period to states and localities, with few strings attached. Two-thirds of the money will go to local governments, with heavily urban and poor rural sections generally making out better than the affluent suburbs. A massive highway bill meanwhile was killed when Senate-House conferees could not agree about tapping the $7-billion highway trust fund for urban mass-transit purposes.

In view of the substantial Federal deficit, the Treasury now estimates that about $12 billion in gross borrowing may be needed through early 1973, with cash needs concentrated in early December and early January. About one-fourth of the needed funds will be achieved through an early November auction of 6½-percent four-year notes. Other funds will come from additions to the weekly bill cycle, sales of two-year notes, and sales of tax-anticipation bills maturing in April and June 1973.

Money: moderate growth

The Federal Open Market Committee, in its latest reported meetings in June and July,

Short-term interest rates move sharply upward . . .

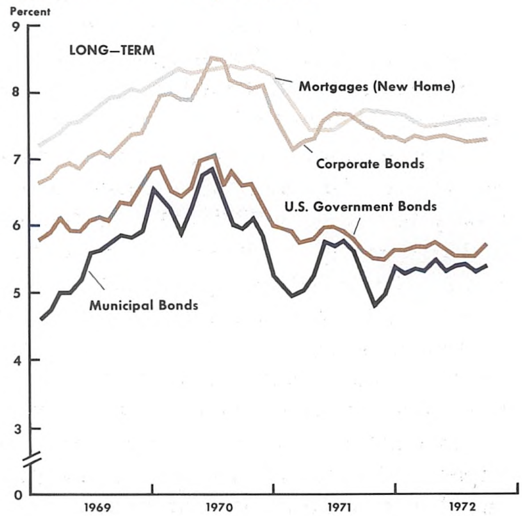


decided to achieve bank-reserve and money-market conditions that would support a moderate growth of the monetary aggregates. As it turned out, most of the key aggregates grew more rapidly over the third quarter than they did over the preceding one. The money stock (narrowly defined) rose at an 8.5-percent rate during the third quarter, considerably higher than the second quarter's 5.3-percent figure but still below the first-quarter pace. Even at that, the third-quarter figure largely reflects a very sharp bulge in monetary growth in early July. Time-and-savings deposits, except for large negotiable CD's, rose relatively slowly in early summer, but accelerated later in the quarter. Consequently, the broadly defined money stock (including such time deposits) increased at a 9.3-percent rate in the third quarter. Net sales of large time CD's continued to expand sharply during the July-September period. Meanwhile, member banks shifted to a net borrowed reserve position, reflecting accelerated borrowing at the Federal Reserve discount window.

Commercial-bank credit expanded strongly throughout most of the third quarter, with most of the expansion showing up in loans rather than in security portfolios. In particular, the brisk pace of economic activity resulted in a long-expected improvement in business and other short-term credit demands. Business loans were very strong during August, and consumer and real-estate loans expanded significantly throughout the entire quarter. Bank holdings of municipal and Federal-agency issues rose modestly, but holdings of Treasury issues weakened.

Short-term interest rates advanced sharply throughout most of the summer and early fall. The three-month Treasury bill was bid at around 4.80 percent at mid-October, as against 3.85 percent just two months earlier. This surge in rates reflected selling pressures associated with Federal Reserve open-market operations and some liquidation of bill holdings by foreign central banks, as well as an increase in Treasury new bill offerings. With short-term rates rising and long-term rates showing little change, the unusually wide spread that had developed earlier between long- and short-term rates began to narrow considerably.

. . . while long-term rates remain relatively stable



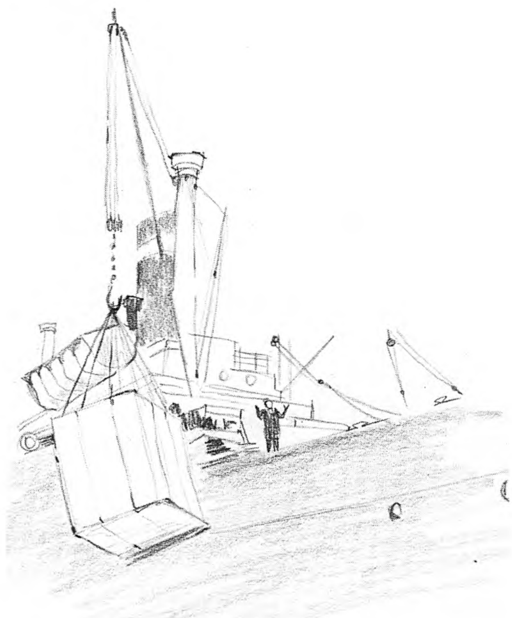
The October rise in the prime business-loan rate, to 5¾ percent at most banks, brought this key rate one full percentage point above its low point of the past year. Most of that increase occurred just between June and October. Federal Reserve Chairman Burns, in his role as chairman of the Committee on Interest and Dividends, "viewed with concern" the recent increases in the prime, although he saw little indication that these increases would be transmitted to the rates in the long-term sector, such as home-mortgage and consumer-loan rates. Indeed, pressure on long-term rates could remain rather mild, in view of such factors as the high level of savings flows and the strength of corporate liquidity and cash flow. At any rate, the Committee now plans to extend its surveillance to the earnings of financial institutions, and will not limit itself to the monitoring of interest rates.

Export deficit

In the world economy, U.S. exports of goods and services increased during the third quarter—but imports also rose, so that the nation continued with a net deficit on merchandise-trade account. Even so, the $3.4-billion rate of deficit was the lowest since the devaluation of last December.

The trade outlook should improve significantly, and not just because of the unexpected boom caused by heavy grain sales to the U.S.S.R. and more recently to China. Farm exports increased about 4 percent to a record $8 billion in fiscal 1972, and the $1-billion Russian grain deal should boost the figures even higher in 1973. Indeed, the U.S.S.R. expects to be a major importer of American wheat, feed grains and soybeans for at least the next several years.

The upswing in the U.S. economy has induced a strong demand for imports, while the business slowdown of its major trading partners has been holding down the demand for U.S. exports. But as the European nations and Japan improve their economic performance in coming months, they should buy more from the U.S. In addition, this nation's better record recently in combatting inflation—with an inflation rate only about half that of the Common Market countries—should act to stimulate exports while curbing the flow of imports.



Government leaders of the nine Common Market countries (including the three candidate countries) met in Paris in October and set the goal of transforming the present separate states into a European union by 1980. They agreed to set up a European Monetary Cooperation Fund by next April, to be administered by central-bank governors for intervention in foreign-exchange markets. The purpose would be to narrow fluctuations between members' currencies, already supposed to operate within one-half the band observed elsewhere. A report due by the end of 1973 would deal with the pooling of central-bank reserves within this fund, leading to the development of an embryonic central bank.

The cause of increased European cooperation was threatened by the latest crisis of the pound, which created uncertainty in world monetary markets throughout the summer and fall months. The pound was set afloat from its $2.60 parity rate in June, and since then it has been weakened by a number of domestic problems, as well as by the expected payments drain resulting from the U.K.'s entry into the Common Market next January 1. A lagging growth rate, lagging investment, a high rate of inflation and bitter industrial relations have plagued the U.K. in recent years, and the pound's weakness has now been accentuated by the gradual subsidence of inflation in this country. Also, the U.K. is scheduled to set a new fixed rate as a part of the Common Market's integration plan, and some observers feel that rate should be as low as (or lower than) the October low of $2.32. To combat its many problems, the Government in November took a leaf from the American book and imposed a 90-day freeze on prices and incomes.

To combat a completely different set of problems, Japan in October unveiled its "Third Yen Defense Program." This program, like its two predecessors of the past year and a half, is aimed at reducing the substantial surplus that Japan has built up in its payments dealings with other nations. Determined to prevent a second revaluation, Japan instead has relied on a 20-percent reduction in import tariffs on industrial, mining and agricultural products, and on restrictions on exports in 18 major areas, including autos, radios, cameras, and machinery. Japan's efforts to stave off revaluation, along with Britain's efforts to stabilize its currency rate at an equilibrium level, should influence international money markets for some time to come.

William Burke

Rapid Expansion (West)

The Western economy continued to expand at a good clip during the summer and early fall months. Civilian employment exceeded 12.5 million during the third quarter, and employment gains were widespread throughout the nine westernmost states. All major industries scored strong gains, and all except the aerospace industry reached new employment peaks.

As a consequence, there was a further reduction in unemployment in the West. Jobless workers accounted for 6.2 percent of the Western labor force during the July-September period—still higher than the nation's 5.5-percent figure, but still a percentage point below the year-ago regional level. The strongest improvement occurred in California and Washington, the states that were worst hit by aerospace cutbacks of several years ago. In little over a year's time, California's rate has dropped 1½ percentage points to 5.9 percent, and Washington's rate has fallen 3 full percentage points to 8.7 percent.

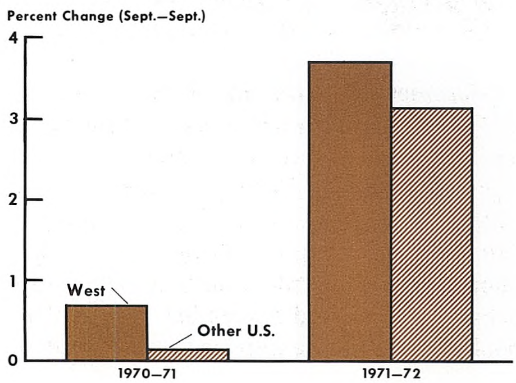
Farm prosperity

Western farmers participated in the nationwide farm boom during the summer and fall months, although not to the same extent as their counterparts elsewhere. Marketing receipts at mid-summer were 6 percent above a year ago—about one-half of the gain scored in the rest of the nation. The slower-than-national pace reflected the West's limited production of some commodities (hogs, soybeans, and feed grains) that have been scoring rapid price gains.

The third-quarter growth in Western farm receipts was based largely on the nationwide upsurge in livestock prices. Yet, despite the high levels of fed beef prices, profit margins were reduced drastically because of rising costs of feeder cattle and feed grains. Egg prices meanwhile strengthened substantially in California, in response to cutbacks involved in a new marketing-control program and to the liquidation of flocks affected by the widespread Newcastle disease.

Farm returns during the present quarter should rise substantially because of the $1-billion Soviet grain sale. The Pacific Northwest's wheat harvest did not begin until the deal with the U.S.S.R. had been publicized. Northwest farmers, unlike many of their counterparts in the Southern Plains area, thus were able to benefit from the skyrocketing price of wheat — up 30 percent in two

Employment—especially in West— rises sharply over past year

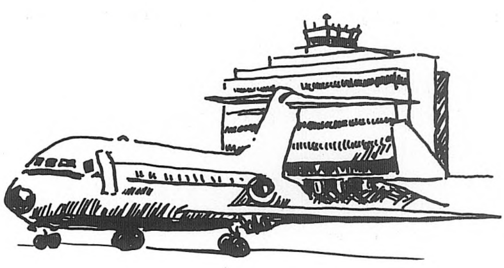


months' time—as well as from an expansion in wheat output.

Total crop output in the West is scheduled to rise slightly during the present crop year, despite a sharp weather-caused decline in output of deciduous fruits. Strong increases are expected in field crops, such as cotton and wheat, and in processing vegetables, especially tomatoes.

Aircraft take-off

The improved situation in aerospace brought about a 10,000 gain in employment over the third quarter, to 534,000 in September—the best performance since the turnaround in the industry's fortunes a year ago. Aircraft production (especially commercial aircraft) accounted for most of the recent improvement in business. In California the expansion was strongest in the electronics industry, while in Washington the expansion was strongest in aircraft production. Continued funding of defense projects also helped to bolster employment; the $2 billion in defense prime-contract awards recorded during the second quarter was one of the largest quarterly gains of the past four years.



Washington's aerospace industry expects a 15-percent improvement in employment by mid-1973, largely because of increased backlogs of orders for Boeing commercial jets. The firm's commercial backlog, after a sharp deterioration during the previous four years, jumped from $1.0 billion to $1.6 billion just between March and September. The orderbook encompasses a historic breakthrough in the China market, with the $150-million sale of ten 707-model jets, and it also includes another historic first, the sale of the 1,000th plane in the very successful 727 series.

July's award of the $2.6-billion space-shuttle contract generated little immediate activity. Initially, it had been expected that California's aerospace employment would show a small net increase by late 1973, with layoffs in certain firms offsetting the new hires at contract-winning North American-Rockwell. The latest information reinforces this picture, since NASA has announced that total outlays for fiscal 1973-74 combined will not exceed $140 million for the entire shuttle project.

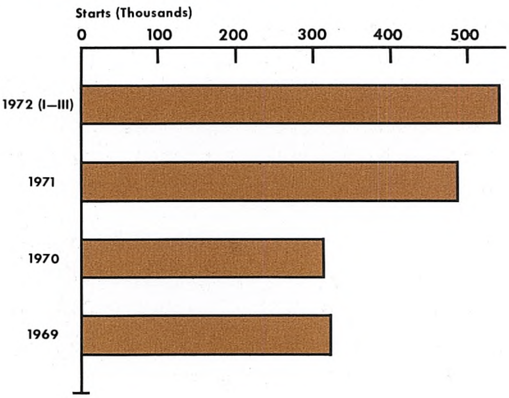
Housing and environment

Housing activity accelerated in the West this summer and fall after a second-quarter downturn. During the third quarter, residential construction contracts jumped 12 percent to a record $8.4-billion rate, and housing starts rose 6 percent to a high but not record rate of 525,000 units. Industry leaders continued to express anxiety about overbuilding, in view of apartment vacancy rates ranging as high as 7 percent and above in some Western markets. Mobile-home shipments meanwhile continued at a rate ahead of last year's record of 79,000 units.

Nonresidential and heavy construction activity gained about 3 percent over the quarter to a $6.6-billion annual rate, measured by the dollar volume of construction awards. The pace was still behind the peak first-quarter rate, however. Contracts increased for construction of streets, highways, bridges, dams and rivers-and-harbor work. These gains were offset by declining activity in public-utility projects and commercial and manufacturing plants.

The major building news this fall was September's ruling by the California Supreme Court that environmental-impact statements must be filed with requests for building per-

Housing starts reach peak for second straight year



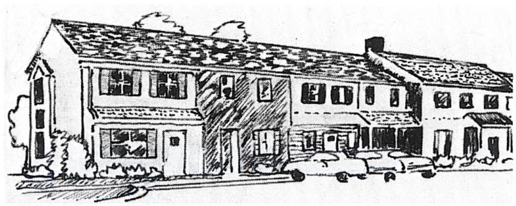
mits on all private construction where a "significant" impact occurs. The Court agreed with environmentalists that the same type of statement already required for public-building projects should also be required for private projects. The decision threw the state's building industry into a turmoil — some communities even stopped issuing building permits—but it created a bonanza of new business for environmental consulting firms.

Housing and lumber

The housing boom's unrelenting pressure on the Northwest's forest-products industry continued, as lumber and plywood prices rose sharply despite the presence of Phase II controls. By September wholesale prices of softwood lumber were 12 percent, and softwood plywood 17 percent, above year-ago levels.

Price pressures continued despite a number of steps taken by the Cost of Living Council to bring the lumber industry under tighter controls. In July the Council revoked a small-business exemption and reimposed price and wage controls on lumber producers and dealers with sales in excess of $100,000 a year. In October it extended reporting requirements to firms with sales in excess of $5 million annually. It also asked the Agriculture Department to increase timber supplies, and asked the Justice Department to investigate pricing practices within the industry.

Some producers began taking steps—including price refunds and production cutbacks—to prevent profit margins from exceeding acceptable levels under the price-stabilization program. Two of the largest firms in the industry actually reduced prices voluntarily to keep prices down, but the strong-demand, tight-supply situation kept the overall level of prices rising nonetheless.



Metals strengthening?

Western steel production declined more than seasonally this summer, but it then picked up sharply in September. A rising tide of imports helped account for the regional industry's problems. During the January-August period, imports into the Western market were up 34 percent over a year ago, as against a 12-percent decline nationally.

With help from the recuperating aircraft industry, Northwest aluminum producers boosted their operating rate during the third quarter. In the process, one leading producer announced a shift of production from an Alabama plant to more modern facilities at Troutdale, Oregon.

Western copper producers experienced a greater-than-seasonal decline in demand during the third quarter. Refined copper deliveries ran above the 1971 level, but only because a strike affected the year-ago figures. The basic problem was overproduction in the world market, which helped bring world prices well below the U.S. producer price of 50½ cents a pound.

The Cost of Living Council excepted silver from price controls in August, enabling domestic producers to benefit from the sharp increase in world silver prices. The Council said that the existing $1.61-an-ounce ceiling price, which reflected the depressed market conditions in the prefreeze period, would tend to discourage domestic production and divert U.S. supplies overseas. In the two months after the decision, the U.S. producer price rose to $1.79 an ounce.

Refining activities at Western oil refineries continued to rise during the third quarter, to 7 percent above year-ago levels. Western crude production meanwhile declined, so refineries utilized larger supplies of imported oil. Imports of foreign crude jumped sharply over the quarter, in September amounting to 40 percent of total crude supplies. Also, imports of foreign refined products increased somewhat above year-ago levels.

The Western economy in the late fall of 1972 generally anticipated a prosperous 1973. The very strong situation of most farmers and ranchers, the thicker order books of aerospace producers, and the surprisingly high level of the housing market—all provided a solid underpinning to the regional economy. The metals industries also looked forward to expanding in line with the growth of the national economy.

Donald Snodgrass, Verle Johnston and Yvonne Levy

Faster Loan Pace

After mid-year, as the economy continued to gather momentum, Western banks experienced heavier credit demands in an environment of rising money-market rates and increasing reserve pressure. Commercial-bank credit at Twelfth District banks increased $1.8 billion in the third quarter—a larger gain than in the first two quarters of the year. Yet, this 9.9-percent (seasonally adjusted) annual growth rate fell considerably below the nation's 13.9-percent rate, mainly due to different movements in security holdings. District bank loans rose $2.6 billion, for a substantial 19.8-percent rate of gain. (Still, this was only slightly above the national pace.) The loan expansion was broadly based and included, for the second successive quarter, a large gain in business loans as well as a further acceleration in mortgage and consumer lending.

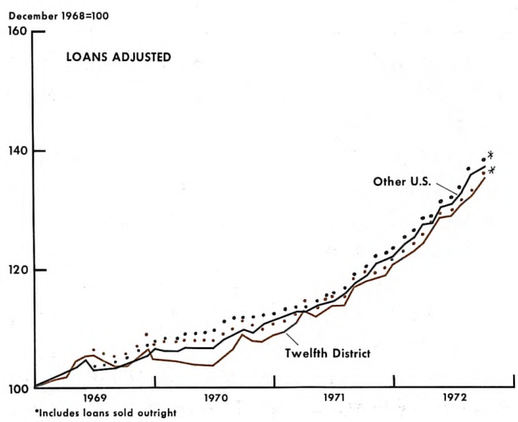
Less favorably, however, the pace of deposit expansion fell off sharply during the July-September period. As a result of this slower deposit growth, District banks reduced their holdings of securities to meet the heavier loan demand. Portfolios of U.S. Treasury issues decreased $529 million — largely in issues of 1-to-5-year maturities — despite some additions in longer-term maturities. District banks also reduced their holdings of "other" securities by $258 million, in contrast to a build-up in such holdings at banks elsewhere. They sold off longer-term issues for the most part, largely because of expectations of price declines in long-term tax-exempts on the part of some portfolio managers.

Slower deposit growth

Total deposits of District member banks expanded at a 3.9-percent annual rate during the third quarter (seasonally adjusted, daily average basis). This was less than half the rate of increase in the first two quarters of the year. The $613-million increase was almost entirely in the time-deposit component, but even this was only half as large as the second-quarter gain. A major factor in the diminished inflow was a greater-than-seasonal reduction in public time deposits. These withdrawals followed an unusually large buildup in May, when California banks received record amounts of public funds because of newly-instituted state withholding of income taxes.

Rates paid by District banks on passbook savings and consumer-savings instruments

Loans expand strongly, both in West and in rest of nation



remained generally unchanged during the quarter. Thus, the relatively wide spread continued between savings-and-loan and bank offering rates.

Savings in the form of consumer-type time-deposit instruments (not seasonally adjusted) expanded at a substantial rate throughout the third quarter, approximating the relatively large second-quarter gain. On the other hand, passbook savings increased only nominally, except in September when quarterly interest was credited. An increase of $565 million in large negotiable time cerficates meanwhile provided large District banks with a substantial source of funds; in both July and August, CD's rose over $225 million, and in September District banks successfully replaced those CD's which matured at the mid-month tax date.

Net demand deposits (seasonally adjusted) remained virtually unchanged in the third quarter, as a $442-million increase in private demand deposits was offset by a comparable decrease in U.S. Government deposits, which reflected the unusually low level of Treasury cash balances. Private demand deposits grew more rapidly than in the second quarter, but U.S. Government deposits declined at a much faster rate.

Increased reserve pressure

Since most of the deposit increase was concentrated in time deposits, the increase in District banks' required reserves amounted to only $53 million in the July-September period (daily average basis). But because of an increasingly firm monetary policy, banks' borrowings from the Federal Reserve Bank of San Francisco rose to $26 million from the second quarter's $5-million figure. They also recorded average net *borrowed* reserves of $5 million, compared with net *free* reserves of $6 million in the preceding quarter.

Many large District banks were net purchasers of Federal funds — that is, borrowers of unused bank reserves — in the July-September period. As a group, however, these banks were net interbank sellers (lenders) with daily-average sales of $909 million compared with $568 million in the prior three months. On the other hand, they continued to be net borrowers from securities dealers, although on a reduced scale. On all Fed-funds transactions, large banks were net sellers of $863 million, compared with $393 million in the second quarter.

This Fed-funds position appears inconsistent in light of banks' increasing reserve pressure, but it is partially explained by the further increase in the already record high borrowings of funds (from corporations and public agencies) under repurchase agreements. Some of these borrowed funds, which exceeded $2 billion during the quarter, were resold in the Fed-funds market.

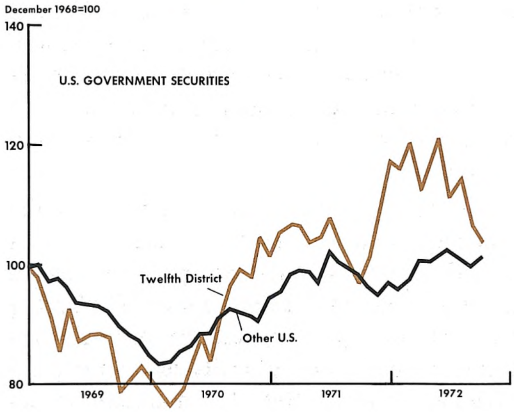
Expanded borrowing

The expanded demand for business loans, already evident in the second quarter, continued in the July-September period. Business loans rose in each month of the quarter for a total increase of $569 million, only slightly below the preceding quarter's pace. The same general theme was evident after adjustment of the data to include loans sold to affiliates, at least for the quarter as a whole.

Loan demand still remained only moderate from the durable-goods sector, except for primary-metals manufacturers. Most nondurable-goods manufacturers in contrast increased their borrowings substantially, although some of this (as in the food sector) represented mainly seasonal borrowing. The utilities sector — especially communications — and the construction sector substantially expanded their bank borrowings also.

The cost of business borrowing rose during the quarter, as prime-rate increases by District banks followed increases in other parts of the country. Western banks raised their prime rate by ¼ percentage point in

Western banks reduce holdings of Treasury securities . . .



late June (to 5¼ percent), and this rise was reflected in higher average rates on short-term business loans, as measured by the Federal Reserve's August survey. (In major West Coast cities, the average weighted rate on short-term loans was 5.82 percent, 22 basis points above the May average; on revolving-credit loans, the average rate was 5.72 percent, up 15 basis points.) In late August, Western banks again followed the national trend, raising their prime rate to 5½ percent. A further increase — to 5¾ percent — occurred just as the fourth quarter began, in early October.

Consumer instalment loans continued to expand during the third quarter, but the gain fell somewhat short of the previous quarter's pace. Instalment loans (not seasonally adjusted) rose $306 million at large District banks in July-September, compared with a gain of $428 million in the preceding three-month period. As borne out by recent consumer surveys, individuals obviously have overcome their earlier reluctance to make purchases of autos and other big-ticket items involving instalment credit.

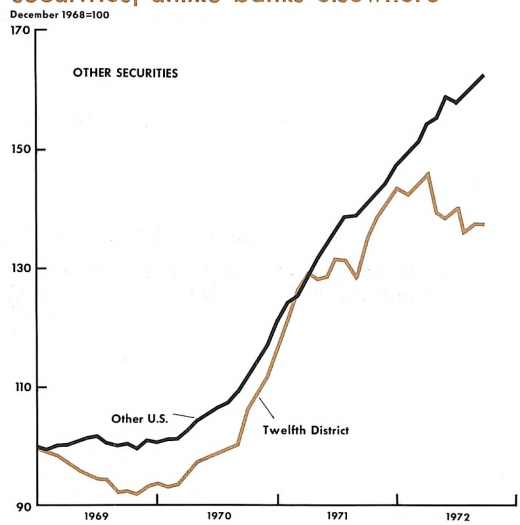
Active mortgage markets

Western commercial banks and savings-and-loan associations continued to experience a flood of savings inflows during the third quarter, and the pace of mortgage lending consequently accelerated. Large commercial banks increased their savings deposits (passbook savings and certificates) by about $766 million, while savings-and-loan associations recorded a $1.9-billion net savings gain, both before seasonal adjustment. In both cases, however, recent gains fell below last winter's record inflow.

With savings continuing to roll in, the pace of mortgage lending increased. During the quarter, commercial banks expanded their mortgage portfolios by $717 million, and the S & L's increased their portfolios by a record $2.0 billion. At the same time, loan commitments of S & L's remained at a high level.

The continued strength of mortgage-loan demand contributed to a further slight firming of mortgage rates at Western S & L's, as the average rate on a conventional new-home loan rose by about 5 basis points during the quarter to approximately 7.75 percent. However, average loan maturities eased slightly, and downpayments decreased slightly in most Western markets.

. . . and meanwhile sell off other securities, unlike banks elsewhere



Favorable fourth quarter?

Western banks again showed an erratic pattern in bank earnings in the third quarter, both before and after securities transactions. Large-bank performance ranged from heavy net gains to heavy net losses, while medium and small banks generally reported substantial year-to-year increases in income.

In the present quarter, the outlook for bank earnings is generally favorable. The latest ¼-percentage-point increase in the prime business-loan rate should, together with the several earlier increases, improve loan revenues. (However, mortgage and consumer loans have been accounting for the major part of the loan expansion, and rates in these categories have remained relatively flat in recent months.) Meanwhile, recent sharp increases in yields should increase banks' rate of return on securities.

On the other hand, the cost of bank funds also has edged up recently. The rate on Federal funds again has moved up around the 5-percent level, and offering rates of banks on large negotiable CD's have risen around 30 basis points above rates quoted around midyear. Revisions in Regulations D and J, effective November 9, may inject some uncertainties into the bank-earnings picture, particularly during the changeover period. Overall, however, the spread between rates of return and costs should be at least as favorable as in the preceding three-month period.

So far this quarter, loan demand in the mortgage and consumer sectors has continued at the accelerated pace of recent months. Business demand for credit also has been strong, and appears to be well distributed both geographically and among individual banks. But to maintain time-deposit inflows, District banks will have to rely more heavily on CD's to offset seasonal declines in public deposits and payouts of Christmas Club accounts. By December, however, banks can expect the yearly seasonal peak in deposits by states and political subdivisions, with the deposit of December tax receipts.

Ruth Wilson and Verle Johnston

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

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