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Business Review

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Monetary Policy: A Letter

The role of the money supply in the conduct of monetary policy was discussed in detail in a recent letter from Arthur F. Burns, Chairman of the Board of Governors of the Federal Reserve System, to Senator William Proxmire of Wisconsin. The text of the letter follows.

November 6, 1973

The Honorable William Proxmire
United States Senate
Washington, D. C.

Dear Senator Proxmire:

I am writing in further response to your letter of September 17, 1973, which requested comments on certain criticisms of monetary policy over the past year.

As stated in your letter, the criticisms are: (1) "that there was too much variation from time to time in the rate of increase in the money supply, that monetary policy was too erratic, too much characterized by stops and starts"; and (2) "that the money supply had increased much too much last year, in fact that the increase would have been too much even if we had been in the depths of a recession instead of enjoying a fairly vigorous economic expansion."

These criticisms involve basic issues with regard to the role of money in the economy, and the role that the money supply should play in the formulation and execution of monetary policy. These issues, along with the specific points you raise, require careful examination.

Criticism of Our Public Policies

During the past two years the American economy has experienced a substantial measure of prosperity. Real output has increased sharply, jobs have been created for millions of additional workers, and total personal income—both in dollars and in terms of real purchasing power—has risen to the highest levels ever reached.

Yet the prosperity has been a troubled one. Price increases have been large and widespread. For a time, the unemployment rate remained unduly high. Interest rates have risen sharply since the spring of 1972. Mortgage money has recently become difficult to obtain in many communities. And confidence in the dollar at home and abroad has at times wavered.

Many observers have blamed these difficulties on the management of public economic policies. Certainly, the Federal budget—despite vigorous efforts to hold expenditures down—continued in substantial deficit. There has also been an enormous growth in the activities of Federally-sponsored agencies which, although technically outside the budget, must still be financed. The results of efforts to control wages and prices during the past year have been disappointing. Partial decontrol in early 1973 and the subsequent freeze failed to bring the results that were hoped for.

Monetary policy has been criticized on somewhat contradictory counts—for being inflationary, or for permitting too high a level of interest rates, or for failing to bring the economy back to full employment, or for permitting excessive short-term variations in the growth of the money supply, and so on.

One indication of dissatisfaction with our public policies was provided by a report, to which you refer in your letter, on a questionnaire survey conducted by the National Association of Business Economists. Of the respondents, 38 percent rated fiscal policy "over the past year" as "poor"; 41 percent rated monetary policy "over the past year" as "poor"; and only 14 percent felt that the wage-price controls under Phase IV were "about right." If this sampling is at all indicative, the public policies on which we have relied are being widely questioned. Many members of the above group, in fact, went on record for a significant change in fiscal policy. In response to a question whether they favored a variable investment tax credit, 46.5 percent said "yes", 40 percent said "no" and 13.5 percent expressed "no opinion."

Let me now turn to the questions raised in your letter and in some other recent discussions about monetary policy. I shall discuss, in particular, the role of money supply in the conduct of monetary policy; the extent and significance of variability in the growth of the money supply; and the actual behavior of the money supply during 1972-73.

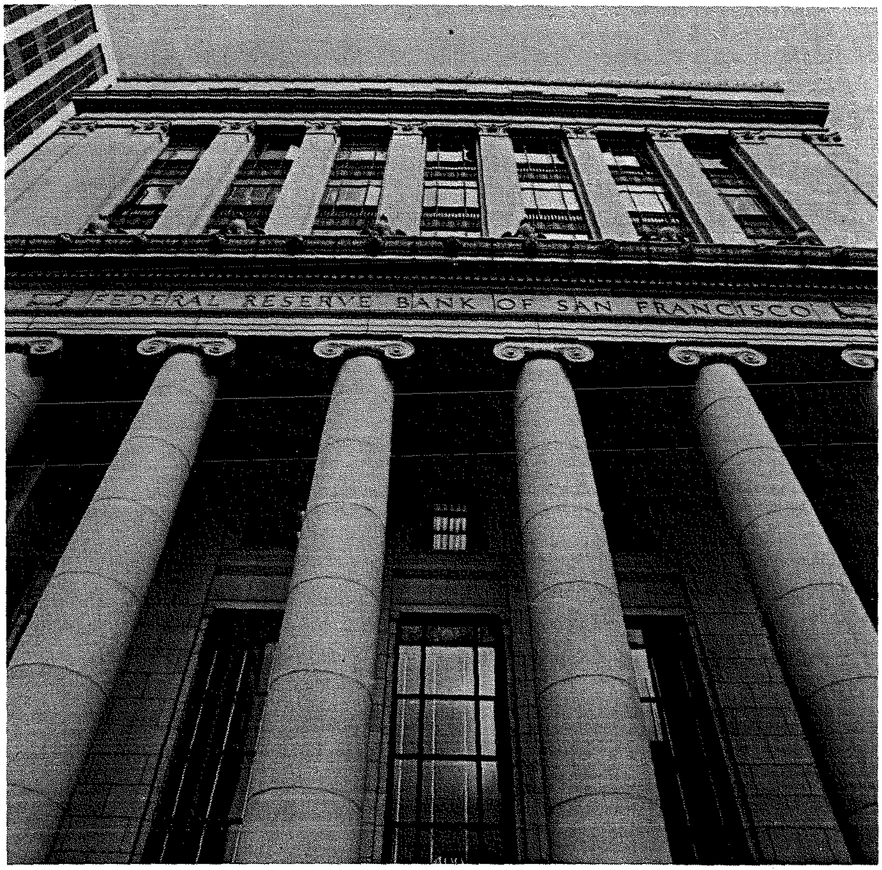
Role of Money Supply

For many years economists have debated the role of the money supply in the performance of economic systems. One school of thought, often termed "monetarist," claims that changes in the money supply influence very importantly, perhaps even decisively, the pace of economic activity and the level of prices. Monetarists contend that the monetary authorities should pay principal attention to the money supply, rather than to other financial variables such as interest rates, in the conduct of monetary policy. They also contend that fiscal policy has only a small independent impact on the economy.

Another school of thought places less emphasis on the money supply and assigns more importance to the expenditure and tax policies of the Federal Government as factors influencing real economic activity and the level of prices. This school emphasizes the need for monetary policy to be concerned with interest rates and with conditions in the money and capital markets. Some economic activities, particularly residential building and State and local government construction, depend heavily on borrowed funds, and are therefore influenced greatly by changes in the cost and availability of credit. In other categories of spending—such as business investment in fixed capital and inventories, and consumer purchases of durable goods—credit conditions play a less decisive role, but they are nonetheless important.

Monetarists recognize that monetary policy affects private spending in part through its impact on interest rates and other credit terms. But they believe that primary attention to the growth of the money supply will result in a more appropriate monetary policy than would attention to conditions in the credit markets.

Needless to say, monetary policy is—and has long been—a controversial subject. Even the monetarists do not speak with one voice on monetary policy. Some influential monetarists believe that monetary policy should aim strictly at maintaining a constant rate of growth of the money supply. However, what that constant should be, or how broadly the money supply should be defined, are matters on which monetarists still differ. And there are also monetarists who would allow some—but infrequent—changes in the rate of growth of the money supply, in accordance with changing economic conditions.



It seems self-evident that adherence to a rigid growth rate rule, or even one that is changed infrequently, would practically prevent monetary policy from playing an active role in economic stabilization. Monetarists recognize this. They believe that most economic disturbances tend to be self-correcting, and they therefore argue that a constant or nearly constant rate of growth of the money supply would result in reasonably satisfactory economic performance.

But neither historical evidence, nor the thrust of explorations in business-cycle theory over a long century, give support to the notion that our economy is inherently stable. On the contrary, experience has demonstrated repeatedly that blind reliance on the self-correcting properties of our economic system can lead to serious trouble. Discretionary economic policy, while it has at times led to mistakes, has more often proved reasonably successful. The disappearance of business depressions, which in earlier times spelled mass unemployment for workers and mass bankruptcies for businessmen, is largely attributable to the stabilization policies of the last thirty years.

The fact is that the internal workings of a market economy tend of themselves to generate business fluctuations, and most modern economists recognize this. For example, improved prospects for profits often spur unsustainable bursts of investment spending. The flow of personal income in an age of affluence allows ample latitude for changes in discretionary expenditures and in savings rates. During a business-cycle expansion various imbalances tend to develop within the economy—between aggregate inventories and sales, or between aggregate business investment in fixed capital and consumer outlays, or between average unit costs of production and prices. Such imbalances give rise to cyclical movements in the economy. Flexible fiscal and monetary policies, therefore, are often needed to cope with undesirable economic developments, and this need is not diminished by the fact that our available tools of economic stabilization leave something to be desired.

There is general agreement among economists that, as a rule, the effects of stabilization policies occur gradually over time, and that economic forecasts are an essential tool of policy making. However, no economist—or school of economics—has a monopoly on accurate forecasting. At times, forecasts based largely on the money supply have turned out to be satisfactory. At other times, such forecasts have been quite poor, mainly because of unanticipated changes in the intensity with which the existing money stock is used by business firms and consumers.

Changes in the rate of turnover of money have historically played a large role in economic fluctuations, and they continue to do so. For example, the narrowly-defined money stock—that is, demand deposits plus currency in public circulation—grew by 5.7 percent between the fourth quarter of 1969 and the fourth quarter of 1970. But the turnover of money declined during that year, and the dollar value of GNP rose only 4.5 percent. In the following year, the growth rate of the money supply increased to 6.9 percent, but the turnover of money picked up briskly and the dollar value of GNP accelerated to 9.3 percent. The movement out of recession in 1970 into recovery in 1971 was thus closely related to the greater intensity in the use of money. Occurrences such as this are very common because the willingness to use the existing stock of money, expressed in its rate of turnover, is a highly dynamic force in economic life.

For this as well as other reasons, the Federal Reserve uses a blend of forecasting techniques. The behavior of the money supply and other financial variables is accorded careful attention. So are the results of the most recent surveys on plant and equipment spending, consumer attitudes, and inventory plans. Recent trends in key producing and spending sectors are analyzed. The opinions of businessmen and outside economic analysts are canvassed, in part through the nationwide contacts of Federal Reserve Banks. And an assessment is made of the probable course of fiscal policy, also of labor-market and agricultural policies, and their effects on the economy.

Evidence from all these sources is weighed. Efforts are also made to assess economic developments through the use of large-scale econometric models. An eclectic approach is thus taken by the Federal Reserve, in recognition of the fact that the state of economic knowledge does not justify reliance on any single forecasting technique. As economic research has cumulated, it has become increasingly clear that money does indeed matter. But other financial variables also matter.

In recent years, the Federal Reserve has placed somewhat more emphasis on achieving desired growth rates of the monetary aggregates, including the narrowly-defined money supply, in its conduct of monetary policy. But we have continued to give careful attention to other financial indicators, among them the level of interest rates on mortgages and other loans and the liquidity position of financial institutions and the general public. This is necessary because the economic implications of any given monetary growth rate depend on the state of liquidity, the attitudes of businessmen, investors, and consumers toward liquidity, the cost and availability of borrowed funds, and other factors. Also, as the nation's central bank, the Federal Reserve can never lose sight of its role as a lender of last resort, so that financial crises and panics will be averted.

I recognize that one advantage of maintaining a relatively stable growth rate of the money supply is that a partial offset is thereby provided to unexpected and undesired shifts in the aggregate demand for goods and services. There is always some uncertainty as to the emerging strength of aggregate demand. If money growth is maintained at a rather stable rate, and aggregate demand turns out to be weaker than is consistent with the nation's economic objectives, interest rates will tend to decline and the easing of credit markets should help to moderate the undesired weakness in demand. Similarly, if the demand for goods and services threatens to outrun productive capacity, a rather stable rate of monetary growth will provide a restraining influence on the supply of credit and thus tend to restrain excessive spending.

However, it would be unwise for monetary policy to aim at all times at a constant or nearly constant rate of growth of money balances. The money growth rate that can contribute most to national objectives will vary with economic conditions. For example, if the aggregate demand for goods and services is unusually weak, or if the demand for liquidity is unusually strong, a rate of increase in the money supply well above the desirable long-term trend may be needed for a time. Again, when the economy is experiencing severe cost-push inflation, a monetary growth rate that is relatively high by a historical yardstick may have to be tolerated for a time. If money growth were severely constrained in order to combat the element of inflation resulting from such a cause, it might well have seriously adverse effects on production and employment. In short, what growth rate of the money supply is appropriate at any given time cannot be determined simply by extrapolating past trends or by some preconceived arithmetical standard.

Moreover, for purposes of conducting monetary policy, it is never safe to rely on just one concept of money—even if that concept happens to be fashionable. A variety of plausible concepts merit careful attention, because a number of financial assets serve as a convenient, safe, and liquid store of purchasing power.

The Federal Reserve publishes data corresponding to three definitions of money, and takes all of them into account in determining policy. The three measures are: (a) the narrowly-defined money stock (M_1), which encompasses currency and demand deposits held by the nonbank public; (b) a more broadly-defined money stock (M_2), which also includes time and savings deposits at commercial banks (other than large negotiable time certificates of deposit); (c) a still broader definition (M_3), which includes savings deposits at mutual savings banks and savings and loan associations. A definition embracing other liquid assets could also be justified—for example, one that would include large-denomination negotiable time certificates of deposit, U.S. savings bonds and Treasury bills, commercial paper, and other short-term money market instruments.

There are many assets closely related to cash, and the public can switch readily among these assets. However money may be defined, the task of determining the amount of money needed to maintain high employment and reasonable stability of the general price level is complicated by shifting preferences of the public for cash and other financial assets.

Variability of Money Supply Growth

In the short run, the rate of change in the observed money supply is quite erratic, and cannot be trusted as an indicator of the course of monetary policy. This would be so even if there were no errors of measurement.

The record of hearings held by the Joint Economic Committee on June 27, 1973 includes a memorandum which I submitted on problems encountered in controlling the money supply. As indicated there, week-to-week, month-to-month, and even quarter-to-quarter fluctuations in the rate of change of money balances are frequently influenced by international flows of funds, changes in the level of U.S. Government deposits, and sudden changes in the public's attitude towards liquidity. Some of these variations appear to be essentially random—a product of the enormous ebb and flow of funds in our modern economy.

Because the demands of the public for money are subject to rather wide short-term variations, efforts by the Federal Reserve to maintain a constant growth rate of the money supply could lead to sharp short-run swings in interest rates and risk damage to financial markets and the economy. Uncertainties about financing costs could reduce the fluidity of markets and increase the costs of financing to borrowers. In addition, wide and erratic movements of interest rates and financial conditions could have undesirable effects on business and consumer spending. These adverse effects may not be of major dimensions, but it is better to avoid them.

In any event, for a variety of reasons explained in the memorandum for the Joint Economic Committee, to which I have previously referred, the Federal Reserve does not have precise control over the money supply. To give one example, a significant part of the money supply consists of deposits lodged in nonmember banks that are not subject to the reserve requirements set by the Federal Reserve. As a result there is some slippage in monetary control. Furthermore, since deposits at nonmember banks have been reported for only two to four days in a year, in contrast to daily statistics for member banks, the data on the money supply—which we regularly present on a weekly, monthly, and quarterly basis—are estimates rather than precise measurements. When the infrequent reports from nonmember banks become available, they often necessitate considerable revisions of the money supply figures. In the past two years, the revisions were upward, and this may happen again this year.

Some indication of the extent of short-term variations in the recorded money supply is provided below. Table 1 shows the average and maximum deviations (without regard to sign) of M_1 from its average annual growth rate over a three and a half year period. As would be expected, the degree of variation diminishes as the time unit lengthens; it is much larger for monthly than for quarterly data, and is also larger for quarterly than for semi-annual data.

Table 1
DEVIATIONS IN M_1 FROM ITS AVERAGE RATE OF GROWTH
1970 THRU MID-1973

	Annual Rates of Change in percent	
Form of Data	**Average Deviation**	**Maximum Deviation**
Monthly	3.8	8.8
Quarterly	2.4	5.5
Semi-annual	1.8	4.1

In our judgment, there need be little reason for concern about the short-run variations that occur in the rate of change in the money stock. Such variations have minimal effects on the real economy. For one thing, the outstanding supply of money is very large. It is also quite stable, even when the short-run rate of change is unstable. This October the average outstanding supply of M_1, seasonally adjusted, was about $264 billion. On this base, a monthly rise or fall in the money stock of even $2½ billion would amount to only a 1 percent change. But when such a temporary change is expressed as an annual rate, as is now commonly done, it comes out as about 12 percent and attracts attention far beyond its real significance.

The Federal Reserve research staff has investigated carefully the economic implications of variability in M_1 growth. The experience of the past two decades suggests that even an abnormally large or abnormally small rate of growth of the money stock over a period up to six months or so has a negligible influence on the course of the economy—provided it is subsequently offset. Such short-run variations in the rate of change in money supply may not at all reflect Federal Reserve policy, and they do not justify the attention they often receive from financial analysts.

The thrust of monetary policy and its probable effects on economic activity can only be determined by observing the course of the money supply and of other monetary aggregates over periods lasting six months or so. Even then, care must be taken to measure the growth of money balances in ways that temper the influence of short-term variations. For example, the growth of money balances over a quarter can be measured from the amount outstanding in the last month of the preceding quarter to the last month of the current quarter, or from the average amount outstanding during the preceding quarter to the average in the current quarter. The first measure captures the latest tendencies in the money supply, but may be distorted by random changes that have no lasting significance. The second measure tends to average out temporary fluctuations and is comparable to the data provided on a wide range of non-monetary economic variables, such as the gross national product and related measures.

A comparison of these two ways of measuring the rate of growth in M_1 is shown in Table 2 for successive quarters in 1972 and 1973. The first column, labeled M, shows annual rates calculated from end-months of quarters; the second column, labeled Q, shows annual rates calculated from quarterly averages.

Table 2
GROWTH RATES OF MONEY SUPPLY ON TWO BASES

		Annual Rate of Change, in percent	
		M	**Q**
1972	I	9.2	5.3
	II	6.1	8.4
	III	8.2	8.0
	IV	8.6	7.1
1973	I	1.7	4.7
	II	10.3	6.9
	III	0.3	5.1

As may be seen, the quarterly averages disclose much more clearly the developing trend of monetary restraint—which, in fact, began in the second quarter of 1972. Also, the growth of M_1, which on a month-end basis appears very erratic in the first three quarters of 1973, is much more stable on a quarterly average basis. For example, while the level of M_1 did not expand significantly between June and September, the quarterly average figures indicate further sizable growth in the third quarter. For purposes of economic analysis, it is an advantage to recognize that the money available for use was appreciably larger in the third quarter than in the second quarter.

Experience of 1972-73

During 1972, it was the responsibility of the Federal Reserve to encourage a rate of economic expansion adequate to reduce unemployment to acceptable levels. At the same time, despite the dampening effects of the wage-price control program, inflationary pressures were gathering. Monetary policy, therefore, had to balance the twin objectives of containing inflationary pressures and encouraging economic growth. These objectives were to some extent conflicting, and monetary policy alone could not be expected to cope with both problems. Continuation of an effective wage-price program and a firmer policy of fiscal restraint were urgently needed.

The narrowly-defined money stock increased 7.4 percent during 1972 (measured from the fourth quarter of 1971 to the fourth quarter of 1972.) Between the third quarter of 1972 and the third quarter of 1973, the growth rate was 6.1 percent. By the first half of 1973, the annual growth rate had declined to 5.8 percent, and a further slowing occurred in the third quarter.

Evaluation of the appropriateness of these growth rates would require full analysis of the economic and financial objectives, conditions, and policies during the past two years, if not longer. Such an analysis cannot be undertaken here. Some perspective on monetary developments during 1972-73 may be gained, however, from comparisons with the experience of other industrial countries, and by recalling briefly how domestic economic conditions evolved during this period.

Table 3 compares the growth of M_1 in the United States with that of other industrial countries in 1972 and the first half of 1973. The definitions of M_1 differ somewhat from country to country, but are as nearly comparable as statistical sources permit. It goes without saying that each country faced its own set of economic conditions and problems. Yet it is useful to note that monetary growth in the United States was much lower than in other major industrial countries, and that it also was steadier than in the other countries.

Table 3
ANNUAL PERCENT RATES OF GROWTH IN MONEY SUPPLY

	1971.4 to 1972.4	1972.4 to 1973.2
United States	7.4	5.8
United Kingdom	14.1	10.0
Germany	14.3	4.2
France	15.4	8.7
Japan	23.1	28.2

The next table shows, in summary fashion, the rates of change in the money supply of the United States, in its total production, and in the consumer price level during 1972 and 1973. The table is based on the latest data. It may be noted, in passing, that, according to data available as late as January 1973, the rate of growth of M_1 during 1972 was 7.2%, not 7.4%; and that the rate of increase in real GNP was 7.7%, not 7.0%. In other words, on the basis of the data available during 1972, the rate of growth of M_1 was below the rate of growth of the physical volume of over-all production.

The table indicates that growth in M_1 during 1972 and 1973 approximately matched the growth of real output, but was far below the expansion in the dollar value of the nation's output. Although monetary policy limited the availability of money relative to the growth of transactions demands, it still encouraged a substantial expansion in economic activity; real output rose by about 7 percent in 1972. Even so, unemployment remained unsatisfactorily high throughout the greater part of the year. It was not until November that the unemployment rate dropped below 5.5 percent. For the year as a whole, the unemployment rate averaged 5.6 percent. It may be of interest to recall that unemployment averaged5.5 pe rcent in 1954 and 1960, which are commonly regarded as recession years.

Since the expansion of M_1 in 1972 was low relative to the demands for money and credit, it was accompanied by rising short-term interest rates. Long-term interest rates showed little net change last year, as credit demands were satisfied mainly in the short-term markets.

Table 4
MONEY SUPPLY, GNP, AND PRICES IN THE U.S.
(Percent change at annual rates)

	1971.4 to 1972.4	1972.4 to 1973.2	1972.4 to 1973.3
Money supply (M_1)	7.4	5.8	5.6
Gross National Product			
Current dollars	10.6	12.1	11.7
Constant dollars	7.0	5.4	4.8
Prices			
Consumer price index (CPI)	3.4	7.1	7.8
CPI excluding food	3.0	4.0	4.1

In 1973, the growth of M_1 moderated while the transactions demands for cash and the turnover of money accelerated. GNP in current dollars rose at a 12 percent annual rate as prices rose more rapidly. In credit markets short-term interest rates rose sharply further, while long-term interest rates also moved up, though by substantially less than short-term rates.

The extraordinary upsurge of the price level this year reflects a variety of special influences. First, there has been a world-wide economic boom superimposed on the boom in the United States. Second, we have encountered critical shortages of basic materials. The expansion in industrial capacity needed to produce these materials had not been put in place earlier because of the abnormally low level of profits between 1966 and 1971 and also because of numerous impediments to new investment on ecological grounds. Third, farm product prices escalated sharply as a result of crop failures in many countries last year. Fourth, fuel prices spurted upward, reflecting the developing shortages in the energy field. And fifth, the depreciation of the dollar in foreign exchange markets has served to boost prices of imported goods and to add to the demands pressing on our productive resources.

In view of these powerful special factors, and the cyclical expansion of our economy, a sharp advance in our price level would have been practically inevitable in 1973. The upsurge of the price level this year hardly represents either the basic trend of prices or the response of prices to previous monetary or fiscal policies—whatever their shortcomings may have been. In particular, as the above tables show, the explosion of food prices that occurred this year is in large part responsible for the accelerated rise in the over-all consumer price level.

The severe rate of inflation that we have experienced in 1973 cannot responsibly be attributed to monetary management or to public policies more generally. In retrospect, it may well be that monetary policy should have been a little less expansive in 1972. But a markedly more restrictive policy would have led to a still sharper rise in interest rates and risked a premature ending of the business expansion, without limiting to any significant degree this year's upsurge of the price level.

Concluding Observations

The present inflation is the most serious economic problem facing our country, and it poses great difficulties for economic stabilization policies. We must recognize, I believe, that it will take some time for the forces of inflation, which now engulf our economy and others around the world, to burn themselves out. In today's environment, controls on wages and prices cannot be expected to yield the benefits they did in 1971 and 1972, when economic conditions were much different. Primary reliance in dealing with inflation—both in the near future and over the longer term—will have to be placed on fiscal and monetary policies.

The prospects for regaining price stability would be enhanced by improvements in our monetary and fiscal instruments. The conduct of monetary policy could be improved if steps were taken to increase the precision with which the money supply can be controlled by the Federal Reserve. Part of the present control problem stems from statistical inadequacies—chiefly the paucity of data on deposits at nonmember banks. Also, however, control over the money supply and other monetary aggregates is less precise than it can or should be because nonmember banks are not subject to the same reserve requirements as are Federal Reserve members.

I hope that the Congress will support efforts to rectify these deficiencies. For its part, the Federal Reserve Board is even now carrying on discussions with the Federal Deposit Insurance Corporation about the need for better statistics on the nation's money supply. The Board also expects shortly to recommend to the Congress legislation that will put demand deposits at commercial banks on a uniform basis from the standpoint of reserve requirements.

Improvements in our fiscal policies are also needed. It is important for the Congress to put an end to fragmented consideration of expenditures, to place a firm ceiling on total Federal expenditures, and to relate these expenditures to prospective revenues and the nation's economic needs. Fortunately, there is now widespread recognition by members of the Congress of the need to reform budgetary procedures along these broad lines.

It also is high time for fiscal policy to become a more versatile tool of economic stabilization. Particularly appropriate would be fiscal instruments that could be adapted quickly, under special legislative rules, to changing economic conditions—such as a variable tax credit for business investment in fixed capital. Once again I would urge the Congress to give serious consideration to this urgently needed reform.

We must strive also for better understanding of the effects of economic stabilization policies on economic activity and prices. Our knowledge in this area is greater now than it was five or ten years ago, thanks to extensive research undertaken by economists in academic institutions, at the Federal Reserve, and elsewhere. The keen interest of the Joint Economic Committee in improving economic stabilization policies has, I believe, been an influence of great importance in stimulating this widespread research effort.

I look forward to continued cooperation with the Committee in an effort to achieve the kind of economic performance our citizens expect and deserve.

Sincerely yours,
Arthur F. Burns

Weakening Boom?

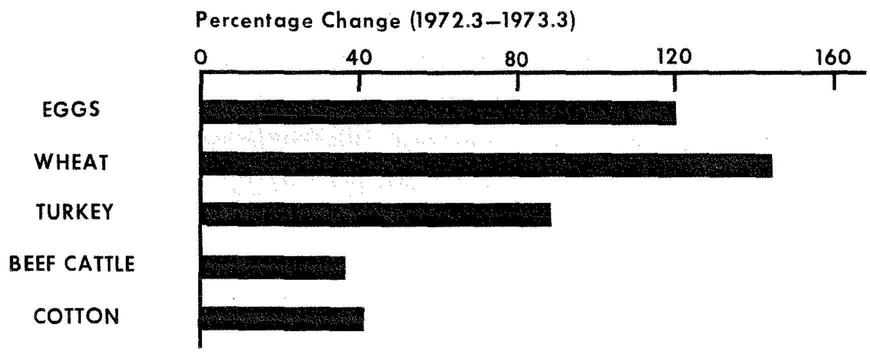
The Western boom continued during the summer and early fall months, helped along by the upsurge in the farm sector and in the export trade. At the same time, production became seriously strained by shortages of fuels and other basic materials. A slowdown in employment growth reflected some of these supply difficulties, but it probably signified also a weakening of demand in certain sectors of the regional economy. Then, as the fuel shortage worsened in late fall, many observers began to revise downward their forecasts for regional business in 1974.

Civilian employment increased at less than a 2-percent annual rate during the third quarter, extending a deceleration which first appeared during the spring period. Jobs continued to expand in most industries, but sluggishness was apparent in several fields, such as non-aerospace manufacturing. Not surprisingly, the unemployment rate remained rather high, averaging 5.5 percent during the third quarter, just as it had for most of the earlier part of the year. In view of a slower-than-national rise in employment, the regional jobless rate remained above the national rate during the quarter, and this situation continued in October as the national rate fell from 4.8 to 4.5 percent.

Consumer buying generally held at a high level, despite the first signs of weakness in durable-goods sales and a deceleration in instalment-credit growth. Yet with prices soaring, real gains moderated in most sectors, especially food.

Business firms continued to spend substantial sums for new plant and equipment, in an attempt to keep up with heavy boom-level demands. Public utilities, trading firms and durable-goods manufacturers relied heavily on bank term loans for their capital-goods financing. In short-term financing, bank-credit demand slackened towards the end of summer as firms rechanneled much of their business to the commercial-paper market, following a decline in paper rates below the banks' prime-loan rate. But retailers and some manufacturing firms, especially in machinery and transportation equipment, maintained a heavy demand for bank credit.

State and local governments remained in a relatively easy fiscal position, helped by boom-generated tax revenues and further infusions of Federal revenue-sharing funds. At the same time, municipal-bond financing continued stronger than in 1972; for the year to date, new issues have totalled about $2.2 billion, or 7 percent above the



Western farmers and ranchers benefit from soaring prices, with wheat being only the most conspicuous example

year-ago pace. During the third quarter, local governments in California and Arizona, and state agencies in Alaska and Oregon, went to market with sizable issues.

Farming: banner year
Western farmers this fall began closing their books on a banner year. Total cash receipts may approach $11.0 billion in 1973, about 24 percent above last year's record, and net farm income could rise even faster to a record $3.3 billion, despite falling government payments and rapidly rising production expenses. Sharply higher field-crop prices and expanded fruit and vegetable production are contributing to a record gain in crop receipts, offset only partly by a drought-induced 17-percent cutback in the Pacific Northwest's wheat crop. Similarly, record price increases are boosting returns to livestock producers substantially, more than offsetting a moderate decline in the volume of marketings.

The sharp price rises underlying the Western farm prosperity reflect to some extent the boom in farm exports. In fiscal 1973, Western farm exports jumped to an all-time high of $1.5 billion. The sharpest gains were registered by Pacific Northwest farmers, with the area's wheat exports alone far more than doubling in a single year's time. Moreover, export demand for farm products remains strong, especially for wheat, cotton and rice.

For livestock producers, 1973 remains a difficult year despite soaring prices and incomes. They have had to contend with soaring feed costs, along with the market uncertainties arising from last spring's consumer boycott and last summer's price freeze. Livestock production has been running below year-earlier levels, with cattle and calf slaughter during the January-September period falling about 6 percent below the comparable 1972 figure. Prospects for livestock production now look more promising, however, in view of the lifting of beef price ceilings and the availability of bumper feed crops. The number of cattle and calves on feed this fall was about 2 percent higher in California, and 4 percent higher in Arizona, than a year ago.

Aerospace: stronger
The Western aerospace industry remained a positive force on the regional employment scene, adding 13,200 workers to its payrolls between June and October. Total employment in the industry now stands at 580,500—about 15 percent above the mid-1971 low but still about 25 percent below the late-1967 peak. Both California and Washington shared in the gain, which was centered in electronic equipment and aircraft and reflected the strength of the commercial market for those products. A highlight of the Washington aerospace market was the strong pace of orders for the Boeing 747. As of September, the Company had received a total of 29 orders for the wide-bodied plane, compared

with only 7 for the comparable period a year ago.

While the civilian sector has been responsible for most of the recent strength in aerospace employment, the ability of the industry to sustain employment growth next year may well depend upon the emerging strength of the defense market. The Arab-Israeli war may provide additional thrust to an already evident uptrend in military spending. The Pentagon has submitted a $2.2-billion supplemental budget request, mostly to replace war material furnished to Israel, and it may ask for more funds to buy transport planes and expand its inventory of sophisticated missiles.

A slowdown in commercial-aircraft orders seems all but inevitable, on the other hand, in light of the poor traffic and earnings reports emanating from the nation's major airlines, plus the cutbacks in scheduled flights necessitated by the current fuel shortage. Lockheed has announced plans to layoff 1,500 workers by January, because of the decision of one of its major airline customers to postpone delivery of nine L-1011 jetliners, and the profits outlook for this and other aerospace manufacturers has become somewhat clouded.

Construction: mixed

The pace of construction activity increased during the third quarter, with construction awards rising about 9 percent to a $15.4 billion annual rate. The increase centered largely in the non-residential sector: as a result, this District contributed more than its share to the nation's fixed-investment boom. Non-residential construction surged to new highs in virtually every state of the region, with awards rising substantially for commercial, educational and (especially) manufacturing facilities. Heavy construction activity also advanced during the quarter, largely in response to increased demand for water-supply and waste-disposal systems.

In the residential sector, activity continued to recede from the early-1973 peak, with a sharper-than-national decline. The number of Western housing starts declined to a 422,000-unit annual rate, some 21 percent below the 1972 pace. (The decline in dollar terms was less, reflecting the continued upsurge in construction costs.) Mobile-home sales meanwhile trailed last year's pace in most District states.

The early-1973 downturn reflected a general weakening of housing demand, and thus preceded the late-spring run-up in interest rates. The more recent decline, in contrast, reflected a growing stringency on supplies of available funds and an attendant rise in borrowing costs.

Western S&L's experienced a net outflow of savings, because of the strong competition from inceasingly attractive money-market instruments. (The bellwether Treasury-bill rate rose from 7 percent in June to over 9 percent in mid-September—a full percentage point above the early-1970 tight-money peak). New savings actually exceeded the year-ago inflow by almost 30 percent, but a doubling of withdrawals resulted in an overall net outflow of $165 million. California S&L's accounted for all of the loss, however; most other District states recorded continued (albeit reduced) savings inflows. For their part, large District banks posted a net inflow of $313 million—several times the previous quarter's inflow—as a substantial increase in consumer-type certificate accounts more than offset a large loss in passbook savings.

The mortgage-lending pace remained at a fairly high level even in the face of this overall slowdown in savings flows. District

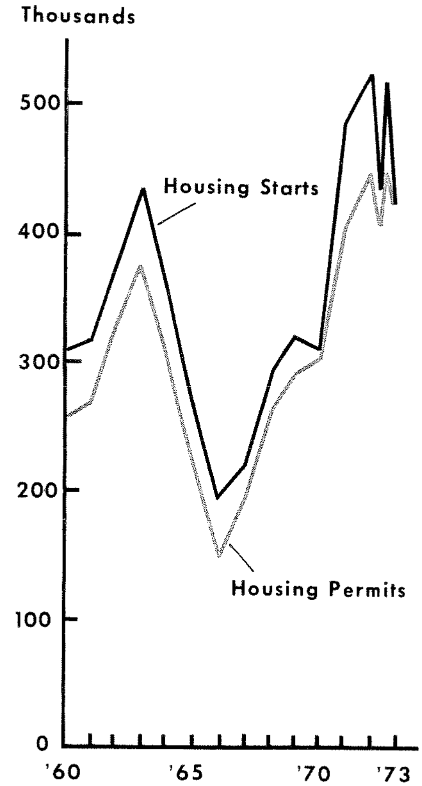
S&L's increased their mortgage portfolios by $1.1 billion during the third quarter, partly by reducing their cash and liquid investments, and partly by drawing on advances from the Federal Home Loan Banks and other borrowings. District banks increased their mortgage loans by $1.2 billion, with roughly three-quarters of the total in residential mortgages. Some individual banks became less willing to make mortgage commitments, especially for multi-family units, but banks generally did not curtail their lending.

Mortgage borrowing costs rose substantially during the summer quarter, reflecting both the contraction in savings inflows and the rising cost of funds associated with the mid-year increase in rate ceilings payable on savings. The average rate on conventional loans rose from about 8 percent in early June to almost 9½ percent in late September, even exceeding the rate increase reported nationwide. In October, however, a number of lenders began paring their lending rates—in some cases to 8½ percent on prime-quality homes—in response to a decline in money-market rates and an improvement in bank and S&L savings inflows.

Materials: short

Strong demand and upward price pressures characterized the markets for most Western-produced basic materials this summer and fall. The one major exception was forest products, and even there a shift is now in the wind. Lumber prices had advanced almost without interruption for 2½ years until last spring, but were already dropping from record levels when the 60-day freeze was imposed in mid-June, so that the Cost of Living Council felt safe in exempting the industry from Phase IV wage-and-price controls.

By October, wholesale prices for softwood lumber were almost 4 percent below their May peak, while softwood plywood prices were almost 37 percent lower. The turnaround was triggered by governmental actions to increase supply, and the price decline continued as housing activity slowed. However, the closure of six Oregon plywood mills in mid-October, due to a shortage of glues and fuels, touched off a wave of scare buying, and initiated a 30-percent surge in prices for key items within a month's time.



Regional housing activity shows decline, measured on any basis

Nonferrous-metals producers were prevented by price controls from raising their prices during this period, despite the worldwide boom in demand which sent foreign prices soaring well above U.S. producer quotations. The outflow of metal to overseas markets combined with production problems to create serious shortages, which in one case (zinc) forced a major steel producer to discontinue galvanizing operations. Fearful that supplementary supplies from the government stockpile would soon run out, producers asked Congress to authorize the release of additional stockpile metal, but passage of such legislation seemed remote because of national-security considerations.

Pacific Northwest aluminum producers were hard-pressed to meet customers' heavy demands because of a shortage of hydroelectric power. This drought-caused shortage forced a cutback in operations to 75 percent of capacity by mid-July. During the summer months, the domestic industry relied on government stockpile metal to meet 20 percent of customers' total requirements, but by November all of the aluminum authorized for sale had been withdrawn, pointing to even more serious supply problems in future months.

The Western steel industry experienced the highest third-quarter production levels in its history, as output surpassed the year-ago mark by 10 percent. The industry benefited not only from the strong demand for steel for non-residential construction, but also from a slowdown in the flow of foreign imports. Steel imports tapered off in response to the devaluation of the dollar and strong overseas demand, which induced Japanese producers to turn to other markets. Despite its improved balance sheet, the domestic steel industry was one of the first to receive permission to boost its prices after the freeze was lifted this summer. The Cost of Living Council supported industry arguments that a 4.8-percent increase in prices for sheet and strip items was justified on the basis of higher costs, as well as necessary to finance the new capacity required to prevent a future "steel crunch."

Western oil refineries boosted their operations to near-capacity levels during the summer and early fall, and thereby recorded a 7-percent year-to-year increase in output. Foreign crude flowed in at an increased rate after mid-April, when the Administration suspended oil-import quotas and removed existing tariffs on crude and products. These imports more than made up for the continued decline in domestically-produced crude.

Western refinery activity is bound to decline as a result of the Arab embargo on oil shipments to this country and related cutbacks in their shipments to other nations. Prior to the embargo, Arab states were supplying over one-third of the crude oil imported into the Pacific region, but supplies from Canada—another large exporter—also will be affected by the Arab moves.

The West thus will be confronted with severe problems because of the petroleum crisis, but it could also play a major role in the long-term solution of the crisis. On the consumption side, heating-oil problems could be less severe than elsewhere, at least partly because of the milder temperatures on the Pacific rim, where most of the region's people live. Gasoline may be a different matter, not only because Westerners rely almost completely on the private auto as a means of transportation, but also because Western driving involves much longer distances than driving elsewhere. On the production side, the crisis has already hastened Congressional acceptance of the Alaska pipeline, and it may also hasten the exploitation of Rocky Mountain coal and shale-oil resources, which up to now have lain idle because of both economic and environmental considerations.

Verle Johnston, Yvonne Levy and Dean Chen

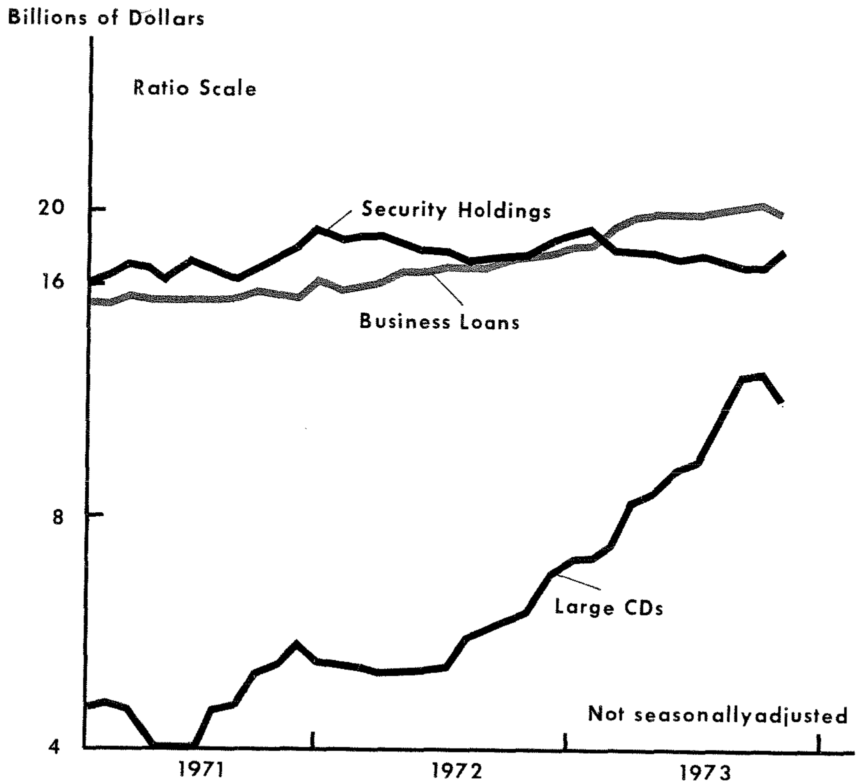
Fueling Bank-Loan Growth

Commercial banks, regionally as well as nationally, continued to meet heavy boom-level loan demands during the third quarter of the year. Money-market rates increased steadily, pushing bank costs for funds to record highs and posing problems of disintermediation. Banks also had to meet higher reserve requirements against demand deposits, as well as newly imposed marginal reserve requirements on certain of their deposit and non-deposit sources of funds. To counter these developments, banks made numerous increases in their prime business-loan rate, to a record 10 percent, and bid aggressively for large-denomination time certificates (CD's), and also for four-year certificates during the relatively brief period in which rate ceilings were removed on these deposit instruments.

In late September and October, however, there was evidence of some slackening in bank-credit demand. Money-market rates moved down from their record highs; also, banks bid less aggressively for funds and (in October) lowered their prime rate generally to 9¾ percent.

Loans at Western banks rose by $2.5 billion in the July-September period. This increase represented a 15-percent annual growth rate, slightly higher than in the previous three-month period but only half as large as the spectacular first-quarter gain. The regional loan expansion lagged somewhat behind the national pace during the summer period, reflecting a slowdown in business-loan growth which actually began as early as last May. On the other hand, mortgage lending in the West accelerated from an already rapid pace and contributed nearly half of the total third-quarter loan increase.

To accommodate these heavy loan demands, District banks reduced their holdings of Treasury securities by $800 million, but partially offset this reduction by adding $350 million in tax-exempt and Federal-agency securities. Banks also increased their borrowings from the Federal Reserve Bank and through repurchase agreements with corporations and public agencies. But the major source of funds for the third-quarter credit expansion came from a $2.1 billion increase in time deposits, mainly in large-denomination CD's.



Business loans finally level off at Western banks . . . security holdings increase, and CD upsurge tapers off

Deposits mixed

Total deposits at District member banks increased by $1.9 billion in the third quarter. This 11-percent annual growth rate was low only in relation to the exceptionally high rates recorded during the first two quarters of the year. Incidentally, it was somewhat greater than the third-quarter gain reported by banks elsewhere in the nation.

A decrease in the demand-deposit component was due to a large decline in U.S. Government deposits, as the Treasury ran down its balances to unseasonally low levels. As monetary pressures mounted, private demand deposits slowed to a 3-percent expansion rate, down from the high 12-percent rate of the January-June period. Even the time-deposit rise, at an 18-percent rate, represented some reduction from the first-half pace as banks began to feel the effects of disintermediation.

Individual deposit components moved in divergent directions, as is evident from an examination of unadjusted data for large District banks. By July and August, disintermediation at these banks was seen in a sharply higher outflow of passbook savings. Their third-quarter decrease amounted to $573 million, or several times larger than the normal seasonal decline reported during the preceding quarter. However, attrition at banks was relatively small compared with the withdrawal rate of savings-and-loan associations.

The more favorable bank experience was surprising, since many major banks retained a 4½-percent rate on savings instead of moving to the 5-percent ceiling permitted under Federal Reserve Regulation Q as of mid-year. However, most District banks increased rates on other consumer-type deposits to their higher ceilings, so that these time deposits rose $886 million in the quarter. Of this amount, over $200 million was in certificates with 4-year maturities—the "wild cards" which were freed from rate ceilings on July 1.

The volume of "wild card" deposits doubled, but this percentage gain was only one-fourth as large as the increase reported by banks elsewhere, perhaps reflecting the less-active bidding for such deposits on the part of Western banks. But these longer-term deposit instruments are now likely to become a less-important source of bank funds, in view of the 7¼-percent rate ceiling that was reimposed on November 1. During October, however, they grew rapidly in response to offering rates as high as 7½ percent.

The most significant change, however, was the $2.6-billion increase in large-denomination negotiable CD's. Last spring's removal of rate ceilings on such deposits permitted banks to bid competitively for corporate and other funds, in contrast to the situation in 1969 and early 1970, when severe attrition occurred because ceilings did not permit CD rates to rise as high as the rates offered on other money-market instruments.

Western banks were particularly aggressive in bidding for CD money during the July-September period; outstandings rose 28 percent in this period alone, substantially above the increase reported by large banks nationally. (But at the end of the quarter, CD's accounted for only one-fourth of time-and-savings deposits at District banks, compared with a one-third share nationally.) Some of the funds acquired through issuance of CD's served to offset the large $855-million decrease in deposits of states and political subdivisions—a somewhat greater-than-seasonal decline.

Record rates

Rising interest rates this summer presented banks with serious cost problems in the face of continued strong loan demand and a restrictive monetary policy. The Federal Reserve discount rate went to a record 7½ percent in mid-August, and the Fed-funds rate and CD offering rates reached 10½ percent or more at their September highs. Banks thereupon took a number of actions in the third quarter to increase their return on earning assets.

They made nine increases, of ¼ percentage points each, in the prime rate for large business borrowers, bringing this rate to a record 10 percent in mid-September. However, in line with the rate guidelines of the Committee on Interest and Dividends, banks made smaller adjustments in rates charged to smaller business customers. Fewer and smaller adjustments also were made in mortgage-loan rates and rates on consumer loans.

For many banks, their most important cost decision was a negative one—not to increase the rate paid on passbook savings to the 5-percent ceiling permitted under the revised Regulation Q. The cost reduction obtainable from maintaining a 4½-percent rate was quite substantial, since savings deposits at District banks exceed $21 billion.

The higher loan rates that were applied to the expanded loan volume produced increases in income for most Western banks, both before and after adjustment for securities transactions. But the wide variation in individual bank performance, already noticeable early in the year, was very marked during the third-quarter. During that period, some major banks recorded lower earnings, either because of special circumstances or because of large borrowings and heavy reliance on high-cost CD's.

Higher required reserves

Required reserves of District member banks rose by $219 million in the third quarter, to $5.7 billion, at least partly because of an increase of about $2.0 billion in deposits subject to reserves. In addition, reserve requirements against net demand deposits were raised by ½ percentage point in mid-July. Also, marginal reserve requirements (over a mid-May base) were imposed in June and early July on large-denomination CD's, as well as on funds obtained from sales of finance bills and funds obtained through issuance of holding-company commercial paper. A further increase in marginal reserve requirements became effective in early October.

As monetary policy became more restrictive, banks borrowed more heavily at the discount window to meet their reserve requirements. Borrowings from the San Francisco Federal Reserve Bank rose from $174 million in the second to $195 million in the third quarter. On the other hand, major District banks reduced their net purchases of Federal funds by about one-fourth to $275 million. (But these aggregate figures do not reveal the continued heavy reliance by some banks on the Fed-funds market as a source of borrowed funds.) Repurchase agreements with corporations and public agencies provided banks with their largest source of borrowed funds—over $2.3 billion, for a one-third increase over the prior quarter. (Data on reserves and borrowings are on a daily average basis.)

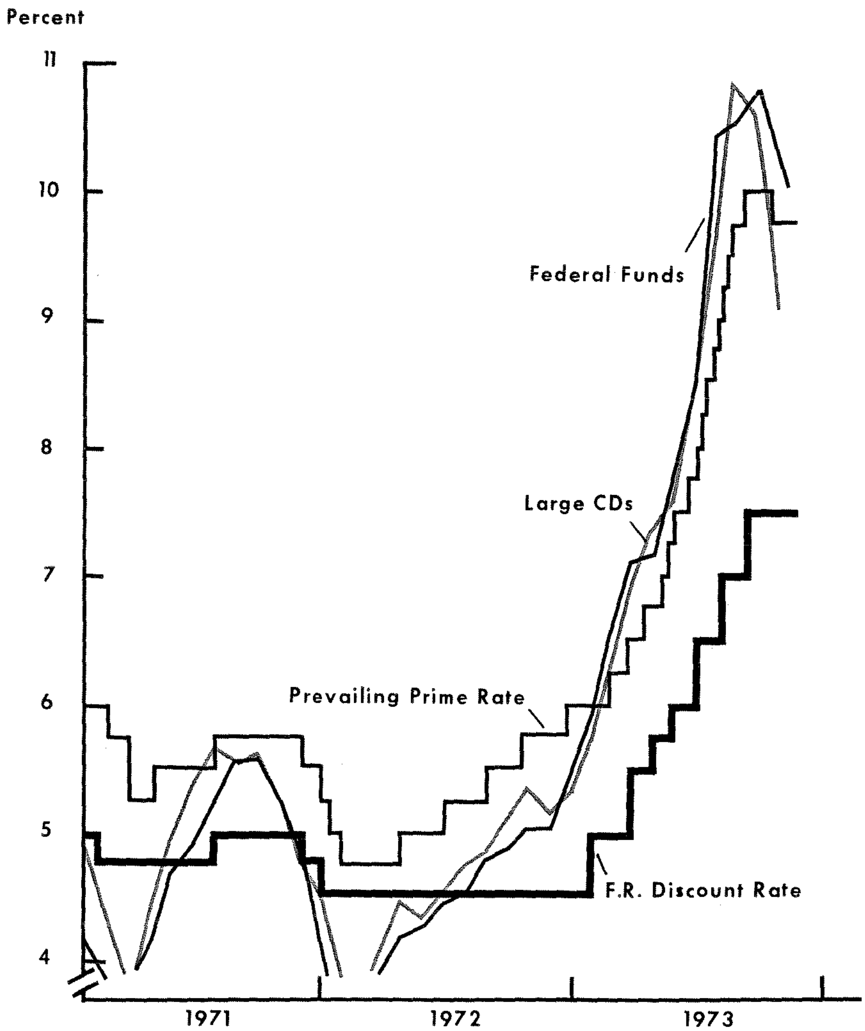
More favorable setting?

As the economy showed signs this fall of gearing down to a more sustainable rate of growth, loan pressure on banks abated somewhat, although pressure on reserves continued restrictive. It should be noted, however, that some of the recent slackness in business-loan expansion was due to the diversion of lending to the commercial-paper market which followed the drop in the paper rate below the banks' prime rate. In addition, some easing in term lending began to occur in the wake of heavier corporate borrowing in the capital markets. With business-loan volume declining and money-market rates falling, banks lowered their prime rate from 10 to 9¾ percent in late October, and some even went as low as 9½ percent.

Mortgage rates at some Western banks dropped from 9½ to 9¼ percent this fall. Although real-estate loans have continued to expand at a relatively rapid rate, a slowdown is expected as residential construction stays on its downtrend. Meanwhile, the high ratio of consumer debt to income apparently is being reflected in a reduced expansion rate in instalment credit. As overall loan demand eases, banks should be able to replenish their holdings of securities and improve the collateral-shortage problems that have been plaguing some of them in recent months.

District banks borrowed less from the San Francisco Reserve Bank in October, but they continued under reserve pressure with the Fed-funds rate holding around 9¾ to 10 percent. The threat of disintermediation lessened, and banks showed a small gain in passbook savings as well as continued expansion in consumer-type time deposits. In this situation, banks bid less aggressively for negotiable CD's, running off over $800 million in these deposit instruments. Banks' earnings prospects improved in October as the cost of CD money fell, but the picture clouded again during November's energy/ financial crisis, which saw money-market rates stiffening again.

Ruth Wilson



Bank borrowing costs decline (at least temporarily) in early fall, permitting drop in prime business-loan rate