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Review

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Inflationary Forces Prevail

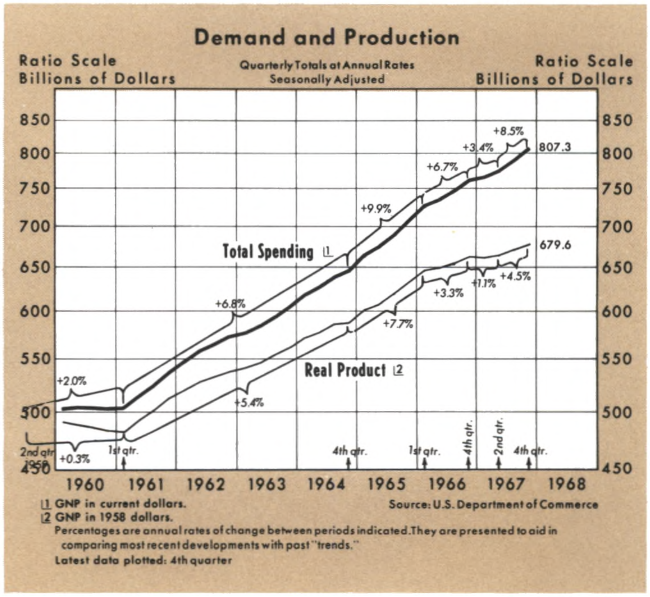
UNDERLYING ECONOMIC FORCES are strong, and economic activity continues to accelerate. Production has picked up since last spring but has lagged the growth in demand. In addition to pressure from excess demand, rising costs of production have contributed to rapidly rising prices. Monetary policy, which had been very stimulative in 1967, moved toward restraint early this year. However, fiscal actions have continued to be expansionary, and the prospect of larger than anticipated increases in defense spending threatens the economy with additional inflationary pressure.

Investment spending has shown the sharpest advance since mid-1967, with most of the rise being due to an expansion of inventories. Business fixed investment, which has increased since mid-1967 following a sluggish performance earlier in the year, is expected to accelerate in 1968. Consumer spending, while still moderate relative to gains in other years since 1961, has been adding to the demands on productive resources. Growth in demand for goods and services by the government sector has been rapid, and has contributed to upward pressure on prices by supplementing the buoyant private demand.

Output, Spending and Prices

Real product has increased at a 5 per cent annual rate since mid-1967, following a slowdown early last year. Much of the expansion in output has been due to inventory accumulation, which rose from near zero last spring to an annual rate of $9.2 billion in the fourth quarter. Investment in inventories early this year has been prompted to some extent by expectation of higher prices and anticipation of strikes in the steel industry this summer.

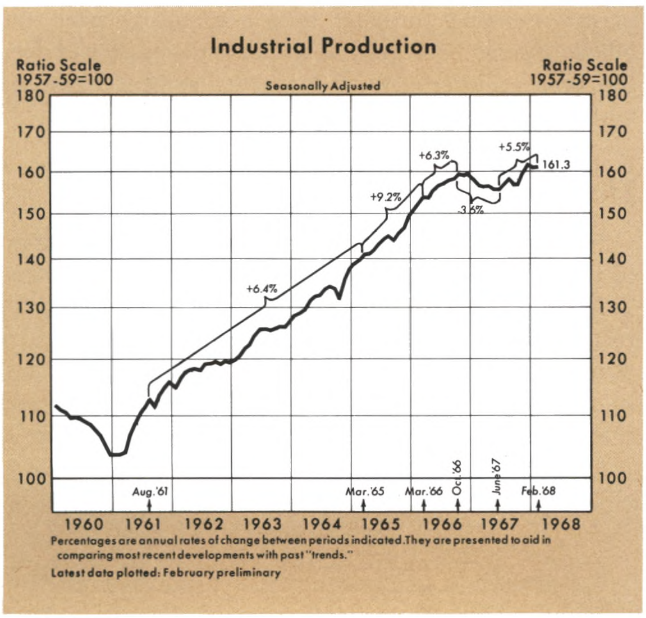
Industrial production increased at a 5.5 per cent annual rate from June to February, compared with a 4.6 per cent average gain from 1957 to 1967. Production moderated early this year because of strikes



and a probable reaction to the unusually rapid expansion of output in the last two months of 1967.

Employment has grown significantly as the pace of economic activity has picked up. Employment rose at a 4.0 per cent annual rate from last spring to February, following a 2.2 per cent rate of decline over the previous four months. Payroll employment, which was held down by strikes in the fall, has increased, on balance, at a strong 4.2 per cent rate since last spring. By comparison, population of working-force age has increased at an estimated 2 per cent annual rate.

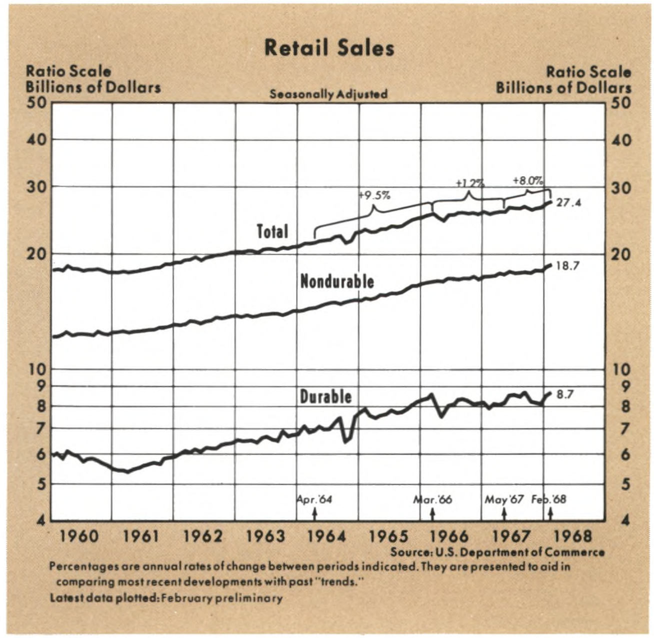
Personal income rose at a 9 per cent rate from spring to February, reflecting increasing employment and rising compensation. By comparison, income grew at a 6 per cent trend rate from 1957 to



1967. Recent growth in income has been reinforced by increased social security benefits as well as the general expansion in economic activity.

Consumer spending has advanced, in response to income growth. Households are still saving a relatively large portion of their take-home pay, but the recent rapid increases in income have allowed consumer spending to pick up. Retail sales increased at an 8 per cent annual rate from last spring to February, following little change over the previous year. Sales of durables were particularly strong early this year, partly as a result of purchases of automobiles which had been postponed earlier when availability was limited by strikes.

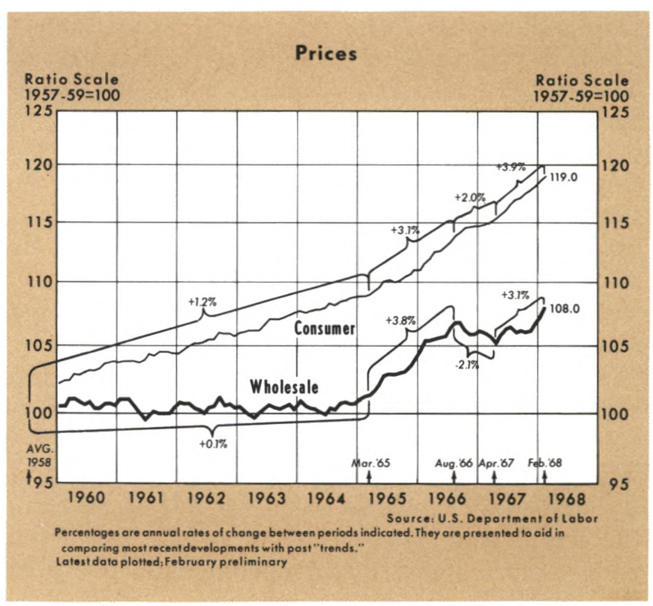
Acceleration of demand and increased costs have placed increasing upward pressure on prices since

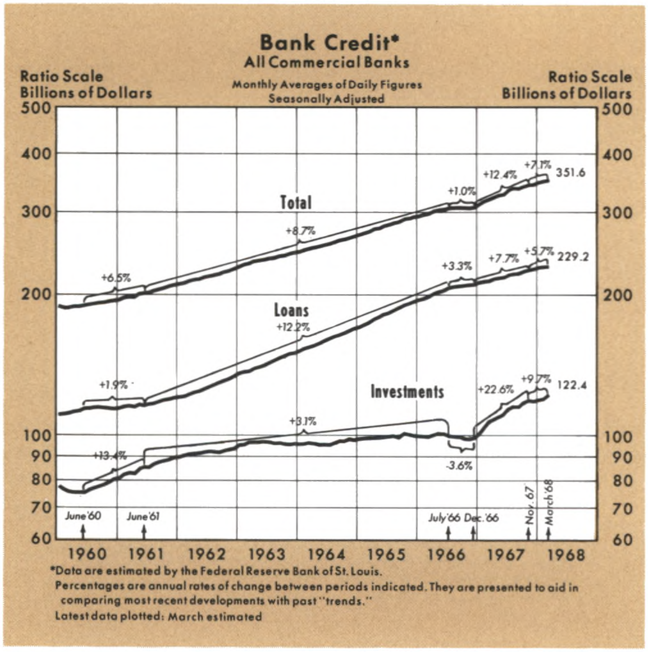


mid-1967. From last July to January, the prices of consumer commodities other than food increased at a 4 per cent rate, up from a 2.2 per cent rate of rise earlier in the year. Food prices, which had declined last fall, rose sharply in December and January. After changing little in the first seven months of last year, wholesale prices of industrial commodities rose at a 3.8 per cent annual rate from July to February.

Monetary and Fiscal Actions

Growth in most monetary aggregates has slowed during recent months as monetary policy shifted to-





*Data are estimated by the Federal Reserve Bank of St. Louis.
Percentages are annual rates of change between periods indicated. They are presented to aid in comparing most recent developments with past "trends."
Latest data plotted: March estimated

ward restraint. From November to March, the nation's money stock, currency held by the public plus private demand deposits, expanded at a 3.4 per cent annual rate, down sharply from the 8 per cent rate of increase over the previous ten months. Growth in bank credit has also slowed, increasing at an estimated 7.1 per cent rate over the four months ending in March. In contrast, bank credit rose at a 12 per cent rate from December 1966 to November of last year. The slowdown of bank credit over the recent four-month period was associated with a reduced rate at which banks purchased securities.

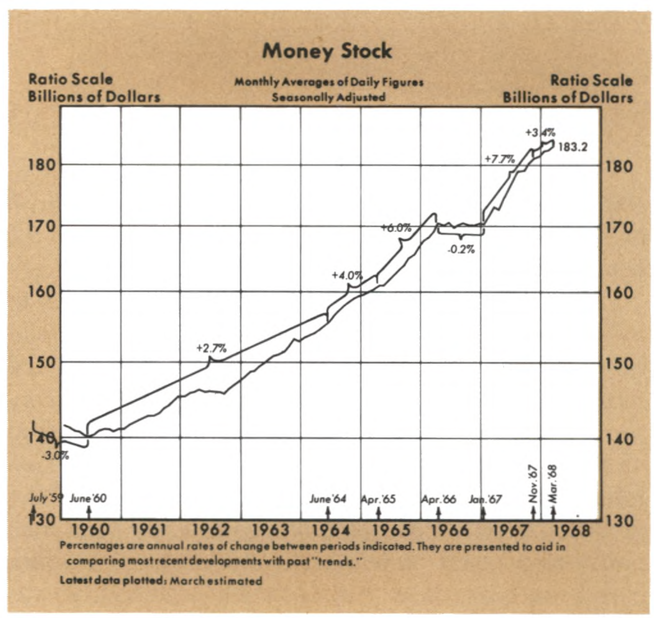
Fiscal actions continue to be a stimulative force on economic activity. The high-employment budget, which is a measure of discretionary government action, was in deficit at an annual rate of $11 billion in the second half of last year, little changed from the first half. The nature of fiscal policy in 1968 depends critically on whether the proposed tax surcharge is adopted and how closely Government expenditures are held to the levels proposed in the budget message. In the absence of a tax increase and with expenditures as proposed in the January budget message, the Government will continue to be as expansionary as in 1967. If defense spending increases beyond present projections, causing total Government outlays to rise, the surcharge would serve to offset some part of the impact of the increased spending, and on balance might do relatively little to moderate the expansionary nature of fiscal actions. A move to reduce expenditures would reinforce the restrictive effect of the income tax surcharge.

The moderation of monetary expansion was primarily designed to curb domestic inflation, but it was also timed to improve international confidence in the dollar. The heavy speculative demand for gold in Europe during the first half of March was based on expectation that the price of gold was likely to rise.

In an attempt to prevent the speculative demand for gold from upsetting the international monetary mechanism, the London Gold Pool[1] agreed in Washington on March 17 to allow the private price of gold to seek its own level, while the U.S. reiterated its pledge to maintain the price of gold at $35 an ounce to foreign central banks. This was designed to insure that the present monetary gold stocks of the world's central banks would continue to be valued at $35 an ounce, and thus assure that the international money supply would not be upset by a change in the commodity price of gold. It is hoped that separating the private demand for gold as a commodity from the official demand for gold as a monetary asset will free the present international monetary system from the major shocks of private speculation.

The Composition of Demand

There have been marked shifts in the composition of demand for goods and services in the period since 1965. Reflecting the war in Vietnam, the portion of resources allocated to government use has risen sharply. Investment spending as a portion of GNP fell sharply in the first half of last year but has increased since. On balance, consumers have accounted for a



Percentages are annual rates of change between periods indicated. They are presented to aid in comparing most recent developments with past "trends."
Latest data plotted: March estimated

[1]Belgium, Great Britain, Italy, Netherlands, Switzerland, United States, and West Germany.

declining portion of total spending since 1965.

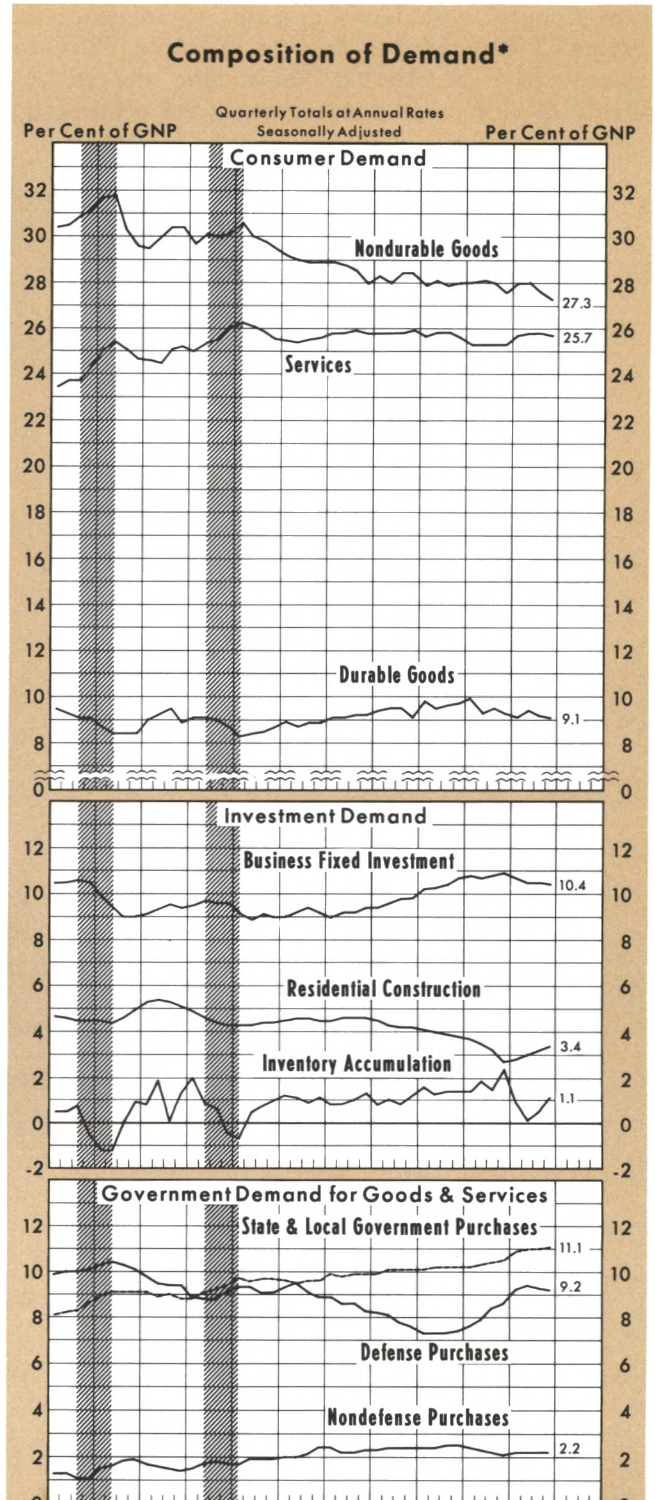
The expansion of inventories since mid-1967 is in line with average performance over the period from 1961 to 1965. In the fourth quarter of last year inventory accumulation accounted for 1.1 per cent of GNP, the same as the average share over the period from 1961 to 1965. This is in contrast to late in 1966, when a rapid and unsustainable inventory build-up accounted for a 2.4 per cent of total spending.

The pattern of other investment spending relative to GNP has also shifted since 1966. Expenditures for plant and equipment averaged 9.1 per cent of total spending from 1960 to 1963. Businesses began to accumulate fixed capital at a rapid rate in 1964, and this share rose to almost 11 per cent by 1966. The sharp addition to capacity became excessive as total demand slowed in late 1966 and early 1967. Fixed investment then moderated, and the share of GNP allocated to plant and equipment fell to 10.4 per cent by the fourth quarter of last year.

In contrast to fixed investment, the share represented by residential construction began to decline early in 1964, after averaging 4.5 per cent of total spending over the period from 1960 to 1963, and reached a low of 2.7 per cent of GNP late in 1966. Homebuilding expanded last year and by the fourth quarter accounted for 3.4 per cent of total spending.

Consumer durables accounted for an increasing share of GNP from early 1961 to early in 1966, rising from 8.3 in the first quarter of 1961 to 9.9 per cent in the first quarter of 1966. As prices began to accelerate, consumer spending for durables moderated. Since early 1966 durables have declined as a portion of total spending, falling to 9.1 per cent by the fourth quarter of last year. Consumer nondurable purchases have declined relative to GNP since early 1961, falling from 30.6 per cent in the first quarter of 1961 to 27.3 per cent in late 1967. The share going to services has changed little since 1960 and remains near 25.5 per cent.

As defense spending accelerated after mid-1965, the portion of resources allocated to defense rose sharply from 7.3 per cent in the second quarter of 1965 to 9.4 per cent in the second quarter of 1967. Growth in defense spending has moderated since early last year, and defense expenditures as a portion of total spending have declined slightly. The portion of demand accounted for by defense is small relative to the Korean War period when defense claimed as much as 13.5 per cent of GNP. Federal nondefense purchases of goods and services have changed little relative to total spending since 1960, accounting for about 2.3 per cent of GNP. Spending by state and local government accounted for a fairly stable portion of demand from 1960 to 1965. The share increased from 10.2 per cent in early 1966 to 10.9 per cent a year later, and has changed little since.



*Based on GNP in current dollars.
Basic data source: U.S. Department of Commerce
Shaded areas represent periods of business recession as defined by the National Bureau of Economic Research.
Latest data plotted: 4th quarter 1967

Summary

Following a period of adjustment in early 1967, private demand for resources has expanded at a rapid rate. Coupled with heavy defense requirements, the expanded demand has become excessive. Price increases have accelerated, threatening the sustainability of current economic growth and contributing to a weakening of the position of the U.S. economy in the international market.

The excessive demands were fostered by stimulative monetary and fiscal developments. In recent months monetary expansion has slowed, and now serious consideration is being given to adopting more restrictive fiscal actions.

Member Bank Income and Expenses--1967

NET INCOME at member banks in the Eighth District continued to increase in 1967, although less rapidly than in 1966. Net income after taxes rose 8 per cent for the year compared with a 14 per cent increase a year earlier and an average annual rate of gain of 7 per cent during the 1957-67 period.

Total operating revenue rose 13 per cent in 1967, reflecting both a larger volume of earning assets and a somewhat higher average rate of return on these assets. Expenses were up 16 per cent, with the greatest increase being interest payments on time and savings deposits. Net current earnings (operating revenue less operating expenses) rose only 4 per cent. However, the net effect of security transactions was more favorable than a year earlier, resulting in net income being up more than net current earnings.

Net income after taxes at all member banks in the nation rose 18 per cent, a much greater increase than at district banks. Gains in net current earnings at banks in the district were not greatly different from member banks in the nation, rising 4 per cent and 5 per cent respectively. A major factor in the more rapid gains in after-tax income at banks in the nation was the handling of valuation reserves and gains or losses on security transactions. While recoveries, transfers from valuation reserves, and profits on security sales rose 24 per cent from the previous year at banks in the nation, such adjustments fell 21 per cent at district member banks. Losses, charge-offs, and transfers to valuation reserves declined about one-fifth from the previous year in both the district and the nation.

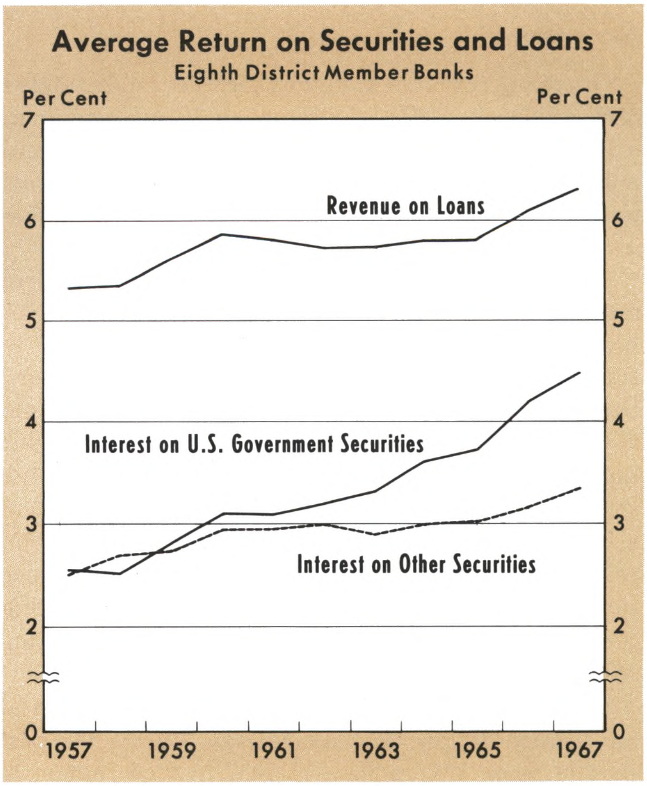


Table 1

REVENUES AND EXPENSES OF EIGHTH DISTRICT MEMBER BANKS

	Millions of Dollars				Per Cent Change		Annual Rate
	1967	1966	1965	1957	1966-67	1965-66	1957-67
Revenue on loans	374.2	334.3	287.4	140.8	11.9	16.3	10.3
Interest on securities							
U. S. Government	82.7	75.7	69.6	47.6	9.2	8.8	5.7
Other	53.4	43.5	36.7	12.7	22.8	18.5	15.4
Service charges on deposit accounts	20.5	18.6	16.9	9.3	10.2	10.1	8.2
Trust department	16.8	15.1	13.8	6.6	11.3	9.4	9.8
All other revenues	18.1	15.1	11.0	10.2	19.9	37.3	5.9
Total Operating Revenues	**565.7**	**502.3**	**435.4**	**227.2**	**12.6**	**15.4**	**9.6**
Salaries, wages, and benefits	132.4	118.8	109.0	63.7	11.4	9.0	7.6
Interest on time deposits	171.8	138.4	114.2	22.6	24.1	21.2	22.5
Other expenses	113.8	102.8	87.1	50.7	10.7	18.0	8.4
Total Operating Expenses	**418.0**	**360.0**	**310.3**	**137.0**	**16.1**	**16.0**	**11.8**
Net Current Earnings	**147.7**	**142.3**	**125.1**	**90.2**	**3.8**	**13.7**	**5.1**
Recoveries, transfers from reserves, and profits	16.0	20.2	18.1	5.2	−20.8	11.6	11.9
Losses, charge-offs, and transfers to reserves	35.5	45.2	36.9	16.7	−21.5	22.5	7.8
Net Income (Before Income taxes)	**128.2**	**117.3**	**106.3**	**78.7**	**9.3**	**10.3**	**5.0**
Taxes on net income	36.1	32.1	31.3	33.1	12.5	2.6	0.9
Net Income (After Income taxes)	**92.1**	**85.2**	**75.0**	**45.6**	**8.1**	**13.6**	**7.3**
Cash dividends on common stock	35.0	32.8	30.9	18.2	6.7	6.1	6.8
Interest on capital notes and debentures[1]	2.0	1.9	1.4	*			
Number of banks	478	480	483	491			

[1]Includes small amount of cash dividends on preferred stock.
*Less than 0.05

Revenues

Operating revenues at district member banks totaled $566 million in 1967, an increase of 13 per cent from a year earlier. Major factors influencing this rise were a substantial increase in loans and state and local government securities, along with a slightly higher average rate of return on earning assets.

Although total revenue increased somewhat more rapidly than loan revenue, the latter accounted for nearly two-thirds of the dollar amount of increase in total revenue from a year earlier. Revenue from securities other than U. S. Government securities (mostly issues of state and local jurisdictions) was the most rapidly rising source of revenue. Income from these sources rose 23 per cent from a year earlier and accounted for almost one-sixth of the gain in total revenue at district member banks. Miscellaneous revenue rose 20 per cent from a year earlier, reflecting the broader range of non-lending services being offered by commercial banks.

Operating revenues at district banks have risen at an average 10 per cent annual rate during the past decade, from $227 million in 1957 to $566 million in 1967.[1] In addition to an increase in total assets of these banks, the growth in revenue reflects a marked rise in the general level of interest rates, and a shift in the composition of assets, to relatively more of the higher earning types.

Largely as a result of national monetary expansion, total resources of district member banks grew from $6.6 billion in 1957 to $11.9 billion in 1967, an average annual increase of 6.1 per cent. Reflecting a slight decline in the proportion of assets in cash balances, earning assets grew somewhat more rapidly, from $5.0 billion in 1957 to $9.4 billion in 1967, a 6.4 per cent rate.

In addition to the growth in earning assets, banks have enhanced operating revenues by adjusting the composition of their portfolios to include proportionately more of the higher earning types of assets. Bank holding of U. S. Government securities dropped from 28 per cent of assets in 1957 to 16 per cent in 1967.

[1]These data do not take into account changes in total number of banks, resulting from new member banks, withdrawals from membership, mergers, etc. The effect of such changes in the totals shown would be very minimal.

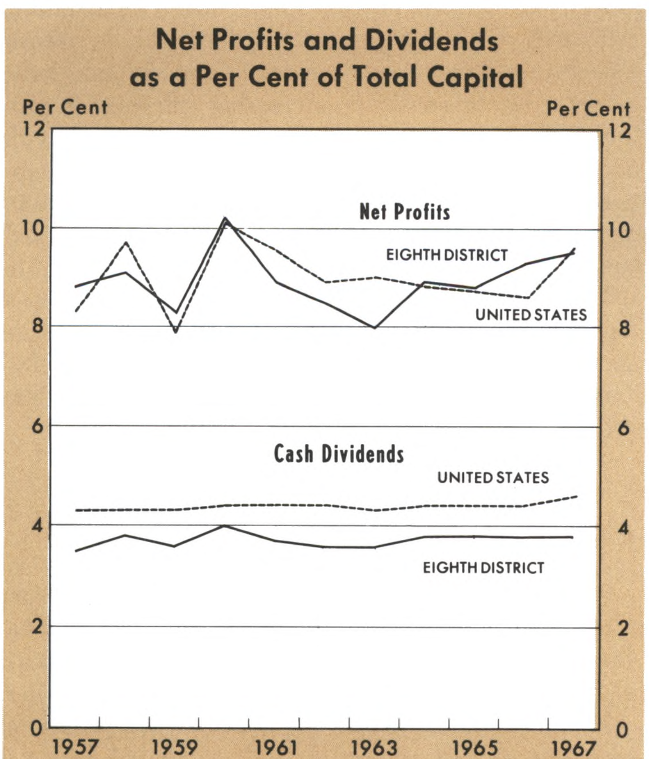
Meanwhile, loans rose from 40 per cent to 50 per cent of assets, and "other" securities (mostly tax exempt issues of state and local governments) rose from 8 to 13 per cent.

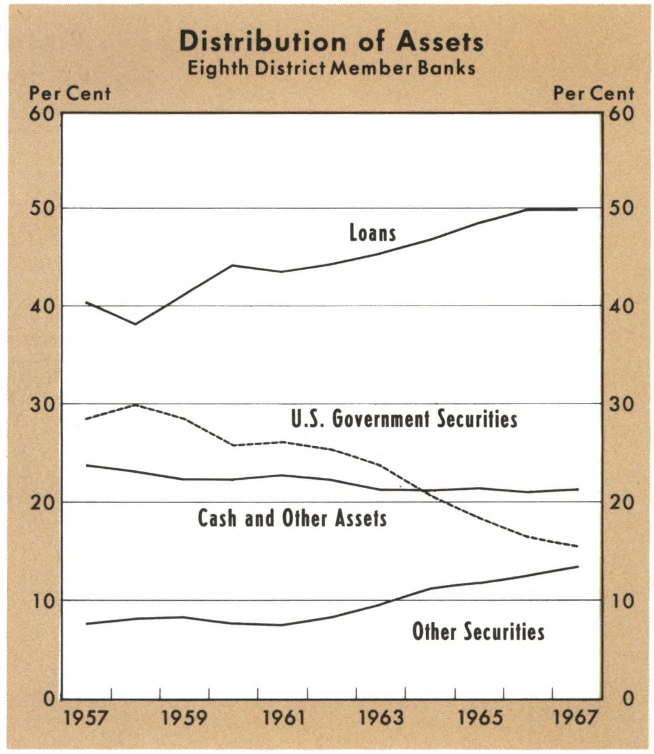
A major factor tending to increase revenues of banks during the past decade was the upward trend of interest rates. The average return on bank loans increased from 5.3 per cent in 1957 to 6.3 per cent in 1967. Meanwhile, the average return on Government securities rose from 2.6 per cent to 4.5 per cent.

Greater interest and fees charged on bank loans have accounted for a major portion of total bank revenue growth during the past decade. From $141 million in 1957, or 62 per cent of the total, revenue from loans rose to $374 million in 1967, or 66 per cent of the total. Returns on loans increased at an average annual rate of 10 per cent during the period.

The most rapidly growing source of revenue over the past decade has been interest on securities other than U. S. Governments. Revenue from these securities rose from $13 million in 1957 to $53 million in 1967, an average annual increase of 15 per cent.

Although revenue from U. S. Government securities has continued to rise during the past decade, such revenue has declined as a proportion of total revenue. Interest on Government securities was $48 million in 1957, 21 per cent of total revenue, while in 1967 such revenue was $83 million, 15 per cent of the total. From 1957 to 1967 such revenue rose at an annual rate of 6 per cent.



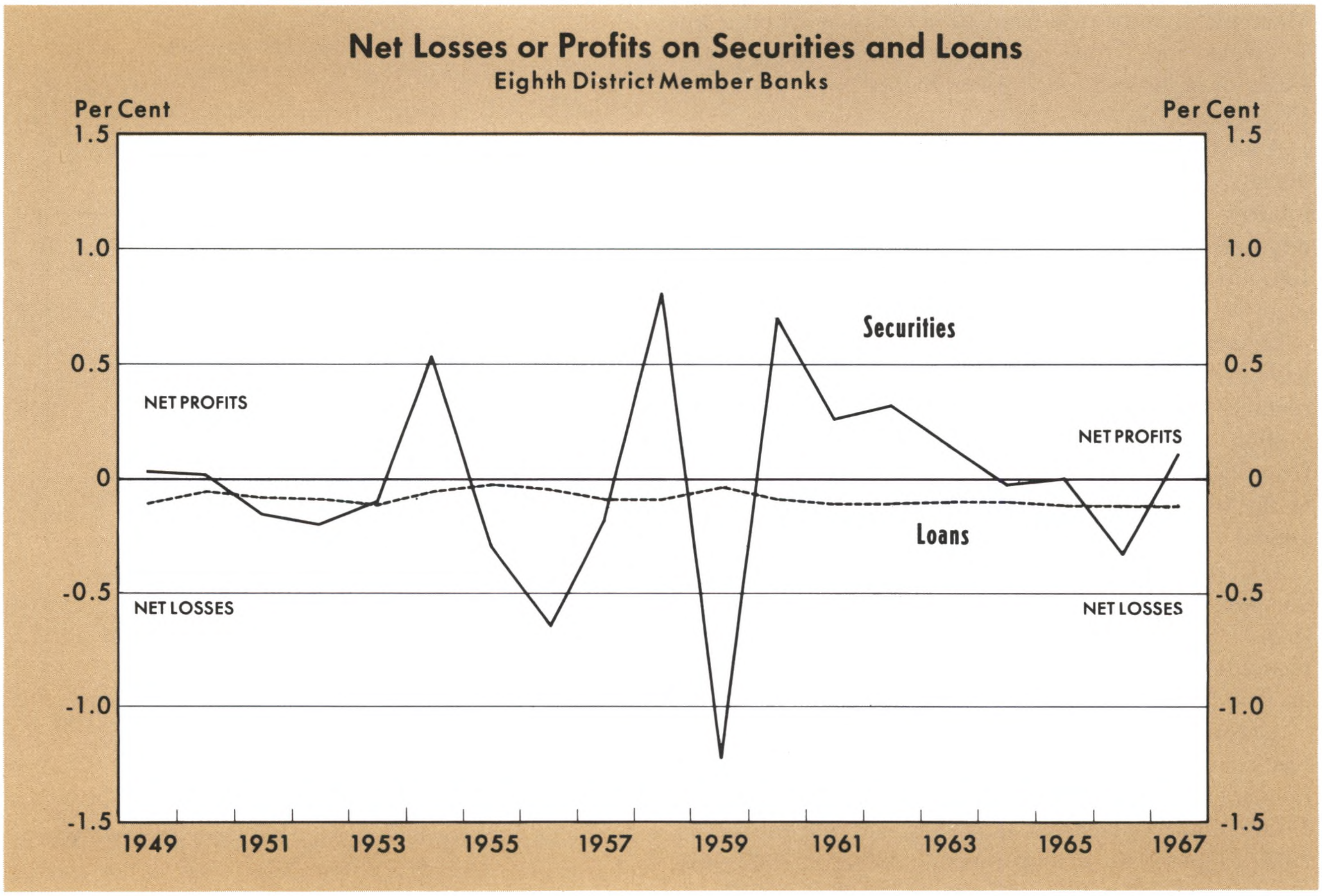


Income from sources other than loans and investments has also grown during the past decade. Service charges on deposit accounts have risen at an average annual rate of 8 per cent since 1957, and trust department earnings at a 10 per cent rate. Revenue from all other sources showed very little net increase from 1957 through 1965. In the past two years however, such miscellaneous revenue has expanded rapidly, rising 37 per cent in 1966 and 20 per cent in 1967.

Expenses

Operating expenses at district member banks totaled $418 million in 1967, an increase of 16 per cent from the previous year (Table I). As in most other recent years expenses grew at a more rapid rate, although by a smaller absolute amount, than revenues. Reflecting both the rising interest rates and growth in time and savings deposits, interest paid on time and savings deposits was the most rapidly rising major expense item from 1966 to 1967, increasing 24 per cent. Wages, salaries, and employee benefits rose 11 per cent, as did all other expenses.

Over the past decade operating expenses increased at a high annual rate, but somewhat less than the rise last year. Since 1957 operating expenses of member banks in the district have risen from $137 million to $418 million, an average annual rate of increase of 12 per cent. A sharply rising volume of time and savings deposits and an upward trend in interest rates paid



on these accounts have resulted in interest expense accounting for a major portion of the rise in bank operating expenses.

Reflecting the generally rising demand for loanable funds and the competition of financial agencies to obtain such funds, interest paid by banks has increased sharply during the past decade. Interest expense rose from $23 million in 1957 to $172 million in 1967, an increase of 23 per cent per year. The volume of time and savings accounts at district banks rose from $1.3 billion in 1957 to $4.2 billion in 1967, or 12 per cent per year, while the average rate paid on these accounts rose from 1.68 per cent to 4.07 per cent.

Other major expense items have increased, but less rapidly than interest expense during the past decade. Salaries, wages, and fringe benefits rose at an average annual rate of 7.6 per cent, and all other expenses rose at an 8.4 per cent rate.

District member banks have made sizable gains in the efficient use of labor resources. The number of bank employees in the district has increased less rapidly than either bank assets or loans. Since 1957 the number of employees has dropped from 2.5 per $1 million total assets to 1.8 per $1 million assets last year. Relative to loans the decline has been even greater. In 1957 member banks in the district employed 6.2 persons per $1 million loans outstanding, compared with 3.7 persons in 1967. These trends reflect some gains in economies of scale as banks have grown. Also, there was an increasing efficiency in performing the numerous clerical tasks associated with bank operations, resulting in part from increased adaption of electronic data processing equipment in banking. Reflecting these developments, furniture and equipment expense increased from $5.8 million in 1961 (the first year such expense was reported as a separate item) to $15.3 million in 1967, an average annual increase of 17.5 per cent. Of those expense items reported by banks, only interest expense on time and savings deposits rose more rapidly.

Net Losses on Loans and Securities

Actual losses on loans at district member banks totaled $7 million in 1967, about unchanged from the previous year. The ratio of net losses to total loans was 0.12 per cent, a slight decline from a year earlier.

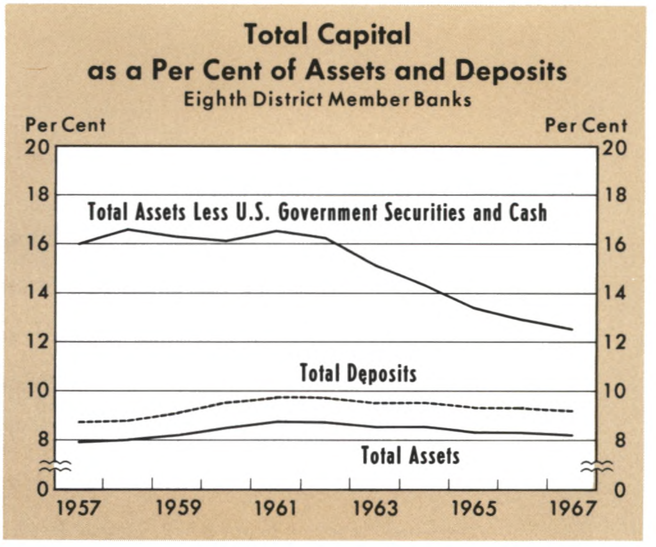
District member banks experienced net profits on securities of $3.8 million in 1967, compared with net losses of $11 million in 1966. Several factors contributed to these gains on securities sold. The demand for loans at commercial banks in 1967 was somewhat weaker than in 1966. Consequently, there was less need to sell securities to meet loan demands. In addition, 1966 was a year of depressed securities prices, and banks could take losses which are often favorable on after-tax income. In much of 1967 securities prices were rising, and loss-taking opportunities were not so prevalent.

Net Earnings and Income

Net current earnings of member banks in the Eighth District totaled $148 million in 1967, an increase of 3.8 per cent from a year earlier (Table I). This was somewhat below the average annual increase of 5.1 per cent during the 1957-67 period. The effect of adjustments for net losses, charge-offs, and transfers to valuation reserves, however, was more favorable in 1967 when net current earnings were reduced only $19.5 million, compared with a $25 million reduction in 1966.

Net income before taxes totaled $128 million, an increase of 9 per cent over $117 million in 1966. Income taxes rose 13 per cent from the previous year. In addition to the moderate rise in net current earnings, the larger tax payments reflected net profits on security sales, compared with large losses on such sales in 1966.

Net income after taxes at district member banks totaled $92 million in 1967, an increase of 8 per cent and slightly above the trend rate of 7.3 per cent per year during the past decade. In comparison, net income after taxes at all member banks in the nation has risen at an 8.4 per cent rate since 1957. Net after-tax income relative to capital accounts was 9.5 per cent in 1967, compared with 9.3 per cent a year earlier. During the past decade the ratio of profits to capital at member banks in both the district and the



nation has been in the 8-to-10 per cent range.

Member banks in the Eighth District distributed dividends on common stock of $35 million in 1967, an increase of 6.7 per cent from the previous year. Net retained earnings at these banks totaled $55 million. These undivided profits are the primary source of increased capital in banks. In addition, member banks in the district sold $3.9 million in capital notes and raised $3.2 million of other capital, for a net increase in capital of $62 million, 6.7 per cent above year-end 1966.

Conclusions

The operations of member banks in the district showed somewhat mixed results for the year 1967. Net operating earnings rose somewhat less rapidly than the average rate of gain for the past decade. Although after-tax income of these banks rose 8 per cent, this was considerably less than the 18 per cent gain experienced by all member banks in the nation. Net income relative to capital accounts was 9.5 per cent in 1967, compared with 9.3 per cent in 1966.

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