Federal Reserve Bank of San Francisco

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Business Review

Monetary Policy: A Letter

... Chairman Burns examines the record of monetary policy, in a letter to Senator Proxmire.

Weakening Boom?

... The Western boom showed signs of weakness even before the onset of the energy crisis.

Fueling Bank-Loan Growth

... Third-quarter loan upsurge helped by sell-off of securities and by expansion of CD funds.

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Weakening Boom?

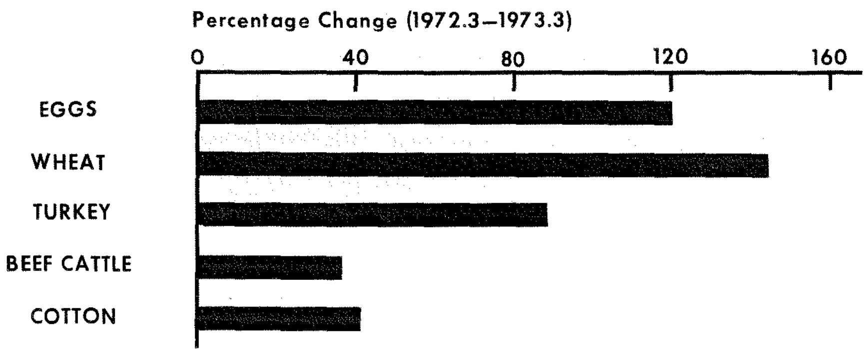
The Western boom continued during the summer and early fall months, helped along by the upsurge in the farm sector and in the export trade. At the same time, production became seriously strained by shortages of fuels and other basic materials. A slowdown in employment growth reflected some of these supply 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

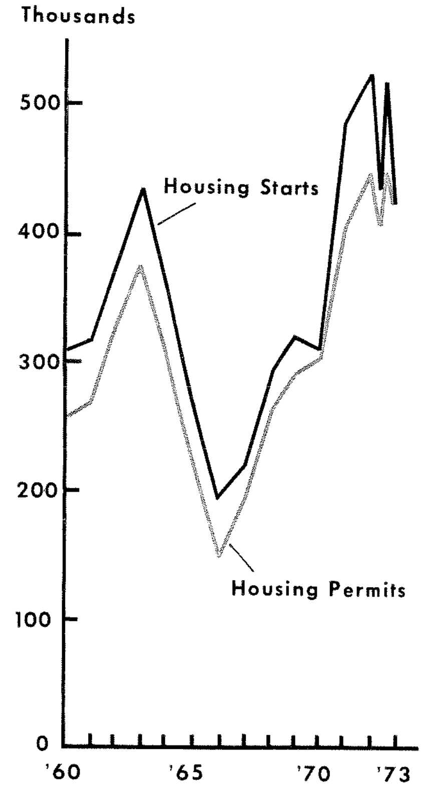
S&L's increased their mortgage portfolios by $1.1 billion during the third quarter, partly by reducing their cash and liquid investments, and partly by drawing on advances from the Federal Home Loan Banks and other borrowings. District banks increased their mortgage loans by $1.2 billion, with roughly 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 world-wide 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.

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