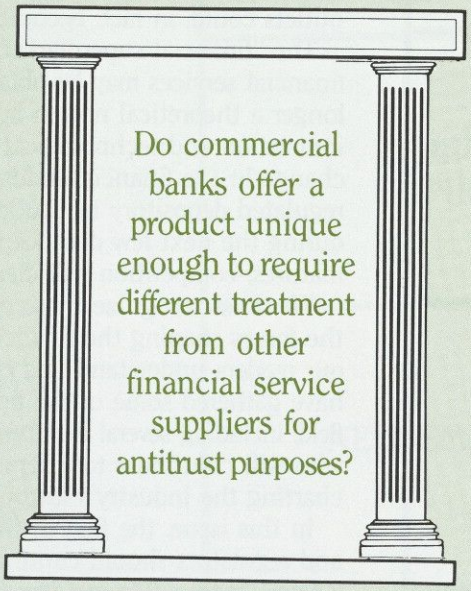
INTRODUCTION

In the financial services industry, major changes in legislation usually follow convulsion or revolution from within the industry. The industry's convulsion during the Great Depression of the 1930s brought a wave of federal legislation establishing a set of specialized financial institutions which were segmented by product and by geographic markets. Today this product and market segmentation still exists, but a new revolution within the financial services industry has stimulated the passage of new federal legislation and the introduction of still more legislation with the potential to eliminate the segmented structure of the industry, established five decades ago.

Demanders of financial services are pushing suppliers into expanding the services they provide, and into finding new and innovative means to supply those services. The new services demanded generally cannot be provided by any single supplier under regulations established in the 1930s. As a consequence, financial suppliers are revolting against the product constraints imposed by outdated regulations.

Antitrust laws have allowed the courts to further shape the financial services industry into an industry segmented by types of products. A key to this segmentation was the Supreme Court's 1963 decision establishing commercial banking as an industry offering a unique product, a line of commerce separate and distinct from that produced by any other suppliers of financial services. Commercial banking, in other words, was a separate "line of commerce." Then, through application of the antitrust laws, the courts were able to mandate that there would be a large number of competitors not only within the commercial banking segment, but within each of the other segments as well. Today we find more than 40,000 suppliers of various types of financial services.

The purpose of this issue of the **Economic Review** is to summarize and evaluate a longstanding controversy—do commercial banks offer a product unique enough to require different treatment from other financial service suppliers for antitrust purposes? Should commercial banks be treated as a separate industry rather than as part of the much larger financial services industry for antitrust purposes? The answers will determine how the financial industry is likely to evolve in this country during the next few decades.



If the courts continue to treat commercial banking as a separate line of commerce, we will see a continuation of our fragmented financial services industry. On the other hand, if the courts decide that commercial banks produce a product which is not unique, but rather is available through many other types of financial firms, the result will be a broadening of the product definition.

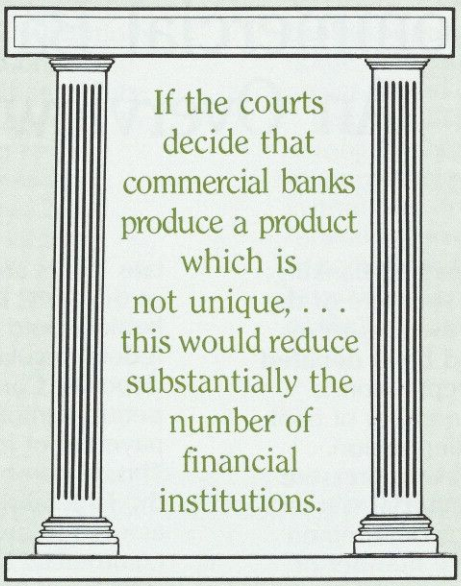
Ultimately this would reduce substantially the number of financial institutions, with each of the future institutions potentially offering the same array of services. This development may come either through new legislation or through redefinition of the line of commerce by the courts, or by some combination of the two.

The passage of the Monetary Control Act of 1980 (MCA) is evidence that Congress perceives a need to reevaluate the existing statutory restrictions on financial service suppliers in light of changing market forces. Legislation passed in the next few years will shape the financial services industry, perhaps for decades into the future. The relevance of commercial banking as a separate

line of commerce stands at the center of the struggle.

Federal Reserve Bank of Atlanta senior financial economist **David Whitehead** begins with a brief overview of the important forces which have shaped the financial services industry during the past five decades. He also sets the stage for the current controversy by describing the major forces changing the industry today. **George Benston**, economics professor at the University of Rochester and Visiting Scholar at the Atlanta Fed, offers an intriguing alternative to the standard explanation for the wave of financial legislation in the 1930s. This legislation was not so much a result of fears about the financial system's safety, Benston argues, as it was a product of the self-interest of the suppliers of financial services.

Section one reviews the legal, legislative, and regulatory history of the line of commerce approach. **Doug Austin**, president of Financialysts, Inc., traces the concept back to 1963, when the Supreme Court surprised the financial world by applying antitrust laws to commercial banking. Since then, the Court has held fast to the idea that the "cluster" of services offered by commercial banks was sufficient to separate commercial banking's product from the products of other financial service suppliers.



Robert Eisenbeis, Wachovia Professor of Banking, University of North Carolina at Chapel Hill, and Visiting Scholar at the Atlanta Fed, outlines the slightly different approaches taken by the various regulatory agencies on the line of commerce question. Despite the recent "revolutionary" changes in the financial marketplace, Eisenbeis concludes that, for commercial customers, commercial banks' cluster of services is as unique today as it has ever been. Thus, as long as the courts continue to direct antitrust action toward the protection of customer classes rather than toward competitors, they are not likely to change their basic opinion on the uniqueness of the commercial banking product.

In section two, we examine the economic rationale for the line of commerce argument. **Ira Horowitz**, Graduate Research Professor of Management at the University of Florida, evaluates the theoretical foundations for defining banking as a separate line of commerce. The courts' definition hinges on the fact that third party transactions accounts are a monopoly product offered in a clustered group of products. Horowitz concludes that the courts were on firm theoretical grounds, if banks in fact tie a group of services together.

B. Frank King, research officer at the Federal Reserve Bank of Atlanta, reviews the economic literature on whether or not these clusters of services actually exist. Although much existing evidence is dated, economists increasingly are recognizing the significance of nonbank alternatives for each kind of financial service offered by commercial banks. Competition between banks and nonbank suppliers has intensified. Evidence on the "clustering" issue, however, is just beginning to come in.

Section three presents three new studies aimed at the crucial "clustering" question. An Atlanta Fed survey of small businesses indicates that small businesses do indeed perceive the commercial bank product as a cluster of services. **Bill Cox**, associate director of research at the Atlanta Fed, approaches the question differently with a survey of price competition between southeastern banks and thrift institutions. His study suggests that banks do not price their NOW accounts, six-month money market certificates, or small savers certificates as if thrift competition matters.

In the third article, **Cynthia Glassman**, economist with the Federal Reserve Board, reports on an interagency survey of lending officers at commercial banks. The survey's findings suggest that nonbank suppliers of financial services are becoming more important and competition is intensifying, but that banks generally do not perceive nonbank sources to be active lenders to small businesses.

A concluding article presents policy recommendations based on the evidence compiled in this special issue of the **Review**.

THE DEFICIT
Some Reasons to

Today there is widespread concern about the effects of large and persistent federal budget deficits on our economy. That concern has recently produced dramatic swings in financial markets. News implying reduced borrowing by the Treasury has pushed market interest rates down, while information to the contrary has provoked upward rate movements. Similar sensitivity persists in Washington, where there is a consensus that reduced deficits are a highly important economic objective, even though there is considerable disagreement about how to achieve such reductions. Public opinion polls reflect widespread belief that borrowing to finance federal deficits operates to "crowd out" private borrowing.

So it is, to say the least, an important subject. For this special issue of our **Economic Review** we have compiled a series of research papers on the economic consequences of federal budget deficits. To lead off, **James R. Barth,** visiting scholar at the Federal Reserve Bank of Atlanta and economics professor at George Washington University, and **Stephen Morrell,** financial economist with the Atlanta Fed, present a primer on the subject of federal budget deficits, describing how they are derived and measured. During the first 140 years of the Republic, they show, the U. S. budget was in the red only 32 percent of the time, while the half century from 1931 to 1981 produced deficits 84 percent of the time. The size and persistence of today's deficits, and of those being forecast for the years ahead, are well outside the general historical experience of the United States.

The mere size and growth of deficits, however, may not always provide an accurate assessment of their effects. Deficits are countercyclical, since both tax revenues and federal spending under entitlement programs vary countercylically. Much of the deficit can be attributed to changes in the business cycle, quite aside from legislative changes. Recognizing this, Morrell uses statistical techniques to separate the growth of the inflation-adjusted deficit into that associated with the deviation of output from its trend growth and that caused by current legislative action. Since deficits arising from a weak economy are usually accompanied by falling private credit demands, while those resulting from noncylical changes may not be, Morell finds that weak-economy deficits have not generally produced upward interest rate pressures whereas strong-economy deficits sometimes have produced such pressure.

Gerald Dwyer, visiting scholar at the Atlanta Federal Reserve and economics professor at Emory University, next examines the relationship between deficits and inflation. After examining the channels through which deficits can contribute to inflation, Dwyer applies tests of causation to evidence on the deficit-inflation relationship. His analysis suggests that, in the past, knowledge of the deficit would not have helped in predicting the inflation rate, but that knowledge of the inflation rate would have helped in predicting the deficit. Inflation tends to "cause" deficits, Dwyer finds, implying that the persistent inflation characterizing today's economy makes it difficult to reduce deficits.

PUZZLE:
be Apprehensive

Turning to direct evidence concerning effects of deficits on interest rates, **Victor Canto** and **Donald Rapp,** researchers at the University of Southern California School of Business, find that patterns have varied significantly from year to year. As a consequence, their statistical analysis does not reveal a consistent simple relationship between deficits and interest rates, implying that higher deficits do not bring higher interest rates in every case but will in some cases and not in others. Their analysis implies that, in addition to the size of the deficit, information such as the savings rate is needed to gauge the relationships between deficits and interest rates.

Randall Holcombe, economics professor at Auburn University, gets at the crowding out question another way, by focusing on the effects of deficits on private-sector saving and capital formation. He finds that private savings have not increased sufficiently to finance both private investment and higher deficits. As a result, private capital formation has suffered from deficits, and crowding out has been typical.

The final paper, by **Ernest Tanner,** economics professor at Tulane University, examines the disillusion with fiscal policy as a tool for stabilizing economic activity. Tanner reports that the economics profession's views have come full circle.

In summary, we think that the reader who studies the following pages will emerge more concerned than ever about the economic effects of large and persistent federal deficits.

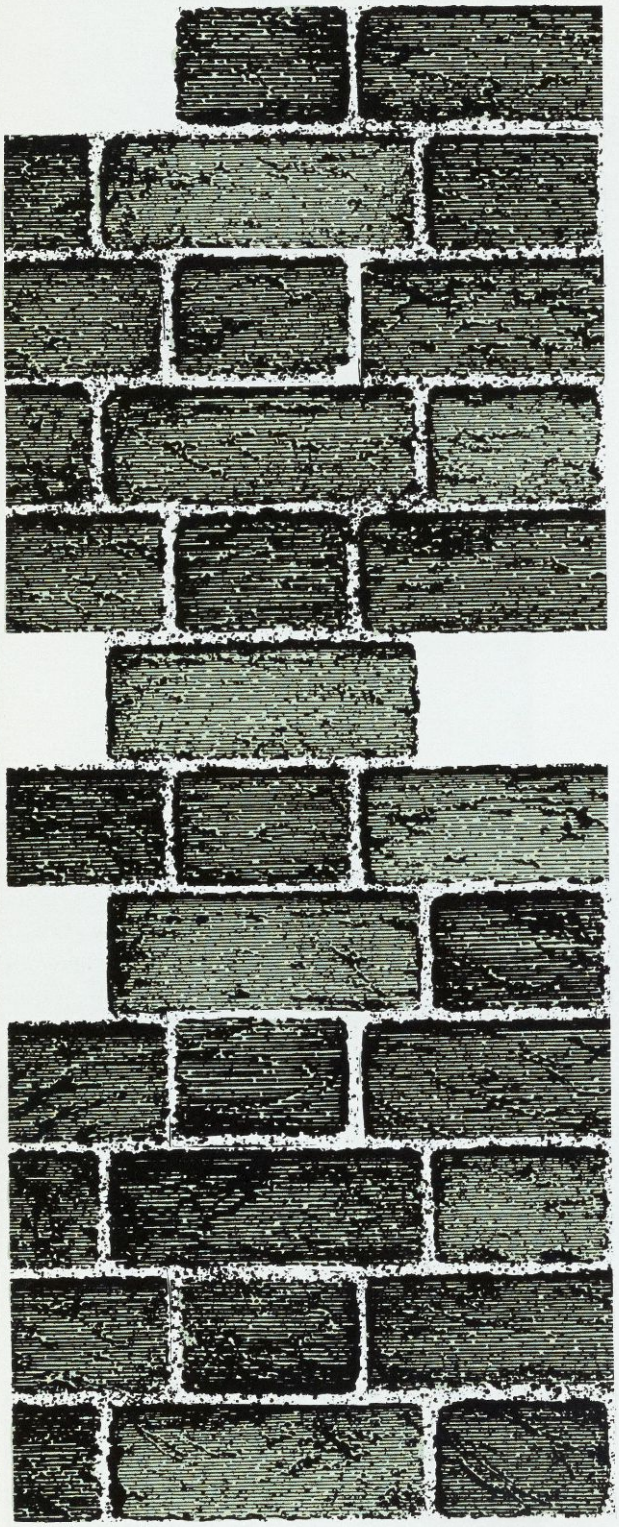
It is apparent, as Canto and Rapp suggest in the fourth article, that there has been no systematic relationship, historically, between deficits and interest rates, and that we must look for the answer in the circumstances surrounding each situation.

When we apply that prescription to the situation in 1982, the other articles give some reasons to be apprehensive that the public deficits will indeed push up interest rates and crowd out private spending and investment. Barth and Morrell show how current and impending federal deficits exceed our nation's general experience. Morrell goes on to argue that large deficits may produce upward pressure on interest rates when our economy is expanding, as it will be during the recovery from the 1982 recession. Dwyer's work points to persistent deficits as a product of inflation, suggesting that it may be unusually difficult to reduce the deficit in an economy where inflation and inflationary expectations are so strongly embedded.

Holcombe's article casts doubt on another "way out" of the current predicament, arguing that federal deficits historically have not induced an equal amount of saving in the private sector. Tanner's paper concludes by documenting the dwindling evidence and support for traditional demand-side fiscal policy, which we see reflected in today's combination of high deficits and economic weaknesses.

This, at least, is the way we read the evidence presented in this issue of our **Economic Review.** But beyond that, we hope you, our readers, will take the time to examine the evidence compiled by these scholars, and to draw your own conclusions from it. The urgency and persistence of our nation's economic problems demand nothing less.

Introduction



Legislative walls that have partitioned the American financial system into separate commercial banking, insurance, investment banking, savings and mortgage lending and nonfinancial segments have eroded during the past several years. They seem likely to continue to crumble as businesses try to diversify their financial offerings in the future. This issue of our **Economic Review** will survey the important issues bound up in the process of product deregulation now occupying financial markets, regulators and lawmakers. It parallels our analysis, published in this **Review** in May 1983, of the breakdown of geographic barriers to banking.

The regulatory limits to banks' activities arose from public concerns about the safety and soundness of banks and the financial system and about concentration of financial power. Present-day limits grew primarily from federal laws passed in reaction to economic problems of the 1930s. Chaotic conditions in the nation's financial system accompanied by the failure of one-third of the nation's banks induced far-reaching reforms. Congress introduced federal deposit insurance and improved the Federal Reserve's ability to provide bank reserves through the discount window and open-market operations in order to restore and maintain confidence in banks and the financial system.

In addition, the Congress sought to control banks' costs by limiting the interest that they could pay on deposits. It also sought both to control their risk and to limit concentration of financial power by limiting banks' activities in the securities business. This latter limitation, combined with earlier prohibitions against certain real estate and insurance activities, served to keep commercial banks specialized in the deposit-taking and lending business until activity restrictions began to fall in the early 1970s.

A third limit—barring interstate banking—had been passed earlier and was reaffirmed in the early 1930s. By prohibiting interstate banking by national banks, the McFadden Act of 1927 insulated banks from out-of-state competition and also limited their geographic diversification. State branching and bank holding company restrictions, the McFadden Act and, later, the Douglas Amendment to the Bank Holding Company Act, are largely responsible for the existence of approximately 14,000 commercial banks in the nation today.

Each of the limitations served to insulate various types of financial firms from price, geographic

or product competition. Since the payment of interest on deposits was limited, interest rate increases in other markets had limited effects in raising banks' cost of funds. The McFadden Act limited deposit and loan competition from out-of-state organizations, again holding down the cost of funds and possibly raising the return on loans. Activity limitations compartmentalized product offerings, restraining competition and insulating banks from whatever risk may have been associated with investment banking, insurance and real estate operations.

Market and legal conditions have changed since the 1930s. The Depository Institutions Deregulation Committee has removed interest-rate ceilings on all deposits but passbook savings and transactions accounts. Geographic restraints imposed by state laws, the McFadden Act and the Douglas Amendment are breaking down, largely because of bank holding companies' nonbank activities and states' reciprocal banking laws.

What's more, product restraints are being severely tested (witness the NOW accounts offered by thrifts, money market mutual funds, and the new financial services offered by nonbanks such as Merrill Lynch, Sears Roebuck, American Express and J. C. Penney). These changing market conditions certainly indicate the need for a reappraisal of the current product limitations. Technology has changed, and interest rates show greater variability today than has historically been true. Some states are now allowing banks to engage in nonbanking activities prohibited by federal banking laws. In addition, various proposals before Congress contemplate increased bank powers in securities, insurance and real estate activities. Adding to the confusion, large banks perform many domestically prohibited activities in foreign countries. Even the definition of what constitutes a bank is in question.

The product regulations imposed on commercial banks were designed to preserve the safety and soundness of the banking system and to prevent undue concentration of financial power. The former rationale revolves around a desire to guarantee the safety of deposited funds in order to maintain stability of the money supply and to ensure efficacy of the savings and investment cycle and the payments mechanism. In terms of product deregulation, fears are centered on the increased risk that some assume to be associated with banks' expanding product offerings. The fear of concentrated financial power seems to be based on concern that concentration of financial resources through banks' product diversification may lead to a misallocation of economic resources. In other words, as the division between banking and commerce erodes, banks may gain power to earn excess profits and to allocate credit on the basis of their own ownership interest rather than on an unbiased view of the investments undertaken.

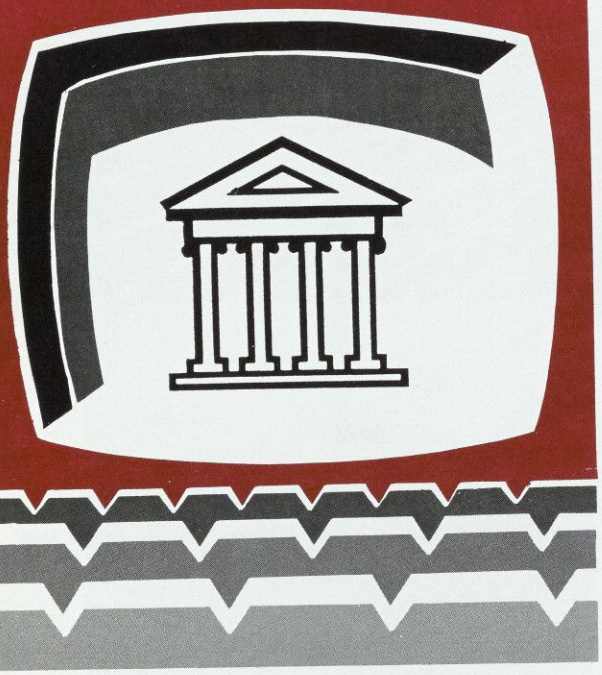
The first section of this issue of our **Economic Review** will provide an assessment of the safety and soundness question. Robert A. Eisenbeis, Wachovia Professor of Banking at the University of North Carolina, and Larry Wall, a Federal Reserve Bank of Atlanta economist, will analyze the potential impacts on bank and financial system risk associated with product deregulation in the financial services industry. The second section, written by Elinor Solomon, professor of economics at George Washington University, will assess issues related to potential concentration of financial power resulting from financial product deregulation. Is this fear of concentrated financial resources really justified?

The third and fourth sections deal with potential benefits of deregulation to banks' customers. All financial institutions would like to believe they can provide all things to all customers, but market realities may not support this optimism. Veronica Bennett, a financial industry research specialist, will reveal the results of three attitude surveys that sought to determine how consumers prefer to receive their financial services. She reports on a special survey of consumer attitudes undertaken by the Atlanta Fed as well as evidence from proprietary studies.

Bernell Stone, Mills B. Lane Professor of Banking and Finance at Georgia Institute of Technology, will address the same question from corporate customers' perspective: What do corporate customers want and from whom do they want to receive these services? The fifth section deals with what we can learn about product deregulation in financial services through a case study of U.S. banks' experience in the securities industry. This section was written by Samuel L. Hayes III, Jacob Schiff Professor of Investment Banking at Harvard University. The concluding section will pull the evidence together and suggest policy implications. We hope you find this issue of our **Economic Review** interesting and informative.

—B. Frank King
David D. Whitehead

OVERVIEW



Introduction

Traditionally, commercial banks have stood between purchasers and sellers, not only providing the means through which transactions are settled (demand deposit accounts) but collecting and dispersing information relevant to these transactions. The latter is integral to the service banks provide because collecting and dispersing information facilitates the bank-customer contact on which customer loyalty is based. But with technological advances in the electronic communications field, nonbanks are finding it advantageous to offer alternatives to the banks' payment systems. The alternative payment systems offered by nonbanks may effectively eliminate the unique payment systems franchise commercial banks have traditionally enjoyed.

The commercial banks' franchise in the settlement area is not particularly threatened by these events because banks still control the means of settlement, demand deposits. However, the new technology is threatening the banks' unique role in providing access to and information concerning consumers' bank accounts. Automated teller machines (ATMs), point-of-sale (POS) terminals, and home banking are three examples of how communications technology is being applied to replace established payments devices. The purpose of this special issue of our **Economic Review** is to assess the comparative advantage of banks or nonbanks in supplying these new payment systems. We explore the revolution now underway in the retail payments area and attempt to define the degree to which banks may be in danger of losing the uniqueness of their franchise in the payments area.

Banks, retailers, data processors, communications companies, and vendors of the new technology all are locked in a serious struggle to establish their niches in the electronic payment systems of tomorrow. The winners will profit handsomely and will form the basis of a new structure of financial institutions and ser-

vices. As an essential part of the current payment system and as a regulator entrusted with ensuring the safety and soundness of the banking and payment system, the Federal Reserve is most interested in the outcome of this competition.

The Federal Reserve Bank of Atlanta sponsored a one-day workshop with key representatives from each of the major sectors vying for a position in the future payment system. The speakers were associated with firms actively engaged in or testing the feasibility of ATMs, POS, or home banking services. We asked each to review his firm's experience and from that to generalize on the future of the various services. Specifically, the speakers were asked to assess the value added by each of the electronic services, and this raised further questions. Are consumers willing to pay for the value added? What are the relative costs and benefits of supplying these services? What types of firms appear to be in the best position to offer these services profitably? The presentations stimulated lively discussion and culminated in a much clearer picture of which electronic services are likely to be accepted by consumers and of the types of firms that hold a comparative advantage. The role of commercial banks in the payment system is indeed changing.

George Benston, a visiting scholar at the Federal Reserve Bank of Atlanta and professor of accounting, economics, and finance at the University of Rochester, opened the workshop with a concise statement of the economics of electronic payment systems. He set the stage by outlining the potential costs and benefits of each type of electronic service, and the characteristics of firms most likely to enjoy a comparative advantage in offering the services. **David Whitehead**, senior financial economist for the Atlanta Fed, followed with a description of the firms actually involved in offering or testing the feasibility of electronic payment services today. He emphasized what the players are doing and how they are doing it.

Next to speak was **Craig Gieler**, vice president of administration for The Williams Group and former Kroger executive, who presented the potential advantages and disadvantages of ATMs and POS from the retailer's viewpoint. **Gordon Oliver**, executive vice president of Citizens and Southern National Bank, then countered with a generalized banker's view based on his experience with C&S and the Avail network; **David Strickland**, senior vice president of Barnett Banks of Florida, gave a close look at his organization's experience offering retail electronic funds transfers in Florida through the Honor System. To round out the morning session, **Ronald Osterberg** of the Antietam Group presented a stimulating analysis of who is likely to benefit from ATM and POS transactions and, hence, who is likely to pay whom for the services.

The afternoon session was devoted to questions surrounding home banking. Among these, the chief question was whether home banking would provide consumers with sufficient value added to allow banks to play a leading role in developing home information systems, or whether home banking is likely to be simply one more service on the menu. **Lee Pomeroy**, vice president, Chemical Bank, presented Chemical Bank's experience with Pronto home banking, and its long-term strategy in the home banking arena. **Allen R. DeCotiis**, vice president of Payment Systems, Inc., broadened the picture with a more generalized overview of the home banking issue.

We asked **Bernell Stone**, Mills B. Lane professor at Georgia Institute of Technology, **Peter Merrill**, president, Peter Merrill Associates, and **William Cox**, the Atlanta Fed's associate director of research, to summarize the findings of the workshop. Each approached the significant results somewhat differently, but all agreed on the probable future role that commercial banks will play in the evolving electronic payments area. We trust you will find this special issue of our **Economic Review** both informative and enjoyable.

—David Whitehead