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CONTENTS

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Monetary Expansion Continues

FEDERAL RESERVE CREDIT, member bank reserves, and the money supply have increased at extremely rapid rates since last summer. Money supply growth from last June to April was the most rapid for a ten-month period since World War II.

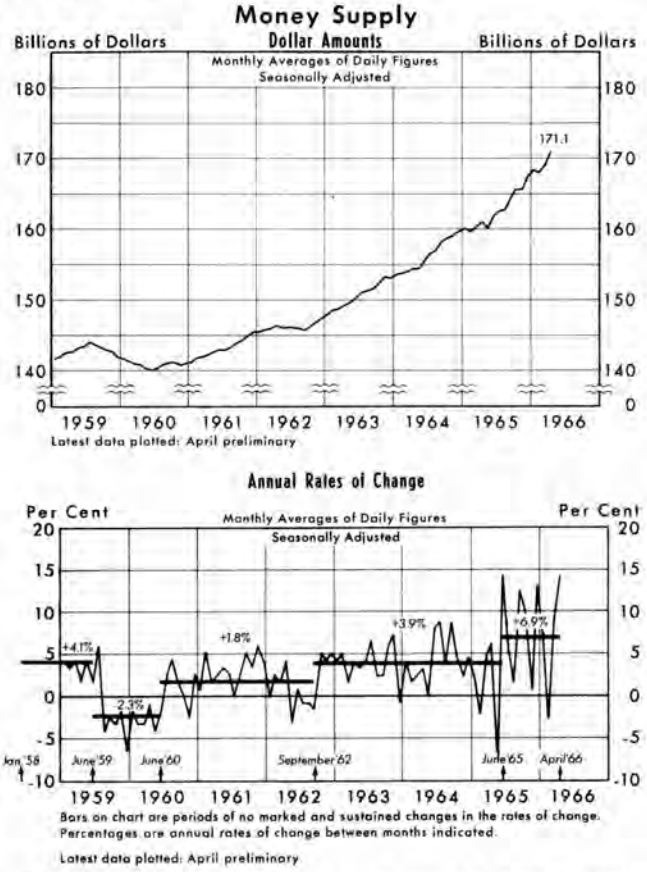
Notwithstanding the growth of money and reserves, some observers have concluded that monetary developments have become restrictive. This conclusion has been inferred from movements in several popularly observed monetary variables, particularly interest rates and borrowings from Federal Reserve Banks. However, when the nature of these variables is examined and their recent movements put in perspective, the impression of restriction may prove to be an illusion.

The increase in money and credit since last summer has nurtured an increase in total dollar demand for goods and services by augmenting purchasing power in the hands of borrowers. If borrowers are financed in part by the creation of credit not related to planned saving, they can add more to the income stream than savers undertake to withdraw, and total demand expands.

Ideally, total demand should just match the economy's potential to produce, so that both high employment and relative price stability can be achieved. The increase in money and credit since last summer, combined with a stimulative fiscal situation, has fostered a very large expansion of demand. Output and prices have both risen substantially, and pressures in resource markets have increased.

Monetary Developments

Money Supply. A strong upward trend in the money supply (checking accounts plus currency) which commenced last June has continued in recent months. To April the money supply expanded at a 12 per cent annual rate from February, an 8.0 per cent rate from November, and a 6.9 per cent rate from June. These figures compare with a 2.6 per cent rate of growth in money from 1960 to 1964 and a 1.4 per cent rate from 1953 to 1960.



Rapid increases in the money supply usually have been followed by marked increases in spending. As banks expand their loans and investments, demand deposits, the major component of the money supply, rise. Borrowers and sellers of securities spend the proceeds of their loans or sales, and the income and money holdings of owners of factors of production rise. When the money supply increases rapidly, people find themselves holding greater cash balances than they desire at prevailing interest rates. When people have more money than they wish to hold, they spend money on other financial assets and goods and services. This places downward pressure on interest rates and causes a rise in money income, thus helping to equate desired holdings with actual money holdings.

Reserves. The rise in the money supply has been facilitated by a large increase in reserves available to support private demand deposits, a variable influenced by Federal Reserve actions. To April these reserves rose at a 19 per cent annual rate from February, a 10.2 per cent rate from November, and a 6.3 per cent rate from June, compared with a 1.4 per cent rate from 1960 to 1964.

The growth of reserves available for private demand deposits, the primary determinant of the money supply, is determined by the growth of total reserves less change in reserves required against time deposits, Government demand deposits, and interbank deposits. Total reserves have increased at an 11 per cent annual rate since last fall and at a 5.2 per cent rate since June 1965 compared with a 3.5 per cent rate of growth from 1960 to 1964. A large increase in Federal Reserve credit (which includes Federal Reserve holdings of Government securities, check collection float, and borrowings of member banks) has been responsible for the rise in total reserves since summer. The rise in Federal Reserve credit has more than offset a decline in the gold stock and increases in currency in circulation, both of which absorb reserves.

A smaller portion of the increase in total reserves has been required against time deposits and Government deposits since the end of last November, and a larger portion has been available for private demand deposits. While time deposit growth was substantial from late November to early March, it was not so rapid as in recent years. U. S. Government demand deposits were at low levels in the first four months of 1966.

Bank Credit. Bank credit (bank holdings of loans and securities) rose at an estimated 9.7 per cent rate from November to April and at an estimated 8.8 per cent rate from last June to April. This compares with a 7.9 per cent growth rate from 1960 to 1964.

In response to strong loan demands in recent months, banks expanded their holdings of loans rapidly while they reduced holdings of Government securities. For all commercial banks the ratio of loans to deposits was an estimated 65.6 per cent in April compared with 64.5 per cent in November, 62.2 per cent last April, and 55.9 per cent in 1960. Many banks currently find meeting all demands for loans difficult or impossible. This situation stems from the intense demand for funds and not from exceptional restriction of the supply of funds. Meeting all demands for loan funds would facilitate continuation of excessive demand which makes for inflation.

Illusion of Restraint. Despite the rapid monetary expansion since summer, some analysts and financial writers have concluded that monetary action has been "firmer," "tighter," or "more restrictive." The belief that there has been a tightening of policy may stem from recent movements in several well publicized financial variables, especially net borrowed reserves (borrowings less excess reserves) and interest rates. Also, borrowers are finding credit somewhat less readily available.

The notion that net borrowed reserves have increased and that this amounts to a restriction or rein on credit is a double illusion. First, net borrowed reserves have been widely criticized as a measure of monetary policy.[1] Briefly the criticism is: if the Federal Reserve were to conduct its policy by fixing a target level of net borrowed reserves, it would lose control over other variables such as money and bank credit. Whenever member banks attempted to increase borrowings or reduce excess reserves, causing net borrowed reserves to be above the target, the Federal Reserve would inject reserves into the system, reducing borrowing or increasing excess reserves to the level needed to achieve the target net borrowed reserves. The member banks, in turn, might desire to expand credit further. Thus, it is possible for money and credit to increase at any rate with a given level of net borrowed reserves. In the short run, the level of free or net borrowed reserves may reflect swings in credit demand and other market forces, not monetary policy. The second illusion is that net borrowed reserves increased in the period from June 1965 to March 1966. Net borrowed reserves averaged $129 million in the period from December to April compared with $144 million in the period from June to November.

The rise in market interest rates since last July and the increase in the discount rate and ceiling rates on time deposits in December have been mentioned as indications of a tightening of monetary policy. An interest rate rise may be caused by an increase in the demand for funds or by a decrease in the supply of funds. Higher interest rates resulting from growing demands for funds ration available credit and encourage saving. Such an interest rate rise is not a sign that monetary expansion is any less rapid. On the other hand, a rise in interest rates might indicate a reduction in the flow of loan funds which has resulted from restrictive actions by the monetary authorities.

The interest rate rise since last July has been caused by a swelling demand for funds rather than by monetary restriction. The intensity of the demand for loan funds is witnessed by a very rapid expansion of bank loans, very large offerings of corporate and municipal securities, and a substantial increase in Government debt outstanding as well as by the increase in interest rates.

The upward adjustments in the discount rate and ceiling rates on time deposits in early December were in the direction of keeping up with the tide of rising market rates. These adjustments were not of a restrictive nature.

Other Policy Developments

The economic impact of the Government's taxing and spending actions has been, and is expected to continue to be, stimulative. The high-employment budget[2] was nearly in balance in late 1965, the most stimulative level in many years. During the four years of economic expansion from mid-1961 to mid-1965 the high-employment budget showed a surplus averaging $8.3 billion a year. Preliminary data indicate that Government actions have continued to be expansionary in early 1966.

Guidelines policy has undertaken to limit price increases in the past year. Such a policy attempts to affect wages and prices by persuasion and thus prevent inflation in times of strong demand. Similar to the guidelines policy are programs of persuasion regarding investment plans, export of capital, and other economic decisions.

The guidelines policy, which resembles the "incomes" policies of some other countries, may have some effect in areas of monopoly power and administered prices. However, in a major portion of the economic system it is not practical as a means of limiting increases in price levels. The policy has not been applicable, for example, in controlling rapid rises in agricultural prices in the past 15 months. This policy can possibly be helpful if accompanied by adequate limitation of total demand by means of monetary and fiscal policies.

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[1] See Harry Brandt, "Controlling Reserves—The Heart of Federal Reserve Policy," *Monthly Review*, Federal Reserve Bank of Atlanta, September 1963; "The Significance and Limitations of Free Reserves," *Monthly Review*, Federal Reserve Bank of New York, November 1958; Jack M. Guttentag, "The Strategy of Open Market Operations," *The Quarterly Journal of Economics*, February 1966; Alexander James Meigs, *Free Reserves and The Money Supply* (Chicago: University of Chicago Press, 1962); "Monetary Policy and Free Reserves," *Monthly Economic Letter*, First National City Bank, New York, July 1965.

[2] For an explanation of the various budgets, see Keith M. Carlson, "Budget Policy in a High-Employment Economy," *Review*, Federal Reserve Bank of St. Louis, April 1966.

Business Developments

Preliminary data indicate a further strong rise in total spending and output in the first quarter of 1966. Spending has outpaced production, and prices have increased.

The growth of gross national product (GNP), the dollar value of the nation's output of goods and services and a measure of total demand, has picked up since mid-1965. At a $714 billion annual rate in the first quarter, GNP is up at a rapid 9.8 per cent annual rate since the third quarter of 1965 and is 8.6 per cent above a year ago. GNP rose at a 5.7 per cent rate from 1960 to 1964 and at a 4.9 per cent rate from 1951 to 1960.

Real output of goods and services rose at a 6.2 per cent annual rate from the fourth quarter of 1965 to the first quarter of 1966 compared with a 7.7 per cent rate of expansion from the third to the fourth quarter of last year. Output grew at a 4.3 per cent annual rate from 1960 to 1964 and a 2.7 per cent rate from 1951 to 1960.

Expansion of output since mid-1965 has been made possible by a further reduction of unemployed workers and idle industrial capacity, by growth of labor force and capacity, and by increased productivity. The number of persons estimated to be unemployed has declined from 3.5 million last summer to 2.9 million in April. Unemployment decreased from 4.6 per cent of the labor force last summer to 3.7 per cent in April. Over the same period the unemployment rate for experienced wage and salary workers declined from 4.3 per cent to 3.4 per cent, and the rate for married men fell from 2.4 per cent to 1.8 per cent. From last summer to March the average workweek in manufacturing industries rose from 41.0 to 41.6 hours and in contract construction, from 37.3 to 38.5 hours.

In view of the current low unemployment rate and the high level of capacity utilization, the 6.9 per cent annual rate of growth of output prevailing since last summer may not now be sustainable. If so, total demand should appropriately grow less rapidly.

Some of the surge in demand since last summer has spilled over into an acceleration of price increases. The implicit GNP deflator, the broadest of the price indexes, rose at a 3.6 per cent annual rate from the fourth quarter of 1965 to the first quarter of 1966. The deflator rose at a 1.3 per cent rate from 1960 to 1964. The wholesale price index rose at a 4.7 per cent rate from October to April after increasing at a 2.3 per cent rate from June 1964 to October 1965 and remaining about unchanged from 1958 to mid-1964. Prices of farm products and processed foods climbed at a 10.1 per cent rate from October to April while industrial prices increased at a 2.9 per cent rate. The consumer price index rose at a 3.5 per cent rate from October to March, after rising at a 1.2 per cent rate from 1960 to mid-1964. In the consumer category, food prices have risen at a 9.4 per cent rate since October while the prices of nonfood commodities have risen at a 0.7 per cent rate and the prices of services have risen at a 2.9 per cent rate.

Percentages are annual rates of change between months indicated.
Latest data plotted: Consumer-March preliminary; Wholesale-April preliminary

Source: U.S. Department of Labor

International Developments

The balance-of-payments deficit, on a liquidity basis,[3] is likely to be at as high a rate in the first quarter of 1966 as during 1965. The trade surplus in the first quarter of 1966 was somewhat less than the 1965 average and considerably below the 1961-64 average. This contraction of our trade surplus results from the additional foreign exchange costs associated with the Vietnam commitment (estimated to be $700 million to $900 million in 1966) and from the strength of total demand in the United States. Because of continued strength in the services balance (largely due to steady growth in investment income) the current account balance will probably show little change in the first quarter.

The rapid growth in domestic demand has caused an acceleration in imports of both consumer durables and business investment goods. Imports in the first quarter were at an annual rate of about $24 billion,

[3]There are two basic ways in which the U. S. Government defines the balance of payments, the "liquidity" basis and the "official settlements" basis. The differences concern the treatment of certain capital account items. The liquidity measure treats increases in foreign private short-term holdings of dollars as a way of financing the deficit in the balance of payments. The official settlements basis treats these private holdings of dollars as a demand on the part of foreigners for dollar balances, and thus they represent a short-term capital inflow.

a substantial 21 per cent annual rate of increase over the last half of 1965. The annual growth in imports averaged 7.8 per cent from 1961 to 1965. Exports increased at an annual rate of 6.5 per cent in the first quarter over the last half of 1965, which is better than the 3.9 per cent growth in 1965 and about the same as the average growth rate from 1961 to 1964. The simultaneous appearance of boom conditions in the United States and less expansionary conditions in the other industrial countries has shrunk our trade surplus. If further shrinkage of the trade surplus is to be avoided this year, domestic inflationary pressures will need to be held in check.

Only scattered data on the capital account of the balance of payments in the first quarter is available at the time of publication. On the favorable side, there was a net decline in outstanding U. S. bank credit to foreigners at an annual rate of more than $1 billion. On the adverse side, there was a sharp increase in American purchases of foreign securities, dominated by a bunching of new Canadian issues which had been postponed from the fourth quarter of 1965.

There is some evidence that the recent tightening in the money and credit markets in the United States has had a favorable effect on the capital account. As total loan funds in the United States become scarcer relative to demand, foreign customers are finding their credit lines reduced and the terms for floating new issues in the American capital market less attractive. For example, the Government of Japan, which anticipated floating $130 million in government and government guaranteed bonds during the year, is reported to be revising its plans downward because of the tight capital markets both here and in Europe. When these natural market forces plus the voluntary foreign credit restraint program, introduced in February 1965, are taken into consideration, it seems likely that outflows of U. S. private capital were at no higher a rate in the first quarter of 1966 than in 1965.

Conclusion

Rapid monetary expansion since last summer has augmented the volume of spendable funds, and the aggregate demand for goods and services has expanded at a very rapid rate.

The surge in demand has been met by a large expansion of output and imports and by price increases. The expansion of output since summer has been accompanied by a substantial decline in unused resources, and consequently the rate of increase in real output henceforth may not be so rapid as in the past.

The Government deficit, investment, and consumer borrowing may now appropriately be financed to a greater extent by saving (i.e. foregoing consumption) and to a lesser extent by bank credit creation (which does not require any cutbacks in spending). Total demand would then probably rise less rapidly than since last summer. Not only would this be appropriate for the domestic situation but the restraint on inflation and the higher interest rates which would follow would be helpful in reducing the country's adverse balance of payments with the rest of the world.

Floors and Ceilings:
Guidelines and Understandings in Commercial Banking[1]

by George W. Mitchell
Member, Board of Governors of the Federal Reserve System

COMMERCIAL BANKS are perhaps the oldest surviving business institutions whose product and method of manufacture has been relatively unchanged over the years. They have continuously been a highly important and integral part of our economic system, attracting and allocating or reallocating credit resources among a broad spectrum of needs. But commercial banking has not remained static. In particular, during our generation banks have had to change in order to cope with an environment in which two discordant—and interrelated—trends have been at work.

First, they have found themselves facing more intense competition from new financial institutions—as well as from the money and capital markets and nonfinancial businesses. Second, mainly as a heritage from

[1] Remarks made at the Annual Executive Forum of the American Institute of Banking (St. Louis Chapter), St. Louis, Missouri, April 13, 1966.

historical experience—especially, but not solely in the 1930's—banks have been subject to detailed regulation by the States and the Federal Government. And, as competition has come increasingly to substitute for regulation in promoting and protecting the public interest in many sectors of our economy, the confining effect of regulation appears intensified.

It is the inhibitions on competitive behavior of banks, self-imposed and superimposed, that I should like to discuss with you today: the rules, the guidelines, and the informal understandings that condition the way banks behave in the market place. These factors not only influence portfolios and profits of banks, but also how much and how well banks contribute to the effectiveness and efficiency of our economic system.

Banking history for the past decade or so demonstrates that commercial banks can and have used competitive methods to grow and to prosper. The earlier disdain many of them had for small depositors, consumer instalment credit, and residential mortgages has disappeared but not before it provided the opportunity for specialized financial intermediaries and other credit-granting institutions to become well established. Today banks have become large in the consumer credit field, where they show signs of spectacular innovation. On occasion they enter the mortgage market quite vigorously.

The new spirit of competition has not been limited to the asset side of the balance sheet. Early in this decade, for example, banks saw the demand for their deposits declining because consumers and businesses found other financial assets more attractive. Eventual awareness of this attrition has caused banks latterly to aggressively seek deposits of all types and sizes by offering a variety of attractive claims. They—and the public—are better off, as the new spirit of competition and innovation spreads.

This new competitiveness is, when carried out with sense, all to the good. But there are still many areas where custom, practice, and regulation dull the edge of bank competition, making the life of bankers and bureaucrats more comfortable, to be sure, but reducing the contribution of banks to the well-being of society. These factors, it seems, feed on themselves. The bankers and Government officials who keep saying that banks are different and hence need certain regulations and policies may really mean that these regulations and policies have made the banks different. Moreover, the ghosts of past problems and previous economic environments still haunt the modern banker long after the body of the original problem—if it ever truly existed—has turned to dust. And, what is perhaps even worse, too often it is assumed that the rule, policy, or regulation is successful in alleviating the problem to which it was directed, when study suggests this is just not so.

Present day usury laws are a case in point. These statutes were established in the late 19th and early 20th centuries to prevent the exploitation of small and weak borrowers. The direction of these legislative actions was liberalizing in a degree. The older usury laws simply had made it impossible for most legitimate lenders to supply funds to certain borrowers, and many credit demands were diverted to illegal lenders. But rather than repudiating the usury mores of the Middle Ages, the thrust of legislative action was to exempt certain kinds of loans on a regulated basis. Moreover, there was no recognition of the role of competition in protecting consumers; instead, regulation proliferated with separate laws for each type of lender or borrower.

Has the effect of these laws been to protect the consumer and other borrowers who are the supposed beneficiaries of usury regulations? The evidence suggests the contrary. Take the case of consumer credit, an area where the original laws were supposed to work their protection, and where most of the "controlled" exemption from usury laws has taken place.

The first thing we observe is that in most consumer instalment credit markets actual rates are below the ceilings—which for commercial banks in the various States range between 12 and 16 per cent simple interest. This seems to suggest that most consumer credit markets are operating under competitive market forces. Only at small loan companies, which face greater risks and higher costs, do actual rates tend to be at their ceilings of 24 to 48 per cent.

Despite surface appearances, however, the usury laws do interfere with competition. And they do so because widely different ceiling rates for essentially the same transaction exist between lender groups, such as banks and sales finance companies. Part of this difference, of course, reflects the different types of credit risks that the various lenders face, but the point is that multiple rate ceilings essentially allow each lender group to stake out part of the market for itself free of any competition from a group with rate ceilings below its own. Thus, the superficial appearance of competition is just that: appearance. The public—and banks, whose rate ceilings are among the lowest—would be much better off if there were either no ceiling or a uniform ceiling for all loans,

both of which would permit lenders to attempt to penetrate other markets.

Second, what has been called the "6 per cent myth"—that is, the indoctrination that 6 per cent is a "right" or "fair" rate—has been reinforced by rate ceilings. As a result, legitimate lenders quote rates on a basis that disguises the true, simple interest rate and the consumer finds it impossible to compare costs among alternative borrowing sources. I realize fully that calculating simple interest is not simple, but lenders, including banks, are clearly muddying the water when they quote automobile instalment loan rates at 5 per cent when they know full well that they are charging 10 per cent on the unpaid balance. Perhaps repeal of usury laws would further efforts to devise uniform methods of rate quotation—which would contribute importantly to effective and fair competition.

While consumers are immediately brought to mind when rate ceilings are discussed, the various State laws regarding interest rate ceilings also extend to business borrowing. It has recently been estimated, you may be surprised to hear, that over 40 per cent of all business credit, and almost 60 per cent of farm credit, are subject to some interest rate ceiling. And here, too, usury laws are hostile to their announced purpose, for while many States exempt corporate businesses, most States that have usury laws do not exempt unincorporated enterprises and this fact may deny bank credit to the very enterprises that the usury laws seek to protect.

Consider a bank, which, given today's credit conditions and demand, charges 5½ per cent on loans to its highest quality customers, but cannot charge in excess of 6 per cent on a high-cost, high-risk loan to the corner retailer. Doesn't it stand to reason that the bank must recoup a high enough margin over the rate charged its highest quality customers to compensate for the greater risk and costs of the poorer credit? If usury laws prevent this, the poorer risk loans will not be made even though the would-be borrower is prepared to pay a higher rate rather than forego the funds. Of course, banks can find ways to overcome ceilings—such as requiring relatively larger compensating balances and imposing relatively greater service charges on deposit accounts—but the point is clearly that such ceilings interfere with the market process by putting a real constraint on the freedom of banks to make loan and portfolio decisions in both the public and private interest.

Ceilings on asset returns are paralleled by ceiling rates that banks may pay for deposits. As you all know, banks are prohibited from paying interest on demand balances—because of legislation enacted in the 1930's on the basis of claims that such payments had led to destructive competition in the twenties—and the Federal Reserve, the FDIC, and some States set maximum rates that banks may pay on time and savings balances.

The public policy issues raised by ceiling rates on deposit balances involve difficult practical questions affecting savings institutions, savers and investors, and the allocation of credit among the competing demands for it. Few economists approve ceilings on rates, especially on time and savings deposits, because they interfere with the market adjustment mechanism. Yet the market mechanism, which inevitably involves financial institutions whose assets have a longer maturity than their liabilities, can be quite destabilizing.

If maturities of depositors' claims matched loan repayment schedules, changes in financial market conditions would have roughly comparable effects on rates for both deposits and loans. Under these conditions the close alignment of ceilings with market rates would not be disruptive to the liquidity position of the financial intermediary. But when commitments on the deposit side are short—even on demand—loan runoff from term loans or mortgages cannot cope with withdrawals stimulated by higher returns offered by competitors that are not similarly exposed in their deposit-loan relationships. Thus, an important advantage of relatively stable rate ceilings is that they permit intermediaries to offer savers liquidity and a reasonable return from the higher yields of longer term loans.

But near-instant liquidity of time deposits is a privilege that cannot be widely shared with those whose withdrawals are stimulated by rate incentives when such incentives are pervasive among time depositors. A predictable, even though large, turnover in savings accounts is one thing—a mass withdrawal to take advantage of rising yields is quite another. To meet this problem, many banks are attempting to stratify their time accounts, according the rate conscious-investment type money a more competitive yield but on a fixed maturity and with interest penalties for earlier withdrawal. And other types of savings institutions are beginning to do the same. But the plans of some institutions only amount to changing the name of the game, and others are either unwilling or legally constrained from doing anything.

There is also a statutory responsibility involved in the fixing of rate ceilings. The Federal Reserve Board and the FDIC have no choice under the spirit of the

present law but to establish rate maxima. But, doing so under the law does not change the fact that such ceilings are a competitive inhibition, even though such inhibitions may be justified by the real possibility of serious damage to other financial intermediaries. True, the ceilings may make life easier for policymakers, banks, and other financial institutions, but they may also protect the best of all possible worlds for the small- and medium-sized saver.

Even with ceilings, market pressures are always at work to narrow or circumvent rate differentials. Shorter maturities on certificates of deposit and more frequent compounding, just to mention two examples, are used in lieu of higher nominal offering rates. Even the prohibition of interest payments on demand deposits is partially breached—quite legally. Competing for balances through additional services, or reduced service charges, or varying compensating balances is a kind of substitute for explicit interest payments.

Not all prohibitions are expressed in terms of rate. For example, while member banks may absorb the cost of numerous services to demand depositors, they do not have the option of absorbing exchange charges as the result of nonpar remission of checks. This prohibition denies member banks the use of yet another competitive tool. Would the loosening of constraints here intensify the pressure on nonpar banks to remit the face value of checks? Would competition be able to achieve par clearance, something regulation cannot accomplish, or at least has not accomplished over the years?

Ceiling rates on loans and deposits are established by law. But floors on rates are set by the policy of bankers. The prime rate, for example, establishes the rate at which loans are made to the "best" customers of banks—that is, the large, well established firms, which have the least risk of default. On the surface, this policy—adopted by most banks as an operating convention—seems a rational way to differentiate loan rates on the basis of risk to the lender. However, the history of this policy suggests that it may be in the interests of neither the public nor banks.

The establishment of a nationwide prime rate came in the 1930's when a very liquid banking system faced a greatly reduced loan demand. The combination of banks seeking loans and of customers who were well aware of the large number of available banking alternatives kept downward pressure on loan rates. In an effort to protect themselves from erosion of yields by these competitive forces, banks began to follow the lead of a few large banks who simply announced a floor rate below which they would not lend. Rates were scaled up from this minimum for less prime customers and stability in yields was thus assured. Borrowers were supposed to be happy because they knew that they were paying the lowest rate available. Lenders were supposed to be content since they knew they competitively could not charge more than the going rate, and if they charged less they would simply cause all other banks to join them and, hence, they would "spoil the market." The similarities between the logic of the prime rate and the pricing procedures suggested under the NRA are clear, but there is no evidence that banks displayed the blue eagle when discussing the prime rate.

This anachronistic, inflexible policy is still with us today. To be sure, banks tend to vary the definition of a prime customer as supply and demand conditions change, but the basic inflexibility remains—to the detriment of the public and bank stockholders.

A properly functioning market mechanism should not only foster flexible yields but also permit reasonably stable differentials between the cost of funds and the price of uses. The prime rate convention does little for either objective. Consider the period from 1961 to 1965. The prime rate was unchanged at 4½ per cent, despite two upward changes in the discount rate, an almost 200 basis point increase in short-term yields, a 60 basis point increase in long-term yields, and a 225 basis point rise in the price paid for time deposits. The fixed prime rate over these years clearly suggests that bank loan rates were in a changing relationship to market forces.

Since late 1965, two increases in the prime rate have occurred as market yields have risen sharply and bank liquidity has declined. But the inflexibility of the prime rate convention still shines through. And its rigidity is very much reinforced by the companion convention that a borrower must pay all his creditor banks the same interest rate. Banks themselves are among the most insistent advocates of this latter rule; but they have sacrificed some of their own freedom in the process.

Not all banks experience the same loan demands, face the same portfolio problems, or have the same deposit costs. Bank managements ought to have the flexibility to vary their lending prices accordingly, if they are to produce optimal results. The way banks are pricing CDs, for instance, provides an instructive example. Market competition does create a tendency for the CD rates within a banking market to move toward uniformity, but, within that market uniformity, individual bank CD pricing is freely adjusted to the circumstances at each bank. This kind of price flexi-

bility has a dynamism in it that can serve the best interests of both the individual bank and its customer, and the community at large. The kind of price fixing inherent in the prime rate, on the other hand, contravenes some of the key virtues that we associate with competitive market enterprise.

Furthermore, in the present era of monetary restraint the rigidity of the prime rate structure also hinders the transmission of monetary restraint from banks to many of the largest users of bank credit. The best customers, those with the largest balances over the longest period of time, have a powerful claim on banks' loanable resources. Past policies and understandings make it extremely difficult, if not impossible, for those customers to be turned away, or even scaled down. The only really impersonal inhibition to their borrowing is price, and the prime rate convention inhibits the reasonable use of that alternative. One could almost say it is downright discriminatory to fight inflation with monetary restraint so long as the prime rate is holding the credit door invitingly open to the biggest borrowers in the business.

To summarize, my argument is that floors and ceilings on interest rates set by law and understandings inhibit the competitive stance of banks. So do a whole host of other laws and agreements—chartering, branching, limits on mortgage loans, the voluntary foreign credit restraint program, correspondent bank arrangements, etc. Some of these are necessary ad hoc or long-run compromises with the philosophy of a free market society. But even the cursory review of a few of the concessions that I have discussed today should remind us that too often reconsideration suggests that the costs of intervention in the market system outweigh the benefits—real or imagined. Somehow, it is always necessary for someone to point out that the Emperor is now wearing no clothes.

Banking has an old and honorable tradition, and in recent years has demonstrated anew its ability to change, innovate, and compete. Competition—like progress—helps some and hurts some, has good and worrisome implications. Banks in the last five or so years have learned the benefits of competition and in their own self-interest, as well as the public interest, should be intensifying their efforts to widen the scope within which they can compete. Not all the unfettering called for, however, depends on getting Congress or some regulatory authority to give up the key to a shackle. Some of those keys are deep in banking's own vest or trouser pockets; these keys should be used too.

Bank Borrowing in the Eighth Federal Reserve District, 1963-1965

Introduction

MEMBER BANK BORROWING from the Federal Reserve Bank of St. Louis edged upward in 1965 and early 1966 from the level of 1963 and 1964. Average borrowing was $15.3 million in 1965, up from the $6.3 million level in the 1963-64 period (Chart 1). In the three months ending in April 1960, just prior to the 1960-61 recession, borrowing averaged $28 million. In the three months ending in April 1966, member bank borrowing from the St. Louis Reserve Bank averaged $26.2 million, down from the $31 million of the preceding three months but more than three times greater than a year earlier.

Member bank borrowing from the Federal Reserve System as a whole has risen similarly since early 1963.

Chart 1
Loans to Member Banks by the Federal Reserve Bank of St. Louis

In the three months ending in March 1966, borrowing from the Federal Reserve System averaged $477 million compared with $142 million in early 1963. During the period of alleged tight policy over the past year, borrowing has risen from $431 million in the three months ending in April 1965 to $552 million in the comparable period this year. Just prior to the 1960-61 recession member bank borrowing reached $684 million.

Aggregate borrowing can rise as a result of one or more factors: First, more banks may find it desirable to borrow; second, banks may borrow with greater frequency or for longer duration; third, banks may borrow larger average amounts.

This note outlines briefly some of the factors which affect the decision of an individual bank to borrow from the Federal Reserve and presents some of the facts relating to varying borrowing patterns among banks in the Eighth Federal Reserve District.

Factors Leading to Bank Borrowing

Although commercial banks generally demonstrate a reluctance to borrow, individual banks do, from time to time and for a variety of reasons, choose to borrow. Basically, they do so because it is less costly to borrow than to turn away customers or make asset adjustments which would make borrowing unnecessary.

A bank may borrow from its Reserve Bank, another commercial bank, or other sources. The choice depends upon several factors. For some banks there is less reluctance to borrow from a correspondent or in the Federal funds market than from its Reserve Bank. In addition, some bankers may feel that the role of the Reserve Bank should be confined to that of a lender of "last resort." On this premise, banks may wish to preserve their good credit standing at the discount window of the Federal Reserve.

The relevance from the standpoint of monetary policy of whether banks borrow from other banks or from their Reserve Bank depends upon one's view of the mechanism by which monetary policy affects the behavior of the banking system. Borrowing from the Federal Reserve increases the reserve base of the banking system and thereby permits a multiple expansion in bank credit and money. Emphasis on this line of causation relegates interbank borrowing to a relatively passive role.

On the other hand, according to some analysts the influence of the central bank on the banking system is reflected in increased or decreased bank borrowing, leading to increased or decreased "pressure" on the banking system to repay indebtedness rather than to extend credit further. If individual banks feel pressure to repay indebtedness to the central bank, there is a presumption that they will feel some pressure to repay indebtedness to other commercial banks. To the extent that monetary influence is viewed in these terms, it may be just as important to take account of borrowing among banks as it is to consider commercial bank borrowing from the Federal Reserve.

A member bank may borrow from its Reserve Bank by over-the-counter delivery of an executed note or by mail. A bank may also borrow by telephone, provided collateral is in the possession of the Federal Reserve Bank or is being held for the Reserve Bank by a correspondent of the borrowing bank; such borrowing involves an understanding that an executed note will follow. Borrowing is not to be undertaken principally for taking advantage of interest rate differentials or for obtaining a tax advantage. In considering the length or frequency of the borrowing of an individual bank, a prime factor is that Federal Reserve credit not become an ordinary part of the bank's resources.[1]

Borrowing Since 1963

The rise in bank borrowing from the Federal Reserve since 1963 appears to be related to the rise in national and regional business activity and the accompanying expansion in the demand for commercial bank credit. In addition, the forces leading to borrowing are intensified by the fact that the holdings of readily salable assets are relatively small.

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[1] Relevant portions of Regulation A are as follows:

"(c) Access to the Federal Reserve discount facilities is granted as a privilege of membership in the Federal Reserve System in the light of the following general guiding principles.

"(d) Federal Reserve credit is generally extended on a short-term basis to a member bank in order to enable it to adjust its asset position when necessary because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit beyond those which can reasonably be met by use of the bank's own resources. Federal Reserve credit is also available for longer periods when necessary in order to assist member banks in meeting unusual situations, such as may result from national, regional, or local difficulties or from exceptional circumstances involving only particular member banks. Under ordinary conditions, the continuous use of Federal Reserve credit by a member bank over a considerable period of time is not regarded as appropriate.

"(e) In considering a request for credit accommodation, each Federal Reserve Bank gives due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally. It keeps informed of and takes into account the general character and amount of the loans and investments of the member bank. It considers whether the bank is borrowing principally for the purpose of obtaining a tax advantage or profiting from rate differentials and whether the bank is extending an undue amount of credit for the speculative carrying of or trading in securities, real estate, or commodities, or otherwise."

The most striking fact about borrowing from the Federal Reserve Bank of St. Louis is that very few banks do it. Of the 483 banks in the Eighth District which are members of the Federal Reserve System, 420, or 87 per cent of the total, *did not* borrow from the Federal Reserve Bank of St. Louis at any time during the 1963-65 period. Thus, in discussing member bank borrowing from the Federal Reserve Bank of St. Louis, attention is limited to the behavior of 63 banks, 13 per cent of the member banks located in the Eighth Federal Reserve District.

On the other hand, the 63 banks which borrowed from the Federal Reserve during the 1963-65 period hold nearly 60 per cent of the assets of member banks in the district. Thus, a major portion of the banking business in the Eighth Federal Reserve District is conducted by borrowing banks.

Aggregate borrowing from the Federal Reserve Bank of St. Louis rose during the 1963-65 period. However, the rise did not reflect an increased incidence of borrowing among banks. During 1965, 33 banks borrowed, 11 fewer than in 1964 and 3 less than in 1963. The combination of longer or more frequent borrowing along with greater average borrowing resulted in the substantial rise in aggregate borrowing during the 1963-65 period.

The frequency or duration of indebtedness increased successively in the years 1963, 1964, and 1965. Chart 2 shows the banks which borrowed in 1963, 1964, and 1965 arrayed according to their cumulative indebtedness. The banks on the extreme left of each figure were in debt for one day only; the bank in debt for the greatest number of days appears to the extreme right of each figure. On the average, those banks which borrowed were indebted for a total of 51 days in 1965 compared with 25 days in 1964 and 23 days in 1963 (Table I).

Fewer banks borrowed for short periods, and more banks borrowed for longer periods in 1965 than earlier. Of those banks which borrowed in 1965, only 6 borrowed for less than 10 days (Table I and Chart 2).[2]

Table I

LENGTH OF INDEBTEDNESS

Borrowing Banks in the Eighth Federal Reserve District

Years	Average Number Days of Indebtedness	Number of Banks Borrowing for: Less than 10 Days	Number of Banks Borrowing for: More than 2 Months
1965	51	6	11
1964	25	16	6
1963	23	17	4

During 1965, 11 banks were in debt for more than two months, cumulatively. In 1964 and 1963 only 6 and 4 banks, respectively, were in debt for more than two months.

In analyzing borrowing from the perspective of a bank's reserve behavior, knowledge of the length of indebtedness gives only a partial picture. It is also necessary to take account of the amount of borrowing. For purposes of meeting reserve requirements, the effects of borrowing $10 million for three days or $30 million for one day are identical.[3]

Banks which borrowed in 1965 incurred substantially larger indebtedness than in 1964 or 1963 (Chart 3). On the days on which they were in debt to the Federal Reserve, borrowing banks secured 39 per cent of their required reserves through the discount window.

[2]This does not mean that the banks were in debt for consecutive days; the figures presented are cumulative.

[3]Reserve requirements are calculated as an average over a reserve settlement period. There is a 7-day period for reserve city banks and a 14-day period for country banks.

Chart 2

Duration of Indebtedness

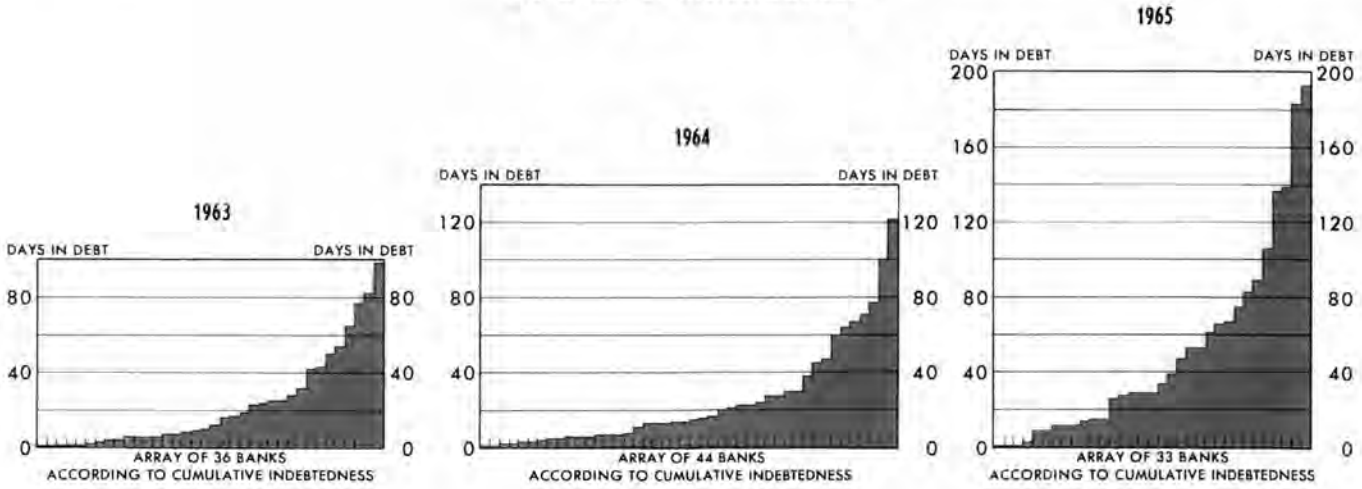
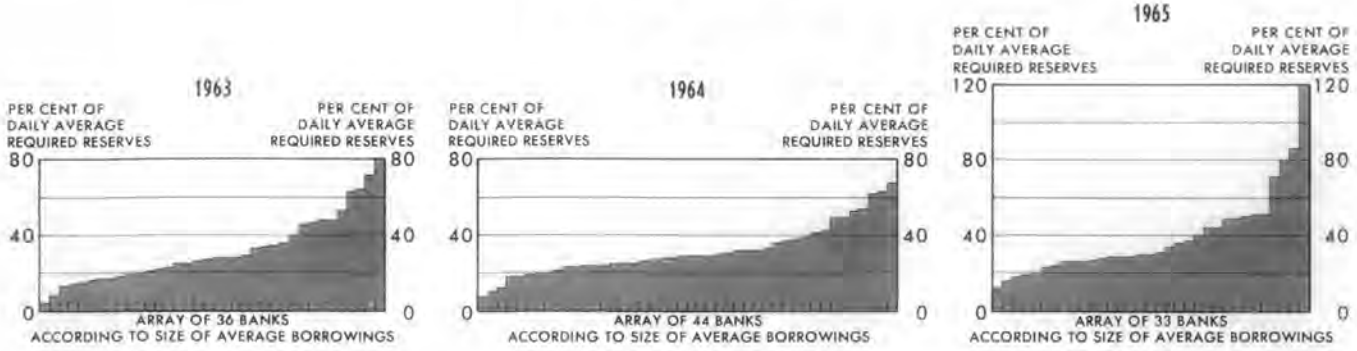


Chart 3

Average Borrowings*



*Computed for days borrowed only.

In 1964 and 1963 borrowing banks in the Eighth Federal Reserve District borrowed 31 and 32 per cent, respectively, of their required reserves (Table II).

Fewer banks borrowed small amounts in 1965 than in the two preceding years. Only 5 banks borrowed as little as 20 per cent of their required reserves. In the preceding year, 8 banks borrowed as little as 20 per cent, and, in 1963, there were 11 "small" borrowers (Table II and Chart 3).

Table II

AMOUNT OF INDEBTEDNESS IN RELATION TO REQUIRED RESERVES

Borrowing Banks in the Eighth Federal Reserve District

Years	Average Indebtedness[1] (Per Cent)	Number of Banks Borrowing: 20 Per Cent or less	Number of Banks Borrowing: More than 60 Per Cent
1965	39	5	4
1964	31	8	3
1963	32	11	4

[1]Mean indebtedness when borrowing.

Although there was no increase in the number of "large" borrowers[4] in 1965, the average size of their indebtedness was substantially greater than in 1963 or 1964. On the days on which they borrowed, the four "large" borrowers borrowed 89 per cent of their daily average required reserves. On borrowing days in 1964, the three "large" borrowers borrowed 64 per cent of their daily average required reserves; in 1963, the four "large" borrowers borrowed 70 per cent.

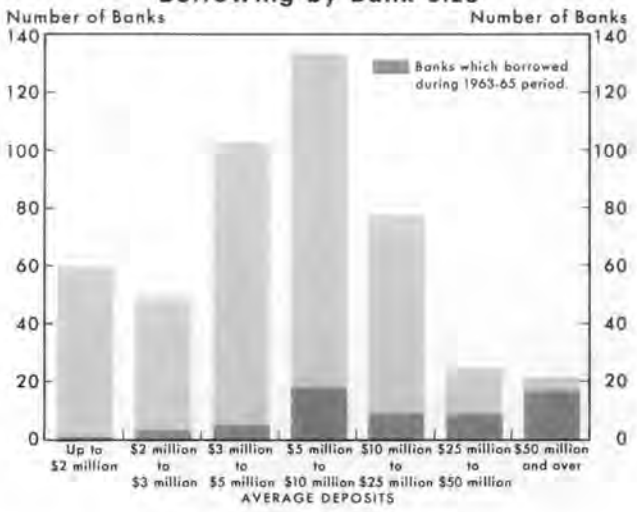
Bank Size and Borrowing

There were 483 banks in the Eighth Federal Reserve District which were members of the Federal Reserve System as of December 31, 1965, approximately one-third of the total number of banks located in the district. The median size of Eighth District member banks during the 1963-65 period was slightly less than $6 million, with 134 banks falling within the $5 million to $10 million range (Chart 4).

Borrowing is a more common practice among large banks than small ones. Of the 60 banks with assets of less than $2 million, only 1 borrowed from the Federal Reserve during the 1963-65 period. The largest number of borrowing banks was from the $5 million to $10 million size group; however, the 18 banks which borrowed constituted only 13 per cent of the banks within that size group. In the $25 million to $50 million group, 36 per cent of the banks borrowed, and, in the $50 million and over group, 77 per cent of the banks borrowed (Chart 4).

Chart 4

Borrowing by Bank Size



Concluding Remarks

During the 1963-65 period, there was a substantial rise in member bank borrowing from the Federal Reserve Bank of St. Louis. However, there was not an increase in the number of banks which borrowed.

[4]Defined here as those borrowing more than 60 per cent of their required reserves.

Instead, those banks which found it expedient to borrow in 1965 borrowed larger amounts and either borrowed more frequently or remained in debt for longer periods than in 1964 or 1963. This does not necessarily mean that borrowing has not become more widespread. It may be that a portion of the rise in borrowing from the Federal Reserve is being used to support interbank borrowing.

WILLIAM R. BRYAN

Member Bank Revenues and Expenses

AFTER-TAX INCOME of all Federal Reserve member banks in the nation totaled $2.1 billion in 1965, up 9.6 per cent from the previous year. Operating revenues increased 12 per cent, and operating expenses climbed 15 per cent. Net income before taxes was up only 2.4 per cent. Thus, most of the gain in net income after taxes reflected a reduction in tax rates.

After-tax income of Eighth District member banks totaled $75.0 million, up 5.9 per cent from a year earlier. Operating revenues rose 11 per cent, operating expenses rose 14 per cent, and net income before taxes declined 0.5 per cent.

Revenues

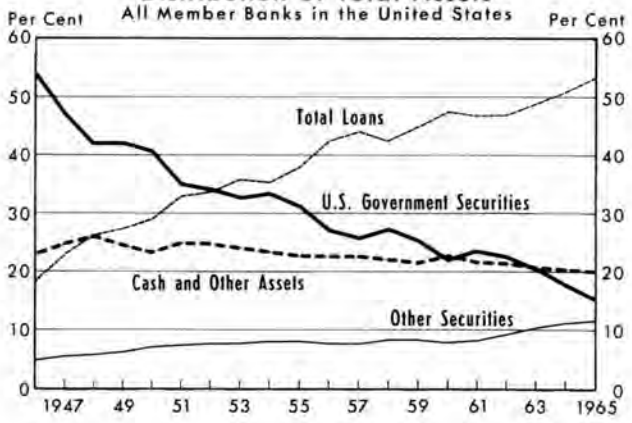
Since 1946 total operating revenues of member banks in the nation have risen from $2.4 billion to $13.9 billion or at an average annual rate of about 10 per cent (Table I). The growth reflected largely an increase in total assets, a shift from nonearning assets and relatively low yielding securities to higher earning assets, and a marked rise in the average level of interest rates.

From 1946 to 1965 total assets of member banks grew from $132.3 billion to $298.3 billion, an average annual rate of increase of 4.4 per cent. The history of member bank asset growth since 1946 may be divided into two periods: from 1946 to 1961, when asset growth was relatively slow, 3.3 per cent per year, and from 1961 to 1965, when assets grew rapidly, at an annual rate of 8.5 per cent.

Earning assets rose 3.4 per cent per year from 1946 to 1961 and 9.1 per cent per year from 1961 to 1965, slightly higher rates of increase than for total assets. The slight disparity in rates of growth in total assets and earning assets reflects the fact that member banks in the nation, due largely to reductions in reserve requirements, placed an increasing proportion of their available funds in earning assets. Cash balances were reduced from 22 per cent of assets in 1946 to 17 per cent in 1965.

In addition to the growth of earning assets, banks have enhanced operating revenues by adjusting their portfolios from lower earning to higher earning types of assets. Holdings of United States Government securities dropped from 54 to 15 per cent of assets during the 1946-65 period (Chart 1). Loans nearly tripled in relative importance, rising from 18 per cent to 53 per cent of assets. "Other" securities (mostly tax-exempt state and local government obligations) rose from 5 to 12 per cent of assets.

Chart I
Distribution of Total Assets
All Member Banks in the United States



Growth in revenue from loans has accounted for the major portion of total bank revenue growth since 1946. From $772 million in that year or 32 per cent of the total, revenue from loans rose to $9.3 billion in 1965 or 67 per cent of the total. Revenue from loans increased at an average annual rate of 14 per cent from 1946 to 1965.

In contrast to the rising importance of revenue from loans, revenue from investments has declined substantially relative to the total since 1946. At that time, investment revenue was $1.2 billion, 50 per cent of total revenues, while in 1965 investment revenue was $2.8 billion, 20 per cent of the total. From 1946

Table I

REVENUES AND EXPENSES OF MEMBER BANKS IN THE UNITED STATES

(Dollar Amounts in Millions)

	1965	Per Cent Change 1964-65	Per Cent Change Annual Rate 1946-65
Revenue on loans	$ 9,317	14.9	14.0
Interest on securities			
a. U.S. Government	1,692	— 2.9	2.5
b. Other	1,081	18.7	11.0
All other revenues	1,783	9.9	7.8
Total operating revenues	**$13,873**	**12.0**	**9.7**
Salaries, wages, and benefits	3,478	6.7	8.8
Interest on time deposits	4,220	24.7	17.1
Other expenses	2,524	12.1	8.3
Total operating expenses	**$10,222**	**14.9**	**10.8**
Net current earnings	**$ 3,651**	**4.6**	**7.4**
Recoveries, transfers from reserves, and profits	324		
Losses, charge-offs, and transfers to reserves	983		
Net income	**$ 2,992**	**2.4**	**5.7**
Taxes on net income	884	—11.4	6.1
Net income after taxes	**$ 2,108**	**9.6**	**5.5**
Cash dividends	1,061	10.4	7.5

to 1965 such revenue rose at an average annual rate of 4.5 per cent.

The sources of investment revenue have changed substantially since 1946. At that time, revenue from U. S. Government securities totaled $1.1 billion, 88 per cent of total investment revenue, and revenue from other securities amounted to $0.1 billion, only 12 per cent of the total. In contrast, U. S. Government securities accounted for 61 per cent of total investment revenue in 1965. State and municipal obligations accounted for most of the remaining 39 per cent.

Revenues from sources other than loans and investments have also grown during the postwar period but contributed proportionately less to total revenues in 1965 than in earlier years. Service charges on deposit accounts, trust department earnings, service charges and fees on bank loans, and other revenue have risen at an average annual rate of 7.8 per cent since 1946. These items accounted for 18 per cent of total revenues in 1946 compared with about 13 per cent in 1965.

During the earlier part of the 1946-65 period bank loans and investments other than U. S. Government securities grew rapidly; expansion was met largely by the funds obtained from sales of Government securities. During the later portion, however, banks met heavy loan demands from a rapid growth in total funds. Since 1961 most of the growth in bank credit has been met without reducing holdings of Government securities.

The greater part of the expansion in assets was made possible by great increases in time and savings deposits. From 1961 to 1965 these deposits rose at an average annual rate of 16 per cent. In contrast, they had risen at a 6.1 per cent rate in the preceding 15 years.

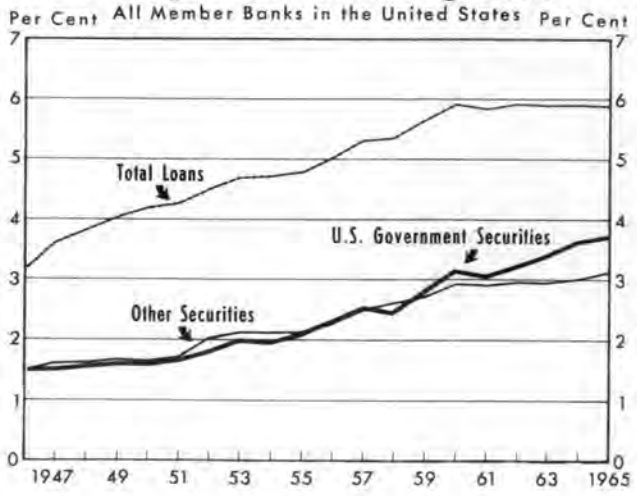
The rise in time and savings deposits has been accompanied and, in some respects, facilitated by institutional changes. In early 1961 a secondary market for large denomination certificates of deposit developed. These CD's have become useful as short-term investments for corporations, state and local governments, and others seeking temporary employment for large amounts of funds. Also, the development of the CD market has provided the banking system with a new means of attracting funds.

The expanded use of negotiable CD's was only the first of several new means of attracting funds to the commercial banks. Since their emergence such additional debt instruments as short-term unsecured notes and long-term subordinated debentures have also been developed. These innovations have helped to make the commercial banking industry an increasingly dynamic element in the financial system.

Another factor tending to increase revenues of member banks in the last two decades has been the upward secular trend of interest rates. The average return on bank loans increased from about 3.2 per cent in 1946 to the 5.9 per cent level which prevailed in the 1960-65 period (Chart 2). The average return on Government securities rose from 1.5 per cent in 1946 to 3.7 per cent in 1965.

Chart 2

Average Return on Earning Assets



In the Eighth District operating revenues of member banks have generally followed the national pattern. In 1965 revenues of these banks totaled $435.4 million, up 11 per cent from 1964, slightly below the gain nationally (Table II). Since 1946 member bank revenues in the district have risen at an average annual rate of 8.6 per cent, also somewhat less than the national rate of gain.

Eighth District member bank revenue growth can be traced to the same sources as for member banks throughout the nation. Earning assets have increased rapidly, largely as a result of growth in time and savings deposits. District banks have also shifted from lower yielding investments to higher yielding loans.

Since 1946 earning assets of district member banks have increased at a 4.1 per cent annual rate. As in the nation, the rate of gain has been much greater in recent years than in the earlier part of the period. Such assets rose 2.9 per cent per year from 1946 to 1961 while the rate has been 8.9 per cent annually since 1961. Time and savings deposits increased somewhat more rapidly than assets, rising at an average annual rate of 5.3 per cent from 1946 to 1961 and at a 15 per cent rate since 1961.

As in the nation, growth in loan revenue has accounted for the major portion of total revenue growth of district banks since 1946. From $33 million in 1946 or 36 per cent of the total, loan revenue rose to $285 million in 1965 or 65 per cent of the total. Revenue from loans at district member banks increased at an average annual rate of 12 per cent from 1946 to 1965.

Table II

REVENUES AND EXPENSES OF EIGHTH DISTRICT MEMBER BANKS

(Dollar Amounts in Millions)

		Per Cent Change	
	1965	1964-65	Annual Rate 1946-65
Revenue on loans	$284.6	13.6	12.1
Interest on securities			
a. U.S. Government	69.6	— 1.0	3.4
b. Other	36.9	19.0	9.7
All other revenues	44.3	10.5	6.1
Total operating revenues	**$435.4**	**11.1**	**8.6**
Salaries, wages, and benefits	109.0	7.9	7.9
Interest on time deposits	114.1	20.7	16.0
Other expenses	87.3	12.7	7.5
Total operating expenses	**$310.3**	**13.7**	**9.6**
Net current earnings	**$125.1**	**5.0**	**6.8**
Recoveries, transfers from reserves, and profits	18.1		
Losses, charge-offs, and transfers to reserves	36.9		
Net income	**$106.3**	**— 0.5**	**5.3**
Taxes on net income	31.3	—13.1	6.0
Net income after taxes	**$ 75.0**	**5.9**	**4.8**
Cash dividends	32.3	7.3	7.1

Note: Detail may not add to totals due to rounding.

Revenue from investments at district member banks totaled $106.5 million in 1965, up 4.9 per cent from a year earlier. Investment revenue was 48 per cent of total revenue in 1946, while in 1965 it was only 25 per cent of the total. From 1946 to 1965 such revenue rose at an average annual rate of 4.9 per cent.

Of the $106.5 million of revenue from investments in 1965, U. S. Government securities accounted for $69.6 million or 65 per cent of the total. Revenue from other securities accounted for the remaining 35 per cent. In 1946 revenue from Government securities totaled $36.6 million, 85 per cent of total investment revenue, while other securities accounted for $6.3 million, only 15 per cent of the total.

Expenses

Total operating expenses of member banks in the nation totaled $10.2 billion in 1965, up about 15 per cent from the previous year (Table I). Of the major expense items, interest paid on time and savings deposits increased most rapidly, rising about 25 per cent. Salaries, wages, and benefits increased 6.7 per cent, and all other expenses, 12 per cent.

Since 1946 operating expenses of member banks in the nation have risen from $1.5 billion to $10.2 billion, an average annual rate of 11 per cent. Reflecting the rapid and prolonged rise in time and savings deposits and the upward secular trend in interest rates, interest expense was the major factor in the overall increase. For the purpose of analyzing the growth in interest cost the years since 1946 may be divided into two periods: the years 1946-61, when interest cost rose at a moderate rate, and 1961-65, when such cost increased rapidly. During the earlier years banks were able to meet most of their loan demands through shifts in portfolio holdings and growth in reserves. They accepted time and savings deposits at relatively moderate interest rates.

Since 1961, however, with the high demand for loans and a minimum of other assets available for shifting into loans, banks have bid aggressively for time and savings deposits. Both the volume of such deposits and the average rates paid have increased rapidly. Time and savings deposits rose at a rate of 6.1 per cent per year from 1946 to 1961 compared with a rate of 16 per cent from 1961 to 1965. The average rate of interest paid on time and savings deposits rose from 0.8 per

cent in 1946 to 2.73 per cent in 1961 and to 3.74 per cent in 1965. This combination of increases in volume of deposits and rates paid has resulted in bank interest expense rising from an average rate of increase of 15 per cent per year in the years 1946-61 to 25 per cent per year in the past four years. Such expense now constitutes 41 per cent of total bank operating expense, whereas interest cost was only 14 per cent of bank expense in 1946.

Other major bank expense items have risen at fairly constant rates during the past two decades. Salaries, wages, and benefits increased at an 8.8 per cent rate, and all other expenses at an 8.3 per cent rate.

Expenses of member banks in the Eighth Federal Reserve District rose to $310 million in 1965 from $273 million in 1964, an increase of 14 per cent. Interest on time and savings deposits rose 21 per cent, salaries and wages, 8 per cent, and other expenses, 13 per cent.

Since 1946 total expenses at district banks have increased at a slightly lower rate than those in the nation. Overall expense in the district rose at an annual rate of 9.6 per cent compared with 11 per cent for the nation. Interest on time and savings deposits rose at a rate of 16 per cent in the district compared with 17 per cent for banks in the nation. Salaries and wages at district banks rose at a rate of 7.9 per cent compared with 8.8 per cent nationally, and all other expenses of district member banks rose at a rate of 7.5 per cent compared with an 8.3 per cent rate of gain nationally.

Net Earnings and Income

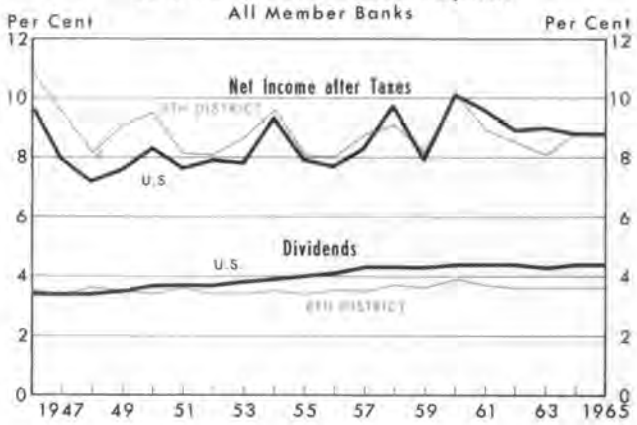
Net current earnings of member banks in the nation rose to $3.7 billion in 1965, an increase of 4.6 per cent from 1964 (Table 1). The net result of adjustments for recoveries, losses, and charge-offs was a reduction in net income before taxes of $659 million in 1965 compared with a reduction of $570 million in 1964. Member banks have shown a net gain from these transactions in only three postwar years (1946, 1954, and 1958), when profits on security sales more than offset loan and security losses and charge-offs.

Net income after taxes totaled $2.1 billion in 1965, an increase of 9.6 per cent from 1964. Net profits relative to capital accounts in 1965 were 8.8 per cent, unchanged from a year earlier. During the postwar period net profits relative to capital accounts at member banks have fluctuated between 7 and 10 per cent (Chart 3).

Since 1946 net income after taxes of member banks in the nation has risen about 5 to 6 per cent per year. The average rate of gain for the two decades was

Chart 3

Net Income after Taxes and Dividends as a Per Cent of Total Capital



5.5 per cent, 5.6 per cent for the years 1946 to 1961 and 5.3 per cent since 1961. Net income before taxes rose at a rate of 5.7 per cent per year for the two decades, and net current earnings (net income before adjustments for recoveries, losses, and charge-offs) rose 7.4 per cent per year.

Member banks in the nation distributed dividends of about $1.1 billion in 1965, an increase of 10 per cent from 1964. Capital also increased about 10 per cent; thus, the ratio of dividends to total capital (4.4 per cent) was unchanged from the previous year.

Net current earnings of member banks in the Eighth District totaled $125 million in 1965, about 5.0 per cent above the previous year. Net losses and charge-offs absorbed $19 million, 53 per cent more than during 1964. Nearly all of this sizable jump is attributable to an increase in transfers to loan valuation reserves, reflecting changes in Internal Revenue Service rulings on methods of calculating maximum permissible additions to bad debt reserves.

Net income before taxes of $106 million was 0.5 per cent below a year earlier; however, income taxes decreased, and net income after taxes rose 5.9 per cent to $75 million.

The growth rate of earnings and income at district member banks during the past two decades was slightly below that for the nation. Net income after taxes at district banks grew at a rate of 4.8 per cent per year compared with 5.5 per cent for the nation. Before-tax income and current earnings grew at rates of 5.3 and 6.8 per cent, respectively, in the district compared with rates of 5.7 and 7.4 per cent in the nation.

After distributing cash dividends of $32.3 million in 1965, an increase of 7.3 per cent from the previous year, district member banks added $42.7 million to their undivided profits.