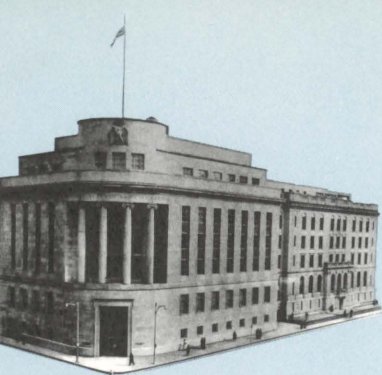

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NEW ENGLAND ECONOMIC REVIEW

Adjustment to Import Competition

Whether adjustment assistance by the Federal Government helps workers and firms to cope with the problems caused by import competition is the subject of this article. It is based on a detailed study of benefit recipients in the Massachusetts shoe industry.

Factors Affecting Bank Structure Change: The New England Experience, 1963-74.

This article reviews the major influences on structural changes in banking and illustrates them with examples from the New England experience of the past ten years. The trends have been markedly different among the six states of the region.

Supplement: Solving the Long-Range Problems of Housing and Mortgage Finance

Remarks by Frank E. Morris, President, Federal Reserve Bank of Boston, May 14, 1975.

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Adjustment to Import Competition

JAMES E. McCARTHY*

This article is based on Research Report No. 58 entitled *Trade Adjustment Assistance: A Case Study of the Shoe Industry in Massachusetts*, Federal Reserve Bank of Boston, June 1975. The Report was written by James E. McCarthy with the aid of a research grant from this Bank as a Ph.D. dissertation for the Fletcher School of Law and Diplomacy.

The report was designed to test the effectiveness of government assistance to workers and firms who would otherwise suffer as a result of freer trade. The shoe industry in Massachusetts was used as the case study because it provided the largest concentration of adjustment assistance cases, both geographically and in a single industry. The study analyzes the adjustment services and the obstacles to their use. It also provides a statistical analysis of the adjustment experiences of the workers and the firms and discusses some alternative approaches. The Report is available without charge on request to the Research Department, Federal Reserve Bank of Boston, Mass. 02106.

MOST economists would support the proposition that free international trade could bring about a significant improvement in the world's economic welfare. In a study conducted for the Brookings Institution, Stephen Magee found that restrictions on U. S. trade impose average annual costs of $7.5 billion to the U. S. economy as a whole.[1] Others have suggested that the total loss is even higher, if one includes the costs imposed by absence of competition and the smaller scale of production which trade restrictions promote.[2]

Yet, for a variety of reasons, the world has not been in any rush to remove all trade barriers. In fact, since the completion of the Kennedy Round of tariff negotiations in 1967, the world has seemed to be slowly moving in the other direction, with import quotas and

* Economist, The Conference Board.

[1] Stephen P. Magee, "The Welfare Effects of Restrictions on U.S. Trade," *Brookings Papers on Economic Activity*, 3:1972, p. 700.

[2] See, for example, C. Fred Bergsten in "Comments and Discussion," *Ibid.*, pp. 702-703.

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"voluntary" restraints by foreign suppliers on the increase.

Much of the resistance to freer trade has come from sectoral interests—firms, unions, and other organizations in threatened domestic industries. These sectoral interests have always been better organized than groups representing the general interest. The harm they would suffer, while smaller than the overall gains from free trade, is concentrated in individual industries and towns, where it is highly visible.

To alleviate the problems of these sectoral interests, and to neutralize their opposition to freer trade, many have suggested expanded programs of adjustment assistance. The purpose of such programs would be to help workers, firms, or communities to cope with the problems caused by increased imports.

Adjustment assistance has been available to some workers and firms under the Trade Expansion Act of 1962. Under this legislation, 18 firms and 52,000 workers have been certified to receive benefits. Tables 1, 2 and 3 give the industrial and geographic distribution of the workers and firms. Benefits for workers could consist of: 1) Trade Readjustment Allowances, which supplement unemployment compensation; 2) testing, counseling, placement, and training services provided by State Divisions of Employment Security; and 3) relocation for new employment. Qualified firms could receive tax assistance, technical assistance, and loans or loan guarantees.

The new Trade Act of 1974 has eased adjustment assistance eligibility criteria. As a result, many more firms and workers may qualify for a similar set of benefits. It is important, therefore, to take a look at the experiences of past adjustment assistance recipients in order to see whether the program is having its intended effects. Whether adjustment assistance helps workers and firms to cope with the problems caused by import competition was the question addressed in an 18-month study of benefit recipients in the Massachusetts shoe industry. This article discusses the results of that study, the policy implications, and potential alternatives to the current program of trade adjustment assistance.

Table 1

WORKER ADJUSTMENT ASSISTANCE CASES CERTIFIED

As of December 31, 1974, By Industry

Industry	*No. of Cases Approved*	*Estimated No. of Workers*
Footwear, except Rubber	42	12,937
Electrical Components & Electronics	12	10,093
Radio, TV, and Phonograph	8	9,794
Rubber Footwear	4	5,232
Musical Instruments (mostly pianos)	11	3,062
Textiles	6	2,835
Automobiles	2	2,150
Stainless & Silverware	2	1,820
Glass	5	1,770
Steel	4	850
Bearings & Rollers	1	650
Marble & Granite	3	380
Tableware	1	270
Hydraulic Presses & Valves	1	26
Total	102	51,869

SOURCE: U.S. Department of Labor, Office of Foreign Economic Policy, "Trade Adjusment Assistance Calendar."

Worker Assistance

The major focus of the study was on worker assistance. A sample of 200 shoe workers from 12 different companies in Massachu-

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Table 2

WORKER ADJUSTMENT ASSISTANCE CASES CERTIFIED

As of December 31, 1974, By State

State	*No. of Cases Approved**	*Estimated No. of Workers*
Massachusetts	20	9,448
New York	9	5,120
New Hampshire	14	4,258
Illinois	8	4,114
Indiana	6	3,675
New Jersey	4	2,990
Tennessee	2	2,920
Connecticut	2	2,660
California	5	2,493
Pennsylvania	7	1,861
Georgia	2	1,730
Kentucky	2	1,500
Michigan	4	1,420
Rhode Island	1	1,162
Maine	4	1,072
South Carolina	2	1,043
West Virginia	2	650
Others**	14	3,753
Total	108	51,869

* The total number of cases listed here is larger than that given in Table 1 because some firms had plants in more than one state. In this table the groups in each state have been counted as separate cases. Number of workers is unaffected.

** The States of Alabama, Florida, Iowa, Louisiana, Maryland, Missouri, North Carolina, Ohio, Oklahoma, Texas, Vermont, and Virginia, each of which had less than 500 workers certified.

SOURCE: U.S. Department of Labor, Office of Foreign Economic Policy, "Trade Adjustment Assistance Calendar."

setts was chosen in order to study the adjustment process and the effects of Federal assistance. The sample was stratified by city and by firm, to assure that roughly 10 percent of the workers in each of these categories would be included in the sample. The sample was otherwise random. Information concerning the workers was collected from the claimant files of the Massachusetts Division of Employment Security. In addition, 191 (95.5 percent) of the workers were personally interviewed.

All the workers belonged to groups certified by the U.S. Department of Labor as having been injured by increased imports. Of the 200 workers, 185 had worked for companies which had gone out of business. The remainder worked for a firm which applied for firm assistance from the U.S. Department of Commerce and was still in business.

The study found that the sample members as a group had severe adjustment problems. One-fourth of those laid off had never found another job. At the time of interview (which ranged from 20 months to 56 months after layoff), half the sample members were not employed full-time. Real wages for those employed had declined 16 percent—from a pre-layoff mean weekly wage of $111.15 to $93.35 at the time of the interview.

Yet of the 185 sample members who were laid off, only one had participated in a government training program, one had received a relocation allowance, and only five had been placed in jobs by the Massachusetts Division of Employment Security. For most workers, assistance consisted only of TRA (Trade Readjustment Allowances), a supplement to unemployment insurance. Sample members received an average of $1,072 in TRA, in addition to $1,635 in unemployment benefits.

In sum, although the sample members faced difficult adjustment problems and nearly all received trade readjustment allowances, virtually none of them made use of the employment services authorized by the Trade Expansion Act. Why? There were at least four reasons. First,

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Table 3

FIRMS RECEIVING ADJUSTMENT ASSISTANCE AND AMOUNTS RECEIVED

(to October 31, 1974)

Industry	*Name of Firm*	*Location*	*Date Proposal Certified*	*Preproposal Technical Assistance*	*Tax Refund Authorized*	*Technical Assistance Authorized*	*Financial Assistance Authorized*	*Total Adjustment Assistance Authorized*
Shoe	*Benson Shoe Co.	Lynn, Mass.	11/19/70	$ 2,500	$ 9,440	$ 250,000	$ 1,400,000	$ 1,661,940
Shoe	*Duchess Footwear Corp.	Salem, Mass.	12/19/72	—	70,000	96,000	3,051,000	3,217,000
Shoe	*Louis Shoe Co.	Amesbury, Mass.	10/19/71 (Modified 5/29/73)	2,500	—	75,000	900,000	977,500
Shoe	American Girl Fashions (formerly Consolidated Nat'l Shoe Corp.)	Braintree, Mass.	2/8/74	43,982	—	138,000	5,072,150	5,254,132
Shoe	Bernie Shoe Co.	Haverhill, Mass.	2/22/74	42,985	—	21,200	806,900	871,085
Shoe	Regina Footwear, Inc.	Brooklyn, N.Y.	10/7/74	29,412	—	80,000	1,095,420	1,204,832
Piano	Estey Piano Corp.	Union, N.J.	3/4/71 (3 later modifications)	16,910	—	166,050	2,944,000	3,126,960
Piano	Grand Piano, Inc.	Morgantown, N.C.	1/30/73	2,500	—	—	325,000	327,500
Electronic Components	Bel-Tronics Corp.	Addison, Ill.	3/3/72	2,500	—	55,000	647,000	704,500
Electronic Components	Ion Capacitor Corp.	Columbia City, Ind.	11/17/72	2,500	—	45,000	1,066,000	1,113,500
Consumer Electronics	H. H. Scott, Inc.	Maynard, Mass.	12/23/71	2,500	233,808	—	—	236,308
Sheet Glass	ASG Industries, Inc.	Kingsport, Tenn.	12/7/71	—	—	—	4,000,000	4,000,000
Sheet Glass	Fourco Glass Co.	Clarksburg, W.Va.	2/17/73	—	—	—	7,000,000	7,000,000
Textile/ Data Processing	The Arista Co.	Winston-Salem, N.C.	1/11/72	—	153,252	—	—	153,252
Textile	The Bibb Co.	Macon, Ga.	8/28/72	—	3,358,356	—	—	3,358,356
Textile	J. H. Bonck Co.	New Orleans, La.	8/23/73	96,762	—	—	900,000	996,762
Barber Chair	Emil J. Paidar Co.	Chicago, Ill.	8/20/70	—	—	35,200	3,784,394	3,819,594
Stainless Steel Flatware	Utica Cutlery Co.	Utica, N.Y.	5/20/73	2,500	—	150,000	600,000	752,500
			TOTALS	$247,551	$3,824,856	$1,111,450	$33,591,864	$38,775,721

* Firms whose experiences were studied

SOURCE: U.S. Department of Commerce, Office of Trade Adjustment Assistance

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Table 4

SOME COMPARISONS BETWEEN THE FIRM-ASSISTED SUBGROUP AND WORKERS PERMANENTLY LAID OFF

	Item	*Firm-Assisted Group*	*Workers Permanently Laid Off*
1.	Number of Workers in Sample	15	185
2.	Mean Age (range)	51.2 (22-76)	53.9 (17-77)
3.	Sex	66.7% Female	71.4% Female
4.	Mean Years of School (range)	8.5 (4-12)	9.0 (0-16)
5.	Percent U.S.-Born Whites	80%	86.2%
6.	Mean Pre-Impact Wage	$89.73	$101.27
7.	Number of Months From Layoff to Interview	49.9	39.2
8.	Mean Current Wage	$123.30	$106.63
9.	Mean Current Wage in Real Terms*	$101.67	$92.50
10.	Relationship of Mean Current Wage to Mean Pre-Impact Wage for Currently Employed Persons**	+27.5%	−5.3%
11.	Relationship of Mean Current Real Wage to Mean Pre-Impact Wage for Currently Employed Persons**	+5.1%	−17.9%
12.	Mean Number of Full Weeks of UI Benefits Collected, Impact to 1/1/73***	11.5	33.1
13.	Mean Number of Partial Weeks of UI Benefits Collected, Impact to 1/1/73***	13.3	8.7
14.	Mean Amount of TRA Collected	$451	$1,122
15.	Mean Amount of UI + Extensions Collected to 1/1/73	$818	$1,701
16.	Mean Total Benefits Collected to 1/1/73 (14 + 15)	$1,269	$2,823
17.	Mean Number of Full Weeks of UI Benefits Collected Since Expiration of TRA***	2.6	7.7
18.	Mean Number of Partial Weeks of UI Benefits Collected Since Expiration of TRA***	0.3	2.1

$$\text{* Current Wage} \times \frac{\text{Consumer Price Index at Time of First Layoff}}{\text{Consumer Price Index at Time of Interview}} = \text{Current Real Wage}$$

** Since these were computed only for persons currently employed, the figures may differ slightly from what would be obtained by using the mean figures of 6, 8 and 9.

*** Includes extensions of unemployment benefits.

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the time lag between application for and receipt of benefits was so long that most applicants were forced to adjust on their own. Workers in our sample waited a mean 19.4 months from date of layoff to receipt of their first TRA check. Much of the delay was the result of the cumbersome procedures required by the Trade Expansion Act.

Second, knowledge of available benefits was not widespread. In our survey, less than 70 percent of the workers who applied for and received TRA knew that they were also eligible to receive retraining or relocation benefits. A more detailed survey of worker knowledge, undertaken by the Bureau of International Labor Affairs, found even less awareness: less than 40 percent of those potentially eligible for benefits were aware of the training, placement and relocation aspects of adjustment assistance.[3]

Third, many impacted workers were simply not interested in the services. In addition to the few who did retrain or relocate,[4] only 17 percent of our sample members expressed any interest in retraining and less than 7 percent an interest in relocation. The workers' personal characteristics probably had a good deal to do with this disinterest. The median age of the workers was 55. More than a third of the group were secondary wage earners. Educational levels were low, a mean nine years of school. And most workers had lived in the same area almost all their lives.

Finally, those workers who were interested in the services often faced insurmountable administrative obstacles in trying to obtain them. Government training classes had long waiting lists, and single referral for private training courses was generally available only in Boston, outside the commuting area of most sample members. Relocation allowances were available only to heads of families who obtained employment or received a bona fide offer of employment outside the commuting area, and only if the Secretary of Labor determined that the worker could not reasonably be expected to secure suitable employment within the commuting area. Under these conditions, few even applied.

In most cases the Massachusetts Division of Employment Security (DES) did not make much of an effort to provide special services to trade-impacted workers. Most claimants only dealt with the unemployment insurance (UI) side of DES. The employment service, which would provide counseling, refer individuals to training, etc., was a separate branch, sometimes in a different building. UI personnel did refer some individuals for counseling, but unless the person was young and unemployed at the time he filed for TRA, he or she was generally not referred.

Variables Affecting Worker Adjustment

The scarcity of adjustment services made it impossible to examine how effective such services could be. However, it was possible to examine the adjustment problem itself. Five different measures of worker adjustment were considered: 1) whether or not the worker found subsequent employment; 2) the number of weeks of unemployment and TRA benefits collected; 3) for those who found work, the number of weeks of unemployment before find-

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[3] U.S. Bureau of International Labor Affairs, "Survey of Workers Displaced by Import Competition," unpublished, 1972, Tables XVI and XVII.

[4] In addition to the one person who entered a government training course and the one person who received a relocation allowance, three people relocated on their own and 14 people were retrained, 13 through on-the-job training provided by subsequent employers.

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ing work; 4) the difference between wage at the job lost due to imports (pre-impact wage) and initial wage at the next job; and 5) the difference between pre-impact wage and real wage at the time of interview. Statistical tests were performed relating to the last four of these measures in an effort to determine what worker characteristics or other variables affected the adjustment process. The statistical techniques employed (regression analyses) made it possible to evaluate the influence of each worker characteristic or other variable separately, apart from the influence of other variables. The results can be summed up in eight short paragraphs:

First, men adjusted more easily than women. They found jobs more quickly and, once they found jobs, suffered significantly fewer weeks of unemployment. They also fared better in both the short- and long-run measures of wage change. For all workers, the mean change in real wage from prelayoff jobs to jobs held at the time of interview was a reduction of $17.81. But the burden of this reduction fell mostly on women. After removing the influence of other variables, current real wage minus pre-impact wage was $41 higher for men than for women. In other words, men generally increased their wages while women did not.

Second, older workers had a more difficult time adjusting than the young and the middle-aged. Persons 55 years of age, according to the regression equation, collected 7.7 more weeks of benefits than persons aged 45; 65 year-olds collected a further 11.1 weeks. This reflects the fact that older people often did not find work: one-third of the 55-64 age group had not held a job since their layoff.[5] Older workers also generally had lower wages at subsequent employment. Middle-aged workers were most likely to show wage gains.

Third, reinforcing our second observation, workers with the most seniority and experience had a more difficult time adjusting than other sample members. Workers with many years in the industry collected significantly more weeks of benefits and suffered significant wage losses which persisted over the entire period from layoff to interview. Workers with many years at the company suffered significant initial wage losses in shifting jobs.

Fourth, those with more highly paid jobs took bigger absolute cuts in wages at subsequent jobs. The loss continued through the period under study and was larger for jobs held as of the interview date than for initial post-layoff employment.

Fifth, it was apparent that workers who remained in the shoe industry did not suffer negative effects as a result. They had fewer weeks of unemployment and at time of interview were earning a significant premium of $11.25 a week over their fellows who went to work in other industries. Despite the low wages paid in the shoe industry, it appears that the other jobs open to shoe workers paid even less. However, the option of remaining in the shoe industry was not open to many workers: in many cases there were simply no shoe jobs available within commuting distance.

Sixth, where there were high rates and rising trends of unemployment in the local labor market, there were longer periods of unemployment before sample members found jobs. Higher unemployment rates also led to more weeks of benefits collected and lower initial wages when work was found; but the wage effects were apparently not long-lasting, as no

[5] To some extent it also reflects the fact that persons 60 or over at the time of layoff were eligible for 13 more weeks of TRA. But even with this extra entitlement, 64 percent of those over 60 exhausted their TRA benefits, while only 39 percent of those under 60 did so.

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significant effect was found on current wages.

Seventh, training, where provided by subsequent employers, had significant positive effects on current wages, averaging $19 per week. The conclusion that these effects were due to training is reinforced by the finding that before training, the same workers had lower than average wages.

Eighth, it appeared that workers given more notice of impending layoff were better able to adjust. They suffered significantly fewer weeks of unemployment overall and received higher mean wages (though not significantly so) at subsequent employment.

These findings lead us to the following conclusions about worker assistance: 1) Employers should be required to give some notice of their intention to shut down a plant. Nearly 20 percent of the sample members reported having no notice at all of the management's intention to close the plant. These people had longer, more difficult adjustment periods. Adequate notice would give individuals more time to think about their plans and seek alternative employment. It would also enable the state and Federal governments to provide more timely adjustment assistance. 2) Special efforts must be made to deal with the groups which bear the heaviest adjustment burdens. In the Massachusetts shoe industry, these were older workers and women. 3) Adjustment programs need not encourage individuals to change industry, if other employment opportunities are available in that industry nearby. Where there are not such opportunities, workers will face a more difficult adjustment task and will need the special attention of the state employment service. 4) Training, in this case principally on-the-job training, appears to offer increased wages to workers after relatively short periods of time and should be part of a more effective assistance program. And 5) it must be realized that prevailing economic conditions will play an important role in the adjustment experiences of individuals. Even the best adjustment program will not be able to compensate for high or rapidly rising unemployment rates.

Firm Assistance

Another method authorized by the Trade Expansion Act for dealing with the problems caused by increased import competition was for the government to offer assistance to adversely affected firms. Eighteen firms had been assisted under the program as of October 1974. Table 3 gives information concerning the firms and the types of assistance given.

The experiences of three Massachusetts shoe firms which were among the first to receive help were studied. In addition, since the workers at one of these firms had qualified for worker assistance, their experiences were compared with those of the 11 other worker groups to determine the effects of firm assistance on workers.

Firm assistance had positive effects on workers in the one case studied. As Table 4 demonstrates, workers at the assisted company had personal characteristics similar to the 11 other groups, but their adjustment experiences were markedly different. Obviously, the employees benefited from the fact that their employer was able to stay afloat. They were unemployed fewer weeks and collected less than half as much in total unemployment benefits. In addition, the mean real wages of the group rose 5.1 percent over the adjustment period, while real wages of currently employed members of the other groups dropped 17.9 percent.[6]

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[6] Statistical tests showed firm assistance to have a significant effect in reducing the number of weeks

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The effect of firm assistance on firms was less clear-cut. Of the 18 firms to receive assistance, two (including one of the Massachusetts shoe firms) have since gone out of business.

Many of the firms which applied for help were small, family-owned businesses. Often, the firm's management is its most serious problem. It is not always possible to bring about substantive change in the way the firm is run—change which may be necessary if the firm is to survive.

Firm assistance came in three varieties: tax, technical, and financial. Tax assistance was an extension to five years of the usual three-year carryback of net operating losses. Technical assistance consisted of management consulting services from private consulting firms. And financial assistance consisted either of loan guarantees or direct loans from the Commerce Department or Small Business Administration. Interest rates on these loans were quite low, ranging from 6 to 7⅜ percent in the three shoe cases,[7] with repayment scheduled over a long-term period, up to 25 years.

At the three shoe firms studied, the assistance given was put to work in the following major areas: 1) creation of new production control and reporting systems to increase efficiency and make more information available to the company's managers; 2) purchase of new equipment or equipment previously leased, and the introduction of new systems of footwear manufacturing; and 3) increasing working capital. The first of these areas was the smallest item in terms of money outlays, but perhaps the most important element as far as successful long-range adjustment is concerned. Technical assistance money went into inventory and production controls, sales analysis, and other important management tools. In addition, two of the three companies were developing new wage structures to encourage an increase in worker productivity.

The second area, purchase of equipment and the setting up of new processes, accounted for roughly one-third to one-half of the funds spent at two of the companies and 15-20 percent at the third. All three companies purchased conveyor systems; all of them changed their plant layouts to increase efficiency; and all of them purchased newer machinery. One of the three also went into new methods of manufacture, producing injection-molded, string-lasted, and flow molded footwear. These processes resulted in considerable labor saving.

Finally, roughly half of the money at two firms and about 75 percent at the third went into working capital. This enabled the firms to purchase materials on a more favorable current basis, to maintain inventory at acceptable levels, etc. This emphasis can be criticized on the grounds that working capital will not solve the firm's underlying problems. But on the other hand, without working capital, none of the firms could have remained in business.

It is too early to draw conclusions as to the usefulness of firm assistance. The number of firms aided has been so small and their problems and potential for adjustment have been so dissimilar that it is impossible to judge the program's potential on the basis of its experience to date.

It can be said in its favor that, thus far, adjustment aid has kept most of the certified firms in business, with positive effects on the workers and communities involved. On the other hand,

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of benefits collected, and to have a positive, but not significant effect on wages.

[7] By contrast, one firm stated that its previous loans had been at rates of 12.9 to 16.0 percent. More important than the interest savings, however, was the fact that these firms were generally no longer able to raise capital in the private market.

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it may simply have postponed the firm's day of reckoning.

The firm assistance program raises two questions which may ultimately limit its usefulness even if it proves successful in dealing with the problems of applicant firms. First, there is a question of equity: is it fair to give aid to one or several firms in an industry while denying it to others? Second, how many of the firms in need of help will actually apply for it? Interviews with several shoe manufacturers who had gone out of business convinced me that they would not have applied for assistance even if it were readily available, because they saw no future for the industry as a whole. These two observations have led some to suggest that the best approach to adjustment aid would be an industry-wide approach.

Industry Assistance

In a study of trade adjustment assistance two years ago, the National Association of Manufacturers suggested that firm assistance be used only as a last resort and that emphasis be placed on industry-wide adjustment aid.[8] Others, including the footwear industry trade association and some individual companies, have suggested that the government assist a footwear industry recovery program.[9]

The crux of their proposals is that the government should give direct assistance for research and development in industries threatened by import competition. The objective would be the development of new processes and machinery to speed up design and production, improve productivity, and thus cut costs and save labor. As a result, the industry would become more competitive with foreign producers.

The proponents of such plans find at least four reasons for government support. First, economic theory suggests that the government should support certain kinds of research because private markets are likely to devote fewer resources to it than would be socially optimal. This is particularly true of basic scientific research because

> it is likely to generate substantial external economies. Important additions to fundamental knowledge often have an impact on a great many fields. If a firm produces an important scientific breakthrough, it generally cannot hope to capture the full value of the new knowledge it creates. It cannot go into the full range of activities in which the knowledge has use, and it is seldom able to capture through patent rights the full social value of the new knowledge.[10]

This is also true to a lesser extent of applied research. Proponents of a shoe industry research and development (R&D) plan argue that the benefits would not be limited to one industry. As with military or space R & D there might be spinoffs applicable to other industries, in this case spinoffs particularly applicable to other labor-intensive industries. Because of these external economies, they argue, the government should help pay for research.

Second, the participation of government in such a program is seen as essential, because recent footwear industry difficulties have made

[8] See *Trade Adjustment Assistance,* a Staff Report prepared by the National Association of Manufacturers, Washington, D.C., February 1973, pp. 31-38.

[9] For a good summary of the types of projects which might be supported by a footwear industry assistance program, see Stanley M. Jacks, "Productivity Issues in the Domestic Shoe Industry," (Washington, D.C.: National Commission on Productivity, August 1971).

[10] Edwin Mansfield, *Micro-economics: Theory and Applications* (New York: W. W. Norton, 1970), p. 430.

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it difficult for private firms to attract sufficient capital for development of radically new systems on their own.

Third, the NAM observes that since the mid-60s, government support for all R & D has declined significantly. This resulted in lower R & D expenditures as a percent of GNP, paralleling slower growth of productivity and a declining trade surplus in technology-intensive manufactured goods. An increase in government support for R & D keyed to trade adjustment, they argue, would help reverse these trends and would be good for the economy as a whole.

Fourth, a successful program might improve the Nation's balance of payments. For example, using a projected 1980 consumption of one billion pair of shoes priced at $5 per pair wholesale,[11] each 1 percent shift from imports to domestic production results in a 10 million pair increase in domestic production and a $50 million improvement in the balance of payments.

None of these is a compelling argument for industry assistance. Starting with the fourth argument, the balance of payments can be improved in a number of ways. Resources channeled into R & D for the shoe industry could just as easily be channeled into expanding export industries, encouraging foreigners to visit the United States, encouraging foreign direct investment in the United States, or any number of other activities, with the result of improving our payments position. Or we may improve our position even without expenditure of resources by devaluation, as we did in 1973. The need to make this improvement is not a sufficient reason to support the shoe industry plan.

The same may be said of the third argument. The objective of increasing productivity is an important one, particularly in light of the recent high rate of inflation. Increased R & D might help achieve this objective. But there is no reason to encourage productivity increases only in industries suffering from increased import competition. The steps taken should apply to all industries.

It is on the basis of the first argument that we must judge industry assistance. If there were sufficient external economies to be generated, government support would be warranted. But the proponents of shoe industry assistance have not given any indication of the size or specific type of such benefits expected. The projects suggested by footwear industry proponents involve applied, not basic, research: the development of machinery and computer systems for specific shoe manufacturing tasks. It is difficult to see how this could be applied to other industries. Lacking evidence to the contrary, it would appear that benefits to other industries from such research would be small, in which case the R & D costs should be borne by the shoe industry. The only remaining argument, that private firms using private sources of capital will not carry out the program on their own, is in itself no reason for the government to do so. Quite the contrary.

Finally, it is important to note that industry assistance does not solve the problems of firms and workers, which were the focus of our study. A successful R & D program would create capital-intensive, labor-saving methods of shoe production. This would probably lead to an increase in firm size and consolidation of the industry. Layoffs of workers might increase as small companies leave the business, or as technology replaces workers in large firms. While these developments might be beneficial from the point of view of the industry and the economy as a whole, they might only increase

[11] USM Corporation projections, obtained in interview, June 1973.

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the adjustment problems of workers and small firms. In short, industry adjustment assistance does not appear to be the answer to the problems of shoe workers and firms suffering from import dislocation.

Changes in Adjustment Assistance

The Trade Act of 1974, signed into law January 3, 1975, introduces substantial changes in trade adjustment assistance. The most important of these is an easing of eligibility criteria which should produce a dramatic increase in the size of the program. In addition, application procedures have been streamlined and benefits somewhat changed.

The most important change in benefits is their expansion to include assistance for communities. Communities which can show that increased imports or the transfer of local firms to foreign countries have injured the local economy may receive technical assistance, planning grants, and public works grants and loans. Businesses within such communities may also receive financial assistance. Up to $500 million in loan guarantees are authorized under the program.

On balance, these changes should improve the program. The wider availability and broader range of benefits may have positive effects not only on workers and firms, but on entire industries and communities.

But the new program is not a panacea. Many (perhaps most) firms in danger of failing will not apply for firm assistance. Most towns which will qualify for community assistance are already eligible for other development programs; the Trade Act may only have added another layer of bureaucracy.

Perhaps most important, the Act will not in itself provide solutions to the adjustment problems faced by workers. To understand why, we must distinguish between the benefits themselves and the system for delivering them. The benefits theoretically available to workers under the Trade Act are quite good. They include cash and almost every conceivable service. The problem lies in delivering the services and in motivating workers to make use of them. Except in rare instances where unions, employers, and state employment service personnel worked together to provide training and jobs,[12] use of such employment services under the Trade Expansion Act was almost nonexistent. There is no reason to expect this situation to change under the new Act.

If worker assistance is to be successful, greater efforts will have to be made to counsel, place, and train affected workers. The success of these efforts will largely depend on the amount of emphasis placed on them at the state and local levels of the Employment Service, and it will be necessary to get unions and employers actively involved in the program.

What is true of training and placement is even more true of relocation. Relocation could aid adjustment in many cases, but it will not be undertaken on a large scale without the help of employment counselors and prospective employers.

Finally, special efforts will also have to be made to deal with the adjustment problems of women and older workers. These two groups suffer the most when a factory shuts down, yet because they are thought to have less of an attachment to the labor force, they receive less help.

The adjustment assistance program could also be improved by a change in one of the

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[12] A case where such cooperation brought about widespread use of employment services is discussed in Jane Mayerson, "The Trade Expansion Act: An Untapped Resource for the Middle-Aged and Older Worker," *Industrial Gerontology*, Spring 1972.

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benefits: the basis for TRA payments should no longer be tied to length of unemployment. Unemployment insurance already provides weekly income while workers search for other jobs. There is no reason to establish a second system of payments with the same goal. As both sample members and Division of Employment Security officials noted, this second system (TRA) simply penalizes workers who find jobs quickly.[13]

Instead, TRA should compensate workers through lump-sum payments based on the number of years they were employed at the affected company. When a firm closes down, workers often lose a great deal in benefits associated with seniority. We found that the old and those with the most seniority and experience had more difficult adjustment experiences. If workers are to receive special compensation for foreign-trade-related layoffs, the fairest method of compensation would be to base the amount on the number of years of employment.

If companies provided adequate severance pay, this lump-sum TRA might not be necessary. But only 2 of the 11 companies in our sample provided production workers with severance pay, and the amounts were small. Thus, TRA could fill a need which is presently ignored.

Weekly TRA payments might continue only for workers who enter training. This would clearly identify training as a goal of the program and provide an extra incentive for workers to participate.

Conclusion

In the period since this study was begun, the U.S. position in international trade has substantially improved. The overall trade figures are somewhat distorted by the extraordinary rise in the price of fuel and agricultural products in the last two years; but, eliminating these items, the U.S. trade balance went from a deficit of $6.0 billion in 1972 to a surplus of $6.8 billion in 1974. In the latter year, for the first time since 1961, the volume of U.S. imports actually declined.

As a result, foreign competition may be less keenly felt now than it was two years ago. But the problems with which adjustment assistance was meant to deal, the hardships caused by the closing of marginal factories in the face of import pressures, are still with us. Even under the strict eligibility criteria of the Trade Expansion Act, 19,142 more workers qualified for adjustment aid in the years 1973 and 1974. This represents a substantial amount of dislocation caused by changes in trading patterns; and undoubtedly there were others who did not apply for aid or could not meet the strict criteria for certification.

The amount of dislocation will increase in coming years if the new round of multilateral trade negotiations, now beginning, achieves a significant reduction of trade barriers. It behooves us, therefore, to improve our capabilities for dealing with such dislocation. The Trade Act of 1974 will provide some of the needed improvement, but a great deal more will depend on the amounts of cooperation and of energy with which business, labor, and government approach the Act's implementation.

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[13] This is not to imply that TRA has served as a disincentive to seek work. In the overwhelming majority of cases, uncertainty of eligibility and slowness of delivering benefits have combined to eliminate that possibility. But it has retroactively rewarded those who, for whatever reason, took longest to find jobs, in effect penalizing the quickest.

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Factors Affecting Bank Structure Change: The New England Experience, 1963-74

STEVEN J. WEISS*

This article is based upon Research Report No. 59 of the Federal Reserve Bank of Boston, *Changing Commercial Bank Structure in New England*, June, 1975. The authors are Katharine Gibson, George H. Gonyer, Deborah Isaacs, and Gina Rogers. The Research Report traces the history and structural development of commercial banking in the New England states from 1963 to 1974.

The report contains a detailed state-by-state analysis of the major trends in commercial banking in the last ten years. The growth of multibank holding companies, merger activity and the expansion of the depository powers of thrift institutions have been significant influences on structural developments in the New England states. The present banking structure of each state is discussed, highlighting the major banking markets. Analysis of these markets provides the framework upon which policy decisions rest. Current legal, technological. and institutional developments affecting banking structure are presented in each of the state chapters, along with a brief discussion of the future prospects of banking in the various states. The report also contains extensive structural data on each state, including major market structure statistics, such as concentration ratios, as well as state concentration statistics and lists of mergers, *de novo* banks, bank holding companies and their banking subsidiaries. The report is available without charge by request to the Research Department, Federal Reserve Bank of Boston, Boston, Massachusetts 02106.

THE structure of commercial banking in the New England states has undergone significant change during the past decade. There has been substantial consolidation of banking resources through bank mergers and holding company acquisitions, but competition in particular banking markets has been intensified by the entry of new competitors; and activity by thrift institutions has presented

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new challenges to commercial banks in the markets for certain financial services.

The purpose of this article is to review the major influences on structural changes in banking and to illustrate their importance by reference to examples from the New England experience over the last decade. The ten-year experience has differed markedly among the six states of the region. Detailed accounts of recent bank structure developments in the New England states, analysis of the current environment and indications of likely sources of change in the future are presented in a Federal Reserve Bank of Boston Research Report, *Changing Commercial Bank Structure in New England* (see Box).

Significance of Bank Structure Changes

Describing the "structure" of commercial banking involves such quantitative measures as the number and size distribution of banks in a particular area, the relative market shares of banking organizations and the patterns of bank ownership and control.[1] The structure of a banking market ultimately affects banks' performance in terms of the cost, quality and variety of services offered to customers. Thus, concern for the welfare of consumers is the fundamental basis for public policies intended to promote a competitive banking structure.

Economic theory suggests that a banking market will be more competitive, and bank customers will be better served, the greater the number of banking organizations competing in the market and the lower the degree of concentration. This hypothesized "structure-performance relationship" has been supported by numerous empirical studies of bank competition. The authors of the most definitive study to date concluded with regard to bank competition for household business that ". . . increases in market concentration can indeed be expected to lead to decreases in bank 'performance,' as measured by prices of services and loans and as measured by such services as overdraft checking powers and banking hours."[2] The structure-performance relationship is the principal basis for regulatory decisions on applications for bank acquisitions, chartering and branching, although offsetting public benefits and financial considerations are also weighed in the balance. Any proposed bank structure change must receive prior approval from regulatory authorities which are charged with responsibility for maintaining an efficient banking system that is both competitive and financially sound.

Statewide Trends and Major Markets

During the period from year-end 1963 through 1974, the number of commercial banking organizations declined significantly in three of the New England states—Maine, Vermont and Massachusetts. Table I presents data for each state on new bank and holding company formations, mergers, and holding company acquisitions during the period. (A holding com-

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[1] For a useful discussion of the concept and measurement of banking structure, see Alfred Broaddus, "The Banking Structure: What It Means and Why It Matters," Federal Reserve Bank of Richmond *Monthly Review,* November 1971, pp. 2-8, 10.

[2] A.A. Heggestad and J.J. Mingo, "Prices, Nonprices, and Concentration in Selected Banking Markets," Board of Governors of the Federal Reserve System, March 1974, p. 27. For a critical review of earlier studies, see N.B. Murphy and S.J. Weiss, "The Effect of Concentration on Performance: Evaluating Statistical Studies," *Magazine of Bank Administration,* November 1969, pp. 34ff.

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Table I

CHANGES IN NUMBER OF COMMERCIAL BANKING ORGANIZATIONS, 1964-1974

	Number of Banking Organizations December, 1963	*New Banks 1964-74*[a] *(+)*	*Mergers*[b] *1964-74 (−)*	*Holding Company Acquisitions*[c] *1964-74 (−)*	*New Holding Companies (+)*	*Number of Banking Organizations December, 1974*	*Percentage Change in Number of Banking Organizations*
Maine	40	8	6	20	4	26	−35%
New Hampshire	60	20	9	12	4	63	5
Vermont	47	—	15	1	1	32	−32
Massachusetts	139	23	26	58	31	109	−22
Connecticut	60	31	21	14	9	65	8
Rhode Island	10	7	1	10	10	16	60
New England	356	89	78	115	59	311	−13

[a] Includes three new banks formed by holding companies in Maine and two in New Hampshire.
[b] Excludes mergers of holding company subsidiaries.
[c] Includes new banks formed and acquired by holding companies.

SOURCE: Federal Reserve Bank of Boston Research Report No. 59, Chapter 1, Table 4.

pany is treated as a single banking organization; even though it may have more than one bank subsidiary in a particular area, the banks are not independent competitors.) The data show that the pattern of these structural changes, which determine net changes in the number of banking organizations, varied widely among the six states. For example, the substantial declines in Maine and Vermont reflect quite different types of activity; in Vermont, the decline was entirely due to a high level of merger activity, whereas the dominant factor in Maine was acquisitions by holding companies. Both mergers and holding company acquisitions were significant in Massachusetts during the period. In Connecticut, where the number of mergers was proportionately even greater than Vermont's, an extraordinary number of new banks were chartered resulting in a net increase in the number of banking organizations. The number of commercial banking organizations in Rhode Island increased sharply during the period because of special institutional or legal circumstances that enabled thrift institutions to enter the commercial banking business by acquiring commercial bank affiliates.

Table II shows figures for 1963 and 1974 on the percentage of total state deposits held by the largest banking organizations. In every state except Rhode Island, this measure of concentration of banking resources for the state as a whole increased during the period. Overall concentration is high in every state, ranging from 66.4 percent of total deposits held by the ten largest organizations in New Hampshire to 97 percent in Rhode Island. Figures are also presented on the percentage of deposits held by the five largest organizations in each state. In Maine and New Hamp-

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Table II

PERCENTAGE OF TOTAL STATE DEPOSITS HELD BY LARGEST BANKING ORGANIZATIONS, 1963-1974

	Percentage of Deposits Held by 10 Largest Com'l Bkg. Organizations			*Percentage of Deposits Held by 5 Largest Com'l Bkg. Organizations*		
	1963	*1974*	*Absolute Change 1963-74*	*1963*	*1974*	*Absolute Change 1963-74*
Maine	74.1	88.1	+14.0	49.7	70.7	+21.0
New Hampshire	58.2	66.4	+ 8.2	39.7	54.5	+14.8
Vermont	61.3	79.2	+17.9	44.7	61.1	+16.4
Massachusetts	72.1	80.0	+ 7.9	63.7	67.0	+ 3.3
Connecticut	78.1	81.8	+ 3.7	55.5	60.7	+ 5.2
Rhode Island	100.0	97.0	− 3.0	90.7	80.7	−10.0

NOTE: 1974 figures are based on data for June 30, 1974, adjusted to reflect structural changes through December 31, 1974.

SOURCE: Federal Reserve Bank of Boston, Research Report No. 59.

shire the five-organization percentage grew by significantly more than the ten-organization figures, suggesting that growth of the largest banking organizations was partly at the expense of others in the top ten. By contrast, in Massachusetts the smaller organizations among the top ten gained ground in terms of their holdings of total state deposits, relative to the five largest. This result reflects the fact that three new holding companies experienced substantial growth internally or by acquisition.

In general, the trend has been toward increasing dominance by the largest banking organizations in each state. (The only exception, Rhode Island, is a special case.) As noted above, the pattern of structural change has varied from state to state. In Vermont and Maine, substantial increases in concentration in the last decade reflect high levels of merger and holding company activity, respectively, on the part of the largest organizations. A three-way merger and a multibank holding company formation, both involving three banks among the top ten in the state, were the major events underlying the increase in statewide concentration in New Hampshire.

The state as a geographic area has no significance in terms of conventional market analysis since state boundaries have been determined by history and geography rather than economics. Nonetheless, changes in concentration at the state level are significant for banking structure regulation for several reasons. In the broadest perspective, recognizing the pervasive impact of banks on virtually all sectors of economic activity, policymakers may

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legitimately be concerned about undue concentration of economic power and political influence if any one banking organization (or a few) grows to a point where it dominates banking in a state. In banking, restrictions on operations across state lines prevent out-of-state banking organizations from directly challenging the position of dominant banking interests in most product and service lines, especially those most affecting individual consumers.

While the state area has no economic meaning as a banking market, it is significant as long as interstate banking is prohibited since the state contains all potential entrants into any given local market. If a few large banks or holding companies are permitted to grow through acquisitions to a point where they gain significant market shares in most major banking markets in the state, the long-run competitive conditions could be quite deleterious to consumers. Compounding the competitive loss from the absorption of potential rivals, entry by new banking groups or smaller organizations lacking comparable resources would be discouraged.[3]

Without the discipline imposed by the significant threat of new entry, and recognizing their interdependence due to "shared" dominance in multiple markets, competitive behavior of the major banking organizations is likely to be moderated, less aggressive.[4] These conditions do not exist presently in any of the New England states, but as statewide concentration increases, careful scrutiny of acquisitions across market lines, especially applications involving large statewide or local market institutions, will become a more important regulatory concern.

Growth of large banking organizations by expansion into new local markets can have pro-competitive effects, and "market extension" mergers or acquisitions, by definition, do not eliminate existing competition. However, the manner in which large organizations enter new local markets or regions of a state makes a great deal of difference. *De novo* entry or entry by a small "foothold" acquisition is clearly preferable to acquisition of a bank that holds a sizable local market share. Well-managed independent local banks have demonstrated their capacity to hold their own against *de novo* or foothold entry by much larger rivals, and they can also form their own (or "regional") holding companies to compete against the state leaders over a broader area.

Acquisitions combining large state organizations have profoundly affected the banking structure in some New England states, as noted above, but very few such acquisitions have been consummated in recent years. The large-organization combinations that have taken place have been "market extension" moves, and "horizontal" acquisitions combining significant direct competitors have become almost a thing of the past. As a result, the structure of major markets in New England has not been adversely affected, in general, and in some areas competitive conditions have been intensified by the entry of large outside organizations. However, concentration remains quite high in most major markets, and many are served by only a relatively small number of independent competitors (see Table III). In some highly concentrated markets which are attractive for entry (as indicated, for example, by a high ratio of population per commercial banking office; Hartford and Worcester are

[3] See the statement by Donald I. Baker, reprinted as "Statewide Yardstick Will Apply In Potential Competition Cases," *American Banker,* March 21, 1973, pp. 4ff

[4] See Elinor Harris Solomon, "Bank Merger Policy and Problems: A Linkage Theory of Oligopoly," *Journal of Money, Credit and Banking,* August 1970.

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Table III

FIFTEEN LARGEST NEW ENGLAND BANKING MARKETS, SELECTED STATISTICS

	Total Commercial Bank Deposits 6/30/73 ($ mil.)	*Number of Commercial Banking Organizations*	*Measures of Market Concentration:*		*Ratio of Population Per Commercial Bank Office*
			*Three-Organization Concentration Ratio**	*Herfindahl Index***	
Boston, Mass.	10,220.7	80	57.0	.140	5,717
Providence, R.I.	2,817.3	18	61.6	.294	4,220
Hartford, Conn.	2,561.2	22	82.3	.311	5,925
New Haven, Conn.	812.4	18	64.0	.167	5,234
Bridgeport, Conn.	765.6	17	77.4	.244	5,060
Springfield, Mass.	666.6	10	81.6	.239	5,354
Worcester, Mass.	603.3	8	90.4	.321	7,228
Portland, Maine	378.3	9	84.2	.243	3,065
Waterbury, Conn.	324.0	8	92.1	.440	4,951
New London-Norwich, Conn.	310.4	12	79.5	.234	6,335
Manchester, N.H.	274.2	9	77.4	.307	5,428
Nashua, N.H.	237.7	6	88.8	.272	3,896
Burlington, Vt.	218.9	5	98.4	.323	3,868
Fall River, Mass.	198.9	7	89.2	.278	4,915
Barre-Montpelier, Vt.	194.1	12	53.0	.135	2,637

* Sum of the three largest market shares held by commercial banking organizations in the market.

** Sum of the squared market shares held by all commercial banking organizations in the market.

SOURCE: Federal Reserve Bank of Boston, Research Report No. 59.

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cases in point—see Table III), entry of outside organizations that could serve to deconcentrate the market may be frustrated by legal barriers or discouraged by virtue of the entrenched positions of local market leaders.

Factors Affecting Bank Structure Change

Changes in banking structure are influenced by numerous factors, which can be classified under four general headings, as follows: (1) the managerial goals of banking firms, and bankers' individual and collective (*i.e.*, trade association) attitudes toward competition and expansion; (2) the economic and demographic characteristics of a particular area, including present conditions and future prospects; (3) state and Federal laws regarding branch banking, bank chartering, mergers, and holding company formations and acquisitions; and (4) regulatory actions at the state and Federal level. This listing reflects an hierarchical arrangement that realistically parallels the process of bank structure change. No change would occur unless bankers were motivated to move, and their principal motivation—increasing profits—must hinge on a determination that economic conditions favor a move into any particular area, justifying the cost of expansion by acquisition or *de novo*. However, many expansionary moves that are attractive to profit- and growth-minded bankers are precluded by restrictive state and Federal laws. As a final constraint, banking organizations must apply to regulatory authorities and obtain prior approval of specific proposals for structural changes.

These four factors will be discussed in the remainder of this article and illustrated by examples from the New England states.[5]

Bankers' objectives and attitudes toward competition and expansion are fundamental determinants of bank structure change and the nature of structural developments, which may enhance or diminish the intensity of bank competition in a given area. A preference for the "quiet life" or a cooperative, "friendly" attitude toward ostensible rivals will not generate structural moves that stimulate competition and bring about improvements in customer service. Competitive benefits flow from the actions of the more aggressive banking organizations—often regarded as mavericks—that are willing to shake up the status quo in order to promote their own objectives.

Many of the recent changes in the structure of banking in the New England states were initiated by organizations that set out to create multiple-office banking systems with effectively statewide coverage. Moves to build statewide organizations have established clear trends, for example, in Maine, Massachusetts and Connecticut. Once such a pattern emerges from the activity of an aggressive organization, it often produces a "bandwagon effect" as other institutions, not wanting to be left behind, follow suit. In Maine, the movement toward statewide systems has generated such momentum that three holding companies have established *de novo* banks in order to enter new markets; curiously, none of the large holding companies in Massachusetts or Connecticut have followed this course, even though they are effectively barred by legal barriers or lack of feasible acquisitions from entering certain major markets by other means.[6]

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[5] All of the examples and many other pertinent episodes from recent developments in New England banking structure are discussed at greater length in *Changing Commercial Bank Structure in New England*, Federal Reserve Bank of Boston, Research Report No. 59, June 1975.

[6] In many other states outside New England, bank

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Aggressive actions by thrift institutions have significantly affected commercial banking in most New England states. The thrifts have consistently sought to broaden their array of services for retail customers, and as they succeed by degrees they compete with commercial banks in more and more product lines. A dramatic example of the thrift institutions' impact is the NOW account, an innovation representing a great gain for consumers in Massachusetts and New Hampshire.[7] Two large thrift institutions, one in New Hampshire and one in Rhode Island, have gone all the way in challenging their commercial bank rivals by obtaining commercial charters and converting.

Economic and demographic factors of particular areas are carefully evaluated by most bankers as a primary ingredient in their expansion planning. Since banks are more likely to prosper in wealthy or growing areas, expansion-minded organizations follow economic and demographic trends skillfully and with keen interest, and the statistics on structural changes tend to bear them out. For example, southern New Hampshire, one of the most rapidly growing areas in the country, has experienced an extraordinary rate of growth in terms of new banking offices and new banks. Similarly, many large banks in Connecticut entered the Danbury area in the early 1960s in anticipation of the rapid employment and income growth that subsequently took place.

Conversely, areas that are sparsely populated or economically stagnant are most unlikely to attract significant new banking activity, and in fact consolidation of banking resources may be the inevitable order of the day. When banking is already concentrated in such areas, the prospect of structural change to produce a more competitive structure languishes as a forlorn hope of regulators. Large banking organizations faced with unpromising economic prospects in their home-base markets have expanded into greener pastures by various means. Thus, large Boston banks have overstepped their county branching limits by establishing holding companies to acquire banks in other parts of Massachusetts; and holding companies have sought more profitable opportunities by entering new fields through nonbank subsidiaries.[8]

State and Federal laws define the ground rules for bank structure changes. Laws, often by unfortunate intent, generally constrain the expansionary activity of banking organizations. Legal changes can have a profound impact on banking structure if they open up opportunities for institutions to compete in new geographic or product markets. Current proposals for recodification of the banking law in Maine would, if adopted, have the effect of stimulating new competition across broader geographic areas and between different classes of financial institutions. Similarly, bank customers in Connecticut are the beneficiaries of a state law that authorizes thrift institutions to begin offering checking accounts at the beginning of 1976.

State branching laws often have serious anticompetitive effects by inhibiting banking office expansion that would otherwise serve the convenience and needs of consumers. Branching was prohibited in New Hampshire until 1963.

holding companies have commonly entered new markets by obtaining new bank charters.

[7] See Katharine Gibson, "The Early History and Initial Impact of NOW Accounts," Federal Reserve Bank of Boston, *New England Economic Review*, January/February 1975.

[8] See Edith S. Boxman, *Bank Holding Company Trends in New England*, Federal Reserve Bank of Boston, March 1974, pp. 23-28 and Appendix.

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The banking public has gained considerably since then as many branches have been opened. However, since the 1963 law contains very restrictive limitations on branching, the gain has come almost entirely through banks' proliferation of offices in their local areas, rather than banks in different markets penetrating each other's areas through establishment of branch offices; the protective features of the law apparently were designed consciously to preclude the latter result. Prior to 1963, the only way to achieve multi-office banking in New Hampshire was to establish a multibank holding company. Similarly, in Massachusetts today, the only way for a banking organization to cross county lines is via holding company acquisitions. This situation works to the advantage of large commercial banks since smaller banks lack comparable resources to establish multibank systems and rival thrift institutions lack the legal means to do so.[9]

A very significant change in Federal law, the Bank Holding Company Act Amendments of 1970, has had an important impact on New England banking structure, particularly in Massachusetts. The primary result of the Amendments was to open the door to bank holding company expansion into nonbanking businesses. In addition to legitimizing broad nonbank activity of holding companies, the Amendments also extended Federal regulation to cover one-bank holding companies for the first time. It is this feature of the legal change that affected banking structure developments *per se*, albeit indirectly. Prior to 1970, holding companies had to choose between combining ownership of only one bank with almost unlimited nonbanking businesses or becoming multibank organizations subject to very strict limits on diversification into nonbank areas. By significantly broadening the permissible scope of holding companies' nonbank activities, the law resolved a widespread bankers' dilemma; companies that would have chosen diversification were freed to embark on multibank expansion as well.

Regulatory actions by state and Federal authorities have an obviously definitive impact on individual structural changes since their prior approval is required for chartering, branching and acquisitions. State authorities share with the Comptroller of the Currency the power to grant new bank charters; state and Federal bank regulators both act on applications for bank mergers and holding company acquisitions, while the Justice Department enjoys the power to challenge individual transactions on antitrust grounds.

Regulatory decisions on key cases can be extremely significant in effecting structural changes in local markets. For example, after the Federal Reserve Board rejected a merger between two banks in New Haven, each of the would-be partners was subsequently acquired by stronger competing organizations which were not previously represented in the New Haven market. Similarly, suits by the Justice Department put a stop to two large-bank mergers proposed in Connecticut. In Vermont, a series of regulatory actions had a most significant pro-competitive impact on structural developments during the period 1971-74, when five proposed horizontal mergers were thwarted: two were denied by the State Banking Commissioner, one by the FDIC, and two were stopped as a result of legal action by the Justice Department. In addition to preventing the elimination of significant existing

[9] This particular inter-institutional inequity would be eliminated by bills currently before the state legislature which would remove or phase out the home county restriction on branching.

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competition and an increase in concentration in local markets, these regulatory actions carried with them an important message. Vermont bankers read the message well; three of the banks involved in the thwarted horizontal mergers were subsequently acquired by banks operating in another part of the state.

Concluding Comment: Regulatory Modesty

Although regulatory authorities can take definitive action with respect to individual applications for acquisitions and other proposed bank structure changes, their influence on structural developments is, for the most part, quite marginal. That fact is brought home by the regulators' fourth and last place position in the hierarchical chain of factors affecting bank structure change. Nonetheless, regulators cherish at least implicit notions of what constitutes an "optimal banking structure" that will best serve the public interest. Apart from their decisions on the margin, where errors sometimes occur, they can only attempt to influence the evolution of a competitive banking structure by arguing for the elimination of restrictive laws, signaling their displeasure with perceived anticompetitive trends and explaining clearly the preferred means of pro-competitive change.

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Remarks of FRANK E. MORRIS, *President of the Federal Reserve Bank of Boston before the 55th Annual Conference of the National Association of Mutual Savings Banks Sheraton-Boston, Boston, Massachusetts, May 14, 1975*

Solving the Long-Range Problems of Housing and Mortgage Finance

THE very title of this session is encouraging. We have passed through a decade of intense public concern over housing finance. Yet this concern has tended to be focused on short-term palliatives which have had very limited success. The mortgage market in its fundamentals has not changed in the past decade, despite the obvious need for change. The mortgage market was just about as sensitive to swings in short-term money rates in 1974 as it was eight years earlier in 1966.

After a decade of failure, it is time to turn away from makeshift responses to the problem of housing finance and begin to seek fundamental answers. These answers, it seems to me, lie in the restructuring of the mortgage instrument. I would like to emphasize that the views I express are solely my own and not necessarily those of the Federal Reserve System.

The year 1966, it seems to me, was the turning-point for the mortgage market. We learned in that year that the thrift institutions, as they were then structured, were not well adapted to an economy characterized by inflation and sharp swings in short-term money rates. This fact raised two major public concerns. First, there was anxiety over the viability of the thrift institutions themselves. Second, there was concern because the vulnerability of our thrift institutions to swings in short-term money rates aggravated the impact of monetary policy on the housing industry.

Housing will always be the most sensitive sector in the economy to shifts in monetary policy, no matter how well we organize and perfect the mortgage market. This will be so because the level of the mortgage rate is much more critical in limiting the ability of the consumer to carry such debt than is the interest rate on any other type of borrowing. But the problems of housing finance in the United States are compounded by the fact that the principal sources of mortgage money in our

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system, the thrift institutions, find that their own money flows tend to dry up or turn negative when short-term money rates rise. As a consequence, we have been subjected to much larger swings in housing construction than would have been the case if the thrift institutions were in a position to adapt to changes in short-term money rates.

In attempting to deal with this problem during the past decade, the Congress has fostered a group of governmental financial intermediaries empowered to raise money in the open market and to channel the funds into the housing market. This approach has met with only limited success for reasons which are familiar to you all.

More recently the Congress has been contemplating credit allocation as a possible solution. Short of comprehensive administrative control over all sources of finance, which would carry with it heavy costs to the society in the form of a less dynamic and less efficient economy, this approach is also likely to fail to meet the problems of housing finance.

While the Federal Government has been trying to innovate in the mortgage market, even if not too successfully, there has been a remarkable lack of innovation on the part of the thrift institutions over the past decade. While it is true that the liability side of their balance sheets has been substantially changed by a major increase in longer-dated liabilities, the composition of their assets has not changed much in the past decade. As a result, the thrift institutions were not in a very much better position to meet the pressures of 1974 than they were to meet the pressures of 1966.

In my judgment, the answer to the problems of the thrift institutions is not to convert them into commercial banks. What we need are specialized housing finance institutions which are capable of functioning in an inflationary economy. To produce this capability, it will be necessary to move away from sole reliance on the long-term, fixed-rate mortgage, a financial instrument which was a product of the Great Depression, when stable prices and low interest rates were properly imbedded in expectations.

At a recent conference on financial innovation at New York University, the question arose: why have we not seen, until very recent months, any significant thrust by private institutions to produce a mortgage instrument better suited to our times? Why have private markets failed to innovate in this case?

The answer, it seems to me, lies in the shelter provided by Regulation Q. In the absence of this shelter, the thrift institutions would have been compelled to innovate. Regulation Q is a crutch which has been just barely strong enough to prevent the necessary adaptation from taking place.

However, it seems to me that the shelter of Regulation Q is rapidly eroding for two principal reasons. First, the market is responding by designing new open market financial instruments to meet the needs of the small saver. In 1973-74, we saw two such new instruments introduced: the floating-rate note and the money market mutual fund. The success of these new instruments, particularly the money-market mutual fund, assures that, in the next period of tight money, the competition of open market instruments is likely to be more severe than ever before.

The second reason why the shelter of Regulation Q is eroding is the rising strength of consumerism. There is a growing awareness that the small saver has been the principal victim of Regulation Q. The rate on home mortgages has been subsidized by artificially depressing the return available to the small saver. This is a very regressive arrangement,

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since the poorest 40 percent of our population owns 25 percent of all savings deposits, but accounts for only 10 percent of mortgage debt. In the past the interests of the consumer as saver have never received much attention in the Congress. I think this is changing. The survival of the NOW account in Massachusetts and New Hampshire is a symptom of this change. It survived the formidable combined opposition of the commercial banks and the savings and loan associations because the NOW account was considered by the Congress as an innovation favorable to the consumer.

No single form of mortgage instrument can meet all of the housing finance needs of the American people. We need an array of mortgage instruments which, in combination, can move us toward three objectives: first, a more stable flow of funds into the thrift institutions; second, a fairer shake on interest rates for the small saver; and third, the solution of the housing "financing gap" caused by higher interest rates.

The level payment mortgage is not well adapted to the expected life-income stream of our young adult population. It has always required that a much higher percentage of the total income of young adults be spent on housing during the early years of the mortgage. This was not so critical when interest rates were low, but when mortgage rates rise sharply the problem becomes acute. A move from 5 percent to 9½ percent in the mortgage rate increases the monthly payment on a $30,000, 30-year mortgage by 57 percent. This creates the "financing gap" I referred to earlier, which is pricing much of our young adult population out of the housing market.

Unless our private institutions respond to this "financing gap" problem by devising a workable graduated payment mortgage, the Federal Government will have to meet the problem with a mortgage interest rate subsidy. Such a subsidy should gradually phase out over the first five or six years of the mortgage as the income of the homeowner rises.

The mortgage market of the future should offer an array of mortgage instruments to the consumer so that he or she can choose the one which best meets his or her needs. The conventional, fixed-rate, level payment mortgage should not be eliminated, but it should be offered at a significantly higher rate than the variable-rate mortgage. If the homeowner wishes to be protected against future changes in interest rates, he should expect to pay an interest rate premium for the privilege. He should not expect, at no cost, to push this risk onto the shoulders of the savings depositor, who typically has a lower income than the homeowner.

In addition to the variable-rate mortgage, a graduated payment mortgage of some sort should be available to the young adult whose income can reasonably be expected to rise substantially in the future. With this array of mortgage instruments, housing finance could be put on a sound basis.

Whenever one talks about restructuring the mortgage portfolios of our thrift institutions, two responses are inevitable. The first is that the idea is impractical because it would take seven or eight years to accomplish significant change. The second is that it is impractical because the consumer will not buy these strange new mortgage instruments. The first argument undoubtedly accounts for much of the lethargic response of the thrift institutions to the idea of the new mortgage instruments. It will, indeed, take a long time before these new instruments could make a significant difference. When money is tight, the attention of the management of thrift institutions must be focused on short-term survival. When the turn

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in short-term money rates comes, and funds start flowing in again, the whole matter loses its sense of urgency. There is never a really good time to work on the long-term viability of the thrift institutions and the long-term stability of the mortgage market.

With respect to the second argument, that these new mortgage forms cannot be sold to the American consumer, I am not persuaded. It is true that to the person who can afford the high initial payments (which many of our young adults cannot), the fixed-rate, level-payment mortgage is a good deal. The lender (and ultimately the savings depositor) bears all the risks of changing interest rates. But is the present mortgage form really a good deal for the American public if it prevents the mortgage market from functioning properly?

The recent Congressional action on variable-rate mortgages stems from the concern which has led state legislatures in the past to impose usury ceilings on mortgage rates—a concern to protect the public from greedy and unscrupulous lenders. The effect of the usury laws, however, has been to impair the proper functioning of markets and to divert money away from the mortgage market whenever the market rate rises above the ceiling. The consumer gains no protection from markets that do not function.

There is a pressing need to restructure the mortgage market so that it can function effectively in the environment in which we find ourselves today. If our private mortgage lending institutions fail to adapt to their environment, either due to their own inertia or due to legislative constraints on their ability to adapt, the Federal Government's role in the mortgage market must expand. These are the alternatives as I see them.

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