

*A review by the* **Federal Reserve Bank of Chicago**

# Business Conditions

**1965 March**



## **Contents**

The trend of business	
Rising inventories—an economic storm signal?	2
Beef futures	8
Trends in banking and finance	
Correspondent banking	13

# THE Trend OF BUSINESS

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## Rising inventories—an economic storm signal?

**B**usiness inventories rose at an annual rate of 6 billion dollars in the fourth quarter of 1964, twice as fast as in the first nine months of the year. The pace of inventory accumulation probably accelerated further in the first quarter of the current year to a rate unequalled since early 1960 when steel holdings were being rebuilt after a 116 day strike.

Most types of manufacturing industries, especially producers of machinery and equipment, increased their inventories in recent months and doubtless are continuing to do so. There was relatively little rise in holdings of retailers and wholesalers, partly because consumer purchases were higher than merchants had anticipated.

Whenever inventories are increased sharply a question is raised about the probable future course of general business activity. As the proportion of current output going "on the shelf" is increased beyond needs for efficient operations of business firms, it is reasonable to expect that such an artificial stimulus will be replaced by an offsetting dampening influence later. How seriously do current

inventory developments threaten prospects for orderly economic growth for the remainder of the year?

### Special factors . . . in autos

The quickened rate of inventory accumulation is closely associated with labor-management negotiations in two major Midwest industries—motor vehicles and steel. Strikes at General Motors and Ford in October and November caused a sharp drop in the number of vehicles in the hands of dealers.

At year-end the book value of automobile dealer inventories, seasonally adjusted, was almost 700 million dollars less than at the end of September. On an annual rate basis this reduction amounted to more than 2.5 billion dollars. If there had been no auto strikes, therefore, the rate of inventory accumulation for all business in the fourth quarter might have been 8 or 9 billion dollars, rather than 6 billion, and would have exceeded the rise in any period since World War II other than those associated with the 1959 steel strike or the Korean war.

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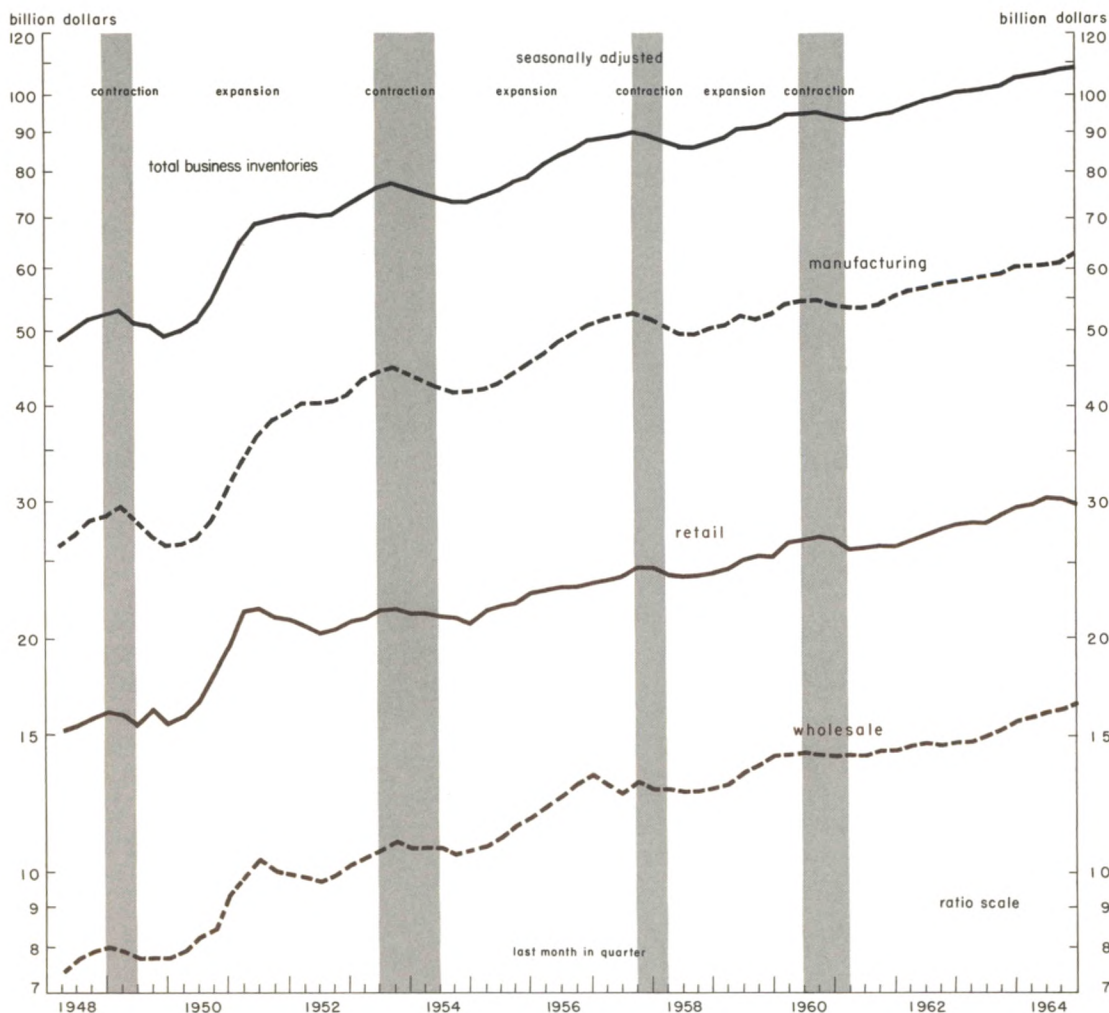
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Output of motor vehicles recovered quickly in December. Passenger car assemblies exceeded 220,000 per week early in the month, an annual rate of almost 11.5 million and far more than ever before. Output has continued at a high level in 1965 and assem-

blies for the first quarter are expected to be at an annual rate of about 10.5 million. Sales have been at record levels and industry spokesmen state that they hope to sell over 8 million cars in 1965—a new high—but well below the current rate of production.

**“Turns” in business inventories**  
typically lag changes in general business



Auto output almost certainly will not be maintained at the first quarter rate in the April-June period. At the end of January, 1 million new cars were on hand, a gain of more than 300,000 from the end of November. It is said that the industry's goal is 1.4 million cars by the end of March, 200,000 more than last year's total, to prepare for expected heavy spring sales.

### **. . . and steel**

During the fourth quarter, inventories of finished steel in the hands of producers, steel service centers (warehouses) and manufacturing concerns rose almost 3 million tons. Given an average valuation of about \$150 per ton, and making allowance for steel in the hands of users other than manufacturers—such as construction contractors and extractive industries—it is likely that total inventories of finished steel rose by an annual rate of at least 2 billion dollars in the October-December period, almost equaling the drop in stocks of finished motor vehicles. Increased consumption of steel is partly responsible for rising inventories, but a more important factor is the threat of a nationwide strike after May 1.

Steel inventories probably have been rising about as fast thus far in 1965 as in the fourth quarter of 1964. Nevertheless, delays in delivery schedules are said to have kept inventory buildup programs of major users behind schedule. As a result, output of those types of steel in strongest demand—particularly sheet, strip and plate—are expected to remain at practical capacity through April, and possibly longer if labor-management negotiations continue past May 1.

### **Keeping inventories low**

At the present time the book value of total

business inventories is about 110 billion dol-

lars. Manufacturers account for nearly 58 per cent of this amount, retailers approximately 27 per cent and wholesalers 15 per cent. These proportions have not changed appreciably in recent years, although there have been small shifts during relatively short periods, as in the final quarter of 1964.

Rising inventories are not, per se, a bad omen. Inventories, as a part of business working capital, can be expected to rise along with production. If the output of goods is to rise 4 or 5 per cent a year in dollar terms, then the book value of inventories might be expected to increase on average by about the same proportion—4 or 5 billion dollars.

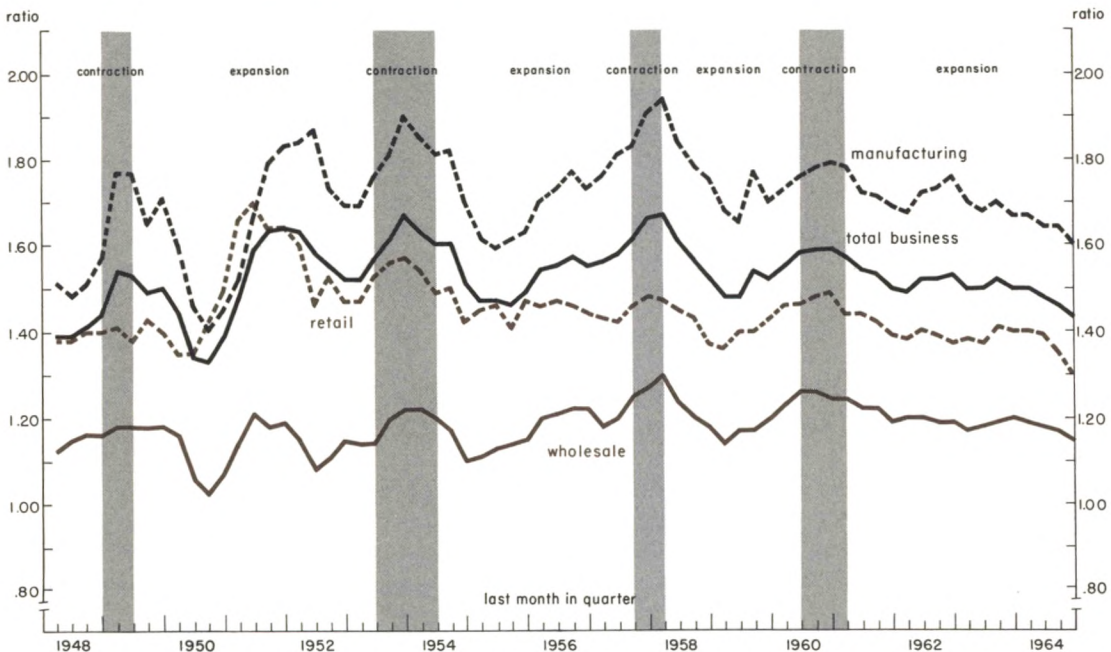
In the current expansion, which started early in 1961, there has been a tendency for total business inventories to decline relative to sales. Prior to the beginning of the recession in mid-1960, the ratio of total business inventories to monthly sales was 1.55. At the start of 1964 this ratio was 1.50 and at the beginning of the current year it was only 1.43, the lowest since the early part of the Korean war when sales rose sharply.

There are a number of reasons why most business firms have been able to operate with a progressively smaller amount of inventories relative to sales. One broad group of reasons can be summed up under the heading of "improved management techniques."

Closer control over inventories has resulted in part from new methods of keeping records—often computer systems that signal the need to reorder only when necessary to prevent supplies and purchased raw materials from becoming so short as to hamper operations. Efforts to economize on inventories also have been aided by such factors as better equipped and better located warehouses, and more rapid transportation.

Inventory control techniques are of little benefit unless two conditions exist: first, sup-

**Stock-sales ratios** have declined  
as sales have outpaced inventory rise



plies must be readily available upon short notice to suppliers; and, second, there must be reasonable confidence that prices of purchased supplies and materials will not rise appreciably. Until recently, both of these conditions have been fulfilled for most businesses.

Order backlogs of steel firms almost doubled in 1964. For all other types of durable goods manufacturers, the increase was only about 10 per cent. Even including steel, unfilled orders amounted to only 2.6 times the month's sales at the end of December, up from a ratio of 2.5 a year earlier, but as low as any other comparable month in the post-war period. Aside from steel and certain types of machinery and equipment, there has been little stretch-out in delivery lead times and, therefore, little concern over the availability

of supplies that would cause buyers to raise inventories to prevent shortages.

Despite widespread announcements of price increases, average wholesale prices of nonfarm commodities were only one-half per cent higher in December than a year earlier. The index of sensitive spot commodities rose sharply in the second half of 1964 before leveling off in November. Nonferrous metals, including tin and zinc and copper scrap and lead scrap were the prime movers in the advance. Prices of each of these commodities, however, reached a peak in October or November and then leveled off or declined. Some users of copper reported paying dealers well over the posted producer price of 34 cents a pound late last year to obtain prompt deliveries, but these prices also tended to decline as

supplies eased and speculation waned.

Expected price increases of moderate proportions do not offer an adequate cause for increasing inventories beyond current and prospective operating needs. A recent survey by *Purchasing Week* reveals that most firms calculate the cost of carrying inventory at 12 to 24 per cent a year when all expenses—including interest, taxes, insurance, storage, handling and risks of deterioration and obsolescence—are considered. Under the circumstances, expected price increases must be substantial, relatively certain and near-at-hand to warrant inventory building beyond needs.

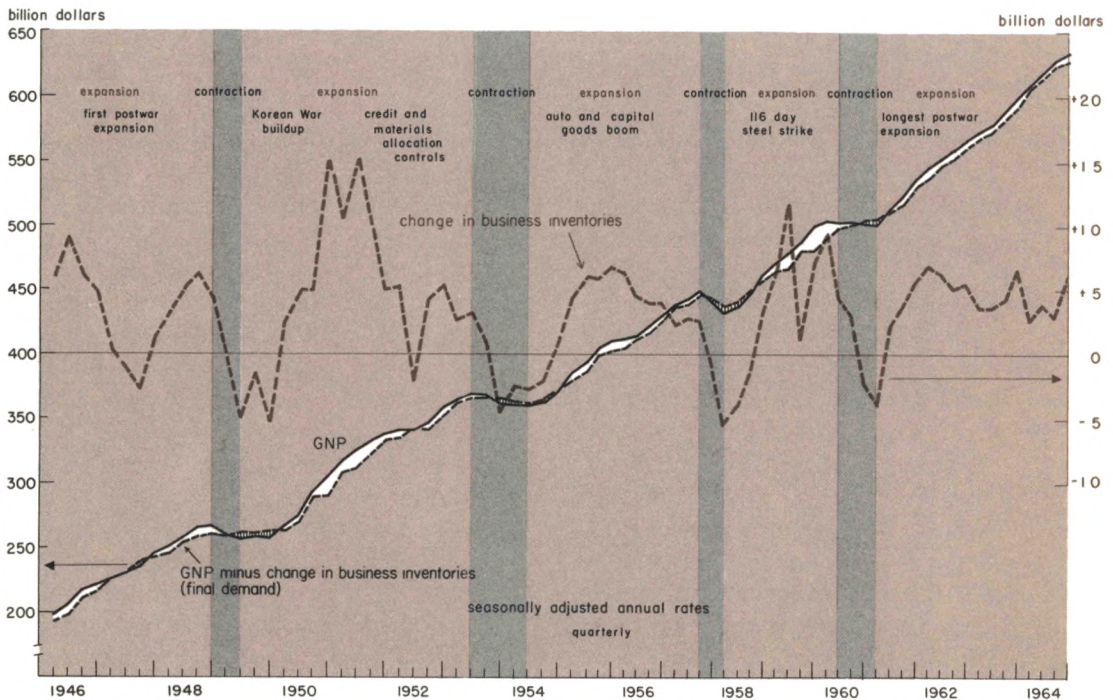
Durable goods manufacturers increased their inventories 2.3 billion dollars in 1964.

More than half of this rise occurred in the fourth quarter. Nevertheless, at year-end inventories of all durable goods producers were only 1.86 times shipments for the month, compared with 1.95 a year earlier, and the ratio was the lowest for December since 1955. In part, inventories remained relatively low at both the manufacturing and trade level in 1964 and early 1965 because sales and shipments exceeded expectations. But clearly there has been no headlong rush to build stocks for a broad range of commodities.

### Inventories and the business cycle

The economy produced about 380 billion dollars of goods in 1964. Of this total only

### Inventory changes have played a major role in postwar business fluctuations



about 1 per cent was added to inventory, near the average both for recent years and the whole postwar period.

Since November the proportion of goods output being added to inventory has been perhaps 2 per cent, the addition being attributable mainly to steel and autos. But the importance of this marginal change should not be minimized.

A shift from inventory accumulation to liquidation can have serious effects upon the economy in general and the goods-producing industries in particular. During prosperous periods of rising activity, output of goods typically is raised 1 or 2 per cent a year because of decisions to increase inventories. In recessions, current output is 1 or 2 per cent below "final sales"—current consumption and additions to the stock of fixed capital. From prosperity to recession, therefore, total output of goods can be reduced 3 to 4 per cent as the result of changes in inventories.

The following table shows the relation of inventory changes to changes in total spending in postwar business contractions:

	Quarter and year			
	4Q'48 to 2Q'49	2Q'53 to 2Q'54	3Q'57 to 1Q'58	2Q'60 to 1Q'61
	(billion dollars)			
Change in:				
GNP	-9.5	-9.9	-15.4	-2.7
Inventory investment				
From	+4.3	+3.1	+ 2.5	+4.2
To	-5.3	-2.7	- 5.5	-3.9
Total	-9.6	-5.8	- 8.0	-8.1
Inventory change as a <i>per cent</i> of change in GNP	101	58	52	300

From peak to trough in each postwar recession, the reversal from inventory accumulation to liquidation has accounted for more than 50 per cent of the decline in gross na-

tional product (including the more stable output of services as well as goods). During the very mild 1960-61 recession, the inventory shift was considerably larger than the decline in total gross national product. In that period purchases of goods and services for noninventory purposes (final demand) continued to rise on a quarter to quarter basis during the course of the cyclical downturn.

Inventory reductions have not initiated business recessions in the postwar period. In fact, inventories typically continue to rise after sales begin to decline because deliveries continue on orders placed months earlier. Similarly, inventories continue to decline after an economic revival begins because sales and shipments rise faster than output for a time.

Nevertheless, a decline in the *rate* of inventory accumulation has preceded each postwar recession as the accompanying chart clearly shows. Any reduction in the rate of accumulation has a dampening influence on activity quite as great as an equivalent acceleration in the rate of inventory liquidation.

Despite the powerful impact of inventory changes on total activity, the influence of this factor does not, in itself, provide an adequate explanation of business fluctuations. Business cycles are complicated phenomena influenced by interactions of capital expenditures, corporate profits, consumer incomes and spending, government outlays and revenues, credit conditions and other factors as well as inventory policy. Understanding of these fluctuations, although improved, remains incomplete.

#### Implications for the months ahead

There can be no question that inventory accumulation in recent months has been proceeding at an unsustainable rate. Except for steel and autos, however, the rate of accu-

mulation has not been appreciably in excess of long-term trends, and there has been no rise at all in inventories of many industries.

Inventories, overall, remain quite low relative to the volume of business sales and shipments, if judged in terms of earlier experience. The situation has been kept in check by improved inventory management and purchasing practices, the fact that delivery schedules for most commodities have not stretched out and the absence of a renewal of general price inflation of the sort that encouraged widespread accumulations prior to the onset of past business recessions.

Declines in output of steel and autos and in corporate profits and payrolls in these industries are almost certain to occur as inventories are reduced late in the spring and early summer. Unquestionably, there will be an impact on the rest of the economy, but this impact will be limited, partly because the prospect has been widely publicized and anticipated by both management and workers.

Managements in both steel and autos can be expected to proceed with the expanded capital expenditure programs currently under

way despite temporary declines in sales and profits. Many workers who may be laid off or find their workweeks shortened have prepared for this development. In addition, family incomes will be supported during any extended layoffs by regular and supplementary unemployment compensation benefits. Most steel and auto workers are well acquainted with sharp fluctuations in income and tend to arrange their family financial resources accordingly.

Twice in the current expansion—in the spring of 1962 and again in 1963—substantial increases in steel inventories have been liquidated following the settlement of labor-management negotiations. In each case there was relatively little repercussion upon the rest of the economy. Nevertheless, these periods of inventory accumulation and liquidation are disruptive and, depending upon their size and duration, are always capable of causing difficulties in other sectors. The earlier an agreement in the current negotiations can be reached the greater the likelihood that 1965 will mark an unprecedented fifth successive year of business expansion.

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## Beef futures

**F**armers can now sell beef cattle at firm prices for future delivery. The contract may extend as long as 11 months. This brings to Midwest farmers, bankers and others the same kind of price insurance that has been available for many years for grains and some other agricultural commodities.

Trading in futures contracts in “choice cattle” began on the Chicago Mercantile Ex-

change, November 30, 1964. This was followed on February 15, 1965 by trading in futures contracts in “choice beef carcasses.” The Chicago Board of Trade has also announced intentions to initiate futures trading in beef carcasses at a later date.

While this represents the first organized trading in futures contracts for cattle, trading in commodities for future delivery is not new.



In the thirteenth century, merchants met daily in many of the major centers in Europe to buy and sell goods for delivery at specified future dates and locations. In the United States, trading in grain on a future delivery basis started before the Civil War, largely as a result of the shipment of grains on the Great Lakes which were not open during the winter months. This type of trading preceded the development of organized markets for trading in futures contracts.

In the cattle industry, farmers and ranchers, packers and retail establishments frequently enter into contracts for future delivery of livestock and livestock products to assure supplies and to lessen the risk of adverse price changes. For a number of years, Corn Belt farmers and livestock dealers have contracted with western ranchers during the summer months for feeder cattle to be delivered in the fall at specified locations and prices. Packing companies occasionally contract with feedlot operators to deliver slaughter cattle at a later date and retail chain stores often arrange with processors for the purchase of specified cuts of beef weeks in advance of actual delivery.

### **The futures contract**

A futures contract is an agreement on the part of the seller to deliver and on the part of the buyer to receive a fixed amount and quality of a particular commodity at a stated price in a specified future month. While cash sales may be made in any amounts, futures contracts are in multiples of some specified amount of commodity. Prices are quoted in terms of the delivery month.

Fulfillment of the futures contract may be by taking or making delivery. But in most cases, the buyers and sellers of such contracts make offsetting transactions prior to the delivery date, thereby removing their obliga-

tions. Thus, desired price insurance is realized and the problems associated with physical delivery of the commodity are avoided.

The cattle futures contracts presently being traded are in units of 25,000 pounds of choice steers, liveweight basis. The cattle must meet certain specifications established by the exchange. There are two standard deliverable units: 25,000 pounds of choice grade or better live steers, with all steers in a weight range 1,000-1,150 pounds and an estimated dressed yield of 61 per cent; or all within a weight range of 1,151-1,300 pounds and an estimated dressed yield of 62 per cent. Discounts are provided for substitutions of weights, grades and dressing percentages other than those specified in the contract, or for an indicated fat covering of more than one inch over the rib eye.

Contracts call for delivery in April, June, August, October and December. Delivery of live beef cattle is to be made at approved livestock yards in Chicago, with Omaha as an alternative delivery point at a discount of 75 cents per hundredweight.

### **Buying or selling futures**

A person desiring to buy or sell futures contracts contacts a brokerage firm having membership on the exchange. In small communities, this may be done by having the local banker place the order through a broker.

The broker will require the customer to deposit with him a sum of money or "margin" to assure fulfillment of the contract. For beef cattle contracts, the minimum initial margin is \$500 per trading unit (25,000 pounds of steers). Additional margin may be required from a buyer if the market declines or from the seller if the market rises. The maintenance margin is \$300 per contract, that is, an additional deposit is required whenever the change in the futures market

price reduces the initial margin \$200 or more. Conversely, the margin may be withdrawn should prices change favorably.

Brokers charge a commission on each contract bought or sold. Commission and clearance fees for cattle futures on a "round turn" transaction (the fulfillment of the contract by an offsetting contract purchase or sale or by delivery or acceptance of the steers) are \$36 per contract.

### Shifting of risk—hedging

The markets in futures contracts provide the most important method of shifting the risk of price changes to others while holding inventories of commodities. The process—hedging—enables the individual to take a position in the futures market offsetting the one he has in the actual commodity. Hedging, of course, does not provide perfect insurance against all price risk because futures contracts may not be offered for the specific commodity, grade, amount or time period a processor or other holder of commodities may desire, but it does provide a means of greatly reducing exposure to adverse price changes. It also restricts the potential to profit from favorable price changes.

Cattle feeders must necessarily hold animals on feed for periods of time varying from a few weeks to many months, during which they are subject to substantial risk because of the frequent large price fluctuations. Like a hedger in any other commodity, a cattle feeder could sell a futures contract at the time the feeder cattle were purchased and later could either buy back an offsetting contract or deliver the steers.

While feedlot operators feeding animals that closely match the delivery specifications of the futures contract will be best able to perform a successful hedge, the futures market may also be used to hedge animals of

different grades, weights and sex, to the extent that prices of these animals move in concert with choice steers.

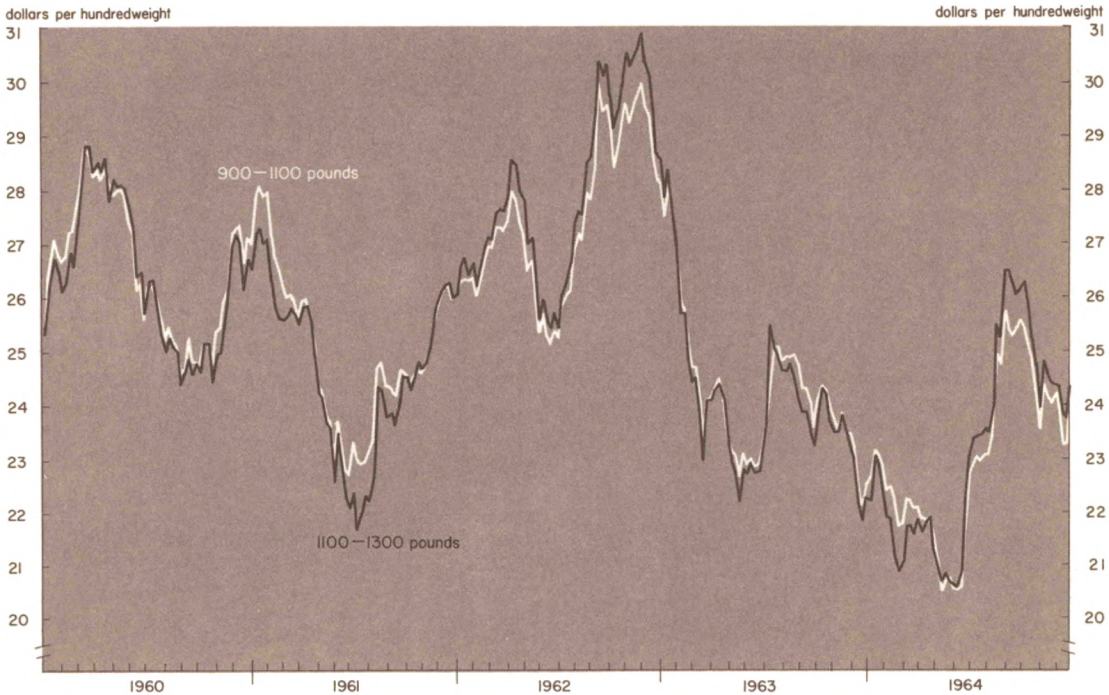
The following hypothetical example illustrates how a hedge might work for a farmer feeding choice steers. In this example, a farmer purchases 700-pound feeder steers in March at \$20 per hundredweight. The estimated feeding and other costs to bring the steers to a market weight of 1,100 pounds and choice grade by October are \$102 per steer, bringing the total cost of the fed steers to \$22 per hundredweight. At the time of the purchase of the feeder steers, October cattle futures are selling for \$24 per hundredweight. Since this would assure him a profit of \$2 per hundredweight, he may choose to sell an October futures contract. He is then assured of that price irrespective of what the actual market price for choice steers may be in October. In October the farmer sells the fat-

### Cattle hedge transaction

	Per hundredweight		Per animal	
	Cash	Futures	Cash	Futures
	(dollars)			
Buy 700-lb. steers (March)	20		140	
Fattening costs			102	
Total cost of fed steers*	22		242	
Sell October futures (March)		24		264
Sell steers* (Oct.)	21		231	
Buy October futures (Oct.)		21		231
Gain or loss	- 1	3	-11	33
<b>Net gain</b>		<b>2</b>		<b>22</b>

\*1,100-lb. steers.

## Steer price differentials vary— weekly average, choice steers at Chicago



tened animals in the usual way and buys an offsetting October futures contract, thus completing the hedge transaction.

Typically, the futures and the cash market prices will come together as the delivery month approaches. In this illustration it is assumed that prices declined to \$21 per hundredweight in October. The farmer, therefore, had a loss of \$1 per hundredweight in the cash market and a gain of \$3 per hundredweight in the futures market, with a net gain of \$2 per hundredweight or \$22 per head (less the fees and interest on the margin money for the futures contract). Had the cattle not been hedged, the farmer in this illustration would have lost \$11 per head.

If on the other hand, prices of fed cattle and October futures had risen to \$26 per hundredweight, the farmer would have realized a gain of \$4 per hundredweight in the cash market but a loss of \$2 on the futures transaction. However, he still maintains his overall gain of \$2 per hundredweight which he attempted to assure at the time he sold the futures contract. Since the price in the cash market increased, the farmer would have been better off not to have hedged. But he did not know this in March and did not wish to take the chance that prices would decline during the feeding period.

The hedging transaction, of course, costs something. These costs are not shown in the

example. First, there is the initial margin deposit of \$500 per contract. Also, the farmer must be in a position to put up additional margin should prices rise substantially. Since he does not have the use of the money deposited as margin, the interest paid (or foregone if not using borrowed funds) is a cost of hedging.

Second is the brokerage fee—\$36 per contract for the complete trading transaction. For a typical feeding operation, the trading fees and the financing charges on the initial margin deposit would amount to approximately \$2 per head. This, of course, would vary depending on the length of the feeding period and price changes that would require additional margin or permit withdrawal of margin money.

### **Tradable commodity?**

Commodities traded on the futures markets usually are subject to substantial price changes, traded in large volume, storable and readily identifiable as to quality. Cattle have some of these characteristics but not all, hence, some doubt has been expressed as to the ultimate success of futures contracts in this commodity.

Cattle prices generally fluctuate substantially and a large volume of cattle is produced and marketed. Thus far, cattle futures have been traded in sizable volume, indicating that individuals taking positions in the futures contracts could buy and sell without having a large influence on prices.

Cattle are not generally considered to be storable. While they often are held for long periods of time for feeding, they are changing in quality and in weight and, therefore, are not the same commodity that they were at the beginning of the period. Whether the inability to “store” the commodity during the life of the contract will prove to be a serious

weakness remains to be seen. Live animals of the same grade and weight often show large variations in the quality and amount of carcasses—also, a possible difficulty in the selling of cattle for future delivery.

Market price relationships, even within grades, often change as market supply and demand conditions vary. For example, choice 1,100-1,300 pound steers at Chicago in February 1964 averaged 80 cents per hundredweight below the price for choice 900-1,100 pound steers. But in August 1964 the relationship was reversed. The ability to consistently and accurately describe what is being traded and to develop a satisfactory schedule of allowances and substitutions for the standard contract may pose a continuing problem.

The potential contribution of futures trading in steers and beef carcasses to the efficient production and marketing of these important commodities cannot be foreseen clearly at this time. As a form of “price insurance,” it can be of great value to farmers and feedlot operators who cannot afford, or do not choose, to incur the risk of adverse price changes while they are feeding cattle.

The potential benefits to meat packers and wholesale and retail distributors are not so readily apparent since choice beef normally is not stored for long periods of time but is moved through the distribution channels quite rapidly.

The availability of hedging choice cattle may make possible the financing of a larger volume by some farmers or feedlot operators. With the risk of loss from price declines largely transferred to others, cattlemen of proven ability may qualify for more credit relative to their net worth. But the sale of a commodity for future delivery cannot substitute for demonstrated ability to produce the specified commodity efficiently.

# Trends in banking and finance

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## Correspondent banking

The 13,000 independent commercial banks, linked by a vast network of correspondent relationships, is a distinctive feature of the American financial machinery. The role of correspondent banking has an important bearing on the question of what kind of banking structure will work best in this economy in the long run, to provide efficient banking services.

How does the correspondent banking system work? Large banks in the major cities hold demand deposit balances of country banks and also of city banks in other areas. These balances constitute an important source of loanable funds, just as does any other type of deposit. In return, the large city correspondents<sup>1</sup> provide many services to their banker depositors, including check collection, accounting and investment advice, purchase, sale and safekeeping of securities, assistance on foreign transactions, loan participations and customer referrals. It is largely because of these correspondent arrangements that small banks throughout the country are able to offer their customers many of the specialized services that only very large institutions can afford to provide. The system combines access to resources and technical knowledge of major banking institutions with local management and customer service.

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<sup>1</sup>For purposes of this article a correspondent bank is a bank which holds the deposits of other banks.

The extensive services provided by large banks to their "country cousins" are not without cost and this must be weighed against the value of the deposits maintained with the correspondent bank. Competition for these deposits is vigorous and has intensified as interest rates have risen in recent years and banks, like other businesses, have attempted to economize on cash balances. Competition for interbank demand deposits is entirely on the basis of services offered, since payment of interest on them is prohibited.

## Slow growth trend

Total interbank deposits at all United States commercial banks at the end of last year amounted to more than 17 billion dollars. This represents a gain of about 5 per cent during a five-year period compared with a 35 per cent rise in total deposits. The growth in interbank balances was only slightly slower, however, than the growth in other *demand* balances; most of the recent deposit growth was in time and savings accounts.

While interbank balances amount to only about 6 per cent of commercial bank total deposits, they are obviously of much greater relative importance to the large correspondent institutions. As would be expected, interbank deposits are rather highly concentrated in the money centers. At the close of the third quarter of 1964, a dozen banks in New

## Correspondent banking—selected data from a survey of banks holding demand balances in other banks<sup>1</sup>

	Bank deposit size (million dollars)									
	100 and over		50-100		25-50		10-25		Under 10	
	Unit	Branch <sup>2</sup>	Unit	Branch <sup>2</sup>	Unit	Branch <sup>2</sup>	Unit	Branch <sup>2</sup>	Unit	Branch <sup>2</sup>
<b>Deposits with correspondents</b>										
Average amount of demand balances (million dollars) . . . . .	12.2	10.1	4.8	3.9	2.7	2.2	1.3	1.2	0.4	0.6
Average number of correspondents . . . . .	32	30	18	12	13	10	8	7	5	6
Per cent of banks also holding time deposits with correspondents . . . . .	9	7	13	6	3	2	1	1	1	7
Per cent of time deposits in form of negotiable certificates . . . . .	100	91	72	94	93	99	98	88	87	58
<b>Credit and related services</b>										
Per cent of surveyed banks which reported:										
Credit lines with correspondents . . . . .	3	8	5	13	8	11	8	12	9	10
[Average number of credit lines . . . . .	1	2	2	2	2	2	1	1	1	2]
Borrowed from correspondent for short- or intermediate-term purposes <sup>3</sup> . . . . .	2	5	5	15	11	12	8	16	7	7
Obtained funds from correspondent through sale of assets <sup>3</sup> . . . . .	3	5	—	4	1	3	1	8	1	2
Purchased Federal funds through correspondent <sup>3</sup> . . . . .	78	75	68	58	35	46	19	31	23	28
Participated in correspondents' loans . . . . .	92	89	74	75	59	55	52	37	24	28
[Average amount outstanding (million dollars) . . . . .	11.9	12.0	1.5	1.2	1.1	0.6	0.4	0.3	0.2	0.3]
Correspondent participated in loans of depositor bank . . . . .	88	85	80	63	65	64	55	60	35	55
[Per cent of dollar amount held by correspondent . . . . .	53	50	55	62	54	78	61	61	60	69]
<b>Other services<sup>3</sup></b>										
Average per cent of out-of-town checks cleared through correspondents . . . . .	43	45	50	73	79	79	87	87	93	92
Per cent of banks using correspondents' services for:										
Safekeeping of securities . . . . .	97	85	91	94	93	87	91	84	77	77
Foreign exchange . . . . .	98	90	92	92	94	87	74	78	41	47
Bank wire service . . . . .	87	79	80	90	86	83	80	86	47	53
Data processing . . . . .	58	58	48	50	38	28	24	16	9	18
Accounting advice . . . . .	44	38	35	41	32	33	34	35	19	28
Investment advice . . . . .	45	51	68	67	68	67	68	61	68	72
Transactions in U.S. Governments . . . . .	71	61	73	67	78	63	81	75	75	84
Transactions in municipals . . . . .	44	39	51	38	51	36	47	44	39	43
Transactions in commercial paper . . . . .	16	9	18	22	18	15	19	15	20	15

<sup>1</sup>Survey made by Subcommittee on Domestic Finance, Committee on Banking and Currency, during September and October of 1963 through a questionnaire sent to a sample of 2,650 banks. For details see U. S., Congress, House, Committee on Banking and Currency, *A Report on the Correspondent Banking System*, Committee Print, 88th Cong., 2nd Sess., 1964.

<sup>2</sup>Banks having one or more branches.

<sup>3</sup>During preceding 12 months.

York City, Chicago, Boston and Dallas accounted for almost 40 per cent of interbank deposits in all commercial banks. The largest correspondent bank had more than 1.2 billion dollars of such deposits and there were fewer than 200 banks that held as much as 10 million dollars. For more than 30 of these institutions, such deposits constituted 20 per cent or more of total deposits.

### **Measuring correspondent services**

While the importance of the functions that correspondents perform for local banks (and through them for their customers) has long been recognized, there has been little quantitative information by which correspondent services could be measured, either from the standpoint of their value to the receiving banks or with respect to the adequacy of banking services available to the public. A recent survey conducted by a congressional committee has developed some interesting information as to the nature and extent of correspondent services. Selected data from the committee's report on correspondent banking are presented in the table on the opposite page.

In the report, information is given separately for unit and branch banks and for a number of deposit sizes. The results are generally similar for unit and branch banks but they vary considerably for banks of different sizes.

Large banks, as would be expected, tend to maintain deposits with a larger number of correspondents than do small banks. The largest size group shown (total deposits of 100 million dollars or more) includes many moderately large banks outside the principal money markets as well as the very largest correspondent institutions.

Relatively few banks (roughly 10 per cent) obtain funds from their correspondents

through credit lines or the direct sale of assets. Where the latter was reported, mortgages were the asset most frequently sold although in some cases correspondents bought municipals or consumer instalment paper from the banks carrying deposits with them. A large proportion of banks—especially in the bigger size classes—purchased Federal funds through their correspondents.

Of major importance are the functions correspondents perform in either supplying or absorbing funds for local banks through participation arrangements in loans—those originated both by the correspondent and by the customer bank. Loan participation was quite general except for the smallest banks. Of the reported loans made by local banks in which correspondents participated, the latter held more than half the dollar volume and their percentage participation was highest at small banks.

Most widely used were the services correspondents offer with respect to check clearing, collection, foreign exchange and other international banking functions, safekeeping of securities, investment advice and transactions in U. S. Government securities. These services were very widely available but were not used by all banks. Some of them, notably check clearing and safekeeping services, are also available to member banks through the Federal Reserve Banks.

### **Interbank differences**

The deposits maintained with correspondent banks provide different functions depending upon the depositing bank and its location. For example, there is an important difference between those state chartered banks which are members of the Federal Reserve System, and those that are not. Member banks must keep their legal reserves (except for vault cash) in deposit balances at their

Reserve Banks. In addition, however, member banks often find it convenient also to maintain deposits with correspondents, both as working balances and to assure availability of the types of services not provided by the Reserve Banks. For nonmembers in many states, on the other hand, in addition to serving as working balances, funds on deposit with other banks satisfy, either in whole or in part, legal reserve requirements.

Through the largest member banks, which are also the major correspondents, nonmember banks benefit indirectly from Federal Reserve services such as check clearing. The survey indicates that more checks are sent to correspondents than to the Reserve Banks for clearing except by banks in the largest size group. It also indicates that the majority of member banks prefer to clear through correspondents, presumably because these banks often give immediate credit and accept checks with less sorting than do the Reserve Banks. The Reserve Banks limit their check clearing service—refusing to handle checks on non-par banks and unsorted items. Many correspondents handle such items, a service that is attractive to small banks. A large number of checks initially routed to correspondents, however, subsequently are cleared through the Federal Reserve Banks, making for some double handling and possible inefficiency.

The dollar volume of checks cleared for the large banks which rely heavily on Federal Reserve facilities is, of course, very great. Thus, although the Federal Reserve's clearing operations are in a sense "supplementary" to those provided by correspondents, they contribute greatly to the ability of the latter to perform that service. A major goal in the establishment of the Federal Reserve System in 1913 was to develop an efficient and uniform check collection process. The standards established by the Reserve Banks have played

an important role in bringing the clearing process to its present quality.

Most banks expressed satisfaction with the performance of the correspondent system and indicated their preference for continuation of the availability of correspondent services on a non-fee basis. Nevertheless, reservations were expressed by a few banks (mainly of larger size) with respect to the upward trend of costs compared with the willingness and ability of smaller banks to maintain balances at levels which would compensate for such costs. Only a small minority of banks favored conversion from the present practice—of maintaining balances determined mainly on an estimate of the value of correspondent services rendered—to a straight fee basis for all services performed. Fees already are being paid by between 10 and 25 per cent of the local banks for a fairly large number of services, including international banking services, data processing and even domestic collections and accounting advice.

The facts assembled through this congressional survey provide information on the existing arrangements among banks to enable them to provide efficient and relatively complete banking services. The use of available facilities was indicated to be much more prevalent among medium- and large-size banks than among small ones. This probably reflects differing needs of these banks and their customers but could also reflect inability of some banks to provide certain kinds of services required only infrequently in their areas. No information is yet available with respect to the volume and frequency with which many of the correspondent services are used. Such information should be considered in any effort to determine the type of banking structure that is most likely to assure efficient, continuous and comprehensive banking services to the public.