Country Banks and the Federal Funds Market

How Much Cash in the Corporate Till?
Country Banks and the Federal Funds Market

... More Third District banks than ever are active in the federal funds market.

How Much Cash in the Corporate Till?

... Corporate liquidity has been declining since World War II. This may not be the problem some think it is.
In March 1965, the Business Review carried an article which discussed the increasing awareness by country bankers of opportunities in the federal funds market. Substantial interest in the earlier article prompted us to undertake an expanded study of activities of country banks in the market, to uncover changes which have taken place and, perhaps even more important, to explain why some country banks have been more inclined to resort to the federal funds market than have others. The principal findings on who is active in the market and in what capacity are presented in the present article. A future Review article will look more deeply into the major factors which influence whether a particular bank is likely to participate in the market.

COUNTRY BANKS AND THE FEDERAL FUNDS MARKET

by Nevins D. Baxter

Almost half of the country member banks in the Third District now buy or sell federal funds compared with just over a third in 1965.

Almost one-third of the banks in the district buy federal funds, at least on occasion. Bigger banks are much more likely to buy fed funds than are small institutions; in fact, two-thirds of banks with deposits over $25 million purchase funds to meet temporary reserve deficiencies. Banks in urban areas1 are more frequently buyers of funds than are their rural counterparts, but this is in part true because urban banks are generally larger. Chart 1 portrays these results. Moreover, it's clear from Chart 2, that banks in any region of the district are just about as likely to be buyers of federal funds as those in any other region.

On the sell side of the market even more banks are active. Over 40 per cent of country member banks in the Third District now sell fed funds from time to time when they have excess reserves. Again, urban banks are much more active than

WHAT ARE FEDERAL FUNDS?*

Federal funds are bank deposits at the Federal Reserve or at correspondent banks. Banks, which find themselves with temporary excess reserves not needed for transactions purposes, can lend these balances, overnight or for a few days, to banks which have temporary reserve deficiencies. Such transactions bear interest at the “federal funds rate,” and thus may provide an efficient way for banks with surpluses to put these funds to work for short periods, and for deficit banks to replenish their reserve positions. Traditionally, loans of federal funds were limited to balances with the Federal Reserve. Recently, however, the market has evolved to the point where big city correspondent banks are buying and selling relatively small amounts of funds on behalf of their country cousins. A typical transaction might involve a country bank “lending,” say $200,000 to its city correspondent. The city bank transfers the correspondent deposit to “bills payable.” The country bank earns interest on the loan of federal funds (the $200,000 for one day at 4 1/2 per cent is $25.00). The city bank can then settle its own reserve position in the national federal funds market.

*For a fuller discussion, see the March 1965 issue of this Review.

1 Such areas were defined as cities with population of at least 25,000.
are rural banks, and big banks are much more likely to sell fed funds than are small banks. (See Chart 3.) Activity is fairly uniform throughout
the district, with no meaningful regional differences apparent.

A comparison of Charts 1 and 3 shows that size of bank is not very important in determining whether a given institution is a buyer or seller of federal funds. This evidence does not lend support to the oft-made suggestion that smaller banks, if active in the market at all, are likely to be sellers of federal funds almost exclusively, whereas larger banks, with stronger pressures on their reserves, are expected to be predominantly buyers.

**CHART 3**  
**BANKS SELLING FEDERAL FUNDS**

The activity of Third District country member banks in the federal funds market is perhaps most striking when we consider that as many as 47 per cent of these institutions participate in the market either as a buyer or seller. Eighty per cent of banks in urban areas and just under 90 per cent of banks with more than $25 million of deposits are active as buyer or seller. And such wide participation is a fairly recent thing.

**Federal funds since when?**

Well over half of the banks active in the federal funds market entered the market for the first time in the last two years, as shown in Chart 4. In fact, before 1961, participation in federal funds by country banks was negligible. Activity was confined almost exclusively to larger banks located in urban areas.

**Size of federal funds transactions**

Table 1 indicates the average size of “typical” transactions in federal funds during the year 1965 for banks who are buyers and sellers. There were a substantial number of institutions active in the market whose average transaction was only a few hundred thousand dollars. Many of the relatively small transactions came from banks in rural

**TABLE 1**  
**AVERAGE SIZE OF FEDERAL FUNDS TRANSACTIONS IN 1965**

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<thead>
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<th>Per cent of respondents in categorya</th>
<th>Purchasers</th>
<th>Sellers</th>
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<td>Bank Located in</td>
<td>Total Purchasers</td>
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<tr>
<td>Urban Areas</td>
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<td>Less Than $150,000</td>
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<tr>
<td>$150,000-$300,000</td>
<td>26</td>
<td>7</td>
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<tr>
<td>$300,000-$450,000</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>Over $450,000</td>
<td>34</td>
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aPercentage need not add to 100% due to some respondents omitting the question.
areas, which is not surprising given the size of such institutions. Even though typical transactions in excess of $450,000 were in the minority, they were still extremely important quantitatively.

There was no striking difference between the size of typical sales and typical purchases, though the sales were somewhat larger. Once again, the data do not support the contention that small banks can be expected to be predominately sellers, due to excess reserve positions. Of course, it may be that small banks “sophisticated” enough to use the federal funds market are least likely to have excess reserves.

Small banks made larger federal funds transactions, both as buyers and as sellers, relative to their total resources. However, they engage in somewhat fewer transactions during the settlement period.

**How often in the market?**

The majority of buyers were active fewer than five days per month, during 1965, as shown in Table 2, but banks selling funds (in some cases this may be the same purchasing bank operating under different seasonal conditions) were typically active for many more days during the month.\(^2\) Neither deposit size of bank, geographic area within the district, nor our urban-rural classification had a strong effect on the typical number of days a month in which banks bought or sold funds. This is perhaps a little surprising because big banks might be expected to have borrowing or lending needs sufficient to put them in the market far more frequently than their smaller cousins.

\(^2\) The fact that sellers were in the market more frequently than purchasers of fed funds, coupled with the previous result that the size of selling transactions was typically larger, would lead us to suspect that country banks in the Third District are net sellers of federal funds. This is not a surprising result; one would expect that country banks throughout the nation would be net suppliers of funds.

### TABLE 2

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<td><strong>Buyers</strong></td>
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<td>70</td>
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<td>29</td>
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<td>18</td>
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The explanation is at least two-fold: first, the seasonal swings or chronic imbalances may be relatively larger for the smaller institutions; second, it appears that the federal funds market presently may be able to accommodate very small transactions as efficiently as larger ones, and even small banks may not need to “save up” surpluses or deficits.

The average number of days per month in the market for banks who were active in fed funds three years ago has not changed significantly. However, remember that only a relatively few banks had experience with federal funds back in 1962.

**Most active periods**

Almost one-quarter of the banks who are buyers or sellers of funds, are particularly active during certain days of the week or certain months of the year as can be seen in Table 3. A somewhat smaller number are more active during certain weeks of the month.

Higher activity during certain months of the year reflects the seasonal nature of the banking business in certain parts of the Third District. In summer resort areas, for example, deposits are highest and loans are being paid off in the summer, and banks have excess reserves some of
TABLE 3
MOST ACTIVE PERIODS IN FEDERAL FUNDS MARKET

Per cent of banks buying or selling fed funds

Particularly Active:
During Certain Days of Week 21%
During Certain Days of Month 13%
During Certain Months of Year 23%

which they may sell in the federal funds market. In the winter and spring, these banks are apt to be net buyers of fed funds. Similar borrowing needs may occur from Christmas Club disbursements which become due in the fourth quarter, and from the normal seasonal patterns of agricultural areas. Banks in the South Jersey region of the Third District (a primarily agricultural and resort area) are especially prone to experience seasonal variation in federal funds activity; half of these banks indicated such volatility as compared to 23 per cent for all country banks in the district.

Why would banks be prone to use the market more during certain days of the week than during others? There are two main reasons for such a preference—the nature of reserve-requirement settlement, and that fundamental institution—the weekend. For country banks reserve requirements are calculated for a two-week period, ending on Wednesday. Several banks indicated increased activity toward the end of this period, as they become able to estimate their exact reserve needs. Thus, volume in the federal funds market is typically heaviest on Tuesdays, especially on double settlement weeks (when country as well as city banks must settle). The sometimes-expressed desire to enter the market over the weekend is simply one of convenience—one transaction on Friday earns interest for three days and hence many banks are especially anxious to put their excess funds to work at this time.

Role of correspondent banks

The big city correspondents are very much involved in assisting the country member banks in the Third District with federal funds and related transactions. The vast majority of country banks (75 per cent) use Philadelphia banks as their lead correspondents, slightly under 10 per cent (many are larger country banks) use New York correspondents, and the remainder deal with banks in Pittsburgh, Scranton-Wilkes-Barre and other cities.

Almost all country banks use their correspondent as the agent with whom they most often buy and sell federal funds. Federal funds is thus an important service provided by correspondents, and the willingness and ability to provide this service is no doubt an important influence on the extent to which country banks participate in the market. Those correspondents which encourage relatively small transactions and minimize paper work will no doubt increase the activity of their bank customers in the federal funds market.

Country banks like to deal in federal funds through their correspondents because it is a very simple matter to do so, involving only a bookkeeping transaction.

Alternative sources of borrowing

Borrowing from correspondents through federal funds is an alternative to direct loans from correspondent banks, to coming to the discount window at the Federal Reserve, to selling securities with a repurchase agreement, and to raising funds by selling unsecured negotiable notes, debentures, etc. The banks were asked to provide

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3 Only 3 per cent of buyers and 3 per cent of sellers principally deal directly with a federal funds broker.
4 The interesting question of the extent to which choice of correspondent influences activity in the federal funds market will be explored more fully in a forthcoming issue of this Review.
5 For a brief discussion of procedure, see the insert on page 3.
data on the number of days each source was utilized in 1965, and on the average borrowing per transaction. The majority of country banks did not borrow in 1965 except in the federal funds market. Of those that used other sources of borrowing, direct borrowing from the Fed was the most common, borrowing from correspondents next, and debentures were issued by only a few of the larger country banks in the Third District. Urban banks were more likely to borrow from more than one source than were their rural counterparts.

Let's take a closer look at borrowing from the Fed and from correspondent banks. First, just as bigger banks are more likely to buy federal funds, so they are also more likely to borrow directly from the Fed or from correspondents. As could be expected, the larger banks borrowed more per average transaction from these sources in 1965 than did smaller banks. On the other hand, there was little correlation between the size of a borrowing bank and the number of days of indebtedness during the year. The average size of individual borrowing transactions from the Fed and from correspondents was quite similar. However, banks were much less likely to come to the discount window for more than 50 days during the year than they were to borrow from correspondents to this extent.\(^6\)

**Developments in the past year**

Chart 5 depicts changes in participation for buyers and sellers of federal funds since last year. On the buying side, 9 per cent of the banks presently active in the market are new participants. On the selling side, 14 per cent are new. In short, there has been a substantial pickup in participation, but this has been especially striking for banks selling federal funds.

\(^6\)This result is likely influenced by the Federal Reserve's position that continuous borrowing at the discount window is inappropriate.

Exactly who are the new buyers and sellers of federal funds? Both groups consist predominately of small institutions (deposits under $25 million) located in rural areas. This result is not surprising since the larger institutions were likely active in federal funds last year. That the growth in participation in the federal funds market has been largely due to the activity of small banks is particularly striking on the sellers' side where 53 of 55 new entrants had deposits under $25 millions. Banks new in the fed funds market are evenly distributed geographically throughout the Third District.

Almost half of the banks who are active in the federal funds market responded in the affirmative when asked whether there had been any apparent differences in the availability or attractiveness of federal funds in the last six months. Large banks, who are perhaps more conscious of credit conditions, were particularly prone to note the effect of tightening money. Some banks noted the more attractive yields for sellers of federal funds and the greater costs for buyers; a few banks also indicated that federal funds were somewhat less available. In none of these comments, however,
is there any indication that the recent growth of the federal funds market is primarily a cyclical phenomenon, associated with the relatively tight money period.

Conclusion
Participation of Third District country banks in the federal funds market, both as buyers and sellers, has increased substantially in the past year. Though big banks are still much more likely to deal in fed funds, the growth in the number of small banks using the market is most striking. Increased activity is apparent in all geographic areas of the Third District.

What factors are most important in determining whether a particular country bank is active in the federal funds market? How important is the "profit squeeze" which many banks are experiencing? Is more aggressive and sophisticated management the answer? Is the generally higher level of interest rates of recent years a motivating factor? How influential is the role played by big city correspondents in influencing whether a particular bank will deal in fed funds?

An analysis of these and related questions is now under way. The results of this study will form the basis for a later article in this Review sometime in the summer.

HOW MUCH CASH IN THE CORPORATE TILL?

by Jack C. Rothwell and Hugh Chairnoff

Despite record money flows into corporate coffers from rising sales and earnings, cash and its equivalent in the corporate till has fallen to a low ebb relative to most measures of corporate business activity. The reason: dollars spent on new plant and equipment, inventory, dividends, and the like have risen at an even faster pace than funds coming in, cutting into the margin of corporate liquidity.

Some say declining liquidity represents a soft spot in an otherwise vigorous economy. With relatively less in cash and near-cash assets, the reasoning goes, businessmen have a thinning margin of funds available to tide them over periods of difficulty. Liquid assets for example, permit the businessman to pay bills, meet payrolls, and pay creditors even if sales and earnings fall off.

On the other hand, liquid assets are non-earning (or lower-earning) assets, hence the businessman generally strives to hold them to a minimum consistent with his appraisal of liquidity needs.

Just what constitutes a "safe" level of liquidity is difficult to tell. One reason why: what is safe is dependent on the future and the future is uncertain. The likelihood of a business downturn, for example, will bear on the prudence of any given level of liquidity as will the probable severity of any downturn and the success monetary and fiscal policies are likely to have in mitigating the effects of recession.

If we can't tell for sure how much cash should be in the corporate till, we can at least give a broader perspective of the problem. Is there historical precedence for present low levels of
A LIQUIDITY LEXICON

What are liquid assets?

A liquid asset usually is defined as an asset that can be readily converted into cash (currency and demand deposits) with negligible conversion costs. There are many examples of liquid assets. The more familiar types of liquid assets are time deposits, Treasury bills, certificates of deposit and, of course, currency and demand deposits.

Less familiarly known are short-term unsecured notes of sales finance companies and industrial firms, bankers’ acceptances, and short-term notes of federal agencies as well as state and local governments.

Corporate balance sheets do not provide much detail about the types of liquid assets held. In fact, currency and demand deposits and marketable United States Government securities are the only types of liquid assets for which data are available.

What is liquidity?

Liquidity is not an absolute concept. Like the artist, the engineer, the consumer, indeed like everybody, the management of corporations think in terms of proportions. Liquid assets represent absolute dollar values; liquidity is the relationship of the dollar value of liquid assets to some other important factor such as total assets, sales, or liabilities. Thus, we cannot know whether $100,000 in liquid assets provides sufficient liquidity unless we also know that the dollar value of total assets, sales, or liabilities amounted to $1,000,000 or $2,000,000.

What about liquidity? Have institutional changes occurred which permit businesses to operate at lower levels of liquidity without seriously compounding the risks of doing business? Here we take a look at these and other questions.

THE LONG VIEW OF LIQUIDITY

There are several measures of corporate liquidity. Perhaps the most critical from the standpoint of corporate solvency is the behavior of and relationship between liquid assets and current liabilities. Three ratios in particular have been useful in gauging this behavior and relationship: the ratios of liquid assets to total assets, current liabilities to total liabilities and liquid assets to current liabilities.

What the ratios mean

Taken together, the three ratios mentioned above provide a meaningful summary of the changing corporate liquidity picture.

Comparing liquid assets to total assets tells us the proportion of total assets which can be quickly converted into cash if the need arises. This proportion represents a “front line of defense” available to meet unexpected corporate needs.

Comparing current liabilities (bills payable, bank debts, and the like which fall due in the near-term) to total liabilities gives us some idea of the most pressing financial needs the corporation has to defend against. Other things remaining the same, a large and increasing volume of current liabilities puts management under increasing pressure to produce quickly, sell promptly, and obtain payment so as to meet a constant and increasing volume of near-term out payments. A break anywhere in the flow of production, sales, and receipts creates problems in meeting the out payments and thus puts a premium on the availability of liquid assets.

Finally, a direct comparison of liquid assets to current liabilities over time tells us whether the front line of defense is growing as rapidly as the force it may be called upon to defend against. In essence, the ratio pits the supply of liquid assets against potential, first priority demands upon them.

How then have the opposing forces fared over the long pull of history?

The perspective of time

As shown in Chart 1, out of every dollar of total assets owned by manufacturing corporations in the 1920’s and 1930’s about 9 cents was held as liquid assets. During World War II, when
business review

After building up to record levels during World War II, liquid assets declined relative to total assets and now are more in line with prewar levels.

RATIO OF LIQUID ASSETS TO TOTAL ASSETS

Manufacturing and Nonfinancial Corporations

Chart 1

*FTC-SEC Report of Manufacturing.
Source: Statistics of Business Income.

"hard" assets (plant and equipment, inventories and the like) were on the scarcity list, a large part of the profits that flowed into corporate coffers was allowed to remain as liquid assets. By war’s end, liquid assets held by manufacturers soared up to 25 cents out of each dollar of total assets.

When the shooting stopped, businessmen once more could buy new equipment, build new plants, and modernize existing facilities, and with no big postwar depression (which many had forecast), they proceeded to do just that. The result: the wartime fund of liquidity was drawn down. By the early 1960’s liquid assets of manufacturers were back to prewar levels. About 9 cents in liquid assets was held for every dollar of total assets.

Does the postwar decline in the ratio of liquid assets to total assets represent “a dangerous shrinkage” of the “first line of defense”? The answer: not necessarily. The relative decline in liquid assets could as well be interpreted as a “normal” return to prewar levels. Indeed, the current level of the ratio for nonfinancial corporations compares favorably with the average level during the first thirty-five years of the twentieth century.

But as already noted, what may appear as a “normal” or “expected” pattern of movement of liquid assets does not necessarily imply a “safe” pattern of movement. Liquid assets (the front line of defense) must be measured against current liabilities (the most immediate of the many corporate contingencies to be defended against) to get a better idea of the “adequacy” of liquid assets. How have current liabilities behaved over the long pull of history?

Current liabilities

Chart 2 shows the behavior of current liabilities since the mid-twenties. After hovering around 40 cents for each dollar of total liabilities in the twenties and early thirties, current liabilities shot up sharply to almost 55 cents per dollar of total liabilities during the 1930’s, then declined sharply in the war years as businessmen used mounting profits to retire their current debts. After a jump up in the immediate postwar period, current liabilities declined again and now represent about

Chart 2

Current liabilities as a percent of total liabilities in the early 1960’s was near the low point registered during World War II.

RATIO OF SHORT-TERM LIABILITIES1 TO TOTAL LIABILITIES

All Nonfinancial Corporations and Manufacturing Corporations

1Does not include accrued expenses or other current liabilities.
*FTC-SEC Report of Manufacturing.
Source: Statistics of Business Income.
38 cents of every dollar of total assets, roughly comparable to the wartime low.*

In short, then, while liquid assets of manufacturing corporations have declined relative to total assets in the postwar period, so have current liabilities relative to total liabilities. Both the front line of defense and the front line to be defended have shrunk in size. The question which remains to be answered: have liquid assets declined at a faster pace than current liabilities, perhaps leaving the corporate flank undefended?

Liquid assets to current liabilities

At the end of World War II—as shown in Chart 3—manufacturers held a little over $2 in liquid assets for every $1 in current liabilities, up mightily from the 60 cents to $1.00 range of the '20's and '30's. The cup of liquidity runneth over.

After the war, however, the cup was tipped and the contents drunk. Liquid assets as a per cent of current liabilities followed an irregularly downward course as businessmen channeled profits into the hardware of production. As the sixties rolled around, only about 50 cents in liquid assets was held for every dollar of current liabilities and the ratio was still headed down, reaching the lowest point on record in the manufacturing sector of the economy.

Thus on the face of it at least, the forward wall of corporate defense would appear to have weakened somewhat. Both liquid assets and current liabilities have declined relative to the aggregates on their respective sides of the balance sheet, but liquid assets have fallen more.

Question: has the slide in liquid assets really increased, and increased markedly, the financial risks of doing business?

* The pattern of current liabilities for all nonfinancial corporations roughly mirrors the performance in the manufacturing sector.

CHART 3

Liquid assets dropped sharply relative to current liabilities in the postwar period, falling below the low levels established in the 1920's and 1930's.

RATIO OF LIQUID ASSETS TO CURRENT LIABILITIES

Nonfinancial Corporations and Manufacturing Corporations

1Does not include accrued liabilities.

*FTC-SEC Report of Manufacturing.
Source: Statistics of Business Income.

PEERING THROUGH MURKY WATERS

Though we can't conclude that corporate liquidity and exposure to financial risk aren't problems, still the perspective of time offers some hints that the dimensions of the problem may not substantiate the case of those who most vociferously "view with alarm" declining corporate liquidity. The hints of history are several in number.

1. First of all, one might reasonably expect a decline in liquidity from the unusual peaks attained during World War II. To a very large degree wartime liquidity was forced on businessmen by shortages, shortages which reduced their option for employing funds. Remove the shortages (and increase the options) and liquidity might be expected to return to more nearly normal levels.
The rate of decline in the ratio of liquid assets to current liabilities has diminished markedly in the later postwar business expansions.

AVERAGE QUARTERLY PERCENTAGE DECLINE IN THE RATIO OF LIQUID ASSETS TO CURRENT LIABILITIES—POSTWAR BUSINESS EXPANSIONS

2. Second, though liquid assets in the postwar period have fallen to new lows relative to current liabilities, these new lows may not be “all that low.” The ratio of liquid assets to current liabilities (for nonfinancial corporations) in the early '60's is not so far out of line with what occurred earlier in the century. Moreover, it should be noted that: (a) 80 cents in liquid assets for every dollar of current liabilities—the ratio for manufacturers in 1929—was not enough to contain the financial difficulties manufacturers experienced in the 1930's and (b) 50 cents to $1.00 was insufficient to preclude the great and sustained business expansion of the 1960's.

3. Third, though the ratio of liquid assets to current liabilities for manufacturers has declined in each of the postwar business expansions, the rate of decrease has slowed considerably. Chart 4 shows, for example, the average monthly percentage decline in liquid assets to current liabilities in the present business expansion is only about half what it was in the 1949-1953 expansion.

4. Fourth, and perhaps most significant, the postwar period has seen important innovations both in public and private economic policy which may go far to diminish the amplitude of business fluctuations and hence reduce the vulnerability that liquid assets are designed to protect against. The greater sophistication of monetary and fiscal policy tools is a case in point, as is the increasing public acceptance of these tools. In the private sphere, corporations are exercising more precise inventory controls and are formulating capital spending plans with an eye more to the longer pull than to the short haul of the business cycle.

In short, the economy today is less vulnerable to serious business reverses, hence less vulnerable to the set of conditions in which liquidity problems can spread in widening ripples into a full-blown financial crisis. This factor and the others mentioned above must all be considered in reaching a meaningful judgment of the volume of liquid assets which should be in the corporate till.
FOR THE RECORD...

SUMMARY

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</table>

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.