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Diversification, Supervision, and the Public Interest

Push-Pull Inflation

Third District Business and Banking Conditions in 1967

Diversification, Supervision, and the Public Interest

. . . Current regulations governing the operations of financial institutions may be outdated for today's space-age economy. Reappraisal of the entire structure is needed.

Push-Pull Inflation:

. . . Increasing wage costs and accelerating aggregate demand are seen exerting upward pressures on prices in 1968.

Third District Business and Banking Conditions in 1967

. . . Business activity in the Third Federal Reserve District ends the year with a healthy upswing, setting the stage for further expansion in 1968.

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Banks and savings institutions are adapting to a changing environment by seeking to diversify. Here, in broad brush strokes, is some perspective on the question of . . .

DIVERSIFICATION, SUPERVISION, AND THE PUBLIC INTEREST

by Clay J. Anderson

Banks and savings institutions have become restive. Savings institutions, facing more intense competition in their special fields, have been striving for authority that would permit more diversification. Commercial banks have been pressing for broader authority and more equitable treatment in taxes and reserve requirements. The Justice Department has manifested renewed interest in preserving competition in banking. Academic economists have been devoting more attention to public policies toward depository institutions.

This growing ferment reflects doubt that regulatory policy is as well adapted to the current environment as it should be. The near-crisis in credit in the fall of 1966 vividly demonstrated the problems of narrow specialization in a dynamic economy. More fundamentally, it reinforced the view that there is need for a careful reappraisal of public regulatory policies toward banks and savings institutions. The fact that most of the maze of regulations was erected many years ago in periods of economic and financial crisis is further evidence of such need.

EVOLUTION OF OUR FINANCIAL STRUCTURE

The present financial system is the product of a long period of evolution. Its structure reflects atti-

tudes of the people and the environment in which it developed.

Era of specialization

Once an economy advances beyond a subsistence level, specialization is usually an important feature of economic development. Division of labor encourages mechanization, improved productivity, and lower unit costs. It creates the need for markets. Markets are enlarged by population growth, improved transportation facilities, and rising incomes.

For decades this process of growth and specialization, plus settlement and development of the West, broadened markets in the United States. With ample market opportunities and a scarcity of capital, companies usually sought growth by increasing output of the specialty rather than by launching new and dissimilar types of production.

The evolving economic structure left its imprint on the development of financial institutions. Specialization and the development of markets created the need for a common means of payment. A shortage of coins stimulated demand for other kinds of money. The rising volume of working capital required in production and marketing created a demand for short-term credit.

To meet this need, the first commercial bank

in the United States was organized in 1781. For many years functions of commercial banks were confined to short-term loans to producers and merchants, and the issue of notes payable in coin on demand. This was typical of the situation in a newly developing country in which economic conditions contribute to a narrow concept of commercial banking. The marketability of collateral and mortgaged property is limited and credit risks are great. The principal liabilities—notes and deposits—are payable on demand. Liquidity requirements emphasize the desirability of restricting credit to self-liquidating loans that will be repaid in a short time.

Typically, commercial bank services in developing countries are confined to the top echelon of the economy—the more profitable, better-known businesses, farmers, and well-to-do individuals. This narrow concept of commercial banking persisted in the United States. But rising incomes and a growing middle class created new needs and opportunities. More people could save and more were interested in owning a home. Instead of commercial banks broadening their services, new institutions developed to meet these emerging demands. Savings banks and savings and loan associations were established in the early part of the last century. They were specialized institutions paying interest on savings deposits and share accounts, and lending most of their funds on mortgages for the purchase of homes.

Industrialization and large-scale production created a demand for longer-term credit to finance the acquisition of plant and equipment. This was not considered a suitable type of credit for commercial banks, nor savings institutions oriented toward mobilizing personal savings and making home loans. Once again a special institution—the investment bank—was organized to

meet this growing need.

As discretionary income grew, manufacturers began producing an ever-growing list of consumer durables—automobiles, washing machines, refrigerators, stoves, and other home appliances. But commercial bankers would have nothing to do with financing this type of expenditure. Their concept of banking was to extend credit for productive purposes, not for living expenses. Neither were savings institutions interested. Thus new institutions were established to extend credit to consumers—personal finance companies, credit unions, and sales finance companies. Not until the 30's did commercial banks, finding themselves with excess funds and declining demand for their specialty of short-term business credit, begin to move into the expanding consumer credit market.

In short, during most of our history emerging financial needs have been met principally by the formation of new institutions instead of by broadening the services of existing institutions. The tendency toward specialization reflected the advantages of division of labor, abundant opportunities for growth, and regulations which prevented or deterred institutions from offering new services.

Shift toward diversification

A high degree of specialization gradually became more hazardous. Disappearance of the frontier eliminated one source of market expansion, thereby diminishing the opportunity for growth in a single field. Growing mechanization and the huge investment in plant and equipment required to produce efficiently in major industries encouraged the formation of large companies. A rapid rise in expenditure for research and development enlarged overhead expenses and accelerated innovation and technological change. A

rising ratio of fixed to total costs lifted break-even points. These developments have made it increasingly risky to “put all of your eggs in one basket.”

The response in the nonfinancial sector has been a trend toward diversification.* Companies have been broadening their product lines in order to reduce vulnerability to innovations and new discoveries which may at any time render some product obsolete. An important reason for the growing popularity of “conglomerates”—combinations of companies producing dissimilar products and services—is the desire to distribute risk.

Diversify or perish

The credit squeeze in the latter part of 1966, which hit savings institutions particularly hard, highlighted the problem of narrow specialization. Savings were being diverted into higher-yielding market instruments and commercial bank time deposits. Savings institutions were unable to pay competitive rates because the bulk of their resources was in long-term mortgages with a fixed rate of interest, and raising rates to attract savings would result in the payment of higher rates on all of the institution’s time and savings deposits.

The problem of the savings institutions is more deepseated, however, than hardships imposed by a temporary credit stringency. In an ever-changing economy, the pattern of services demanded of financial institutions is continually being altered. A financial institution may experi-

* An earlier development was horizontal and integrated combinations. Horizontal combinations consisted of companies producing the same or similar products. The principal purposes were to achieve economies of large-scale production and to reduce competition. Integrated combinations brought under one management companies engaged in various stages of producing a final product. Important objectives were economies and greater efficiency deriving from better control of the flow of materials.

ence a decline in demand for a particular service because of a shift in consumer preferences, increased competition from others moving into its field, and a cyclical decline in economic activity. Savings institutions were confronted with growing competition from other lenders as well as the cyclical decline in demand for housing.

Savers are becoming more sophisticated in alternative uses of their savings. As savers become more knowledgeable about financial markets, securities become a stronger competitor for savings, especially in periods of rising interest rates. Many shift their savings to take advantage of more attractive yields. More volatile savings require a higher degree of liquidity.

The plight of the savings institutions in 1966 reflected, in part, a higher degree of specialization than some competitors, such as commercial banks, but it also reflected more basic underlying economic forces. The space-age economy encourages diversification of financial institutions, emphasizing the need for flexibility to adjust to changing conditions. But flexibility has been impaired by regulations designed to protect the public interest.

REGULATION: ITS EVOLUTION AND PHILOSOPHY

The framework of regulations governing depository institutions has been erected piecemeal over a long period of time—in fact, well over a century. Much of the legislation was enacted as a result of serious financial panics and crises. The latest surge was in the 30’s.

A basic question is whether a financial structure largely molded by regulations adopted many years ago continues to be appropriate in the current economic and social environment. An answer to this question requires a look at reasons why regulations were imposed in the first place.

Competition as regulator

Competition is an integral part of a free enterprise economy. Entrepreneurs, to operate profitably, must produce what the public wants — preferences expressed by expenditures in the market place.

Competition tends to weed out the inefficient. Low profits or losses resulting from higher unit costs diminish ability to attract capital and labor, and tend to drive inefficient producers out of business. The successful, profitable firm will be one that operates efficiently and gears its production to changing wants. Competition is also a powerful force for innovation and improved technology. In short, competition serves in these important respects as a regulator in the public interest.

Shortcomings of competition

But competition may not always produce desirable results or be self-maintaining in all situations. Unrestrained competition may at times lead to concentration and monopolistic practices, even outright monopoly. If a company controls enough of the supply of a product it can “administer” the price, at times setting the price higher than it would be under free competition. In “natural monopolies,” such as public utilities, experience has demonstrated that competition tends to result in higher instead of lower unit costs. Also, competition may not allocate resources according to what is considered socially desirable as, for example, low-cost housing.

“Survival of the fittest” may operate in the public interest in the long run, but the short-run effects may be harsh. The price of inferior management and inefficiency is often failure of the company. For many small, individually owned businesses the hardship of failure is confined to the owner and perhaps a few creditors and em-

ployees. For a large business corporation the effects of failure are more widespread, embracing stockholders, employees, and possibly a number of creditors and suppliers. But the impact of the failure of a bank or savings institution extends far beyond that. The widespread effects of failure are a major reason why operations of deposit institutions are of special public concern.

Evolution of regulation

This concern was first expressed early in our history. It soon became apparent that competition in banking sometimes produced results not in the public interest. Mismanagement and excessive zeal to expand and increase profits often caused trouble. Sometimes expansion went so far that a bank found itself with insufficient cash to pay note holders and depositors on demand as it had agreed. Temporary suspension of cash payments worked hardships on the bank’s customers and the community. If failure resulted it usually inflicted substantial losses on innocent note holders and depositors who, even though acting prudently, would not know of the deteriorating financial condition of the bank.

An even more serious aspect of suspension of cash payments and failure was the repercussions on the economy and the public. The tendency was to undermine confidence and touch off runs on other banks. Once started, runs on banks spread and gathered momentum. The supply of currency was inelastic, so that the quantity could not readily be increased to meet the soaring demand. Sound as well as unsound banks were caught in the panicky scramble for cash and were forced to close their doors.

Prior to the Civil War several states passed laws establishing minimum reserve requirements for commercial banks, and the National Bank Act of 1864 imposed minimum reserve require-

ments against notes and deposits for all national banks. Thus for a century or more commercial banks have been required to maintain minimum reserves, the original purpose being to assure payment of notes and deposits on demand.*

Experience soon demonstrated that reserve requirements were not an adequate safeguard against failure and depositor losses. Safety of deposits depends primarily on the quality of bank assets, not the fractional cash reserve maintained against deposits. Another type of legislation designed to protect depositors and the public was establishment of certain quality standards for loans and investments. Periodic examinations by supervisory authorities were instituted to see that banks conformed to these standards.

The wave of bank failures which began after World War I and reached a climax in the Great Depression of the early 30's incited another surge of regulatory legislation. Over-banking and aggressive competition which led to the payment of high rates to attract deposits were believed to be important sources of difficulty. Once again legislation was enacted in an attempt to eliminate the major causes presumed responsible for the wave of failures. Payment of interest on demand deposits was prohibited, and authority was granted to establish ceilings on rates that could be paid on savings and time deposits. Deposit insurance was introduced, regulations governing loans and investments were tightened, commercial banks had to give up investment banking activities, and further restrictions were imposed on chartering new banks.

Experience demonstrated that the cumulative nature of expansion and contraction of bank credit and the money supply tended to accentu-

ate cyclical booms and depressions. Competition and the profit motive failed to regulate credit and the money supply in the public interest. Accordingly, legislation creating the Federal Reserve System was enacted in 1913. The System was designed to provide a flexible supply of currency so that currency could be issued as needed to meet rising depositor demands for cash. The Federal Reserve was also given powers to regulate bank credit and the money supply in order to prevent excessive expansion and contraction, thus helping to smooth out instead of aggravate fluctuations in business activity. The powers of the Federal Reserve were also increased as a result of the experiences in the late 20's and early 30's.

Another facet of regulation is legislation designed to prevent excessive concentration. Fear that control of our private financial resources might be concentrated in the hands of a few has existed from the beginning of this country. Significant illustrations of this influence are state and federal restrictions on new entry, branching, and mergers.

In summary, financial history reveals the periodic growth of a framework of regulations designed to achieve, among other things, three major objectives that competition failed to provide. One objective—to prevent bank failures and resulting hardships inflicted on depositors and the general public—was met by regulations such as those governing the quality of assets, payment of interest on deposits, reserve requirements, deposit insurance, and restrictions on new entry. A second objective was to prevent undue concentration of financial resources and acquisition of monopoly power. A third aim, which the Federal Reserve System was expected to achieve, was to provide a source of liquidity in time of crisis to prevent financial panics and to regulate

* It has been recognized for some time, however, that the principal value of reserve requirements is to enable monetary authorities to exert some control over the volume of credit and the money supply.

total bank credit so as to mitigate instead of aggravate cyclical booms and depressions.

Shortcomings of regulation

Regulation has weaknesses, too. It creates as well as solves problems. Regulations confining an institution to certain activities and establishing standards for loans and investments may have the undesirable effects of limiting competition and stifling incentives for innovation and efficiency. The resulting rigidity impairs flexible response to changing needs and the efficient allocation of financial resources. Narrow specialization and rigidity, as already pointed out, render an institution more vulnerable to change.

A second undesirable consequence of the regulatory structure that has evolved is inequities among institutions. Commercial banks are subject to legal reserve requirements, other depository institutions are not; activities of savings institutions are more narrowly constrained than those of commercial banks; and the tax burden varies among types of institutions. Differences and inequities are an inevitable result of a regulatory framework erected periodically to deal with particular problems at the time, and in which regulatory authority is distributed among the states and the Federal Government.

A third aspect that merits careful consideration is the impact of regulation on mobility of credit and economic progress. National economic development and growth are best promoted by geographic mobility of financial resources — a free flow from surplus to deficit areas. Some kinds of regulation tend to hamper this flow.

GUIDELINES FOR REAPPRAISAL

The crucial issue now is whether the mix of competition and regulation resulting from a long period of evolution is appropriate in the current

environment; whether it gives us a financial structure that contributes to efficiency and orderly growth. To form an intelligent judgment on such a basic question will require comprehensive review and analysis; however, some significant guidelines for study and reappraisal can be indicated.

Environmental change

One line of inquiry is whether economic changes have significantly altered the conditions regulation was designed to deal with. Several major changes are relevant for regulatory policy.

First, the danger of financial panics and severe depressions has diminished. Government and monetary policies are being used much more effectively to smooth out business fluctuations and to promote stable growth than before the Great Depression. The Employment Act of 1946 directed the Government to use its powers to maintain full employment and a full use of other productive resources. Stable and sustained economic growth is a major goal of fiscal and other Governmental economic policies. The relative growth of the public and service sectors has tended to cushion the economy against sharp declines in total expenditures and employment.

Second, economic developments have encouraged more aggressive competition. Progress in transportation and communications has enabled depository institutions to serve a larger area. Availability of more complete credit information and insurance and guarantees of some loans have also tended to enlarge credit markets. Shifting patterns of demand and a growing need to distribute risk have prompted banks and savings institutions to undertake new services, and to strive for legislation that will make possible further diversification. Thus the trend is toward keener competition in extending credit and in

soliciting deposits.

Third, the structure of the credit market is becoming more complex and the extent of competition more difficult to measure. Banks and savings institutions, as pointed out previously, are tending to increase the range of services offered. The degree of competition may differ for each type of service. For example, the market for business loans is highly competitive for the larger business firms. Such firms have access to credit at a relatively large number of banks, to insurance companies for term credit, and in the commercial paper and securities markets. Competition in lending to small business firms is much more restricted; the market is usually confined to local banks and possibly trade credit from suppliers. Competition for real-estate mortgages includes not only commercial banks in the area but also savings banks, savings and loan associations, insurance companies, and possibly individuals. For consumer loans there is competition among banks, finance companies, and credit unions. For time and savings deposits there is competition among banks, savings institutions, and securities. Thus it is becoming increasingly difficult to determine the impact of structural changes, such as mergers and new entry, on competition. Simple devices such as the number of depository institutions in the community and the ratio of deposits to the community's total deposits are inadequate indicators of competition.

Fourth, the role of financial institutions as intermediaries between savers and borrowers has grown rapidly. In the 1920's over one-half of the net increase in household financial savings went directly into securities; the average for 1962-1965 was about 2.5 per cent. The marked rise in incomes of the "masses" has created a multitude of small savers who want to put their

savings in something safe and with stable value. Depository institutions have afforded an attractive outlet, over one-half of all consumer financial saving going to these institutions in recent years.

A fifth development of significance is an accelerated pace of innovation and change. A vast increase in expenditures for research and development has stimulated new discoveries and technological advance. One result has been swift changes in the pattern of demand and in techniques of production. New products and new industries emerge and grow, old ones decline and disappear. The more dynamic the economy the greater the need for flexibility and mobility in order that institutions may adapt their services to a shifting structure of demand.

Implications for regulation

Environmental changes have modified the conditions that were mainly responsible for the enactment of regulatory legislation.

With the range of business fluctuations narrower, the danger of financial panics and a large number of failures of depository institutions has been substantially diminished. Recessions are still likely, but the probability of severe deflation and economic paralysis, such as the Great Depression, is much less than a few decades ago. It is significant in this connection that recent studies have led to the conclusion that the wave of bank failures in the 20's and early 30's was mainly the result of cyclical fluctuations and the post-World War I deflation instead of over-banking, excessive competition and unsound practices, as was generally believed at the time.

On balance, lending risks have probably diminished. Rising real incomes and loan terms tailored to borrower needs have facilitated repayment; a larger quantity and higher quality of available information enable a more accurate

appraisal of credit risks; and improved management and loan supervision, together with a higher degree of marketability of collateral, increase the probability that outstanding loans can be collected. On the other side of the coin, a more rapid pace of economic change has tended to increase risk. Access to liquidity in time of need has been increased by broadening of securities markets, loan insurance and guarantees, and development of secondary markets for some types of loans.

In the event of failure, insurance now protects depositors and shareholders against loss up to a maximum of \$15,000 per account. Deposit insurance materially reduces the hazard that one or a few failures will touch off runs on other institutions.

The threat of undue concentration of control over financial resources appears to be less than formerly believed. Increased competition and a trend toward diversification have led many financial institutions, in so far as regulations permit, to introduce new services and enter new markets. An institution may now safely and conveniently operate over a larger market area than a few decades ago. Recent studies of market structure and institutional performance indicate no strong inherent tendency toward monopoly. Although studies of the effect of size on efficiency differ in their findings, available evidence indicates that economies of scale are not sufficient to provide any strong inducement for concentration of financial resources in a few large institutions. Neither is the investment required for efficient operation so large as seriously to restrict new entry. In other words, there appears to be no strong natural forces leading to monopoly or oligopoly as in public utilities and some major manufacturing industries.

Now that depository institutions play the major role in mobilizing savings and allocating them

among competing borrowers, regulation is of even greater economic significance. It influences the allocation of savings flowing into deposit institutions both directly and indirectly. Directly, it imposes limitations on loans and investments deposit institutions may make. For example, savings and loan associations are restricted mostly to mortgages. Indirectly, it affects ability to respond to changing conditions, with the result that strong credit demands and restrictive monetary policy hit mortgage and municipal borrowers especially hard.

CONCLUDING COMMENTS

Both competition and regulation are means to ends. They are instruments that can and should be employed in whatever combination best contributes to attainment of our general economic objectives. There are good reasons for an objective reappraisal of the present mix of competition and regulation to determine whether it meets this test.

Most of the regulations governing banks and savings institutions were enacted when conditions were much different from those prevailing in the space-age economy of today. Economic developments of the past few decades have significantly reduced the hazard that panics and severe deflation will result in many failures and large deposit losses. Studies of market structure and institutional performance have not revealed any strong, inherent tendencies toward undue concentration and monopoly. Regulations evolving over the years have produced competitive inequities among depository institutions, thereby tending to contravene the basic principle that success should go to the institution rendering most efficiently the services society demands. Finally, narrow constraints on services an institution may render appear inconsistent in an economy pro-

viding strong inducements for diversification.

On the other hand, to the extent the objectives of full employment and a high rate of growth are achieved there will be less slack in the economy. There may be more danger that growing demand will at times generate inflationary pressures, inducing monetary restraint and tight credit. Yet banks and others, with newly developed sources of funds, have tended to operate pretty close to the margin. If more funds are needed they can sell C.D.'s or turn to the federal

funds market. But the market may not be a reliable source of funds for all institutions when there is a credit squeeze. What are the implications of these likely developments for liquidity and regulation?

Perfection should not be expected in dealing with such complicated questions. The problem is to weigh the advantages and disadvantages of competition and regulation in order to achieve the blend that will best promote the public interest in today's economy.

New Release

Forecasts for 1968. The Department of Research has compiled and analyzed a number of predictions made by businessmen, economists, and Government officials. This compilation includes a summary of forecasts for the economy as a whole and particular sectors of the economy. The more important indicators are presented in chart form.

Copies of this release are available on request from Bank and Public Relations, Federal Reserve Bank of Philadelphia, Pennsylvania 19101.

PUSH-PULL INFLATION

by Sheldon W. Stahl

Of all the problems which may plague the economy in 1968, probably the one most analysts of the business scene rank uppermost is inflation. Although the outlook is far from certain, both cost-push and demand-pull elements appear likely to put prices under severe pressure. Before looking ahead to prices in 1968, however, it may prove useful first to re-examine these two views of inflation.

TWO EXPLANATIONS¹

Prior to the end of World War II there seemed to be little reason to question what had long been regarded as the essentially correct view of the cause of inflation. Inflation was simply "too many dollars chasing too few goods." Although there was more than one variant of this theme, the core of it was that when the level of aggregate money demand exceeded real output capabilities of the economy at full employment the general level of prices would rise as buyers bid up prices of available goods and services. Since demand for the factors of production was derived from demand for goods and services they produced, factor prices would also tend to be bid up. Thus, demand operated to pull up prices of goods and services as well as prices of productive factors.

The line of causation, however, ran from an increase in demand through to increased prices;

¹ Neither cost-push nor demand-pull explanations of inflation should be regarded as mutually exclusive. Rather, they usually complement each other in that both forces operate in varying degrees to bring about price increases. The term "cost-push" inflation relates to periods when cost or supply factors play the dominant role; "demand-pull" inflation describes price increases resulting largely from excess demand pressures.

finally, to rising costs or prices of factors of production. In addition, the theory assumed that both product markets and factor markets were competitive and that prices and costs were determined by the operation of demand and supply in the market.

The experience of the economy during the 1950's—a period characterized by two recessions and a low rate of economic growth—led many observers to question this theory. Prices and costs rose even in the absence of strong demand. Supply factors rather than demand factors took the spotlight and the term "cost-push" inflation gained prominence. This newer explanation of inflation singled out wage earners and profit takers as the initiating forces of inflation.

The crucial assumption at variance with earlier explanations was that wage earners—notably workers in strong unions—and profit-making business firms possessed a degree of market power which permitted them to establish both wages and prices at levels independent of demand for either factors of production or goods and services. Business firms could "administer" prices, boosting profit margins by posting an increase in the price of their products. At the same time, powerful labor unions could, through collective bargaining, bring about a rise in wage rates largely unrelated to the demand for labor and well above the rates which might have been arrived at in a freely competitive factor market. Thus, to the push from profits was added the further push on prices from wages.

To be sure, a certain kind of institutional or politico-economic environment had to exist in

WHAT IS INFLATION?

Inflation, although widely discussed and feared by much of the public at large, still is many things to many people. To some, inflation is rising prices—any prices—pure and simple. Others may regard rising prices as a sign of inflation only when the rate of increase exceeds some specified level subjectively determined by the individuals themselves. Fixed-income recipients, seeing their real incomes shrink in the face of rising prices for goods and services they buy have little difficulty in defining inflation. Workers whose salaries include periodic cost-of-living adjustments based on escalator clauses in their employment contracts might be slower in judging the presence of inflation or in showing the same degree of concern over it.

Despite such differences, a common element is that prices must be rising. However, rising prices, while necessary for the existence of inflation, are not sufficient. When some prices are rising and others falling, only if the net effect is a rise in the general level of prices, with a concurrent depreciation in the value of money, is this inflation.

Which prices?

But if the idea of rising price levels is accepted, the question arises: which price levels are being referred to? Currently, there are three major price indexes: the Implicit Price Index (I.P.I.)—known also as the Gross National Product (G.N.P.) Deflator, the Consumer Price Index (C.P.I.), and the Wholesale Price Index (W.P.I.). The I.P.I. is conceptually the most comprehensive measure of price changes in that it attempts to measure the over-all price behavior of all goods and services. But it is probably the least familiar to the general public. From 1961 through the third quarter of 1967, this index shows that prices have risen by about 13 per cent, with the rate of increase markedly accelerating in the past two years or so. Behavior of the other two price indexes during roughly the same span of time is shown in Charts 1 and 2.

(Continued on Page 14)

CHART 1
CONSUMER PRICES

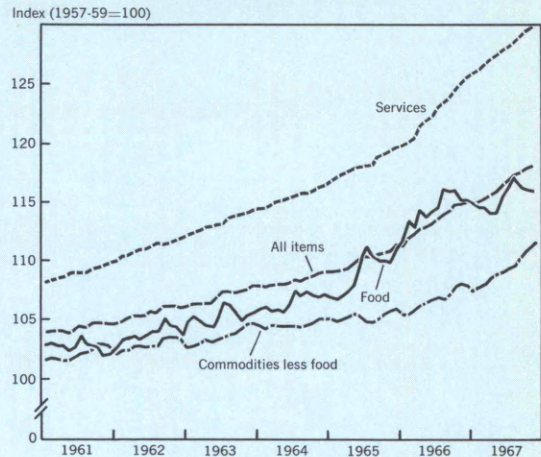
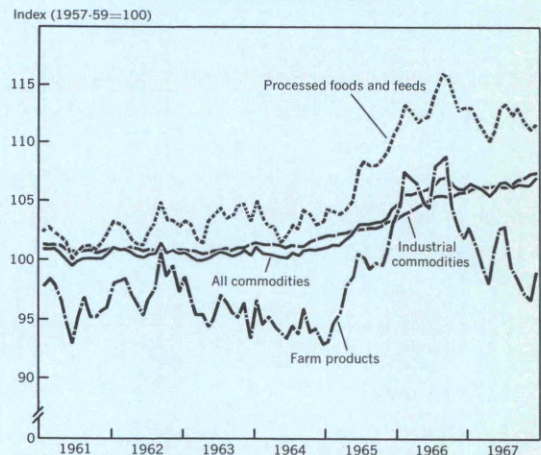


CHART 2
WHOLESALE PRICES



order to validate these attempts to increase income shares. This newer view of inflation held that:

... The strength of economic pressure groups (including but not confined to, trade unions),

together with increased public concern with unemployment, had increased the likelihood (in many countries) of 'disequilibrium' price and wage increases being validated by expansive monetary and fiscal policies, resulting from or-

The All Items Index of consumer prices rose by about 12 per cent from 1961 through the third quarter of 1967, or at about the same rate of increase as in the I.P.I. The pattern of acceleration in the C.P.I. is also similar, and the performance of the services component of the C.P.I. is especially striking. From 1961 through the third quarter of 1967 the average price for services rose by nearly 18 per cent, or half again as fast as the over-all C.P.I. and nearly one-half of this increase occurred during the past two years. Rising food prices at the consumer level have also paced the over-all rise in the C.P.I.

The behavior of the W.P.I., shown in Chart 2, tells a somewhat different story of inflation from 1961 on than does either the I.P.I. or C.P.I. The All Commodities index of wholesale prices showed virtual stability from 1961 through 1964. The entire 7 per cent rise in wholesale prices from 1961 through third-quarter 1967 was compressed into a period of about 18 months. Beginning in 1965, wholesale prices moved upward—paced very largely by a sharp run-up in both farm products and processed foods and feeds—reaching a peak about mid-1966. Following an equally

sharp turnaround in the price of farm products and, to a lesser extent in processed foods, the wholesale price index receded from its 1966 high and has remained below the earlier peak level. The prices of industrial commodities, on the other hand, have risen since 1964, except for a pause in the first half of 1967. Recent months have shown an acceleration in the rate of increase as price rises in the industrial sector have become more numerous and pervasive.

This summary description of price developments since 1961 as measured by three different indexes points up some of the difficulties in unequivocally appraising the behavior of “price levels.” Nonetheless, it serves also to suggest that the indexes do corroborate the generally held view that the past several years have been marked by inflationary pressures. In the case of wholesale prices, only the reversal of earlier price movements in nonindustrial commodities prevented rising industrial prices from being manifested in the over-all W.P.I. If the degree of inflation still remains subject to question, at least the data are sufficiently persuasive to allow us to acknowledge its presence.

ganized pressure on monetary and fiscal authorities. These same factors had also, in this view, decreased substantially the likelihood of ‘equilibrating’ price and wage reductions except in the most drastic of depressions.²

In the more than two decades since passage of the Employment Act of 1946, and especially in more recent years, growing concern over maintaining a high rate of economic growth and full employment makes the above quotation particularly significant.

While either cost-push or demand-pull pressures may raise prices, interaction of the two reinforces inflationary price movements. A look at the current economic expansion dating from

1961 points up the shifting influence of supply and demand on prices and may help to shed light on price prospects in 1968.

A LOOK AT THE RECORD

The year 1965 marked the end of four years of relative price stability. Wholesale prices, in fact, had changed little from 1958 through most of 1964. However, in 1965 they rose by 3.4 per cent. At the same time, consumer prices advanced by 2 per cent. Although wholesale prices peaked in mid-1966, consumer prices accelerated their rate of advance and for 1966 their rise was more than half again as fast as in the preceding year.

As the economy moved into the fourth quarter of 1967, announced price increases had become more numerous at wholesale levels, with industrial prices rising at an annual rate of nearly 3

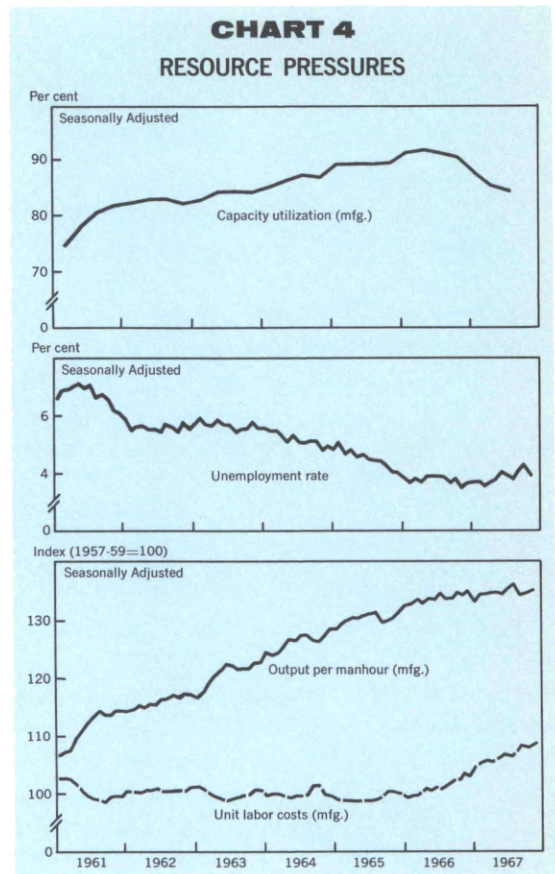
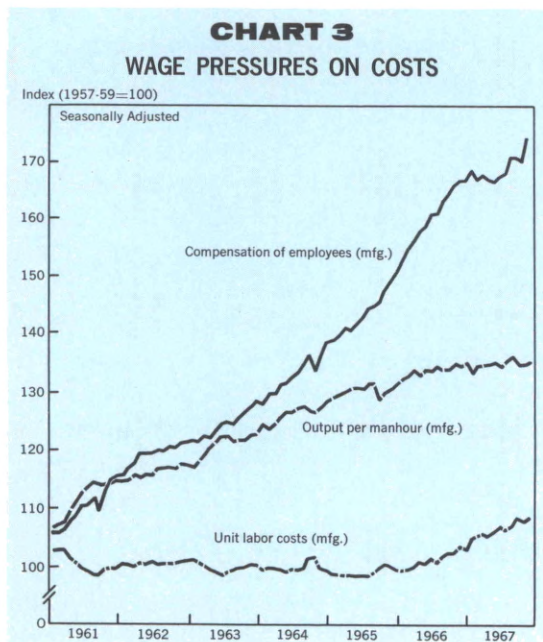
² M. Bronfenbrenner and F. D. Holzman, “Survey of Inflation Theory,” *The American Economic Review*, September, 1963, p. 614.

per cent—a marked acceleration over price rises in the preceding year. During most of 1967, consumer prices continued to advance at about the same pace as in 1966—about 3 per cent a year.

What were the demand and supply forces operating to make prices behave the way they did?

Moderation

The period of relative quiescence on the price fronts from 1961 through 1964 was also a period marked by a reasonably sustainable rate of growth in gross national product. Recovery from recession was proceeding satisfactorily as unemployment moved steadily downward and capacity utilization in manufacturing moved upward from its very low level of the first quarter of 1961. Productivity in manufacturing made good gains, more than keeping pace with employees' compensation. Accordingly, by the end of 1964



unit labor costs were actually lower than in early 1961. (See Charts 3 and 4.)

Through this period, then, demand was not pressing the limits of either human or plant resources. The combination of increasing capacity utilization and an available supply of experienced labor increased productivity growth enough so that moderate wage increases could occur without pushing prices upward. The mix of steady growth in demand and stable unit labor costs was reflected in relatively stable prices and rising profits. Chart 5 shows the growth in manufacturing profits per dollar of sales from 1961 through 1964, along with only a moderate rise

in the ratio of prices-to-unit-labor-costs over the four-year period.

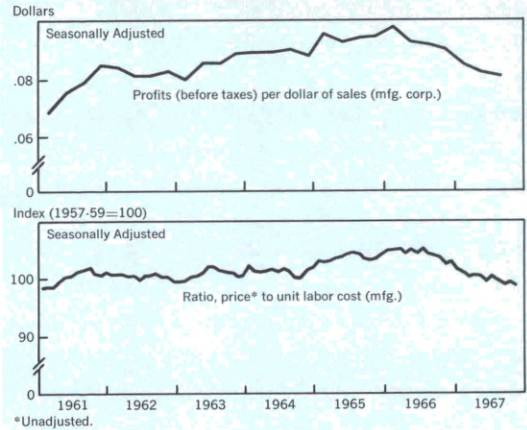
Acceleration

Beginning in 1965, demand picked up sharply. The early surge was largely due to a sizable build-up in steel inventories in anticipation of a strike several months earlier. In the first quarter of 1965 alone, G.N.P. grew by more than \$17 billion—or nearly twice as fast as the rate of growth in the preceding four years. Following this came growing defense outlays for the war in southeast Asia and high rates of investment spending which combined to keep G.N.P. growing at a rapid rate through the end of 1966.

In the face of this sharp step-up in economic growth, pressures on resources and on prices and costs had almost inevitable consequences. The above-normal gains in productivity of 1961 through 1964 gave way to a slackening in productivity increases in 1965 and 1966. Plant capacity utilization soared to over 90 per cent early in 1966. At the same time, unemployment fell sharply during 1965 to 4 per cent at year-end and stayed consistently below that level throughout 1966.

The combination of tightening labor markets which pushed up wages at the same time the reservoir of skilled workers was being eliminated, and the pressures of production against capacity, forced firms to resort to the use of less efficient plant and equipment, additional shifts and overtime, and less skilled workers. In addition, supply bottlenecks became more and more common. The stability which unit labor costs had exhibited through 1964 persisted through most of 1965, but 1966 saw this pattern of stability broken by the relentless pressures both on demand and supply. Prices could not fail to react to the underlying shift in unit labor costs and the growing

CHART 5
THE PROFIT PICTURE



opportunities for profit-taking occasioned by an overheated economy.

A mixture

The first half of 1967 was characterized by an opposing tug between demand and supply. In the second half, emergence of stronger demand reinforced the upward push that costs were exerting on prices. Despite the very slow growth in the economy during the first half of 1967, consumer prices continued to rise and prices of industrial commodities remained on a high plateau.

On the demand side, manufacturers were unable to offset sharply rising unit labor costs by raising prices at a time of general slack in demand for their products. On the supply side, the accelerated rise in unit labor costs resulted from continuing growth in wages and a slower increase in productivity as output declined. Given this set of circumstances, almost the entire increase in wages and supplements was translated into rising unit labor costs in manufacturing. This shows

up clearly in Chart 3.³

Another unusual characteristic of 1967 was the paradox of growing slack in utilization of manufacturing capacity at the same time labor markets generally remained tight. A partial explanation might be that firms were, in effect, “hoarding” workers in anticipation of a rapid turnaround in economic activity. If there is any merit in this explanation, then a look at possible cost-price developments in 1968 would suggest that manufacturing productivity may exhibit fairly impressive recovery if and when production picks up. Evidence already at hand indicates that manufacturing productivity in the third quarter of 1967—although still lagging behind the post-war trend rate of increase—did show some improvement over the disappointing first-half gains.

LOOKING AHEAD

In looking at what may reasonably be expected on the cost-price front in 1968, the following considerations should be kept in mind. The trend of wage rates in 1968 will continue to exert upward pressure on costs. Recent settlements at Ford and Chrysler, and subsequent acceptance of essentially similar terms by General Motors Corporation, have pattern-setting implications. The wage calendar for 1968 covers well over 2 million organized workers including such industries as fabricated metals, glass, construction, aluminum, steel, aircraft, airlines, maritime, and shipbuilding. Even in the absence of these negotiations, continued recovery in aggregate demand

in the months ahead seems likely to put added pressure on employment and hours of work. Gains in production might for a while be achieved with little added resort to more workers or longer hours. However, the tightness of labor markets and relative smallness of the unused plant-capacity buffer when compared to earlier periods in this upswing would suggest that, before long, productivity gains are likely to fall behind wage increases. This problem is compounded by a further rise in minimum wages which is likely to spill over into wages paid for trade, service, and low-wage manufacturing workers. From the cost side, then, upward pressures in 1968 would seem to abound.

The demand side is less clear. The pattern of economic events in 1967 was one of accelerating demand. Resurgence of production to recover output lost in the auto strike, plus the build-up in steel inventories, should swell the growth in output during the first half of the year. In addition, the contract settlement by General Motors without a protracted strike will further boost manufacturing output during the first half of the year, as will growth in spending for new plant and equipment now anticipated for early 1968. As in 1967, government spending may be expected to provide further stimulus to demand.

The key to demand pressures in 1968, however, rests with consumers who for the past six quarters have been an enigma. In the face of rising prices and incomes, they have chosen to save large portions of their incomes. With likely further increases in income in 1968, consumers may decide to step up their rate of spending, particularly if prices continue to rise. If this turnaround should occur in the environment described above, aggregate demand pressures would strongly reinforce cost-push, and 1968 may well witness push-pull inflation.

³ It should be noted, though, that while negotiated wage-rate and fringe-benefit increases in 1967 were well above gains won a year earlier, their impact on average hourly earnings was tempered in 1967 by declining overtime work at premium pay as well as by some layoffs among highly paid manufacturing workers in the face of relatively weak aggregate demand through the first half of 1967.

THIRD DISTRICT BUSINESS AND BANKING CONDITIONS DURING 1967

by Henry A. Watson

Business. The forces slowing down the economy during the first half of 1967 subsided during the fourth quarter and indicators showed signs of renewed vigor. During much of the year the slackening of pressure on key economic resources such as employment and manufacturing output was evident, although all District activities remained at relatively high levels. The prevailing 1966 tight labor market eased during the first part of the year but shortages continued in some key occupations.

Year-end upward movement in the help-wanted index, however, indicated new pressure building. Although unemployment continued to be a problem in some labor market areas, in all fifteen major labor areas it ended the year at the low January 1967 levels.

Increased productivity and capacity helped offset the pressure of rising demand for goods and services. But labor cost per unit of output continued to rise during the year and although factories worked shorter hours, pay raises increased the wage incomes of workers. The cost of living in Philadelphia as measured by the consumer price index, rose by more than 3 per cent for 1967 and threatens to go higher during 1968.

Construction activity reversed 1966 direction, pushing the overall level of activity up over 8 per cent. The advance was reflected in both residential and nonresidential categories. Strength in final demand during the last quarter was evident with increased checkbook spending, consumer credit outstanding and auto registrations.

Banking. The determining force in commercial banking during 1967 was a changing economy and an accommodating monetary policy. District loan activity, while forging ahead at a rate faster

BUSINESS INDICATORS THIRD FEDERAL RESERVE DISTRICT PER CENT CHANGE 1966 TO 1967*

Manufacturing employment	+ 2
Factory payroll	+ 2
Factory working time	- 2
Electric power consumed by manufacturers	+ 2
Construction contracts	+ 8
Residential	+10
Nonresidential	+13
Public works and utilities	- 6
Consumer Price Index	+ 3
Bank debits (15 SMSA's) (s.a.)	+ 6

*First 11 months

UNEMPLOYMENT IN MAJOR LABOR MARKET AREAS—THIRD FEDERAL RESERVE DISTRICT

Per cent of Labor Force Unemployed	December 1967	December 1966	December 1965	December 1964
1.5 to 2.9%	6	6	6	2
3.0 to 5.9	6	6	3	6
6.0 to 8.9	1	1	4	4
9.0 to 11.9	0	0	0	1
12.0 or more	0	0	0	0
Total	13	13	13	13

MEMBER BANKS

(billions of dollars)

	November 1965	November 1966	Change in 1966	November 1967	Change in 1967
NATION					
Loans	163,597	179,106	+ 9.48	190,515	+ 6.37
Investments	80,663	78,935	- 2.14	95,185	+20.59
Time deposits	119,325	127,283	+ 6.67	147,968	+16.25
Demand deposits	141,305	147,393	+ 4.31	154,721	+ 4.97
THIRD DISTRICT					
Loans	7,808	8,604	+10.19	9,349	+ 8.66
Investments	3,883	3,818	- 1.67	4,626	+21.16
Time deposits	5,705	6,430	+12.71	7,413	+15.29
Demand deposits	6,592	6,721	+ 1.96	7,184	+ 6.89

than that of the nation, lagged the 1966 performance. The reduced loan demand, coupled with ample bank reserves, enabled member banks to acquire U.S. Governments and other securities in substantial amounts. Holdings of securities by District member banks increased by 21 per cent. Total deposits continued to climb during the

year, with attractive interest rates producing an increase in time deposits for all member banks in the District of 15 per cent.

Clearly, as the year closed, the District was entering 1968 on an upturn and all categories of business and banking activities were in phase for another period of expansion.

DIRECTORS AND OFFICERS

In a special election on April 5, 1967, Mr. Henry A. Thouron, Chairman of the Board and President, Hercules Incorporated, Wilmington, Delaware, was elected by member banks in Electoral Group 2 as a Class B Director of this Bank to fill the unexpired term of Mr. Ralph K. Gottshall who resigned on December 31, 1966. At regular elections held later in the year, Mr. H. Lyle Duffey, Executive Vice President, The First National Bank of McConnellsburg, McConnellsburg, Pennsylvania, was elected by member banks in Electoral Group 3 as a Class A Director for a three-year term beginning January 1, 1968. He succeeds Mr. Lloyd W. Kuhn. Mr. Philip H. Glatfelter, III, President, P. H. Glatfelter Co., Spring Grove, Pennsylvania, was re-elected as a Class B Director for a like term by member banks in Electoral Group 1.

In December, the Board of Governors of the Federal Reserve System reappointed Dr. Willis J. Winn, Dean, Wharton School of Finance and Commerce, University of Pennsylvania, as a Class C Director for a three-year term ending December 31, 1970. Dr. Winn also was redesignated Chairman of the Board of Directors and Federal Reserve Agent for the year 1968. Mr. Bayard L. England, Chairman of the Board, Atlantic City Electric Company, was reappointed Deputy Chairman of the Board of Directors for 1968.

The Board of Directors of this Bank selected Mr. Harold F. Still, Jr., President, Central-Penn National Bank of Philadelphia, Pennsylvania to serve again during 1968 as the member of the Federal Advisory Council from the Third Federal Reserve District.

During the year 1967, three reductions occurred in the officer staff of the Bank: Mr. Clay J. Anderson, Economic Adviser, retired on January 31. Mr. Richard G. Wilgus, Vice President and Secretary, died on May 21, and Mr. Fred A. Murray, Director of Plant, passed away on August 14, following retirement in June.

Effective June 15, 1967, three promotions occurred within the officer staff: Mr. Edward A. Aff and Mr. William A. James, formerly Assistant Vice Presidents became Vice Presidents, and Mr. Lawrence C. Murdoch, Jr., formerly Assistant Vice President and Assistant Secretary became Vice President and Secretary. Three promotions to officer status were made during the year: on June 15, Mr. Samuel J. Culbert, Jr., formerly Administrative Assistant became Bank Services Officer, and Mr. D. Russell Connor, formerly Regional Analyst became Assistant Secretary. Effective January 1, 1968, Mr. David P. Noonan, Assistant Department Head in Personnel was promoted to Assistant Personnel Officer, and Mr. Connor became Assistant Secretary and Building Officer. Two new officers were appointed to the Research function in 1967 as Research Officer and Economist: Mr. Warren J. Gustus, formerly with Drexel Institute of Technology, effective July 10, and Mr. Sheldon W. Stahl, formerly with the Federal Reserve Bank of Kansas City, effective August 21.

DIRECTORS AS OF JANUARY 1, 1968

Group		Term expires December 31
	CLASS A	
1	HOWARD C. PETERSEN Chairman of the Board The Fidelity Bank, Philadelphia, Pennsylvania	1968
2	ROBERT C. ENDERS President, Bloomsburg Bank-Columbia Trust Co., Bloomsburg, Pennsylvania	1969
3	H. LYLE DUFFEY Executive Vice President, The First National Bank of McConnellsburg, McConnellsburg, Pennsylvania	1970
	CLASS B	
1	PHILIP H. GLATFELTER, III President, P. H. Glatfelter Co., Spring Grove, Pennsylvania	1970
2	HENRY A. THOURON Chairman of the Board and President, Hercules Incorporated, Wilmington, Delaware	1968
3	EDWARD J. DWYER President, ESB Incorporated Philadelphia, Pennsylvania	1969
	CLASS C	
	WILLIS J. WINN, Chairman Dean, Wharton School of Finance and Commerce, University of Pennsylvania Philadelphia, Pennsylvania	1970
	BAYARD L. ENGLAND, Deputy Chairman Chairman of the Board, Atlantic City Electric Co., Atlantic City, New Jersey	1969
	D. ROBERT YARNALL, JR. President, Yarway Corporation Blue Bell, Pennsylvania	1968

OFFICERS AS OF JANUARY 1, 1968

KARL R. BOPP
President

ROBERT N. HILKERT
First Vice President

EDWARD A. AFF
Vice President

HUGH BARRIE
Vice President

JOSEPH R. CAMPBELL
Vice President

NORMAN G. DASH
Vice President

DAVID P. EASTBURN
Vice President

WILLIAM A. JAMES
Vice President

DAVID C. MELNICOFF
Vice President

G. WILLIAM METZ
Vice President and
General Auditor

LAWRENCE C. MURDOCH, JR.
Vice President and Secretary

HARRY W. ROEDER
Vice President

JAMES V. VERGARI
Vice President and
General Counsel

JACK P. BESSE
Assistant Vice President

JOSEPH M. CASE
Assistant Vice President

WARREN J. GUSTUS
Research Officer and Economist

RALPH E. HAAS
Assistant Vice President

WARREN R. MOLL
Assistant Vice President

HENRY J. NELSON
Assistant Vice President

KENNETH M. SNADER
Assistant Vice President

SHELDON W. STAHL
Research Officer and Economist

RUSSELL P. SUDDERS
Assistant Vice President

JAMES P. GIACOBELLO
Chief Examining Officer

THOMAS K. DESCH
Examining Officer

WILLIAM L. ENSOR
Examining Officer

JACK H. JAMES
Examining Officer

LEONARD E. MARKFORD
Examining Officer

JAMES A. AGNEW, JR.
Assistant Cashier

WALTER J. BROBYN
Assistant Counsel

D. RUSSELL CONNOR
Assistant Secretary and
Building Officer

SAMUEL J. CULBERT, JR.
Bank Services Officer

A. LAMONT MAGEE
Assistant General Auditor

DAVID P. NOONAN
Assistant Personnel Officer

STATEMENT OF CONDITION
Federal Reserve Bank of Philadelphia

(000's omitted in dollar figures)	End of year	
	1967	1966
ASSETS		
Gold certificate reserves:		
Gold certificate account	\$ 560,613	\$ 698,902
Redemption fund—Federal Reserve notes	101,189	96,258
Total gold certificate reserves	\$ 661,802	\$ 795,160
Federal Reserve notes of other Federal Reserve Banks	48,728	48,058
Other cash	8,610	6,773
Loans and securities:		
Discounts and advances	1,430	545
United States Government securities	2,525,715	2,289,202
Total loans and securities	\$2,527,145	\$2,289,747
Uncollected cash items	631,426	541,950
Bank premises	2,433	2,510
All other assets	98,935	64,123
Total assets	\$3,979,079	\$3,748,321
LIABILITIES		
Federal Reserve notes	\$2,444,268	\$2,305,967
Deposits:		
Member bank reserve accounts	853,005	896,033
United States Government	76,536	505
Foreign	7,280	8,640
Other deposits	26,460	8,599
Total deposits	\$ 963,281	\$ 913,777
Deferred availability cash items	493,311	456,785
All other liabilities	14,568	11,934
Total liabilities	\$3,915,428	\$3,688,463
CAPITAL ACCOUNTS		
Capital paid in	\$ 31,826	\$ 29,929
Surplus	31,826	29,929
Total liabilities and capital accounts	\$3,979,079	\$3,748,321
Ratio of gold certificate reserve to Federal Reserve note liability	27.1%	34.5%

EARNINGS AND EXPENSES

Federal Reserve Bank of Philadelphia

(000's omitted)	1967	1966
Earnings from:		
United States Government securities	\$110,223	\$ 95,513
Other sources	1,440	1,862
Total current earnings	\$111,663	\$ 97,375
Net expenses:		
Operating expenses*	8,742	8,501
Cost of Federal Reserve currency	1,016	1,295
Assessment for expenses of Board of Governors	567	483
Total net expenses	\$ 10,325	\$ 10,279
Current net earnings	101,338	87,096
Additions to current net earnings:		
Profit on sales of U.S. Government securities (net) ..	40	—
All other	77	93
Total additions	\$ 117	\$ 93
Deductions from current net earnings:		
Loss on sales of U.S. Government securities (net) ..	—	127
Miscellaneous non-operating expenses	2	3
Total deductions	\$ 2	\$ 130
Net additions	115	—37
Net earnings before payments to U.S. Treasury	\$101,453	\$ 87,059
Dividends paid	\$ 1,854	\$ 1,790
Paid to U.S. Treasury (interest on Federal Reserve notes)	97,703	84,886
Transferred to or deducted from (—) Surplus	\$ 1,896	\$ 383

* After deducting reimbursable or recoverable expenses.

VOLUME OF OPERATIONS

Federal Reserve Bank of Philadelphia

	1967	1966	1965
Number of pieces (000's omitted)			
Collections:			
Ordinary checks*	283,400	276,600	262,900
Government checks (paper and card)	32,700	30,800	29,500
Postal money orders (card)	17,300	18,200	17,800
Non-cash items	846	832	836
Food stamp coupons	17,391	9,766	3,685
Clearing operations in connection with direct sendings and wire and group clearing plans**	706	697	679
Transfers of funds	248	233	208
Currency counted	305,200	297,500	268,400
Coins counted	560,700	403,800	159,400
Discounts and advances to member banks	(a)	1	1
Depository receipts for withheld taxes	799	662	609
Postal receipts (remittances)	282	280	286
Fiscal agency activities:			
Marketable securities delivered or redeemed	536	621	538
Savings bond transactions—			
(Federal Reserve Bank and agents)			
Issues (including reissues)	9,934	9,512	8,867
Redemptions	7,260	6,956	6,745
Coupons redeemed (Government and agencies)	1,070	1,072	1,074
Dollar amounts (000,000's omitted)			
Collections:			
Ordinary checks	\$ 94,422	\$ 88,836	\$ 79,445
Government checks (paper and card)	7,983	6,993	6,004
Postal money orders (card)	248	254	246
Non-cash items	1,104	827	563
Food stamp coupons	23	13	5
Clearing operations in connection with direct sendings and wire and group clearing plans**	54,568	49,908	47,649
Transfers of funds	219,815	192,718	167,181
Currency counted	2,258	2,205	2,003
Coins counted	63	45	12
Discounts and advances to member banks	323	1,806	2,086
Depository receipts for withheld taxes	3,935	3,348	2,593
Postal receipts (remittances)	929	914	891
Fiscal agency activities:			
Marketable securities delivered or redeemed	13,571	14,913	13,845
Savings bond transactions—			
(Federal Reserve Bank and agents)			
Issues (including reissues)	459	464	431
Redemptions	385	381	362
Coupons redeemed (Government and agencies)	435	342	225

* Checks handled in sealed packages counted as units.

** Debit and credit items.

(a) Less than 1,000 rounded.