

# august



Banking with Vaults Awash

Growing Role of Institutional  
Investors on Wall Street

Interest Ban on Demand Deposits:  
Victim of the Profit Motive?

**FEDERAL RESERVE BANK of PHILADELPHIA**

# business review



The Duncannon National Bank, with the overflowing waters of the Susquehanna River reaching halfway up its doors, typifies the problem many Pennsylvania bankers faced in the aftermath of Hurricane Agnes.

### **Banking with Vaults Awash**

. . . Hurricane Agnes brought record flooding to many Pennsylvania communities and affected everyone, including banks and bankers.

### **Growing Role of Institutional Investors on Wall Street**

. . . Institutional investors, while constituting less than half the gain in dollar holdings of individuals on the stock market, have a lion's share of the volume traded and largely account for the recent increases in block trading.

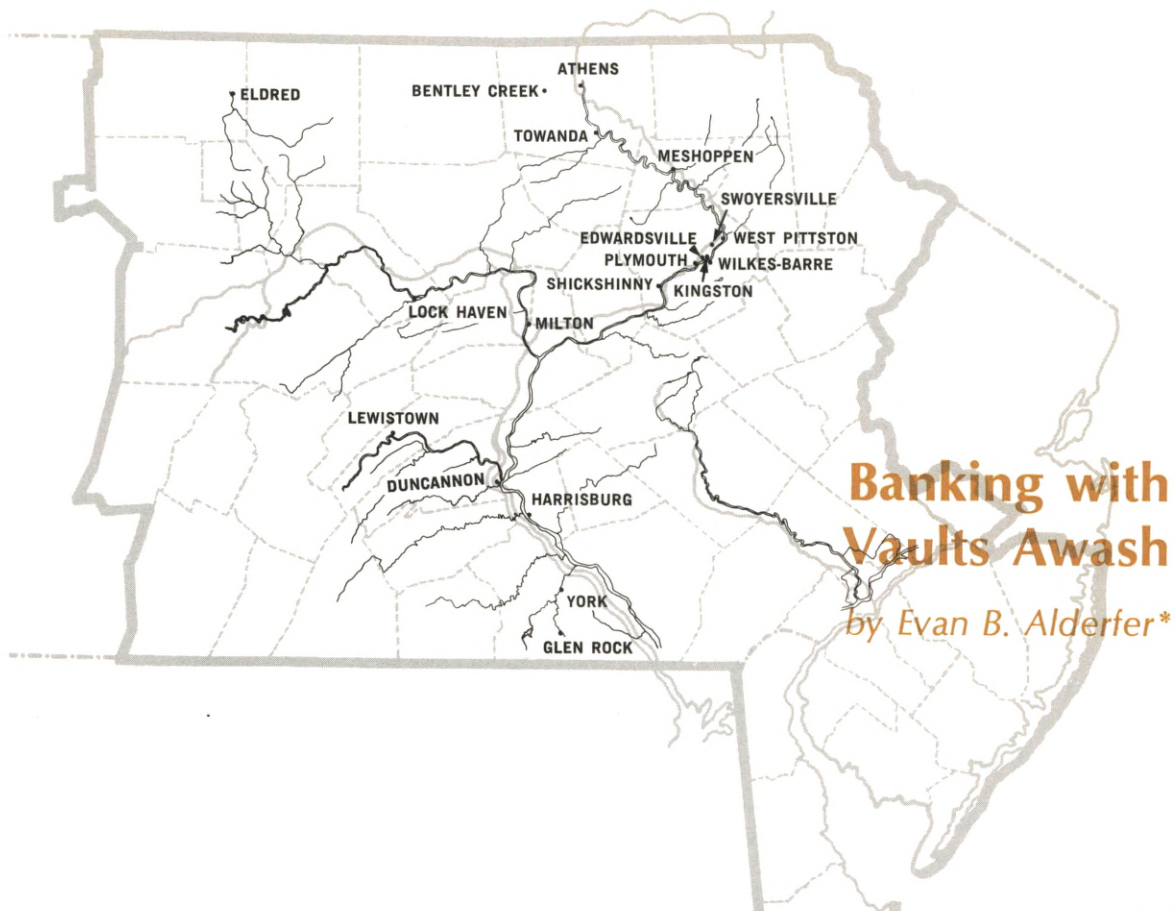
### **Interest Ban on Demand Deposits: Victim of the Profit Motive?**

. . . Neither the national economy nor the banking system seems to profit much from the interest prohibition on demand deposits, but repeal of the regulation itself could worsen the existing situation.

Photographs courtesy of the Duncannon Record and Charles B. Pennell, Executive Vice President of the Duncannon National Bank.

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## Banking with Vaults Awash

by *Evan B. Alderfer\**

Early on the second day of summer of '72, people in Wilkes-Barre were urged to abandon their homes on the double-quick. Men, sandbagging the dikes, couldn't hold back the rapidly rising Susquehanna River much longer. Most residents fled in time, some in their nightwear. The dikes broke.

Three weeks later Wilkes-Barre was still a shambles. The riverfront and nearby areas were a tangle of misshapen houses, broken houses, dashed-to-pieces houses, and occasionally absolutely nothing except stone steps and an iron railing to identify the former place of residence of a homeless family. Hardest hit were the residential and business sections of the city; industries gen-

erally escaped. Street after street was piled high on both sides, like dirty snowpiles, with junk that had been household and store furnishings and fixtures before the flood.

Everything was water-soaked and mud-coated. Heartbreak scenes were: a playpen on the broken roof of a collapsed house, a child's ball on the remains of a detached front porch, a grand piano lying upside down in a washout, an American flag draped over the banister of a gutted house no longer a home. Such was the wreckage of the two-story flood wrought by Agnes.

Sixty-nine of the city's slightly over 5000 residential, commercial, and multiple-use structures were demolished completely. At least 150 require major repairs; very few escaped without some damage. Preliminary

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estimates of total damage came to \$68 million.

Despite the disaster, the spirit of the people might well be described as muddied but unbowed. On a clean-scrubbed storefront hung a sign—"We Made It. It's Great To Be Open." On a damaged house was a notice—"For Sale, Remodeled By Agnes." Elsewhere was a placard—"Rebuild We Will, Operation Snapback."

Have you ever tried to remove four inches of mud from your living room or bedroom floor? Massive mud removal was a citywide occupation as soon as the floodwaters receded. To see a bank vice president, in sweatshirt and dirty trousers, working with his staff cleaning out the mess from the bank floor is a reminder that a flood is a leveler. Mud, however, was not the only problem Agnes dumped in the laps of many bankers.

### DRYING OUT THE BANKS

How soon banks could reopen for business depended in each case upon how high the water had risen and the extent of the damage to machinery and equipment. In Edwardsville, across the river from Wilkes-Barre, the bank was completely submerged, with the room several feet under water. Almost two weeks elapsed before that bank resumed business in rented quarters—a building formerly used for social functions such as wedding receptions. After the flood, however, that bank opened its vault with ease because the chief officer had the forethought to buy \$4.50 worth of lard for application to the sensitive parts of a vault's anatomy.

Muddy floodwaters clogged the time clocks thus preventing the opening of numerous vaults. What could be more frustrating to a banker than being unable to get at his quick assets? One bank had to resort to burning through the concrete. Once inside their vaults, bankers were confronted with the job of separating, identify-

ing, and drying sodden pieces of currency, securities, and other papers of value. Three weeks after the deluge, liquid assets were still being dehydrated.

### UPHILL RESUMPTION OF BANKING

Bankers had to devise all sorts of makeshift operations. Candles and kerosene lamps took the place of electric lights. Hand-operated adding machines and calculators were taken out of mothballs. At a big, highly automated bank a corner of its parking lot was occupied by a growling and snorting Diesel-driven generator that was piping kilowatts through a spray of wires into the bank to run the computer. The rig was leased for the emergency at a substantial monthly rental. The president of another Wilkes-Barre bank, where the main office was little short of a total wreck, operated his organization from a rented trailer parked in the parking lot of one of the bank's branches. A number of banks were so badly washed out that they had to get a complete supply of business forms before they could reopen. With telephones dead, one bank in need of more cash to supply its customers wrote a request for currency on a piece of scrap paper which was delivered by a salesman to us at the Fed. It worked. By one means or another, local banks restored to their communities the most essential bank services in remarkably short time, despite flooded vaults, lost records, and all the other high-water woes.

### LOW LANDS—HIGH WATERS

Wilkes-Barre is only one of many places that were flooded. Across the river on the sunset side of the Susquehanna, flood waters made miserable messes in Plymouth, Kingston, Swoyersville, and West Pittston. Upstream in the small town of Meshoppen, First National's water-flooded basement was messed up further by oil spillage from a ruptured tank. Farther upstream in Towanda, luck was with the bank but private homes

and stores took a beating and so did circumjacent farm properties and crops. Still farther upriver close to the New York State border, Athens got a double dose of adversity by reason of its location between the Susquehanna and the Chemung rivers. Not far west of Athens, normally placid little Bentley Creek became a raging torrent and damaged half the homes of the hamlet named after the stream. South of Wilkes-Barre, at Shickshinny, Wyoming National Bank's branch stood in 14 feet of Susquehanna water; moreover, the bridge connecting the two halves of the town was washed out.

At Milton, on the lower reaches of the west branch of the Susquehanna, the First National Bank had a five-foot inundation on its first floor, enough to ruin most of the furniture and all of the sorting, encoding, and bookkeeping machinery. Nevertheless, the bank gave uninterrupted service by operating from its unflooded branch. The town's industries were likewise able to keep on operating.

Farther upstream on the west branch in Lock Haven, the Piper Aircraft Corporation sustained flood damage of an estimated \$16 million and the Hammermill Paper plant \$3 million. In the far northwestern corner of the District, in McKean County, the First National Bank of Eldred was flooded with over seven feet of water from the Allegheny River. Neighboring banks offered more than condolences, they lent a hand, even to the extent of accepting deposits for First National of Eldred.

What happened in Harrisburg is well known because of the publicity the press gave the capital city.

Banks in the city of York on the Codorus escaped flooding for the most part but damages to other businesses and to residences were reported to be about \$30 million. The Peoples Bank of Glen Rock, on the south branch of the Codorus, likewise fared well but there was substantial property damage.

Agnes also raised havoc with agricultural businesses. Extensive damage was done to crops, farm property, equipment, and feed supplies in the low-lying areas of the entire Susquehanna River basin. According to the Pennsylvania Crop Reporting Service, heavy beatings of rain and wind flattened winter grains and row crops were damaged by sheet erosion.

### HELPING HANDS: PUBLIC AND PRIVATE

The stricken communities received initial help in the form of food and drink, shelter, money and muscle from various public and private benefactors. To the rescue came the Red Cross, Salvation Army, state troopers, MPs, religious, fraternal, and labor organizations. The National Guard and the Army Corps of Engineers assisted in the big clean-up job, and so did individual Amish and Mennonites who served without pay.

Much needed shelter is being supplied by the Department of Housing and Urban Development. By the end of July, HUD had already spent \$50 million in Pennsylvania largely for shelter in the form of camp trailers and mobile homes.

Initial aid was also extended to the flood victims by various financial institutions. Banks in the flooded areas declared a moratorium on mortgage payments for three months and they also designed special loan programs for homeowners and businessmen. Banks outside the flooded areas gave cash assistance to flooded banks and also supplied some of them with hand-operated machines.

The Federal Reserve Bank made special currency deliveries to Third District banks in distress, kept the discount window open to provide appropriate credit to member banks affected by the flood, waived penalties connected with deficiencies in reserve accounts for banks most directly affected by the floods, sent the entire Fed staff of field men into the flooded areas with instructions to stay there as long as they could be of as-

sistance, and also provided 14 men to assist throughout the District in processing applications for loans from the Small Business Administration.

### MAY-FLY CREDIT NOT ENOUGH

Not just credit for a day, but long, long-time credit is what is needed for rebuilding the devastated areas. The readiest source of that kind of help is Section 7(b) of the Small Business Act.

In 1971 the Small Business Administration made 96,000 disaster loans totaling \$385 million to restore homes and businesses damaged by hurricanes, earthquakes, and floods. Under present SBA rules, a businessman can borrow up to a half million dollars on the same terms. Both types of borrowers are given \$2500 outright after the first \$500 of the loan is paid off. Halfway through Congress (the House) is a bill to reduce the rate of interest to 1 percent. Moreover, President Nixon on August 20 signed a \$1.6 billion flood relief bill, allocating some \$1.3 billion for disaster loans.

And there are other long-term credit agencies. The Farmers Home Administration is providing credit to farmers to replace equipment and structures affected by the flood and to ease problems caused by crop damage. The Federal Home Loan Bank Board has liberalized its provision of credit to savings and loan associations in the five-state northeastern region affected by the flood. The Pennsylvania Department of Community Affairs has begun allocating money for housing assistance to people in Wilkes-Barre, Harrisburg, and other flood-stricken areas.

### RAIN ON THE TERRAIN OF PENNSYLVANIA

Agnes, whether a tropical storm or a hurricane, carried a supercharge of water—an estimated 25 cubic miles—"the greatest rainstorm of all time," in the words of the National Hurricane Center. Emerging from

the Gulf of Mexico, she drenched parts of Florida, wove inland and offshore in a northeasterly direction along the Atlantic coastline, drenched sections of Virginia and New York, backtracked into Pennsylvania where she unleashed enough rain to cause almost three-quarters of the total flood damage in all the states traversed. Between June 20-26, from 14 to 18 inches of rain fell in various sections of the Susquehanna watershed which accounts for almost half of the Commonwealth's area.

Not only heavy rain but also the nature of the state's terrain accentuated the flood damage. Pennsylvania's beautiful hills and valleys are a joy in fair weather but they can be a menace in foul. Former Penn State geographers Raymond E. and Marion F. Murphy, in their book *Pennsylvania Landscapes*, observed—"Since Pennsylvania's streams flow for the most part through a hilly region, cutting their way across numerous rocky ledges, it is not surprising that . . . floods are common at some periods of the year and the streams nearly disappear at other times."

Floods are frequent and soon forgotten, except by the victims. The Susquehanna has flooded Harrisburg 20 times since the city's founding. In addition to the current flood, Pennsylvania has had two other major deluges in our time—the double-dosed Connie and Diane, just a few days apart in 1955 and the big flood caused by the combination of heavy rains and the spring thaw of a heavy blanket of snow in 1936. In the 1972 disaster mortality was less than in the other floods but property damage was greater. For example, in 1936 Pennsylvania had 275 bridges destroyed or made unsafe and in 1972 the count was 569.

Levees seldom seem to hold, or do we hear about only those that break? Wilkes-Barre felt safe because its earth levee was built three feet higher than the 1936 crest. But Agnes dumped so much water into Susquehannaland that the river topped the former crest by six feet.

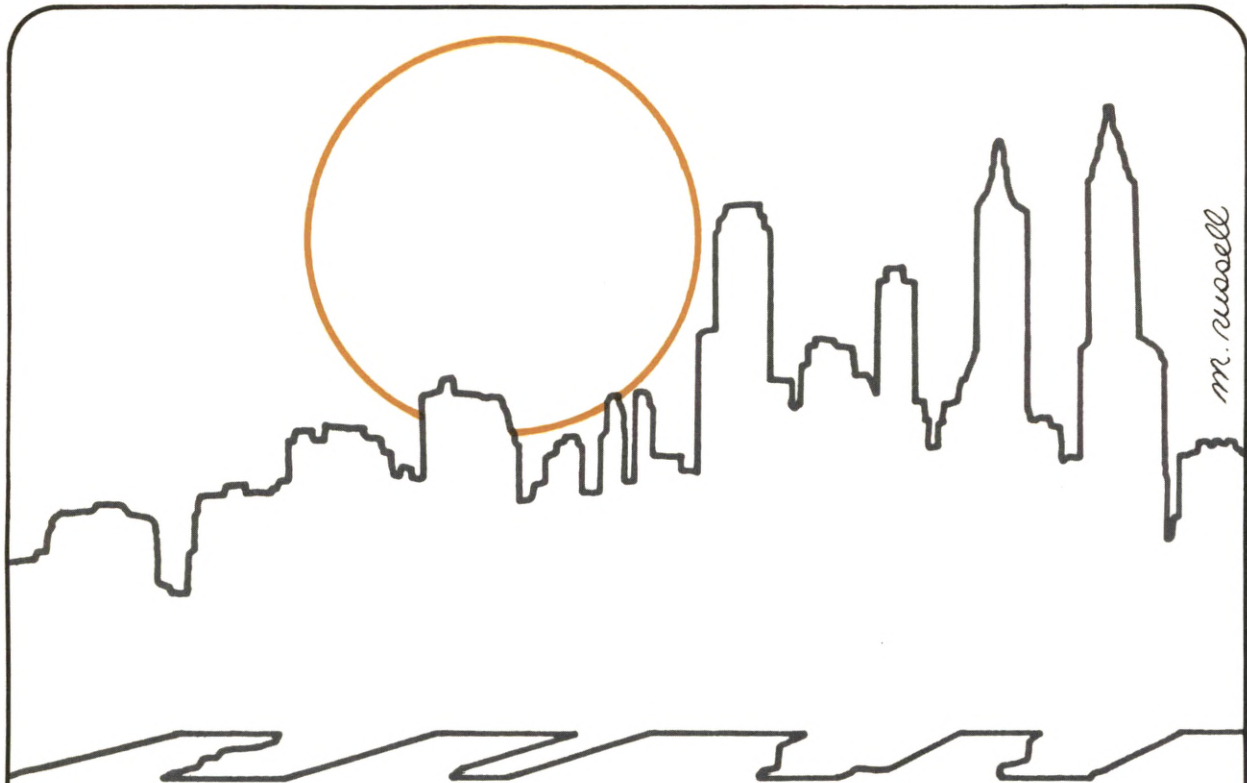


How about more dams? Advocates of dams point out that since the 1936 flood, nearly \$100 million has been invested in dams and related devices on both branches of the Susquehanna and that they saved several communities from destruction in the recent floods.

Proponents of flood plains argue that it is a mistake to think only in terms of how to contain a river or a stream within its customary channel. The key to a solution, they say, is the management of land and water

resources together, not separately. Land along a river where it is naturally subject to flooding during the heavy runoff should be zoned for parks, parking lots, and similar uses. Uncontrolled building in such flood-prone places can increase the extent and destructivity of flood waters.

Perhaps that is what an upstate banker had in mind when in reply to our question—"What have you learned from this flood?" he said—"To build on higher ground." ■



# **GROWING ROLE OF INSTITUTIONAL INVESTORS ON WALL \$TREET**

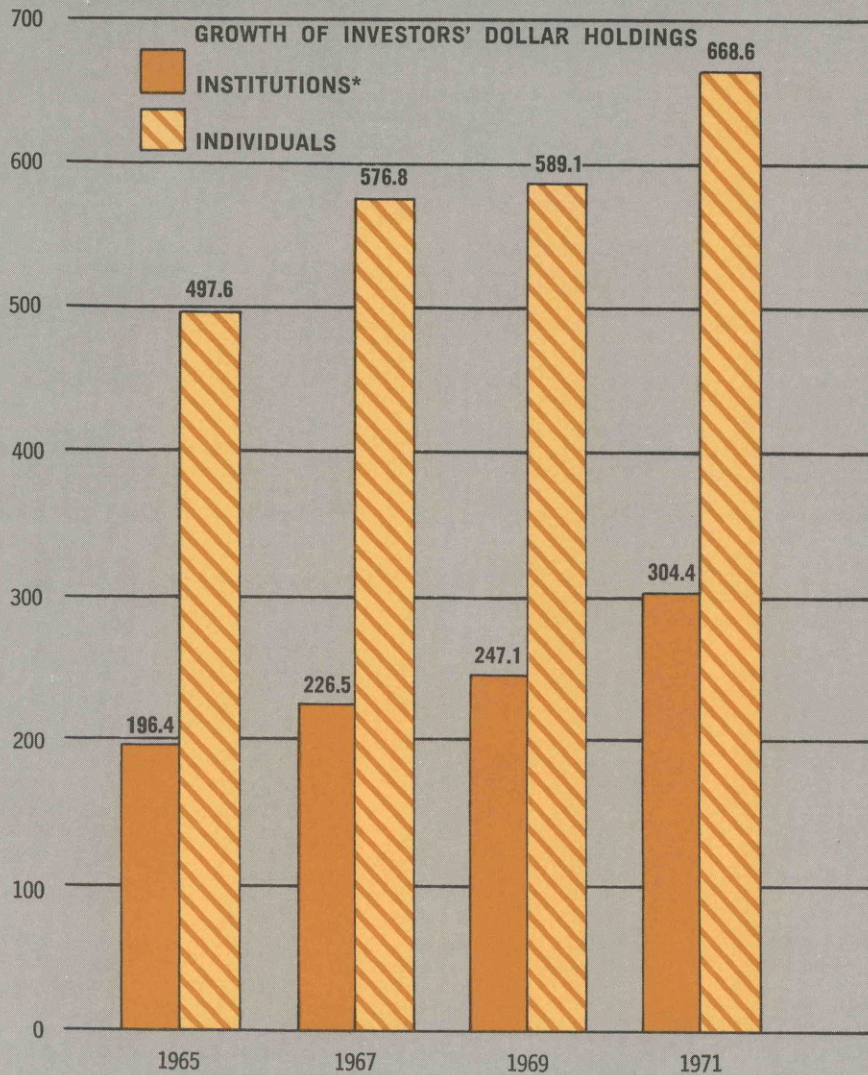
**by gertrude mazza**



Chart 1

**INSTITUTIONAL INVESTORS' HOLDINGS, WHILE GROWING, STILL ACCOUNT FOR LESS THAN HALF THE GAIN IN DOLLAR HOLDINGS OF INDIVIDUALS . . .**

Dollars in billions

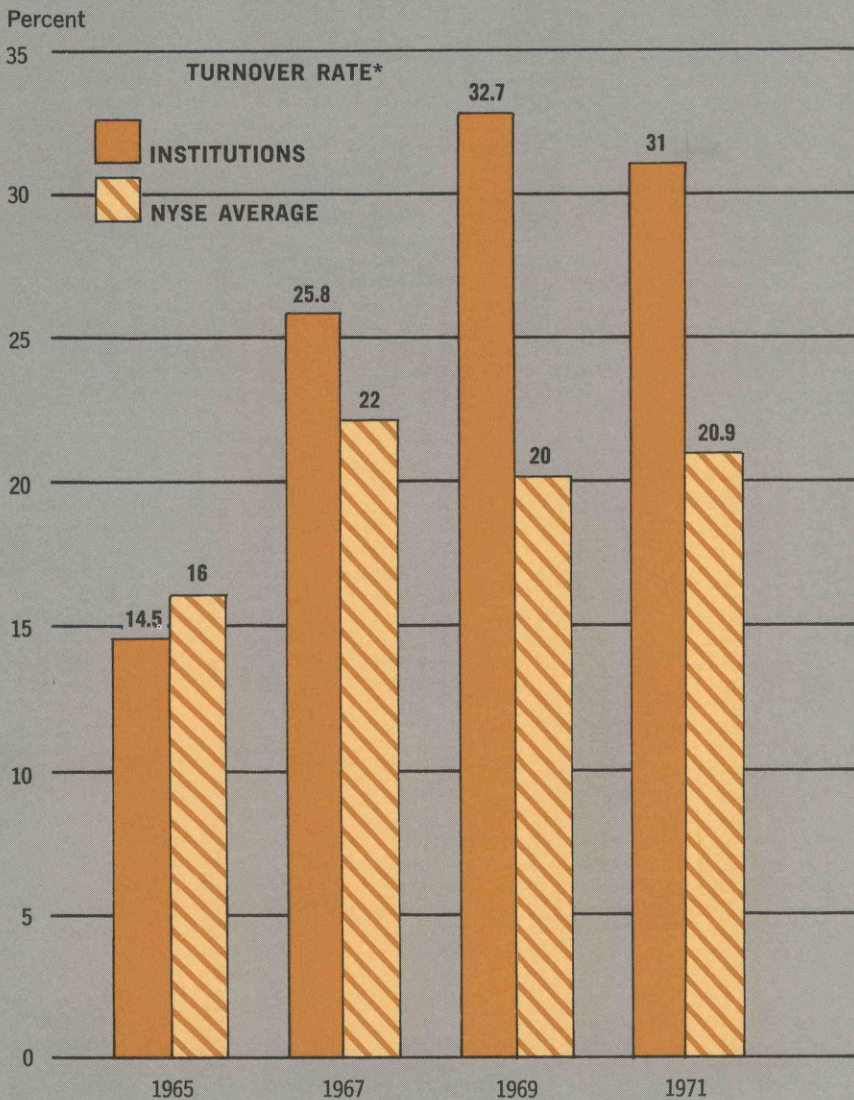


Source: SEC Statistical Bulletin

\* Institutional investors include pension funds, life insurance companies, trust funds, mutual funds, etc.

Chart 2

**BUT THEIR INFLUENCE ON STOCK MARKET PRICES IS NEVERTHELESS CONSIDERABLE THANKS TO THEIR RAPID TURNOVER RATE**

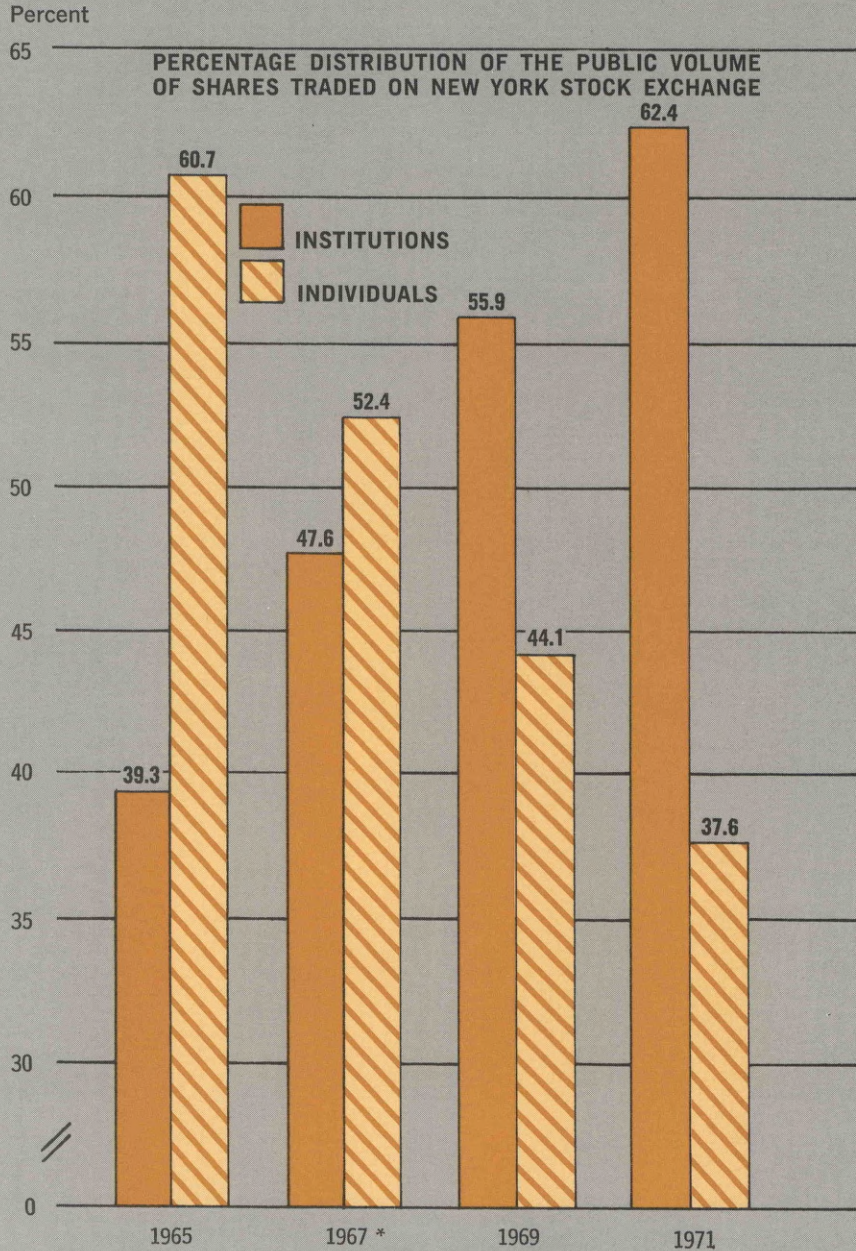


\* Turnover rate per year =  $\frac{\text{Average of purchases and sales during year}}{\text{Average market value of stockholdings at beginning and end of year}}$

Source: SEC Statistical Bulletin; NYSE 1971 Fact Book

Chart 3

**MOREOVER, INSTITUTIONAL INVESTORS HAVE GARNERED THE LION'S SHARE OF THE VOLUME OF SHARES TRADED . . .**



Source: NYSE Public Transaction Study, 1971

\* Estimated

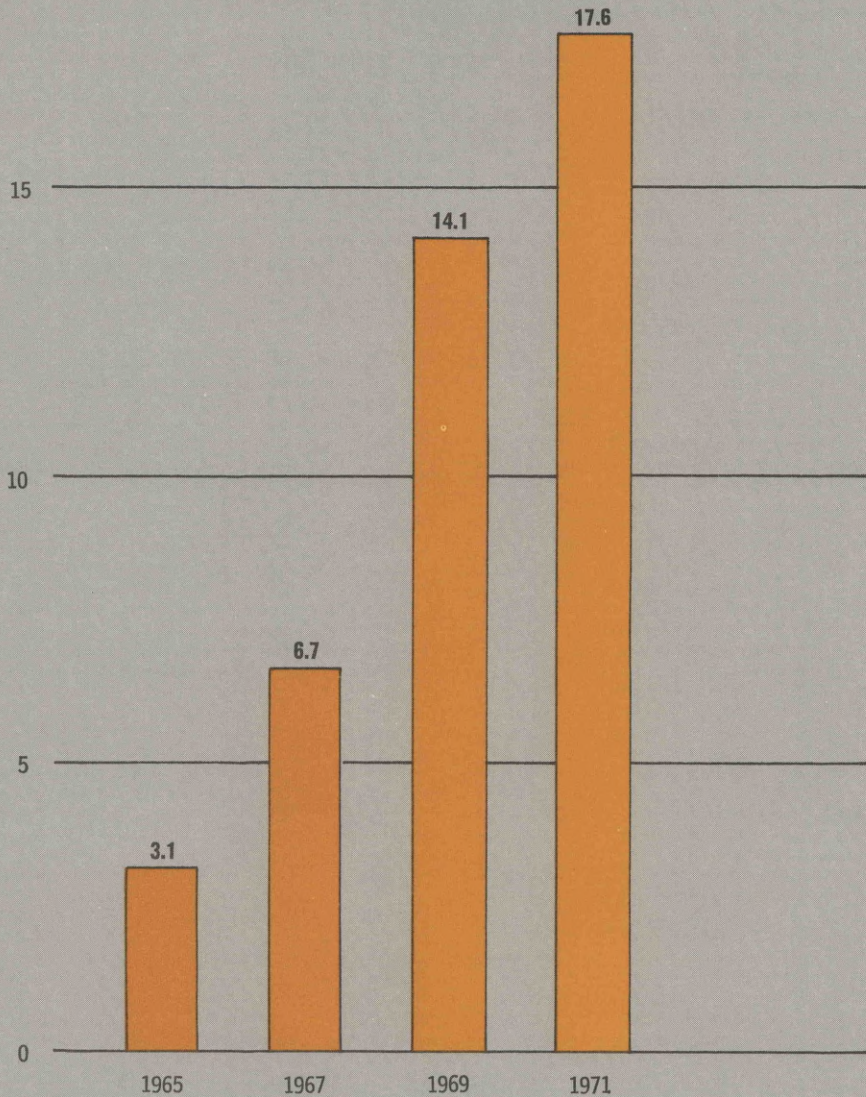
Chart 4

AND, THEY LARGELY ACCOUNT FOR THE RECENT INCREASES IN BLOCK TRADING

Percent

20

BLOCK\* TRADING AS PERCENTAGE OF REPORTED VOLUME



Source: NYSE 1971 Fact Book

\* 10,000 shares or more traded

# Interest Ban on Demand Deposits: Victim of the Profit Motive?

by James M. O'Brien

*No bank shall, directly or indirectly, by any device whatsoever, pay an interest on any deposit which is payable on demand . . .*

*Section 11, Banking Act of 1933*

The period was the early 1930s—a time of financial as well as general economic disaster. The stock market had plummeted to its lowest depths in history. Banks fell like swatted flies. Urgency was the order of the day as Congress sped toward revamping and revitalizing the country's economy in the hope of heading off another great depression. Some changes have provided valuable aid toward achieving economic and financial stability. Take, for example, Federal deposit insurance which is credited with a major role in eliminating bank failures. However, action also spurred the passage of other legislation whose economic contribution is more doubtful. One of these appears to be Section 11 of the Banking Act of 1933—the interest prohibition on demand deposit (checking account) balances.

In sifting through the legislative oratory, two reasons for the prohibition rise to the

fore. One was to protect banks from over-competition. If forced to pay competitive deposit rates, banks would have to seek higher-yielding but riskier loans to cover the higher costs of attracting deposits. Eliminating the interest payment on demand deposits supposedly would allow banks to pursue sounder lending practices thereby creating a more viable banking system, the lawmakers argued.

A second reason advanced was that without interest prohibition, larger, more profitable city banks would outbid small country banks for deposits, or alternatively small country banks would send “excess funds” (reserves) to large city ones in return for interest payments. Either way, small local borrowers depending on the credit sources of small banks would be frozen out as funds flowed to the large borrowers through large city banks.

By forbidding interest payments, checking account competition and bank costs supposedly would be substantially reduced. Banks could extend credit on the basis of need and safeness of the loan without worrying whether revenues would be high enough to cover payments to deposit cus-

tomers. During the 1960s, however, a slip *'twixt cup and lip* became obvious as *non-interest* competition characterized the market for demand deposits.

### THE ACHILLES HEEL: PROFIT AND COMPETITION

Revenue earned on loans is the banker's bread and butter. In order to make a loan, however, sufficient funds or reserves must be on hand. These are acquired primarily by persuading the saver to keep a checking or savings balance with the bank. Like any other businessman, the banker performs his task to make a profit. If, for example, he should find himself besieged with loan customers offering to pay a high rate, he will quite naturally seek more deposits. If, in less fortuitous circumstances, the banker finds his depositors fleeing his ranks for those of competitors, he will likewise have to react by increasing the attractiveness of his deposit facilities.

Interest payments are an effective way to attract or hold depositors. They are also easy to alter. Without a legal taboo, the interest payment doubtless would be a more important weapon in the banker's arsenal for pulling in checking balances. The ban on interest prevents the banker from making a money payment on a checking account but it does not curtail his need or desire to attract these accounts. If the depositor can't be enticed with a dollar payment on his checking surplus, he will likely find himself more heavily showered with other forms of incentives such as reduced service charges or more convenient branches.

Individually, each bank sees such increases in its incentives to checking depositors as enabling it to get more funds and make more loans and, hence, profit. Their collective action, however, makes the greater profit a mirage for the typical banker because competition will simply make deposits more expensive to buy. The interest ban

will not prevent these competitive results from emerging. For the banker's cost accountant, dollars spent on noninterest, implicit payments will appear just as real as if charged to interest costs.

The decade of the '60s was testament to this fact. Over the decade, loan rates climbed and the income-earning ability of the typical banker's demand deposits increased. This spurred keener competition for deposits and resulted in numerous forms of implicit payments on checking balances (see Box). Consequently, the typical banker found himself paying a higher (implicit) price to lure, or hold, checking balances (see Graph for the story on New England banks). Competition's sharp edge seemed to have cut through the cost deterrent posed by the interest ban. The prohibition did not stop the banker from making a payment on checking balances in response to competitive conditions. Rather its major impact appeared to be on the form of the payment.<sup>1</sup>

### FAILURE TO PROTECT SMALL BORROWERS

Besides reducing bank costs, the interest ban was supposed to make it easier for small borrowers to obtain financing from small local banks. Without the ban, the supposedly more profitable, large city banks would offer higher rates on deposits, thereby attracting funds from the countryside. With the ban, the small local bank could maintain adequate reserves to meet the needs of local borrowers. The numerous ways banks found to make payments on checking balances in the 1960s, however,

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<sup>1</sup>Smaller banks often keep demand deposits with larger banks (correspondent balances). The interest prohibition also forbids interest payment on these interbank deposits. But, as with nonbank customers' demand deposits, an implicit payment is made in the form of services (for example, check clearing services) to the bank depositor.

The rising interest rates of the 1960s persuaded the average banker to offer a variety of incentives to the holder of a checking account balance:

1. **Premiums and Ancillary Services.** Dishware, stationery accessories, and clothing became common items offered by many banks to their depositors. Bank branches increased at a historic rate during the '60s offering the depositor greater convenience. In the latter part of the decade, the large demand deposit holder found that he could now obtain portfolio management and investment from his banker at reduced charges. Banks also made it easier to transfer savings deposits to demand deposit accounts, thus tending to blur the distinction between the interest-paying savings account and the demand deposit account.

2. **Reduced Service Charges.** The 1960s also saw the rise of the "free checking account" for the small depositor. The banker offering this incentive levies no service charge for the use of the checking account providing some minimum balance is held in the account. A study of the New England area found that banks offering some sort of "free checking account" increased from almost no banks in the early 1960s to over half by 1969.\*

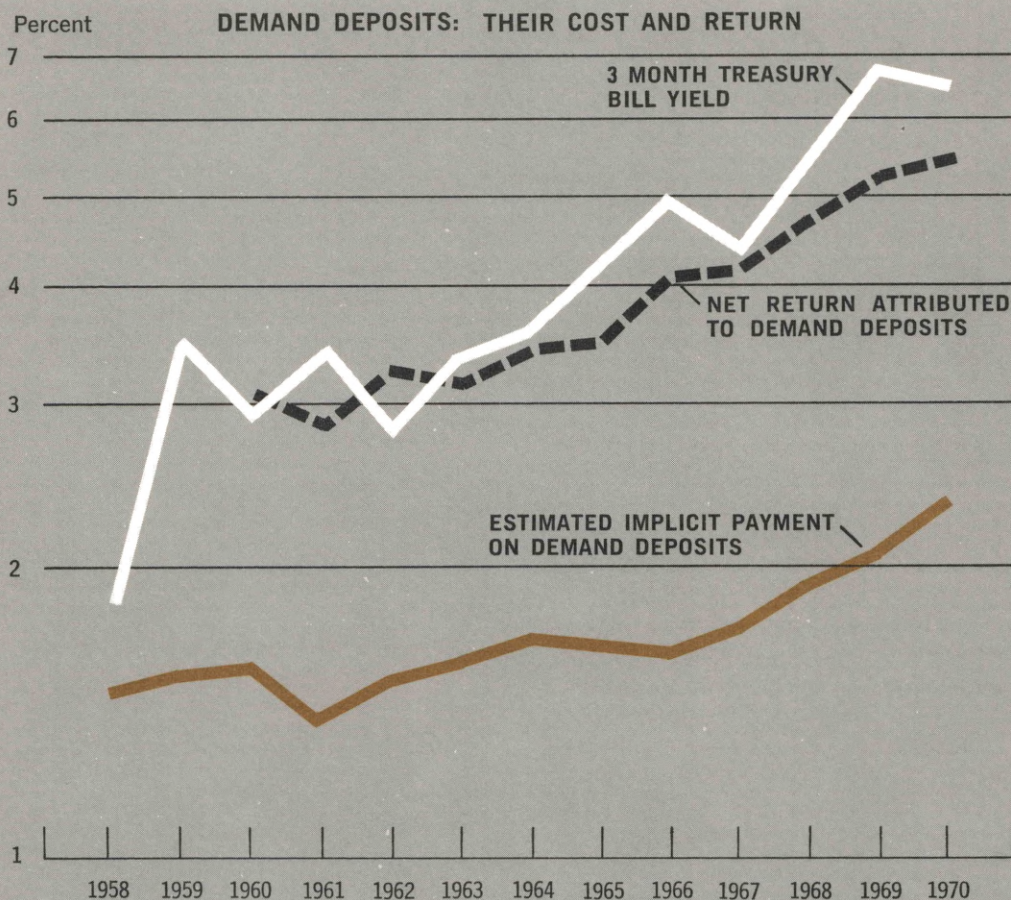
3. **Reduced Loan Rates to Depositors.** Corporations maintaining large balances in their checking accounts are frequently offered a reduced loan rate for maintaining such balances. At least one recent study found that other things equal, the loan rate charged by various banks on business loans was significantly lower the higher the borrower's balance in its checking account.\*\*

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\* Steven J. Weiss, "Commercial Bank Price Competition: The Case of 'Free' Checking Accounts," *New England Economic Review*, September/October 1969, pp. 6-8.

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\*\* Donald P. Jacobs, *Business Loan Costs and Bank Market Structure* (New York: Columbia University Press, 1971), pp. 2-44.



\*The vertical axis is in log form.

*Source of Data:* The indices for Return and Payments on Demand Deposits were constructed using data from the Functional Cost Program: New England Banks 1958-1970. The number of banks in the 13 samples was around 90. The average size of the banks in terms of deposit volume was \$17 million.

**Net Implicit Payment on Demand Deposits.** This is a measure of the estimated average cost per dollar of demand deposits to the banks in the sample. It is equal to the bank's expenses attributed to demand deposits minus service charges; this difference then being divided by the dollar volume of the bank's demand deposit liabilities and multiplied by 100. This measure must be taken only as a rough estimate of the implicit payment because of difficulties in allocating precisely bank costs supporting demand deposit services and premiums. Moreover, no account is taken of the depositor's return via a reduced loan rate if the loan is accompanied by a "compensating" demand deposit balance. Also the failure to include time deposit balances which in effect serve a demand deposit capacity is an additional source of error. These latter two sources of error will cause the estimated payment to understate the actual payment.



**Net Return Attributed to Demand Deposits.** This is a measure of the average return to the sample banks from their demand deposit liabilities. It is computed by multiplying the average per dollar return on loans and securities by the difference between the dollar volume of demand deposits and reserves attributed to demand deposit liabilities plus "due from" items; from this component, costs associated with servicing loans and securities are subtracted; the total is then divided by the volume of demand deposits and multiplied by 100. This is only an approximation of the earning power of demand deposits. One deficiency in the measure is that it takes no account of differences in the types of bank assets most easily supported by demand deposits.

points up the prohibition's limited ability to keep deposits from flowing to their most profitable use. The bank with a high return on its loans is still able to up its implicit payments as a way of attracting checking balances.

Even if the banker does find that the interest ban on checking balances puts a crimp in his ability to pull in reserves, he can lean more heavily on other sources of funds. One important nondeposit source is the Federal funds market. This is a well developed loan market where banks extend credit to other banks at a competitive interest rate. How much a bank commits of its own funds to this market will depend on the profitability of loans to its (nonbank) customers and the interest rate paid on Federal funds. If large borrowers can offer a high loan rate to large banks, then the latter can acquire additional funds to make the loans by offering a higher Federal funds rate. During the mid- and late 1960s the large city bank increasingly relied on the Federal funds market<sup>2</sup> to finance its strong business loan demand while the small country bank became an important (net) supplier of funds to its larger city cousin.

<sup>2</sup> See George Budzeika, "Lending to Business by New York City Banks," *The Bulletin of the Institute of Finance, Graduate School of Business Administration, New York University*, Nos. 76-77 (September 1971).

### COSTS OF INTEREST PROHIBITION

Governmental regulations usually create economic burdens which must be balanced against their benefits. The interest ban is no exception. Although its limited effectiveness is likely to lighten the burdens, some costs will remain.

Being forced to accept payments in kind rather than in money interest is one form of cost the depositor bears. The amount of this burden is how much he would value the interest payment over the value he places on premiums and services he now receives. Without the prohibition, bankers would replace at least part of the services and premium payments with interest, making the average depositor better off.<sup>3</sup>

Economists have focused more on a second set of costs peculiar to the money-

<sup>3</sup> The interest prohibition causes an overproduction in the premiums and services offered. One type of overused service is the payments mechanism itself. The existence of free checking accounts allows depositors to use their account to a greater extent than if they had to pay for the use of the account. Part of what would otherwise be an explicit interest payment is now used to cover the resource cost of the heavier use of the checking account. The better procedure would be to charge for the use of the account and pay interest on the balance which the depositor may do with what he wants rather than "force" the depositor to buy more checking account services as now results from the "free" checking account incentive.

supplying capacity of commercial banks. The contrivance of money contributes greatly to the economic well-being of a nation by oiling the wheels of trade. People would find it much more difficult to produce, buy, and sell goods and services if barter were the form of exchange. Not only does the individual use money to make his purchases, but he also keeps money balances on hand because it is uneconomical to withdraw from savings accounts or sell securities each time a purchase is made. These balances substitute for commodity inventories which the individual would otherwise keep on hand to reduce the frequency of barter. This increases the economic contribution of money by saving on the amount of resources tied up in the form of idle inventories.

With an interest ban, economists argue, people and businesses will generally expend too much effort trying to conserve on the amount of wealth they keep in money form.<sup>4</sup> While an implicit payment takes the place of an interest payment, it is not likely to be as desirable to the checking account holder. For example, in recent years when interest rates and inflation have been high, corporations have gone to great lengths to pare their cash holdings. Computers have been used to let corporate managers know their firm's cash position more quickly; forecasters have been hired to predict cash needs; and, more generally, portfolio costs have increased as it has become worthwhile to move in and out of investment assets for short periods of time. If interest on checking balances had been permitted and allowed to move more freely with other interest rates, corporate treasurers might have allowed money to serve a greater role as a buffer between receipts and expenditures.

<sup>4</sup>For a rigorous analysis using a transactions demand-inventory theoretical approach, see Edgar L. Feige and Michael Parkin, "The Optimal Quantity of Money, Bonds, Commodity Inventories, and Capital," *American Economic Review* 61 (June 1971): 335-349.

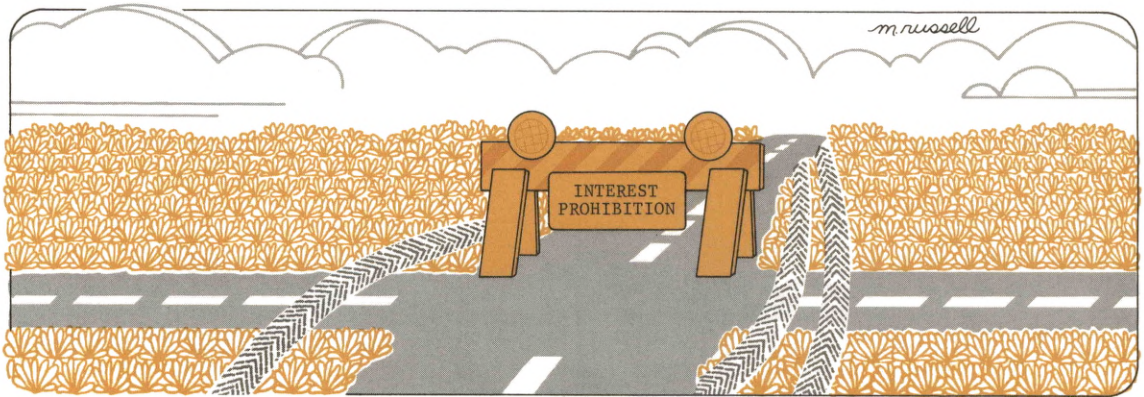
This could have increased the overall usefulness of this asset in making scarce resources more productive.

### INTEREST PROHIBITION: A LESSON FROM EXPERIENCE

Neither the economy nor the banking system appears to profit much from the interest prohibition on demand deposits. The major impact of the regulation appears to have been on the form more than on the degree of competition and bank costs. During the past decade the prohibition did not deter banks from paying higher rewards to demand deposit holders as market conditions dictated.

The interest prohibition produces economic costs but the greater loss may lie in the disrespect for the law that it tends to create. The prohibition is like a detour sign on a road running through a large, open field. As long as the sign warns of no real danger, drivers will simply drive around it, creating new paths to their destination. By analogy, the banker who is prohibited from paying ten cents on a demand deposit balance will reduce the service charge on the account or use some other incentive to attract checking deposits. Because it is not feasible to enforce a prohibition more generally on demand deposit payments, the situation now works to encourage rather than reduce evasion of the law.

For these reasons, striking this 39-year-old statute from the books would appeal to many. However, the interest ban does not stand alone, but is part of an interacting regulatory maze enveloping our financial institutions. Removing any single component without considering its impact on the labyrinth could worsen a bad situation. For example, removing the interest ban may enhance the competitive position of banks in attracting funds relative to, say, savings and loan associations. In order to keep S&Ls viable competitors for deposits, interest ceil-



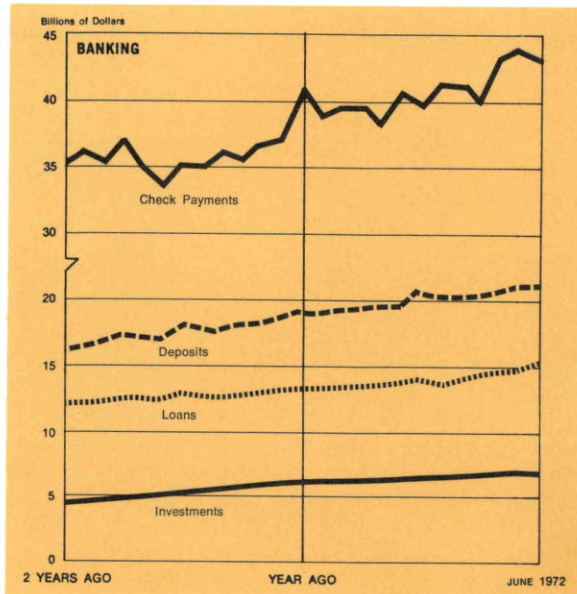
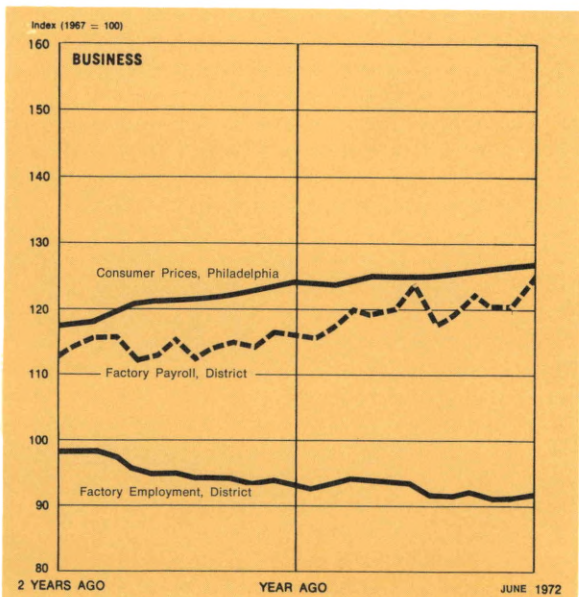
ings on their deposits may also have to be removed. But the removal could be the undoing of these savings institutions since the law restricts how they put their funds to use. A more prudent approach might be to attack the regulatory problem on a broader front. Recently the Hunt Commission (President's Commission on Financial Structure and Regulation) suggested a gradual phasing-out of interest ceilings on time and savings deposits as well as other restrictive financial regulations.<sup>5</sup> If this task were undertaken, it would present a good opportunity to liberalize the checking ac-

count interest regulation.<sup>6</sup> Regardless of the future of the interest prohibition, its history is a valuable lesson in the need for realism whenever legislators and regulators consider enacting restrictions on the financial marketplace.

<sup>5</sup> While the Hunt Commission recognized the deficiencies and costs of the interest prohibition on demand deposits, it recommended against removal at the present time. Its recommendation resulted from possibly adverse effects on deposit flows of thrift institutions caused by an *immediate* abolition of the interest ban.

<sup>6</sup> This discussion has abstracted from the effect of interest prohibition on the conduct of monetary policy to stabilize economic activity. This issue has been debated among academic economists. One side argues that interest payments will reduce the potential of monetary movements to accentuate economic fluctuations (see Richard Ward, "Demand Deposit Interest and Monetary Policy," *National Banking Review* 3 [June 1966]: 471-478). Another says that the ability of monetary authorities to stabilize the economy depends on the fixity of the rate of interest on money (see James Tobin, "A General Equilibrium Approach to Monetary Theory," *Journal of Money, Credit and Banking* 1 [February 1969]: Part 1, 15-29). Currently, the implicit payment on money is a variable rate of return but much less flexible than rates on other liquid assets. Even those who argue for a fixed rate on money, for purposes of monetary policy, could agree that a slowly varying explicit interest payment would eliminate or reduce disadvantages of the implicit payment scheme without damaging the operation of monetary policy. ■

# FOR THE RECORD...



SUMMARY	Third Federal Reserve District			United States		
	Percent change			Percent change		
	June 1972 from		6 mos. 1972 from	June 1972 from		6 mos. 1972 from
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
<b>MANUFACTURING</b>						
Production.....	.....	.....	.....	+ 2	+ 5	+ 5
Electric power consumed ...	- 1	+ 1	+ 3	.....	.....	.....
Man-hours, total*.....	+ 2	+ 1	- 2	+ 2	+ 4	NA
Employment, total.....	+ 1	- 1	- 3	+ 1	+ 2	+ 1
Wage income*.....	+ 3	+ 8	+ 5	+ 3	+10	NA
<b>CONSTRUCTION**.....</b>	<b>+ 9</b>	<b>-13</b>	<b>-29</b>	<b>- 7</b>	<b>+ 6</b>	<b>+15</b>
<b>COAL PRODUCTION.....</b>	<b>-14</b>	<b>-15</b>	<b>- 4</b>	<b>- 3</b>	<b>- 6</b>	<b>- 7</b>
<b>BANKING</b>						
(All member banks)						
Deposits.....	- 1	+10	+13	- 1	+ 6	+10
Loans.....	+ 2	+16	+12	+ 2	+13	+12
Investments.....	- 1	+ 9	+15	- 1	+ 7	+10
U.S. Govt. securities.....	1	- 4	+ 1	- 3	- 1	+ 1
Other.....	- 2	+16	+23	0	+12	+15
Check payments***.....	- 3†	+ 9†	+14†	- 1	+13	+14
<b>PRICES</b>						
Wholesale.....	.....	.....	.....	+ 1	+ 4	+ 4
Consumer.....	0‡	+ 2‡	+ 3‡	0	+ 3	+ 3

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

†15 SMSA's  
 ‡Philadelphia

LOCAL CHANGES Standard Metropolitan Areas*	Manufacturing				Banking			
	Employment		Payrolls		Check Payments**		Total Deposits***	
	Percent change June 1972 from		Percent change June 1972 from		Percent change June 1972 from		Percent change June 1972 from	
	month ago	year ago	month ago	year ago	month ago	year ago	month ago	year ago
Wilmington.....	0	- 2	+ 3	0	- 8	+ 5	- 1	- 2
Atlantic City.....	+ 1	0	+ 2	+17	- 1	+14	+ 1	+20
Bridgeton.....	+ 2	+ 1	NA	NA	N/A	N/A	0	NA
Trenton.....	+ 1	- 1	+ 2	+11	+24	+ 1	- 2	+11
Altoona.....	0	- 6	+ 2	+ 4	- 8	-11	- 2	+ 6
Harrisburg.....	+ 1	- 1	- 1	+ 3	- 6	+17	- 1	+ 9
Johnstown.....	- 1	- 5	- 4	- 4	- 1	+ 4	- 1	+ 7
Lancaster.....	+ 3	+ 2	+ 4	+13	+ 8	+35	0	+11
Lehigh Valley.....	+ 2	+ 2	+ 5	+12	+ 1	+ 5	- 2	+12
Philadelphia.....	+ 1	+ 1	+ 2	+ 8	- 3	+11	- 2	+10
Reading.....	+ 1	- 1	+ 1	+ 5	+ 6	0	+ 3	+11
Scranton.....	0	+ 2	- 1	+ 4	- 3	- 3	0	+10
Wilkes-Barre.....	+ 2	+ 2	+ 3	+12	- 3	+14	- 3	+21
Williamsport.....	-	+ 1	NA	NA	-11	-12	0	NA
York.....	+ 2	+ 3	+ 5	+12	+ 2	- 9	0	+ 8

\*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.