

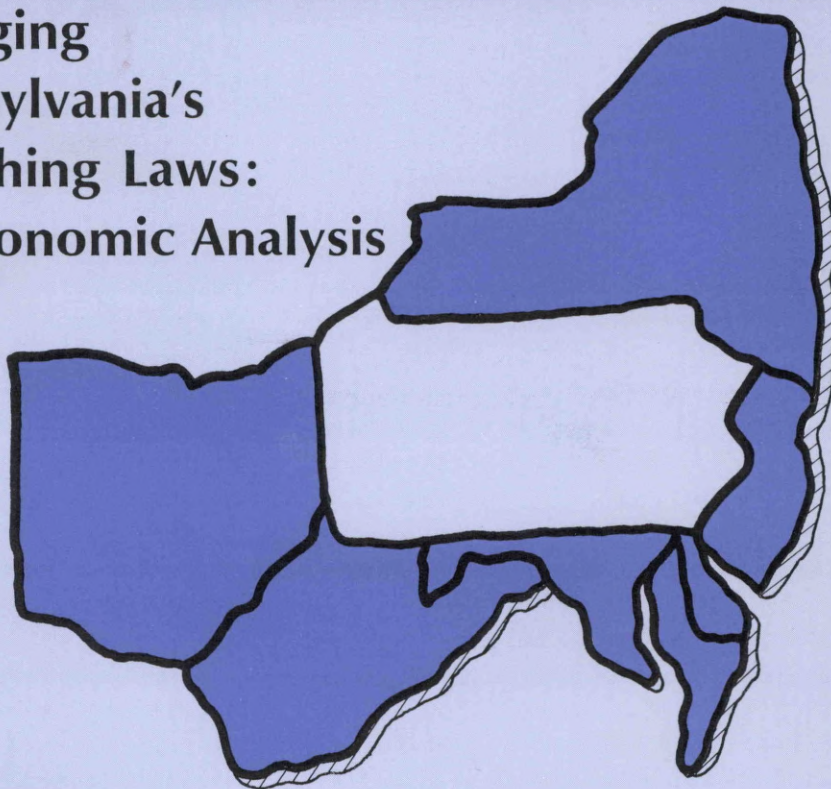
december



FEDERAL RESERVE BANK of PHILADELPHIA

business review

Changing
Pennsylvania's
Branching Laws:
An Economic Analysis



1972

ABOUT THE STUDY . . .

Over the past decade there has been a dramatic change in the banking climate throughout the nation. Banks are entering new financial arenas via holding companies and expanding their geographical limits as more states ease their restrictions on branching. The forces molding this new banking climate are being felt in Pennsylvania to the extent that some change in the Commonwealth's banking laws may be in the offing.

A change in the law with respect to holding companies or branching can have a major impact on the future banking structure of the Commonwealth. This in turn can influence how well the banking industry meets the future needs of the public. What kind of a change is likely to provide the banking services Pennsylvanians will be demanding over the next few decades, in an efficient fashion? This is a tough question for those charged with making the decision. It is also an important question for institutions, such as the Federal Reserve System, charged with protecting the public interest in a number of banking activities.

I believe the Federal Reserve Bank of Philadelphia has some responsibility to pro-

vide whatever objective information it can on this question for two reasons: first, to help those in Harrisburg who will have to make the important decision about changing Pennsylvania's banking laws; second, to emphasize the public's interest in a responsive banking system. Thus, in cooperation with the Federal Reserve Bank of Cleveland, whose district includes the western one-third of Pennsylvania, the Department of Research has conducted this study to determine the economic implications of possible changes in Pennsylvania's current branching law.

The study concludes that *on economic grounds* any liberalization of the contiguous county branching law would result in a more competitive and flexible banking environment for Pennsylvania. On balance, statewide branching would bring somewhat more competition than either statewide holding companies or a district branching plan. I believe these findings merit close attention because fostering such an environment will become increasingly important in an economy characterized by rapidly changing financial demands and developments.

David P. Eastburn
President
Federal Reserve Bank of Philadelphia

BUSINESS REVIEW is produced in the Department of Research. Ronald B. Williams is Art Director and Manager, Graphic Services. The authors will be glad to receive comments on their articles.

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Changing Pennsylvania's Branching Laws: An Economic Analysis*

Bankers are a cool, calm, and collected crew . . . until someone mentions the possibility of changing branch banking laws. Then tempers on all sides of the issue flare—and understandably so. To a banker, tinkering with branch banking laws isn't simply a question of personal convenience or public interest. The structure of the industry is vital to the way he competes for business, to his chances for success or failure, and above all, to his profits. Liberalized branching offers a banker both the chance to move into new markets and the risk that others will move into his current domain.

It's a chance to grow and prosper—or to become overextended.

But what about Pennsylvanians who must use banking services? Which banking structure is best for the public? They have seen local banks merging into larger regional institutions or forming one-bank holding companies. They have heard about the Hunt Commission Report¹ and watched new branching laws enacted in New Jersey. These can't help but cause Pennsylvanians to wonder: "Is this state's present banking structure the right one?" Currently, the Commonwealth's banks can branch in their home county and into any county that touches its border. As a result, Pennsylvania is classed as a *limited* branching state. Multibank hold-

* This summary was prepared by Ronald D. Watson. It is based on the research work of Jerome C. Darnell, Cynthia A. Glassman, Marilyn G. Mathis, Donald J. Mullineaux, George S. Oldfield, and Ronald D. Watson.

¹ Presidential Commission on Financial Structure and Regulation, *Report*, December 1971.

ing companies are illegal, but one-bank holding companies² are not.

Pennsylvania's banking law is not particularly restrictive, but only one neighboring state has a tighter branching law. In Delaware and Maryland banks can branch statewide, and in New York, New Jersey, and Ohio they can form multibank holding companies statewide. Only West Virginia,

² One-bank holding companies are businesses which own a controlling interest in a single commercial bank. Multibank holding companies control more than one bank. Multibank holding companies differ from branch bank systems in that the holding company affiliate banks retain their former identity and can operate with a degree of autonomy that branches seldom have.

among the six neighboring states, still retains a unit banking structure, forbidding banks to have branches (see Map).

To liberalize or not to liberalize the banking structure law: Lawmakers in Harrisburg—who ultimately must answer this question—will undoubtedly face a barrage of claims and counterclaims. Advocates of liberalized branching tout its competitive benefits. Opponents warn that wide area branching spawns harmful concentration of banking resources. Other debates center on the tradeoffs between improvements in the range of services under branch banking and the responsiveness of independent bankers to the unique needs of their local communities (see Box).

TRADITIONAL ARGUMENTS ON LIBERALIZING BRANCHING





Against Liberalization

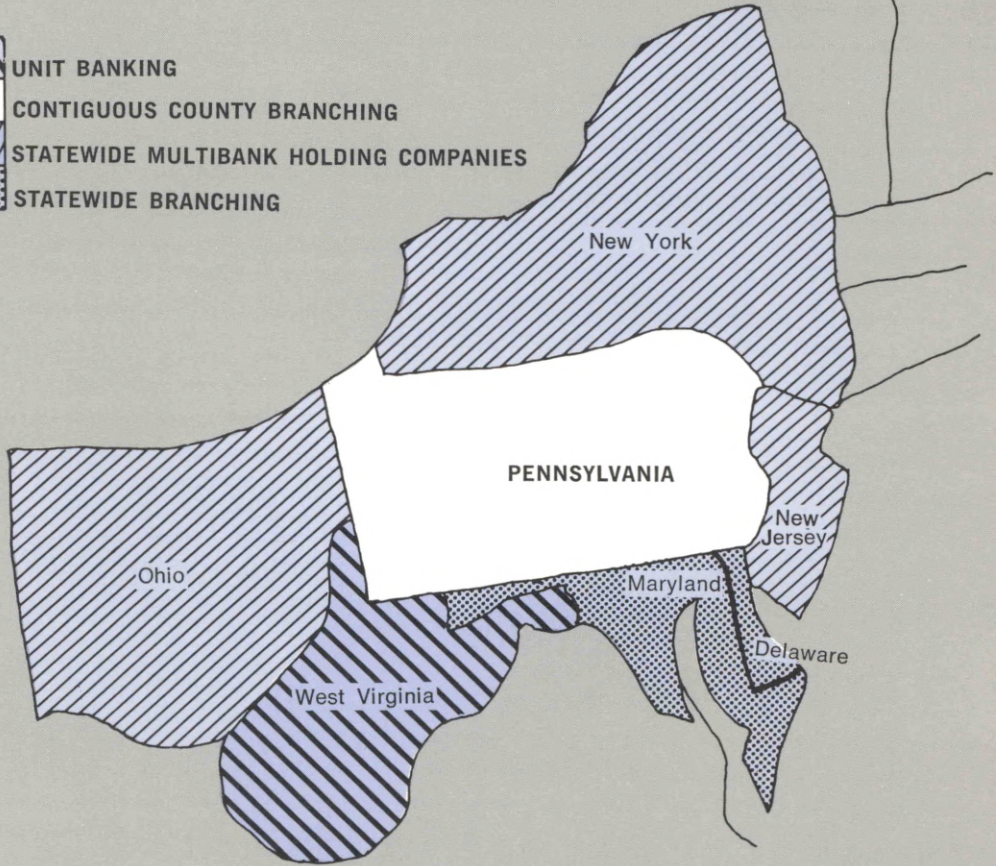
1. More branching authority will enable the big metropolitan banks to move farther into the countryside through the purchase of smaller banks. The result will be domination of the industry by the big banks and less competition.
2. Local banks can offer a personal, area-oriented service that a branch of an outside bank can't match. They understand the people and the region.
3. Large banks use their branch systems as a source of funds for serving big business customers.

Favoring Liberalization

1. Allowing banks to enter new markets will result in more competition and more choices for purchasers of banking services.
2. Wider branching areas will stimulate economic development. Large branching systems improve the mobility and allocation of funds and larger banks are more able to accommodate business lending needs.
3. Branch banks are more efficient to operate than unit banks.
4. Political boundary limits for branching (such as county lines) are poor approximations to commercial trading markets.

Laws in Neighboring States

-  UNIT BANKING
-  CONTIGUOUS COUNTY BRANCHING
-  STATEWIDE MULTIBANK HOLDING COMPANIES
-  STATEWIDE BRANCHING



The arguments are linked to three basic themes:

1. What does more branching mean for bank concentration and competition?
2. Would a different structure entail higher or lower operating costs?
3. Would a different banking structure spur or impede economic development?

Research done by the staff of the Federal Reserve Bank of Philadelphia suggests three main conclusions:

1. Liberalized branch banking would intensify banking competition. Most banking markets within Pennsylvania would be served by more institutions, and this would improve customers' choices and their convenience. Furthermore, the concentration of banking resources in the hands of the largest banks would be held in check as long as the bank regulators continue to interpret the antitrust laws as they do now.
2. No case can be made either *for* or *against* liberalized branching on the basis of the comparative costs of branch and unit banking. For banks with the financial and managerial resources to take advantage of new branching territory under a liberalized law, there are no significant cost differences between unit and branch banks.
3. While economic theory points to expanded branching having some positive influence on a state's growth, the statistics of economic development show no measurable effect.

In short, economic development and operating cost factors turn out to be unimportant in deciding whether to change the law. However, competition would be intensified without increasing banking market concentration, and this benefit could be achieved without offsetting costs. Because economics

puts great stress on the benefits of competition and choice in the marketplace, an economic analysis of the costs and benefits of expanded branching makes a substantial case for liberalizing the law.

These are all economic conclusions. There may be other factors influencing the decision, either *pro* or *con*, including political considerations. Such noneconomic factors may be quite important, but they have not been considered here.

WILL BROADER BRANCHING AUTHORITY LEAD TO A MORE OR LESS COMPETITIVE BANKING SYSTEM?

Legislators, bank regulators, and the courts must periodically implement or revise the rules controlling bank expansion, but it's difficult to predict the long-run consequences of some of these decisions. In an effort to *forecast* the outcome of possible changes in the laws, we employed a computer simulation model of Pennsylvania's banking industry to mirror the process of bank expansion.³ We projected current patterns of branch banking and merging activity into the 1980s to examine the potential impact of revamping Pennsylvania's laws. We also tested the effect that both stricter and more

³Simulation is a technique for conducting experiments on a computer. It is based on the use of a mathematical model that describes the behavior of an economic system over time. In this instance, the economic system modeled is Pennsylvania's banking structure as it evolves over the next decade. Precise descriptions of each bank's financial and managerial characteristics and a profile of the economy of each banking market are used to form projections of the evolution of the state's banking industry. The projections are all based on the assumption that mergers and *de novo* branching decisions in the future will be made on essentially the same criteria as they were in the recent past. If the forces governing bank expansion change, then the results of the simulation will have to be interpreted with greater care. However, it is unlikely that the fundamental determinants of branching will change so dramatically that the directions or relative rankings of the outcomes we have projected will undergo much change.

lenient supervision of mergers might have on the state's banking structure. In each experimental test, the analysis focused on likely changes in the structure of each of the state's local banking markets as well as the state as a whole.

Defining Competition. Everyone wants to create the "ideal" banking structure for the Commonwealth, but defining this "ideal" is a slippery business. No one knows precisely what contributes most to the public good. However, high quality service, low costs, and a wider choice of banking alternatives certainly ought to lead the list.

It is generally presumed in economics that the more competitive a market is, the more closely it approaches the "ideal." This notion applies to banking just as it does to any other form of commercial endeavor. Competition between banks will cause each of them to search for ways of convincing customers that the services it provides are somehow superior to those offered by other banks. A bank can reduce service charges, lower its lending rates, increase payments for deposits, and provide additional service—all to the benefit of its customers. As markets become more competitive, a bank's opportunities for making more than a "normal" return are reduced because its customers will have more or better alternatives for purchasing those services. The pressure on profits that results from offering a better quality product may also force more careful cost control within each bank. The result would be more or better financial service for each dollar spent—a benefit to the state as a whole.

One event that usually stimulates competition is the entry of an additional competitor (or at least a *new* competitor) into a market. If the entrant is large and innovative—common characteristics of many banks venturing into new banking markets—it should possess an above-average ability to compete. Those who oppose liberalized branching authority, however, have some-

times argued the opposite. They say that banks will enter new markets by purchasing existing banks and, because of their lack of familiarity with the region, will offer services inferior to those formerly available from the independent bank.

Arguments like these seem to sell the average bank customer short. If an outside bank enters a market by purchasing a local bank, the service mix it offers could very well differ from that of the acquired bank. However, this just gives bank customers in the area the choice of a "new package" of products or the "old package" as offered by other banks in the region. Customers can then choose the services they prefer, and the banks that offer those services will prosper. If personal service from a local institution that knows its market and the people who live there is what depositors and borrowers want, they will not do business with the new branch bank. Conversely, if the new branch prospers or is able to attract business from other institutions, that would be clear evidence that bank customers in that market want the services offered by the entering bank.

Competition isn't always strictly a question of numbers of competitors. There are markets in which three aggressive banks generate more competition than exists in other markets having ten less aggressive banks. Nevertheless, the number of banks and the share of the market that each commands are the best measures available for assessing the *probable* intensity of competition between banks. Consequently, several readily obtainable measures of banking concentration are employed to judge the quality of bank competition: number of banks serving a market,⁴ three-bank concentration ratio, and numbers-equivalent (see Box).

⁴ In Pennsylvania the most relevant area for measuring competition is the local banking market even though the largest banks compete for customers in a national market. We have defined 55 bank markets for this state.

MEASURING MARKET CONCENTRATION

Lacking hard-and-fast guidelines on the measurement of competition, regulators must use their judgment to cultivate the benefits of competition. Two common statistical measures for assessing competition are used to compare the results of the simulation's projected market structures. They are the "number of banks operating in a market" and the "three-bank concentration ratio." A third index of market structure is the "numbers-equivalent," a measure that has only recently been adopted for judging the concentration of banking markets.

Number of Banks. "Banks serving a market" is the total number of commercial banks having at least one office in the market. This is a relevant indicator of competition because it describes the number of independent banks involved in establishing prices and services in the market and the number of choices customers face in buying those services. The more banks there are in the market, the greater the potential for competition. A bank need not be headquartered in a market to be a force there. Each bank operating branches in a market is a competitive factor which other banks must consider when pricing their services.

Concentration Ratio. A "three-bank concentration ratio" is the total market share of the three largest banks operating in a market. The higher the market share of the top banks, the more they dominate the market, and market domination normally represents an anticompetitive force. In general, competition should be stimulated by policies which cause a reduction in the concentration ratio of each local market.

Numbers-Equivalent. The new statistic, the "numbers-equivalent," is a numerical index of seller concentration in a market. It is designed to represent the number of hypothetical banks, each of the same size, that would generate the same degree of concentration that currently exists in the market. This measure attempts to capture information not only on the number of banks operating in the market but on the market share of each competitor. For instance, a market in which a single bank has a monopoly would have a numbers-equivalent of 1. Likewise, if five banks controlled equal shares of a market, its numbers-equivalent would be 5. However, if one of these five banks held a dominant market share (such as 90 percent), the numbers-equivalent would be approximately 1.6. This would indicate that the market concentration is greater than a situation in which two equal-sized banks operate, but less than a complete monopoly. The higher the numbers-equivalent for a market, the less concentrated the market is and the better off bank customers are.

This study projects differences in the state's banking structure under four branching laws. They represent the general kinds of choices open to Pennsylvanians for liberalizing their state's branching laws.

The first choice represents "no change"—sticking with the present contiguous county branching law. It's important to know approximately what the state's banking structure would be like in the future under the status quo. Without this information it would be impossible to judge whether an alternative branching code would produce a structure different enough to warrant altering the law.

The second legal alternative considered is branching within banking districts. For these experiments Pennsylvania is divided into two regions, an eastern and a western district, and banks are given the hypothetical opportunity to branch anywhere within their home district.

The third choice is multibank holding companies. The law selected for testing is statewide multibank holding companies, but each member of the holding company is restricted to its former contiguous county limits for further branching and merging.

The final option explored is statewide branching in which banks would be free to expand into new markets, subject only to the limits of their own resources. The bank market structures for these alternatives are projected under the assumption that regulators use a strict set of guidelines for judging proposed mergers and that the intensity of merger and branching activity doesn't change dramatically. If there were a flurry of merger or *de novo* branching applications following a change in the law, the market structures described in these projections might occur closer to 1980 than 1982, as we are projecting. None of the laws analyzed considers the possibility of including a home-office protection clause, since such restrictions only serve to thwart the benefits

of competition (see Box).

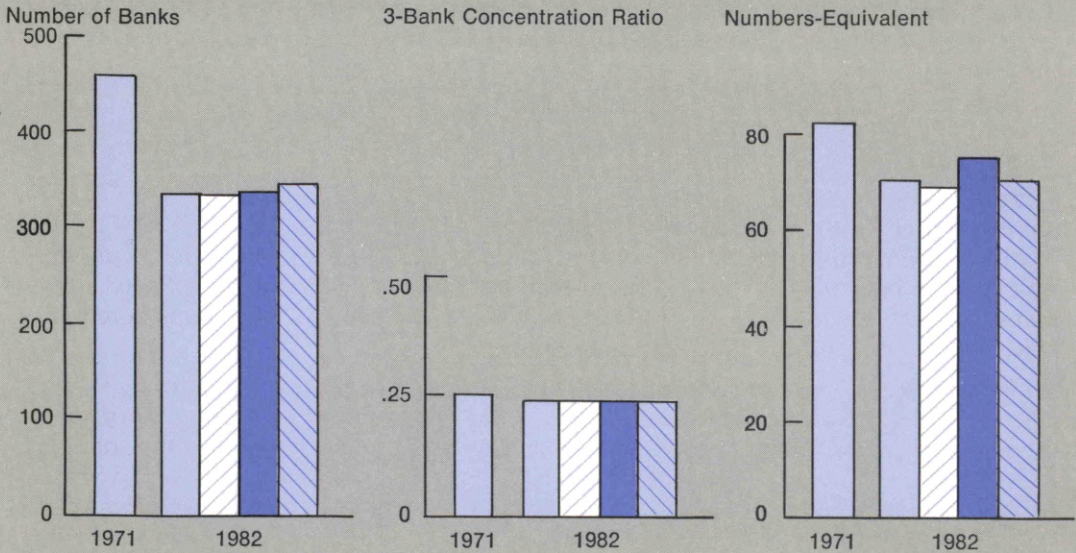
A Decade from Now: The Options Compared. Looking at the *statewide* structure of the banking industry a decade hence, the picture is one of higher concentration. Whether the Commonwealth stays with contiguous county branching or selects a more liberal branching law, there will likely be fewer banks in the state—probably around 330 to 340 rather than the current total of about 450. Of necessity, fewer competitors mean an increase in banking concentration (see Figure 1).

However, statistics on concentration for the state as a whole have little meaning for competition except for the largest banks. It's the *local* banking markets that represent the most relevant area for analyzing inter-bank competition and the number of banking choices open to the customer. In these markets the story is quite different. The average banking market will likely be served by *more* rather than fewer banks, and the statistics point to more competition rather than less. Of the four possible laws, the one that would produce the market structures that are least concentrated would be statewide branch banking. The number of competitors in the average market and the numbers-equivalent are highest under that law, and the concentration ratio is lowest. However, any of the four laws would probably create a more competitive structure. Even a continuation of the contiguous county branching law would promise more competitors and less banking concentration. It's a question of degree rather than direction.

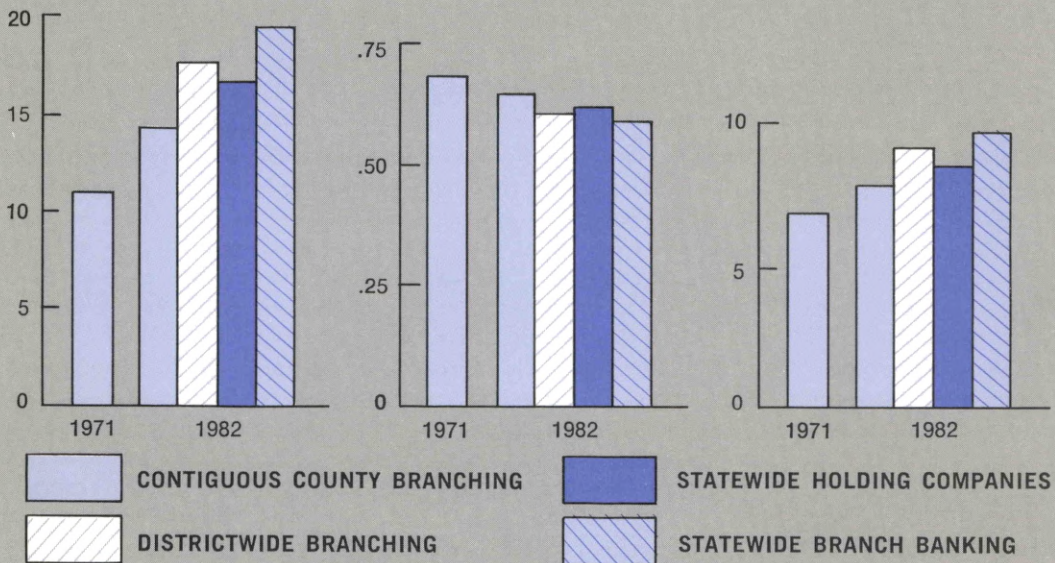
Not every banking market achieves its most competitive structure under the same banking law (see Figures 2, 3, 4). In the state's two largest markets, Philadelphia and Pittsburgh, the most competitive structures would evolve under a statewide branching law. Neither district branching nor multibank holding companies would reduce con-

FIGURE 1
PROJECTIONS OF BANKING MARKET STRUCTURE

I. STATEWIDE STRUCTURE



II. AVERAGE MARKET STRUCTURE



HOME-OFFICE PROTECTION

“Home-office protection” statutes prohibit banks from establishing new branches in communities already served by other banks. These laws attempt to shield the state from the overbanking that might result when too many banks try to share in servicing an area which has limited financial resources. Many people feel that the stability of banking services in such areas is best maintained by preventing unlimited branching into new markets and the destructive competition which might accompany it.

New Jersey presently operates under a home-office protection statute. Banks are prohibited from branching *de novo* into any community in which another bank has its home office or into any town of less than 7500 population which is served by a branch office of another bank. However, a bill which would gradually eliminate most of the home-office protection rules is currently being considered by New Jersey’s lawmakers.

Home-office protection is a questionable way to promote a community’s best interests. While it may shelter a few banks that currently enjoy protected market positions, it denies the benefits of interbank competition to the people living in these markets. The fact that a bank located elsewhere wishes to enter such a market is *prima facie* evidence that the potential entrant feels it can capture enough of the market’s business to make a profit. It will get this business only by offering a better banking product than that presently available from the existing bank. In short, home-office protection rules, by thwarting competition, work contrary to the best interests of the banking public.

centration as effectively as a statewide limit on branching. The secondary metropolitan markets of the state, however, would be more competitive under a law providing for multibank holding companies. The Harrisburg and Reading area markets, for example, would wind up with more banking alternatives, lower concentration ratios, and higher numbers-equivalents under a multibank holding company law than under statewide or district branching. Most of the state’s smaller, nonmetropolitan markets develop the most competitive structure under a statewide branching system. The Bedford market and the Millersburg-Lykens area market, for example, demonstrate the impact of the alternative banking statutes on this class of banking market.

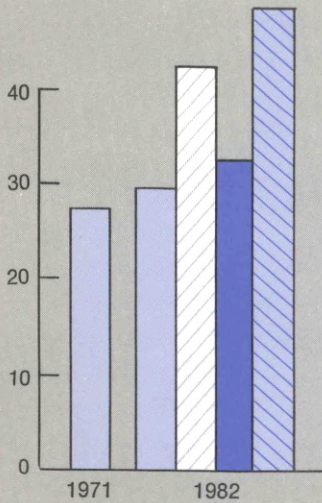
More Competition—A Matter of Degree. Projections for the early 1980s offer the hope that consumers of banking services will see more competition in Pennsylvania regardless of which banking law is ultimately selected. Another decade of contiguous county branching seems certain to produce greater competition in individual markets without creating problems of excessive market concentration.

However, a change in the branching law to provide for either district branching, multibank holding companies, or statewide branching has no predictable competitive costs and appears to offer an opportunity for improving the competitive climate of many of the state’s banking markets. Of the three alternatives to the present law,

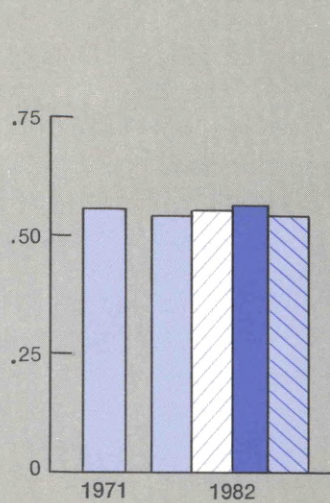
FIGURE 2
PROJECTIONS OF BANKING MARKET STRUCTURE

1. PHILADELPHIA MARKET

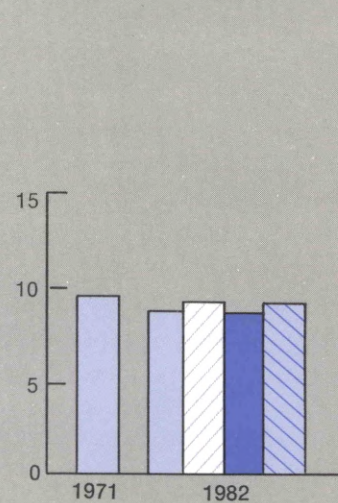
Number of Banks



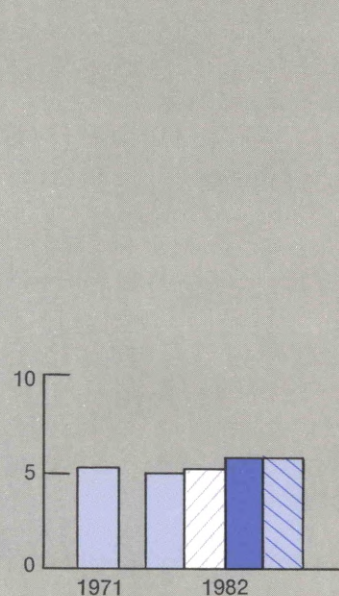
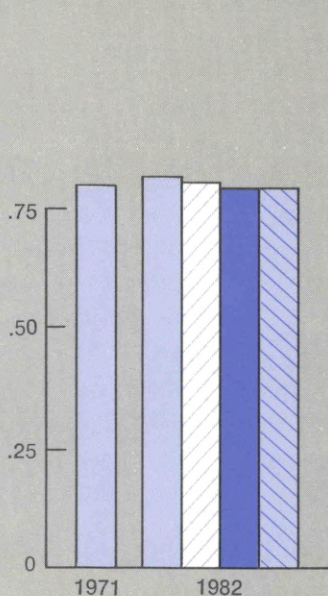
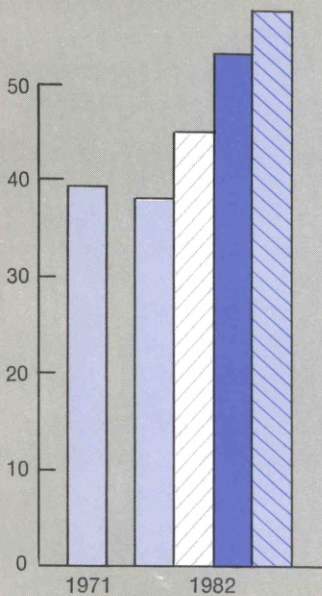
3-Bank Concentration Ratio



Numbers - Equivalent



2. PITTSBURGH MARKET



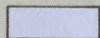



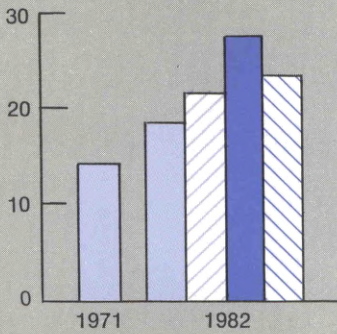
	CONTIGUOUS COUNTY BRANCHING		STATEWIDE HOLDING COMPANIES
	DISTRICTWIDE BRANCHING		STATEWIDE BRANCH BANKING

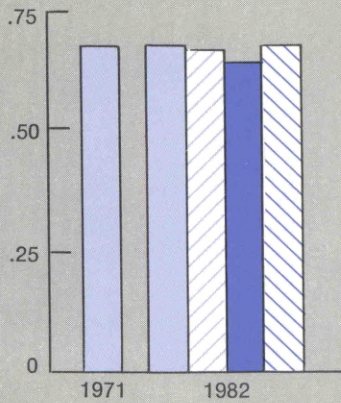
FIGURE 3
PROJECTIONS OF BANKING MARKET STRUCTURE

3. HARRISBURG MARKET

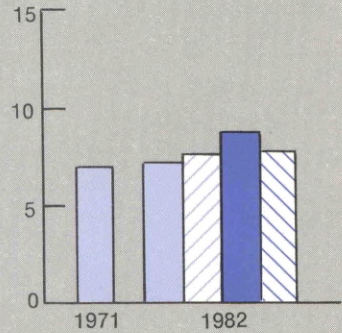
Number of Banks



3-Bank Concentration Ratio



Numbers - Equivalent



4. READING MARKET

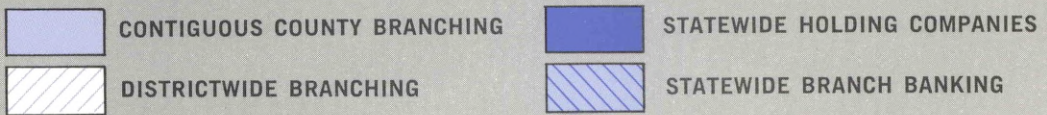
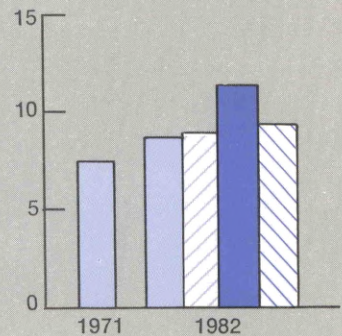
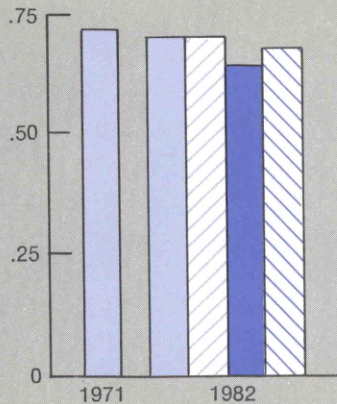
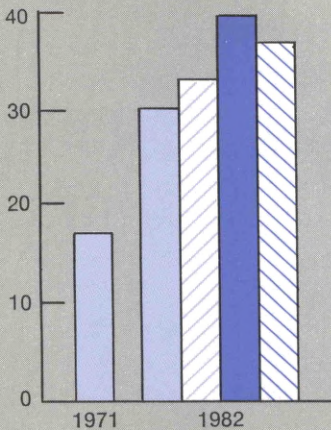
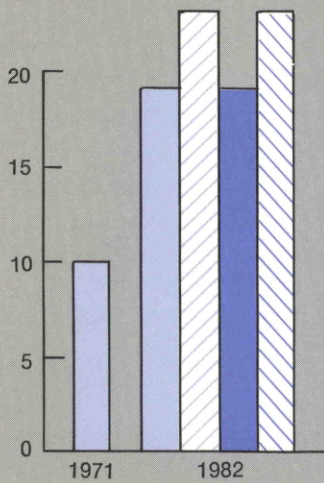


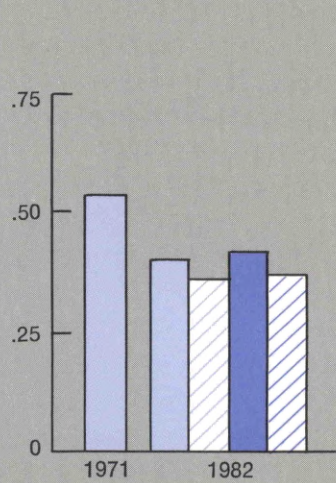
FIGURE 4
PROJECTIONS OF BANKING MARKET STRUCTURE

5. MILLERSBURG – LYKENS MARKET

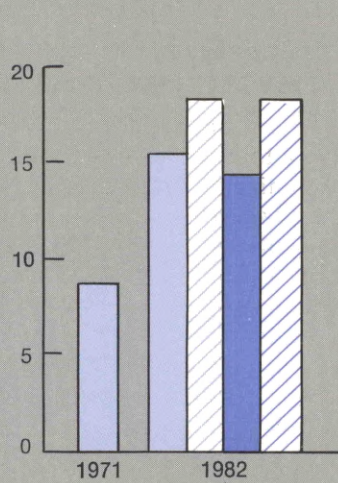
Number of Banks



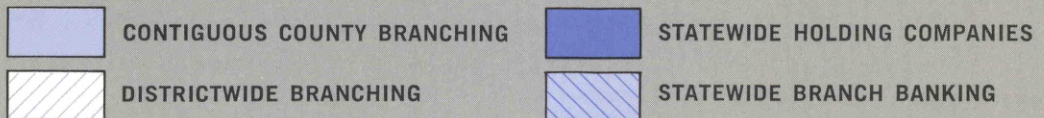
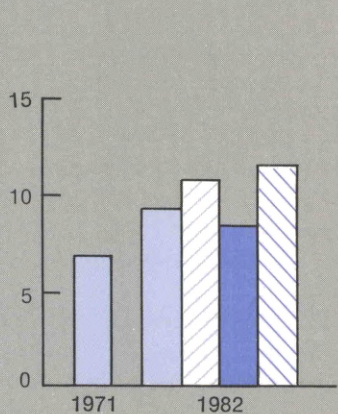
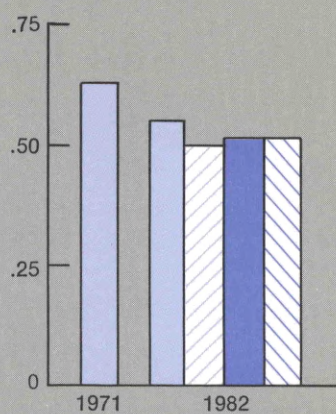
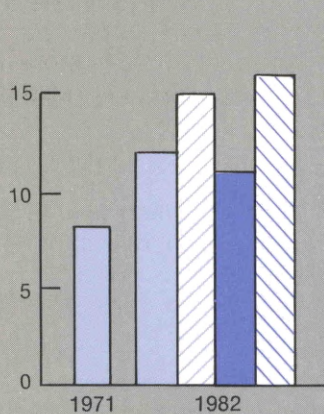
3-Bank Concentration Ratio



Numbers - Equivalent



6. BEDFORD MARKET



statewide branching offers the greatest potential for reaping the benefits of increased competition. The choice between district branching and multibank holding companies is less clear. The selection of one over the other would not be material in terms of projected competition.

WHICH BANKING STRUCTURE IS CHEAPEST TO OPERATE?

Organizational efficiency is important to a society that can legislate the form of banking organization it wants. If branch banks produce services at a lower cost to the citizens of Pennsylvania than unit banks or multibank holding companies, they should be encouraged (as long as no other costs are involved). Our analysis of this question relies on measurements of the relationship between a bank's operating expenses and either the dollar volume of services produced (total revenue) or the number of accounts serviced.

An accurate analysis of bank costs requires distinguishing between two separate kinds of cost relationships: *economies of scale* and *diseconomies of branch banking*. Economies of scale occur when costs increase less than proportionately as output increases. That is, other things being equal, if there are economies of scale, large banks will be more efficient than small ones. Since branching is one way banks can grow larger, the existence of economies of scale might imply that branching should be encouraged. But that conclusion ignores such "diseconomies" as the costs of overhead, organization, and transportation associated with additional banking offices. Investigating the efficiency of branch banks relative to unit banks requires weighing the benefits from economies of scale and the costs resulting from the diseconomies of branching.

Implications of the Cost Comparisons.

Our studies uncovered some evidence of

economies of scale, but only for relatively small banks. Once a bank's assets reach \$50 million, increasing the size of the operation will not lead to lower unit costs.

Little evidence could be found to support the claim commonly made by proponents of liberalized branching that branch systems operate more efficiently than a collection of unit banks with the same number of offices (see Table). However, these cost comparisons fail to consider one of branch banking's most important forms of service output—convenience of location—because it is intangible. Multiple office locations reduce the traveling time of the average customer and benefit those using the bank. Therefore, the comparison of unit and branch bank costs and outputs requires that we assume that competition forces unit banks to supply some offsetting services to compensate for their lower convenience.

The cost disadvantages associated with branching seem to dwindle as the branching system increases in size—possibly because of automated control processes. No significant diseconomies were found when the costs of large branch banks (over \$100 million) were compared to those of unit banks. As a result, we must conclude that, even without their "convenience" output, large branch systems are neither more nor less costly to operate than equal-sized collections of unit banks.

Affiliation with a holding company seems to have opposite effects on the costs of unit and branch banks. When a unit bank joins a holding company, there is a tendency toward lower costs, but it is not significant. But, when a branch bank joins a holding company, there is a significant increase in the branch bank's costs, presumably because of duplication of functions.

These results suggest that expanded branching laws would have different effects on bank costs depending on the size of the banks involved. If large banks expand, costs would not increase significantly. This result

ECONOMIES OF SCALE AND DISECONOMIES OF BRANCHING

A. Output Measured as Total Revenue

(000,000)	UNIT BANKS	BRANCH BANKS	
	Significant Economies of Scale	Significant Economies of Scale	Significant Diseconomies of Branching
\$ 0-5	No	—*	—
5-25	No	Yes	Yes
25-100	—	No	Yes
over 100	—	No	No

B. Output Measured as Numbers of Accounts

\$ 0-50	Yes	No	Yes
over 50	—	No	No

* A blank cell indicates that too few observations were available to estimate the cost function in this size classification.

is quite important in evaluating the economic costs of liberalized branching. In most cases the branching opportunities of small banks are limited by their financial resources rather than by branch banking laws. Therefore, any branching they are likely to undertake in the future will be the same regardless of whether the law is altered.

It's the state's larger banks that have the capacity to expand beyond the contiguous county limits. Because of their financial strength and ability to manage far-flung branch systems, it is these banks that would use the new limits of a wider branching law. Moreover, since the larger branch systems don't experience the same branching diseconomies prevalent among small branch

banks, there would be no additional cost associated with liberalized branching.

IS THERE ANY RELATIONSHIP BETWEEN BANKING STRUCTURE AND ECONOMIC GROWTH? COULD PENNSYLVANIA EXPLOIT THIS GROWTH BY ALTERING ITS BANKING STRUCTURE?

The answer is that there probably is an indirect relationship, but that it can't be exploited in any meaningful way.⁵

On the one hand, we might expect liberalized branching to spur economic develop-

⁵ For a more detailed discussion of this topic, see Jerome C. Darnell, "Does Banking Structure Spur Economic Growth?" *Business Review of the Federal Reserve Bank of Philadelphia*, November 1972, pp. 14-22.

ment because extended branching facilitates the movement of capital into areas of the economy showing the greatest need. A branch of a large bank can tap the resources and lending talent of the parent bank, thereby making money available to its community that couldn't be generated locally. Large banks normally make more loans per dollar of deposits and are better equipped to bear the risks of business lending. Therefore, the creation of larger banks through branch expansion should produce more loan funds for the state.

On the other hand, several factors tend to mitigate the impact that liberalized branching could have on economic growth. First, the banking system has already developed ways to improve the mobility of capital in the economy. Small banks can sometimes use loan participations from large correspondent banks to obtain loan funds they can't provide internally. Furthermore, the Federal funds market⁶ allows banks to sell excess reserve balances to institutions currently facing expanded lending opportunities. Finally, it's clear that capital allocation isn't the only factor that affects the state's development. Economic resources, the present state of development, the skills of the work force, climate, and tax structure will all be important in attracting new development and retaining current business. A state's banking structure can hardly offset serious deficiencies in these other essential ingredients.

What the Numbers Show. The difficulty of trying to estimate the importance of a

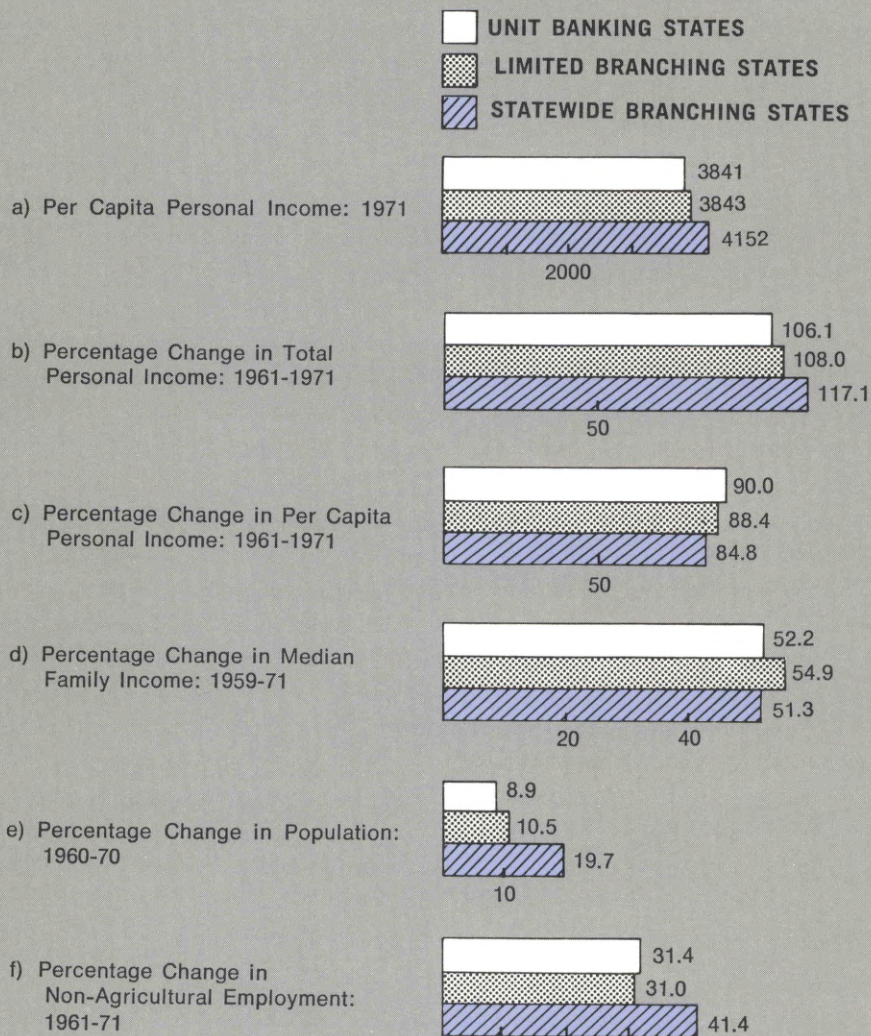
state's banking structure to its economic development can be seen if we look at some statistical comparisons. Consider some statewide comparisons of common economic indicators grouped according to whether a state's banking structure is unit, limited branching, or statewide branching. If banking structure has a measurable impact on a state's economic growth, these statistics should reflect that influence.

Four representative measures of personal wealth are compared (see Figure 5). Per capita personal income in 1971 and the percentage growth in total personal income between 1960 and 1970 both suggest that statewide branching is the banking structure common to our most prosperous states. However, changes over the last decade in per capita personal income favor unit banking while the percentage change in median family income during the same period puts limited branching on top. Not only are the results inconclusive, but the differences in these indices among the banking structures being compared aren't large enough to be statistically meaningful for policy conclusions.

Changes in population should reflect migrations of labor as job opportunities develop in areas experiencing economic growth. During the 1960s population in states having statewide branch banking grew more rapidly than in those with other branching laws. While the relationship is significant, it would be difficult to conclude from this single bit of evidence that a statewide branching law can create economic growth. Additional supporting evidence would be needed to establish the relationship. The final statistic examined is the percentage change in nonagricultural employment between 1961 and 1971. Once again the differences are not substantial enough to be meaningful. These comparisons suggest a tenuous link between a state's branching structure and its economic de-

⁶ The Federal funds market is the financial market through which banks buy and sell excess reserve balances. Banks that supply funds to this market usually do so either because they don't wish to make additional loans to their own customers or there is no demand for additional loans, or as a temporary adjustment to their portfolio. Currently small banks are the major net suppliers in the Federal funds market.

FIGURE 5
MIXED RESULTS FROM GROWTH INDICATORS



velopment, but there is nothing on which to build a case one way or the other. The numbers also fail to reflect the possibility that changes in banking structure could influence the development of local areas within the state. If a community is not being adequately served by the banks located there, liberalized branching offers the prospect of increasing the number of competitors and getting new blood into that area.

Recap. An analysis of factors relevant to economic development leaves little on which to choose sides in the branch banking controversy. There is no empirical support for the contention that one type of banking structure is likely to stimulate substantially faster economic development in the state than another. Similarly, while economic theory points toward statewide branching as the structure most likely to provide the maximum capital mobility and entry of branch systems to less-developed markets, banking structure can't be expected to be the catalyst which sets off an economic chain reaction. Other more basic requisites for economic growth must also be present. Conversely, the risk of economic harm resulting from a liberalization of the branching law is virtually nil. Furthermore, it is possible that expanded branching could benefit some local areas in the state where the banking system currently is not equipped to handle the need for funds. By facilitating new entry into these markets, competition might be sharpened and local development spurred.

WHICH OPTION?

While the evidence regarding economic growth and banking costs supports neither the case for liberalized branching nor the status quo, projections of competition make a strong economic argument in favor of expanded branching authority. If the present law is liberalized, it's probable that most markets would be served by more banks, those markets would be less concentrated

than they would be under the contiguous county law, and competition would be stimulated. Any analysis of the costs and benefits of extended branching authority must cope with the cost that the state incurs if the branching law selected does less to stimulate competition than another option. That opportunity cost is paid in terms of reduced customer choice and lack of service in outlying areas. Such a cost is intangible, but it is nonetheless real.

Any of the expanded branching laws discussed offers more competitive banking markets in the future than the present contiguous county branching law. However, the average market achieves its most competitive structure under the statewide branching law. Statewide branching is the least restricted organizational structure, and it is a more efficient form of organization than multi-bank holding companies.

While multibank holding companies seem likely to create the most competitive market structure in the state's secondary metropolitan areas, the primary attraction of this form of organization is a *noneconomic* one. Multibank holding companies preserve some degree of local control of an area's banking industry. In a holding company more decisions would be made at the local level, because more of the affiliate bank's top management is normally retained in a holding company acquisition than in a merger. The local bank's identity would also be preserved. Finally, a bank that affiliated with a multibank holding company would probably experience less disruption of its operating procedures than if it merged outright with a larger bank.

Districtwide branching does more to foster competition than contiguous county branching, but the only advantage it seems to offer over multibank holding companies or statewide branching is *gradualism*. In addition, establishing boundaries for the branching districts which satisfied all interested parties might be very difficult.

The *economics* of branch banking point to the desirability of liberalizing Pennsylvania's laws. A move toward liberalized branching costs very little and would probably enhance the competitiveness of the state's banking industry. The importance that this analysis assigns to the benefits of

competition tips the scale toward statewide branch banking, with holding companies a close second. Adoption of either alternative holds the potential for providing the state with a flexible and competitive banking system equipped to meet the needs of a rapidly changing economy. ■

WHAT ABOUT THE SMALL BANK?

Many people have expressed the apprehension that small, locally owned and operated banks would be doomed by liberalized branching laws. No doubt, many of the state's smaller institutions will be absorbed over the next decade. However, three factors should be considered in putting this loss in perspective. First, any small bank that is an attractive merger partner is vulnerable under the current branching law. We project that over 100 mergers will occur in the next ten years under the present branching law. A shift to liberalized branching might lead to a flurry of merging activity, but when the dust settled only a few more banks would have been absorbed under the new rules than under the current ones. Wider branching authority would simply offer additional choices to expansion-minded banks.

Second, the small bank's chances for survival might actually be improved. Wider branching authority would give expansion-minded banks the chance to acquire larger partners through merger than they can at present. This results from their ability to branch into markets which are beyond their current area of competitive influence. Moreover, expanded branching bolsters the bargaining power of banks which are willing to be acquired, because it substantially increases the number of potential bidders in the acquisition market. This improves the chances that the acquired bank will command a price that benefits its shareholders.

Finally, small banks offering a competitively-priced array of services that meet the needs of their market will be successful regardless of the branching law under which they operate. If a bank—small or large—is unable to compete effectively, the interests of its shareholders and its community might be best served by absorption into another institution.

APPENDIX

SUMMARIES OF SUPPORTING RESEARCH PAPERS

“Changing Pennsylvania’s Branching Laws: An Economic Analysis” is a consensus of the findings of several technical studies conducted by economists in the Department of Research. These studies range from descriptive papers on Pennsylvania banking to highly technical econometric pieces. Brief summaries of these studies are presented below. Complete copies are available upon request. Please address requests to the Department of Research, Federal Reserve Bank of Philadelphia, 925 Chestnut Street, Philadelphia, Pennsylvania 19101.

PENNSYLVANIA’S CHECKERED BANKING HERITAGE

By Marilyn G. Mathis

Legislation on banking structure in Pennsylvania dates from 1793 when a statewide branching law was passed. The present contiguous county limits originated in a 1933 version of the law. As a result of this law, Pennsylvania banks can expand (either *de novo* or by merging) into a county whose border touches that of their home office county. Multibank holding companies are illegal, but banks have recently started forming one-bank holding companies. Bankers are using this method of organization to facilitate expansion into new commercial activities related to banking.

Several factors, including a liberalization in 1955 of the grounds which justify proposals for new branches, account for the push toward branch banking. Branching allows banks to follow their clientele as both industry and population shift from the central cities of Pennsylvania to outlying regions. Rising incomes of consumers and the attendant demands for wider, more varied financial services put pressure on bankers to upgrade the quality of their financial product. By branching into expanding areas such as new communities, shopping centers, and commercial developments, banks have been able to provide the community with better services and to sustain their own growth and profitability.

This growth is not unique to Pennsylvania; it is part of a trend in all states that permit some form of branching. Yet the surge in the number of branch offices in Pennsylvania seems to have been exceptionally high. Opening new branches accounted for the lion’s share of this surge, but a large number of branches resulted from converting independent banks into branch offices following mergers.

Bankers generally prefer expansion by merger to *de novo* branching. The tighter merger requirements imposed by the Bank Merger Act of 1960 have not appreciably dampened Pennsylvania’s merger wave. However, this law may be partially responsible for the sharp increase in *de novo* branching since 1960.

This checkered legal heritage leaves the Keystone State with a heterogeneous banking structure. Branch banking and unit banking coexist in most parts of the Commonwealth. However, banks with branches account for about 93 percent (as of June 30, 1970) of the total commercial bank deposits in the state. Clearly, branch banking dominates the industry. Although the state has grown and prospered under this system, the question remains: Is it the best system for facing a rapidly changing economy?

BANKING MARKETS IN PENNSYLVANIA

By Cynthia A. Glassman

Areas commonly used as markets in bank structure studies are counties, cities, or Standard Metropolitan Statistical Areas (SMSAs). These do not always conform to the theoretical notion that markets are areas in which economic decision-makers tend to react in the same way to the same influences. This analysis establishes a procedure to define and describe bank market areas in Pennsylvania that is consistent with a theoretical definition of economic markets.

The procedure involves two basic steps: First, economic areas are outlined with the use of service area information, population densities, and commuting pattern data obtained from reports of the various planning commissions within the state. Second, the location of every bank office in the state is pinpointed on a map. Probable boundaries of banking market areas are then estimated with information on geographic factors, structure of industry, and the economic areas already determined. The resulting market areas—55 in all—cover all of the Commonwealth without overlapping. Therefore, each bank office is included in only one area. The process employed relies on judgmental factors and includes subjective elements.

By assuming that price differences between two areas indicate market differences, we can test whether the bank markets, as defined, are meaningful classifications. The price variable used is the interest rate paid on regular savings accounts, which is available for every bank in Pennsylvania. The results of the statistical tests (chi-squared test based on contingency tables) indicate that there is a significant dependence between these rates and market areas, counties, or SMSAs. However, the similarity of results is explained, in part, by similarities in some of the areas. That is, the SMSAs are similar to those markets which include the same cities. Furthermore, some counties are good approximations to bank markets because of coincidence between county boundaries and natural geographic barriers which also help define markets. Also, all markets on the state borders share some common boundaries with border counties.

In short, there is an economic rationale underlying the market areas delineated by the procedures set out in this study. In addition, statistical tests indicate that the market areas are as significant as the political boundaries used in previous research. Thus, these 55 bank markets are employed as the relevant areas to be used in studying Pennsylvania's banking structure.

PENNSYLVANIA BANKING STRUCTURE

By George S. Oldfield and Ronald D. Watson

Legislators, regulatory agencies, and the courts implement or revise periodically the rules that govern bank expansion. Usually, it's difficult to predict the long-run consequences of a series of individual decisions. In an effort to overcome this obstacle, a computer simulation model of the bank expansion process in Pennsylvania is used to generate market structure forecasts ten years hence for each of the local banking markets in the state. The model is specifically designed to examine the impact of alternative branching laws on the industry's structure. Contiguous county branching, two-district branching, multibank holding companies, and statewide branching are all analyzed. In addition, the model is used to test the influence bank regulatory authorities have on the development of market structure.

The simulated development of market structure is based on hypothetical sequences of branching and merging actions by the state's commercial banks. Historical data are analyzed using multiple discriminant analysis to determine how banks select both merger partners and *de novo* branch locations. The results of this analysis serve as a guide to the probable course of bank expansion in the future.

In each simulated year of the forecast, the model estimates the number of mergers and branches that will occur, and selects banks that, on the basis of their size and historical aggressiveness, are likely to expand. If a bank is chosen to open a branch, it first determines the markets it could legally enter and then selects the most attractive market from among these choices. If the bank is attempting to merge, it disregards potential partners which seem likely to draw fire from the regulatory authorities and selects a suitable partner from the remaining banks.

The proposed combination is then examined by a simulated regulatory agency which either approves or disapproves the merger according to prespecified guidelines (determined by using multiple discriminant analysis). Mergers passing this test are consummated, and the model is updated to reflect the change in banking structure.

This bank expansion process is continued for ten years. The entire experiment is then repeated several times in order to estimate the range of possible outcomes and the most likely result under the specific branching law and regulatory guidelines examined.

The projected concentration statistics, which are measures of competition in each banking market, reveal the economic advantages of a more liberal branching law. Concentration is minimized and customer choice maximized in most markets when the state adopts a statewide branch banking law. The banking structure seems likely to be more competitive under statewide branching than either multibank holding companies or district branch banking. However, each of these alternatives fosters a more competitive banking structure than the one likely to occur under the current contiguous county branching law.

BRANCH VERSUS UNIT BANKING: AN ANALYSIS OF RELATIVE COSTS

By Donald J. Mullineaux

This analysis of the costs of branch and unit banking differs from other studies in a number of respects. (1) It compares costs of branch and unit banks located in the same geographic area for two different measures of bank output: a single-valued index of output—(total revenue) and a multiple-product measure of output—the number of various types of accounts). Some conclusions of the study depend on the measure of output used. (2) The cost effects of increasing size (the question of economies of scale) are carefully separated from the cost effects of organizational structure (the question of branch versus unit organizations). Several previous studies fail to allow for differences in scale economies between unit and branch banks. (3) The costs of a collection of unit banks are compared with the costs of operating a branch bank system with the same number of offices. This is a more relevant policy question than whether a branch bank is more or less economical than a unit bank of the same size. (4) The effect on branch bank costs of liberalized geographical branching restrictions is investigated. Most studies fail to weigh the costs of statewide versus limited geographic expansion. (5) The cost effect of affiliation with a multibank holding company is investigated.

Statistical estimates of the extent of economies of scale and of the diseconomies associated with branch banking are derived from an estimated commercial-bank cost function. Data used in the analysis include 1970 balance sheet and income report variables and data collected for that year in the Federal Reserve's Functional Cost Analysis program. Banks in the sample include those located in the First, Second, Third, and Fifth Federal Reserve Districts.

The major results of this study suggest that: (1) Conclusions concerning the existence and magnitude of economies of scale and the relative efficiency of unit and branch banks depend on how commercial bank output is defined. Unfortunately for policymakers, it is difficult to demonstrate the superiority of one definition over the other. (2) Regardless of the definition of output, the diseconomies of branching decline with the scale of operations. (3) Statewide branching by "large"

banks (assets over \$50 million) does not significantly increase estimated banking costs relative to those in a limited branching environment. However, greater geographical expansion by smaller banks ups costs significantly. (4) Affiliation with a multiple-bank holding company increases costs for branch but not unit banks.

BANKING STRUCTURE AND ECONOMIC GROWTH

By Jerome C. Darnell

Research efforts have not uncovered a clear linkage between the type of banking structure and economic growth. Therefore, it is unlikely that a state can increase its rate of economic growth significantly by merely altering its style of banking organization.

Economic growth primarily relies upon the interaction of a host of nonbanking factors that constitutes the economic resource base. Banks, by marshaling financial resources, can enhance the growth process providing that an adequate base exists. But banks cannot offset deficiencies in such vital growth ingredients as availability of skilled labor and transportation networks, the accessibility to raw materials, the proximity of markets, local tax rates, work attitudes, and the cultural environment.

Perhaps the strongest assertion regarding the kinship between banking structure and level of economic activity is that banks, as one of the leaders of the infrastructure, help generate growth. But their role is a secondary one.

An analysis of several growth indicators over the past decade gives a mixed reading on the relationship between economic performance and a state's branching laws. For example, the 1971 level of per capita personal income averages about \$300 higher in statewide branching states than in unit or limited branching states. Alternatively, the average rate of growth in per capita personal income recently has been higher in unit banking states. Still another measure, median family income, favors limited branching states. Despite differences among states grouped by the three major banking structure categories, statistical tests indicate that *none of the income variables is systematically associated with style of banking structure.*

Population changes are highest in the statewide branching states, a finding systematically associated with banking structure classes. Yet, changes in nonagricultural employment, another barometer of economic growth, reveals no close relationship to banking structure. It appears, however, that the level of industrialization is an important conditioner of incomes. States making more rapid strides in manufacturing employment often have had larger gains in personal income.

Two common banking measures are analyzed, and they also yield mixed results. Growth in total commercial bank deposits over the past ten years are not closely allied to banking structure. Conversely, loan-to-deposit ratios are significantly higher in statewide branching states.

Thus, the measures of economic performance as a whole show no consistent relationship between economic development and a particular type of banking structure. This means that changing a state's branching laws is not likely to spur a "great leap forward." ■

The Fed in Print

Business Review Topics, Third Quarter 1972, Selected by Doris Zimmermann

Articles appearing in the Federal Reserve Bulletin and in the business reviews of the Federal Reserve banks during the third quarter of 1972 are included in this compilation. A cumulation of these entries covering the years 1969 to date is available upon request. If you wish to be put on the mailing list for the cumulation, write to the Publications Department, Federal Reserve Bank of Philadelphia.

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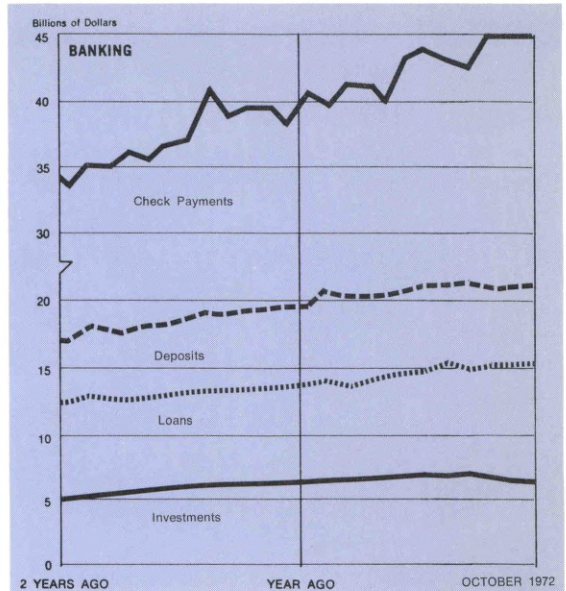
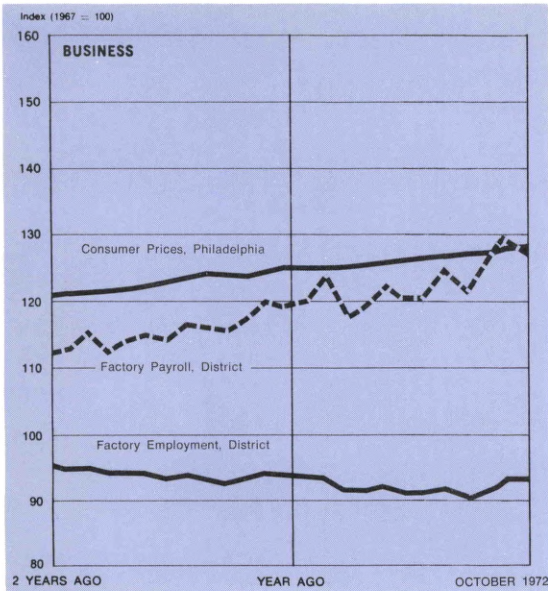
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- "Changing Pennsylvania's Branching Laws:
An Economic Analysis"
- Summaries of Supporting Research Papers
- "The Fed in Print" by *Doris Zimmermann*

FOR THE RECORD...



SUMMARY	Third Federal Reserve District			United States		
	Percent change			Percent change		
	October 1972 from		10 mos. 1972 from	October 1972 from		10 mos. 1972 from
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
MANUFACTURING						
Production.....				+ 1	+ 9	+ 7
Electric power consumed.....	+ 1	+ 7	+ 4			
Man-hours, total*.....	+ 1	- 1	- 1	0	+ 6	N/A
Employment, total.....	+ 1	- 2	- 3	0	+ 3	+ 2
Wage income*.....	+ 1	+ 7	+ 5	0	+ 15	N/A
CONSTRUCTION**.....	-24	+ 10	-15	0	+ 23	+15
COAL PRODUCTION.....	+10	+372§	+ 2	+ 4	+247§	+ 2
BANKING (All member banks)						
Deposits.....	+ 3	+ 14	+13	+ 2	+ 10	+10
Loans.....	0	+ 15	+14	+ 1	+ 16	+13
Investments.....	+ 1	+ 8	+12	0	+ 7	+ 9
U.S. Govt. securities.....	+ 4	+ 2	0	0	0	+ 1
Other.....	0	+ 10	+19	0	+ 11	+14
Check payments***.....	+ 1†	+ 18†	+15†	- 1	+ 14	+14
PRICES						
Wholesale.....				0	+ 5	+ 4
Consumer.....	0‡	+ 3‡	+ 3‡	0	+ 3	+ 3

LOCAL CHANGES Standard Metropolitan Statistical Areas*	Manufacturing				Banking			
	Employment		Payrolls		Check Payments**		Total Deposits***	
	Percent change Oct. 1972 from		Percent change Oct. 1972 from		Percent change Oct. 1972 from		Percent change Oct. 1972 from	
	month ago	year ago	month ago	year ago	month ago	year ago	month ago	year ago
Wilmington.....	0	+ 1	+ 1	+ 9	-19	- 7	0	+ 7
Atlantic City.....	+ 2	+ 4	+ 9	+18	+ 8	+18	+ 1	+17
Bridgeton.....	0	+ 3	N/A	N/A	N/A	N/A	+ 3	N/A
Trenton.....	+ 1	+ 5	- 2	+19	+31	+31	+ 4	+10
Altoona.....	- 1	- 5	- 1	+ 4	-11	+ 7	+ 2	+13
Harrisburg.....	0	+ 2	- 1	+ 9	+ 1	+27	+ 3	+20
Johnstown.....	+ 1	+ 8	- 3	+21	+ 5	+22	0	+ 9
Lancaster.....	+ 1	+ 5	0	+17	+ 6	+54	+ 2	+14
Lehigh Valley.....	+ 1	+ 1	- 4	+12	+ 5	+25	+ 1	+15
Philadelphia.....	0	- 1	0	+ 8	+ 4	+21	+ 3	+14
Reading.....	+ 3	+ 1	+ 3	+12	+ 6	+ 8	+ 8	+15
Scranton.....	- 1	- 1	+ 2	+ 8	- 2	+11	+ 2	+12
Wilkes-Barre.....	0	- 2	+ 1	+ 8	+ 3	+36	+ 5	+31
Williamsport.....	N/A	N/A	N/A	N/A	+ 5	+17	+ 1	N/A
York.....	+ 3	+ 2	+ 2	+ 8	+ 2	+43	+ 2	+12

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

§Increase due to strike in October 1971
 †15 SMSA's
 ‡Philadelphia

*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.