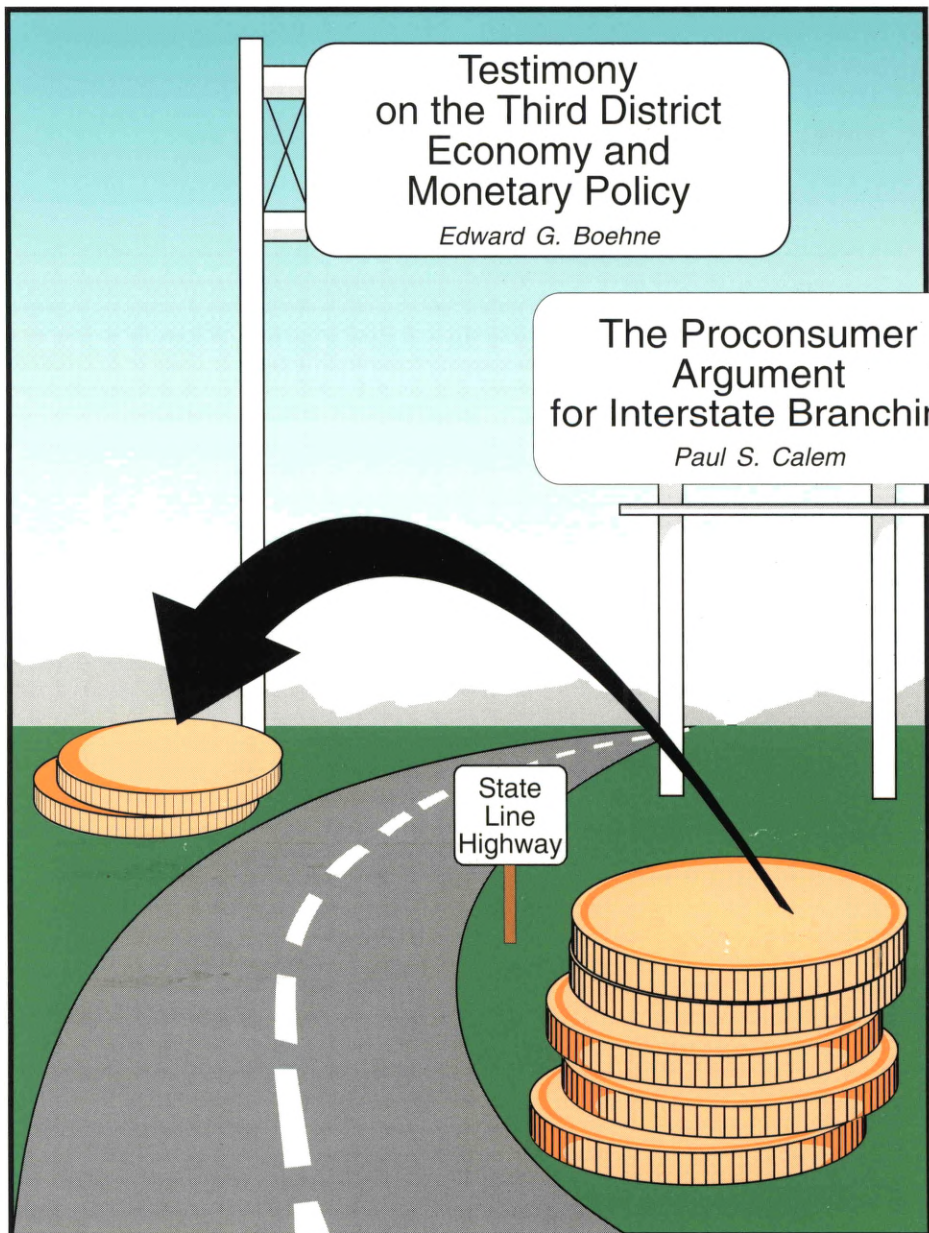


Business Review

Federal Reserve Bank of Philadelphia

May•June 1993

ISSN 0007-7011



Business Review

The BUSINESS REVIEW is published by the Department of Research six times a year. It is edited by Sarah Burke. Artwork is designed and produced by Dianne Hallowell under the direction of Ronald B. Williams. The views expressed here are not necessarily those of this Reserve Bank or of the Federal Reserve System.

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MAY/JUNE 1993

TESTIMONY ON THE THIRD DISTRICT ECONOMY AND MONETARY POLICY

Edward G. Boehne

The Committee on Banking, Housing, and Urban Affairs of the United States Senate invited the presidents of the 12 Federal Reserve Banks to Washington, D.C., to testify about monetary policy and about the economic conditions in their respective Districts. The presidents gave their testimony on March 10 of this year. This article presents the statement of Edward G. Boehne, president of the Federal Reserve Bank of Philadelphia, about conditions in the Third District.

THE PROCONSUMER ARGUMENT FOR INTERSTATE BRANCHING

Paul S. Calem

People from New Jersey work in Pennsylvania or maybe New York. People who live in Connecticut may go to New York for dinner and a show. And what about people in Kansas City, Missouri, or Kansas City, Kansas? In our modern world of rapid transportation, millions of people cross state lines daily, for work or leisure, without thinking twice about it. Would it be more convenient for these interstate commuters if their banks could establish interstate branches? Paul Calem thinks so, and in this article, he presents some consumer-oriented arguments in favor of interstate branching.

Testimony on the Third District Economy and Monetary Policy

*Edward G. Boehne**

Thank you for the opportunity to appear before this Committee to discuss District economic conditions and monetary policy.

BACKGROUND ON THE THIRD DISTRICT

The Third Federal Reserve District, headquartered in Philadelphia, includes the state of

Delaware, the southern half of New Jersey, and roughly two-thirds of the state of Pennsylvania. About one-third of New Jersey's population and more than 70 percent of Pennsylvania's population are in the District. The three states that are either wholly or partially in the District represent more than 8 percent of the U.S. population, employment, and income. The District itself, although small in size geographically, represents about 5 percent of the U.S. economy in terms of population, employment, and personal income. More than 25 of the Fortune 500 companies are headquartered within the District boundaries.

The largest concentration of economic activ-

*Edward G. Boehne is president of the Federal Reserve Bank of Philadelphia. On March 10, he and the presidents of the other 11 Federal Reserve Banks testified before the Committee on Banking, Housing, and Urban Affairs of the United States Senate. This article presents Mr. Boehne's testimony on the Third District economy and monetary policy.

ity in the District is in the Philadelphia metropolitan area. The Philadelphia area is the fourth most populous metropolitan area in the country, with almost 5 million residents. It ranks among the 10 largest U.S. markets in both industrial and commercial office space. The City of Philadelphia is the fifth largest city in the country and has the nation's sixth largest downtown office market.

In general, the economy in the three states of the District is quite diversified and could be described as a microcosm of the U.S. economy, since the nonfarm economy in the three states mirrors the nation quite closely. The proportions of jobs in most nonfarm categories differ little from the proportions at the national level. The two major nonfarm sectors in which the percentage of jobs diverges significantly from the national average are business and personal services and government services. Compared with the nation, about 2 percent more of the jobs in the tri-state area are in the private service industries (including accounting, private education, and health care), and about 2 percent fewer jobs are in the government sector. Agriculture and agricultural services contribute about 1 percent to the total output of the three states—somewhat less than the U.S. average. But agriculture remains a major industry in parts of south Jersey, southern Delaware, and south central Pennsylvania.

The District used to have a high proportion of its jobs in manufacturing, but that has changed. In the early 1970s more than one-third of the jobs in the three states were in manufacturing—about 7 percent more than at the national level. As late as 1980 more than one-quarter of the jobs were in manufacturing, still higher than the national average. Today the percentage of jobs in manufacturing in the Third District states is less than 20 percent and very close to the national average.

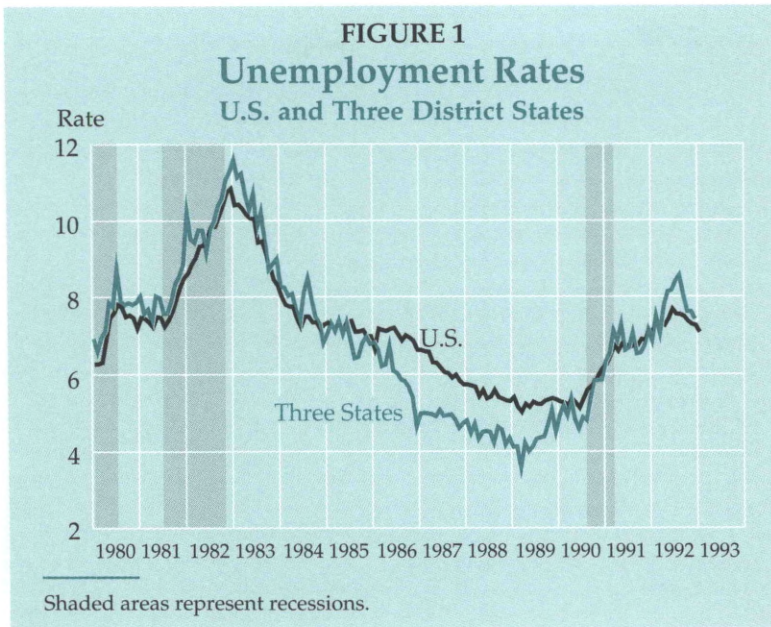
The chemical industry and health services are more heavily represented in the District than in the nation. The production of industrial

chemicals in the District is concentrated in Delaware. Pharmaceutical research and production, also classified among the chemical industries, is concentrated in central New Jersey and in the Philadelphia area. The higher-than-average number of jobs in health services in the District is the result of two factors: the average age of the population in the District is higher than that in the nation, and there are many large medical schools, hospitals, and health research facilities in the District.

Even though the District as a whole is not highly dependent on defense spending, certain parts of the District, such as the areas around Dover Air Force Base in Delaware and McGuire Air Force Base in New Jersey, are heavily dependent on defense. In Philadelphia, the Navy Yard and the Personnel Support and Industrial Supply Centers employ a large number of workers. In addition, the District has some major defense contractors, such as Boeing Helicopter and GE Aerospace (which is currently in the process of being sold to Martin Marietta).

DISTRICT EMPLOYMENT AND UNEMPLOYMENT

The Third District economy enjoyed solid growth during the expansion of the 1980s even as it continued to shift away from manufacturing and toward services. The history of state unemployment rates illustrates how the region's economy performed during most of the 1980s (Figure 1). In the late 1970s and early 1980s, unemployment rates in all three states in the District were regularly at or above the national average. During the long expansion in the 1980s, unemployment rates in all three states fell below the national average. By the end of the decade Pennsylvania's rate was a percentage point below the nation's in some months, and the rates in Delaware and New Jersey were even further below the national rate. For a time, Delaware's unemployment rate was below 3 percent, and the rate in New Jersey was between 3.5 and 4 percent.



during the 1980s.

Unemployment rates in the District came down relative to the national unemployment rate during the 1980s, despite overall job growth that was slower than the national average, because the District's labor force generally grew more slowly than that in the nation. With the exception of Delaware, labor force growth in the three states in the District lagged growth in the nation. This slower growth was partly a function of the age distribution in our District: fewer young people entered the labor

force than in earlier decades. The number of jobs in the three states of the District increased about twice as fast as the slowly growing labor force during the expansion of the 1980s, so many labor markets became very tight near the end of the expansion.

Job growth in our District was very good in the last decade, but not quite as good as the drop in unemployment rates would suggest. Combined job growth in the three states of the District was slower than job growth at the national level, although some labor markets were notable exceptions. Jobs in Atlantic City and Monmouth/Ocean counties in New Jersey, in Lancaster and State College in Pennsylvania, and in the state of Delaware, all grew appreciably faster than the national average. In Delaware, jobs grew more than one-and-a-half times the national rate. Some of these fast-growing areas benefited from special circumstances.

By the late 1980s, the economy in several parts of the District was showing signs of becoming overheated. Wages and prices were rising faster in the Northeast than in the nation as a whole. The rate of increase in the regional Consumer Price Index for the Philadelphia-Wilmington-Trenton area, for example, was 0.5 to 1.5 percentage points higher than the CPI inflation rate for the nation as a whole during the latter part of the 1980s. The region's inflation rate is now close to the national average. Inflation and wage costs are not a concern I hear much about now in the District.

The introduction of casino gambling in Atlantic City in the late 1970s, for example, resulted in very rapid job growth. Atlantic City was the fastest growing labor market in our District in the 1980s; jobs increased by more than 35 percent. Delaware experienced a major boom as financial service firms moved in to take advantage of the state's 1981 Financial Center Development Act. Jobs in the financial service sector more than doubled in the state

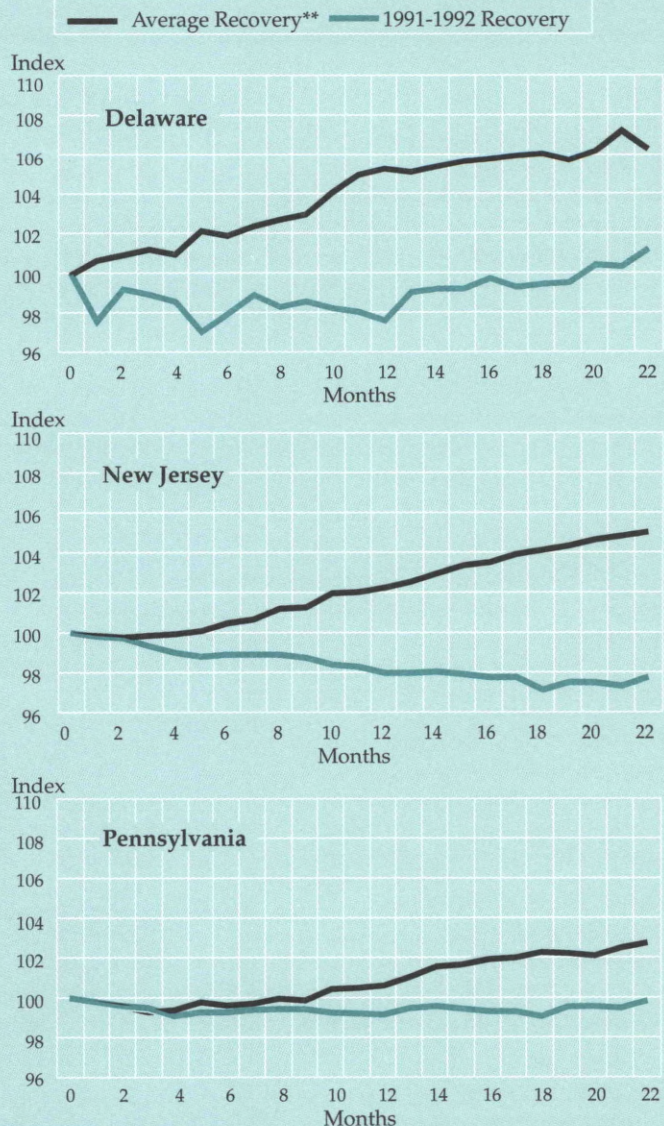
In contrast to the District's better-than-average performance during much of the 1980s, the District has suffered a more serious recession and slower recovery than has the nation in the 1990s. One of the most frequent complaints I heard in the late 1980s when I met with business

people was their inability to find qualified workers. Now I hear from people who cannot find jobs. The job situation turned around dramatically in the District, especially in New Jersey. As measured by the period in which jobs were generally declining, the recession lasted longer in most parts of our District than in the nation. Jobs began to decline in our region before they did in the nation. In New Jersey the general decline began in early 1989—more than a year before the onset of the national recession. In Pennsylvania the general decline began three months before the official beginning of the recession. Mirroring the national pattern, jobs continued to decline in the District beyond the official end of the recession. In New Jersey, there has not yet been any sustained job growth.

The job picture following this most recent recession stands in marked contrast to the average job growth after the other recessions since 1970. I have included a set of charts comparing the job growth in each state in our District following this recession with the average growth following the recessions of 1970, 1974-75, and 1981-82 (Figure 2).

Twenty-two months

FIGURE 2
Job Growth in Recoveries*



* Job growth is measured by payroll employment, indexed at 100 in the last month of the official recession.

** Average of recoveries from business cycle troughs of November 1970, March 1975, and November 1982. The recovery following 1980 is not used because it did not last 22 months.

into the national recovery, only Delaware has more jobs than it did at the end of the recession. The net increase is slightly more than 1 percent, far short of the more than 6 percent average for earlier recoveries. In New Jersey jobs are more than 2 percent *below* their levels at the official end of the recession, and in Pennsylvania they are still slightly below their levels at that time. By this time in earlier recoveries, jobs in these two states averaged 2.5 to 5 percent *above* their levels at the trough of the business cycle.

Given the extended period of job declines in most of our District, it is not surprising that the percentage loss of jobs has been deeper than the loss at the national level. Recently revised numbers show that the job declines in the District were not as severe as earlier numbers suggested, but District losses were still steeper than the national decline. While the U.S. lost less than 2 percent of its jobs, Pennsylvania and Delaware lost 2.4 percent and 2.7 percent, respectively. New Jersey had the highest percentage of job losses; the state lost almost one out of every 14 jobs between 1989 and 1992.

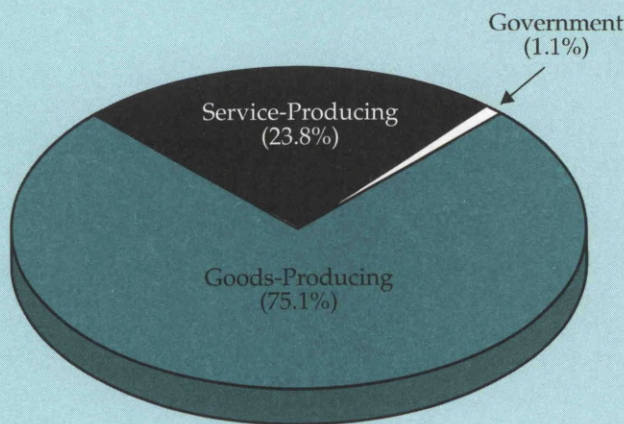
Job losses in the District were spread across every sector of the economy (Figure 3). The goods-producing industries took the biggest hit, as they typically do in any recession. More than three-quarters of the jobs lost in our states were in construction and manufacturing, even though they account for less than one-fourth of the jobs. A larger than usual percentage of the job losses in this recession, however, were in the service-producing industries. In every other recession during the last 20 years, the

private service-producing industries suffered little or no net job loss. This time almost 25 percent of the job losses in our region (between first quarter 1990 and first quarter 1992) were in the private service-producing industries.

Whether in the goods sector or the service sector, the job losses this time seem to be more permanent, as many firms have undergone major restructuring. Our District has suffered, or is about to suffer, cutbacks by several large employers. DuPont has gone through a major restructuring that has reduced its work force by 6000 in Delaware alone. Last year, Bell Atlantic announced reductions of over 1000 positions in New Jersey and almost 1000 in Pennsylvania. GM is slated to close an auto parts plant in Trenton, New Jersey, and an assembly plant in Wilmington, Delaware; Sears closed a distribution facility in Philadelphia; and Bethlehem Steel closed its division in Johnstown, Pennsylvania, eliminating 1900 jobs.

The continuing job losses beyond the end of

FIGURE 3
Distribution of Job Losses
in Three District States
 1990:I to 1992:I



the national recession meant that unemployment rates in most of the District did not peak until mid-1992. Except for Delaware, the state unemployment rates in the District are again higher than the national average, as they were in the 1970s and early 1980s. Pennsylvania did not quite have the boom times in the 1980s that New Jersey did, and Pennsylvania hasn't fallen as far during the past two years either. Pennsylvania's unemployment rate, which had been quite a bit below the national average during the late 1980s, has more recently been very close to the national average. Within Pennsylvania and New Jersey we have a wide range of unemployment rates. Some are in the 5 to 6 percent range; others are over 10 percent. These differences across the states represent differences in the mix of industries in these geographical areas.

The emerging recovery from the recession is uneven across the District. So far the low point for jobs in the District's three states combined was September 1992. Employment was up slightly in the fourth quarter for the District as a whole. I must caution, however, that we have had temporary improvements in the job picture earlier in the national recovery only to see the gains evaporate, so we continue to closely monitor the job picture in the region.

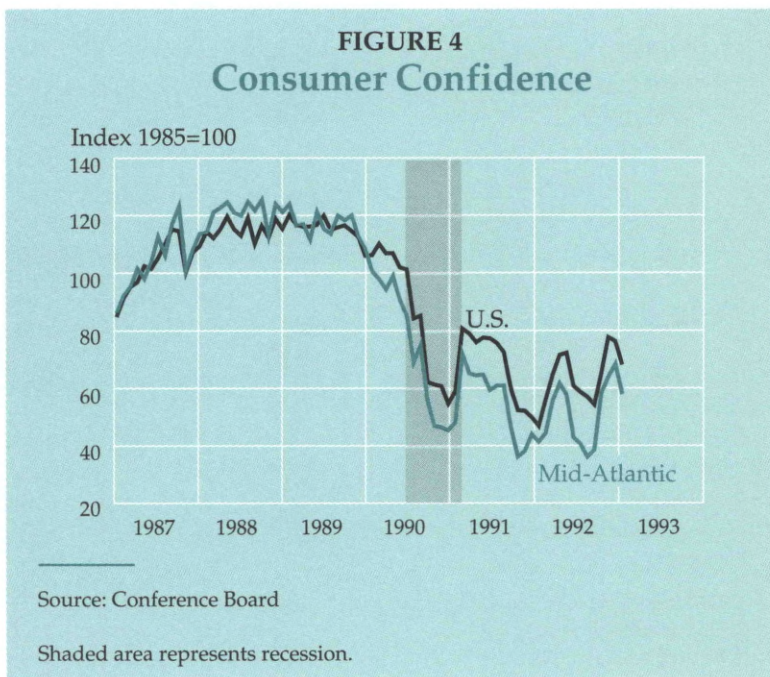
OTHER DISTRICT INDICATORS

Other indicators give some evidence of a pickup in economic activity in several sectors in the District. The index of current activity from the Philadelphia Fed's monthly *Business Outlook Survey* of manufacturers rose from close to zero

in October 1992 to almost 39 percent in February of this year. That means that 39 percent more manufacturing firms reported increases in current business activity than reported decreases in activity. A similar index from our quarterly survey of all types of firms in southern New Jersey rose from 12 percent in the third quarter to 34 percent in the fourth quarter.

Consumers in our region are also showing more faith in the recovery. The Conference Board's Consumer Confidence Index for the mid-Atlantic region was up in the fourth quarter of last year and again in January, but fell back a bit in February. This bears close watching because confidence in the region rose twice before in this recovery before falling back to low levels (Figure 4).

Retail sales in the region have increased since their cyclical low in early 1991. The improvement has not been as strong in New Jersey as it has been in Pennsylvania. Moreover, the advance has been uneven over the past two years.



DISTRICT REAL ESTATE

The real estate sector in the District deserves special mention because a full recovery in that sector is probably still several years away. There is no sign yet of a real recovery in the commercial office market. In the mid-Atlantic region, office construction, measured in square feet, is down more than 75 percent from its peak in 1987. In dollar terms it is down more than 60 percent. Office vacancy rates in the Philadelphia market remained high in 1992 despite the lack of any new construction. Quoted rental rates in the downtown Philadelphia market were down in 1992 and were unchanged in the suburbs.

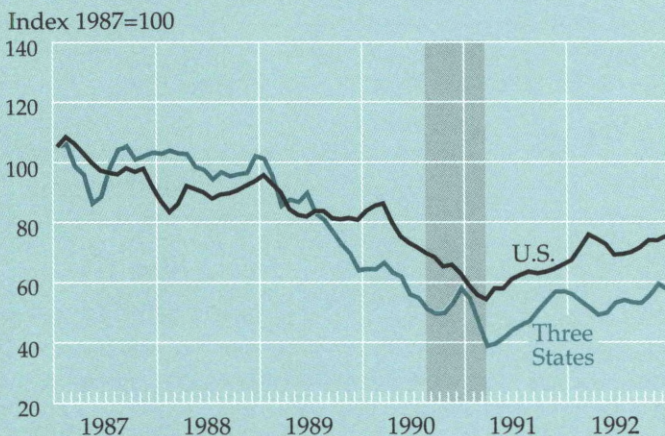
High vacancy rates, lower rental rates, and sales of some distressed properties have meant that purchase prices per square foot in the Philadelphia area have dropped dramatically. The average price per square foot for properties sold dropped from \$94 per square foot in 1990

to \$43 per square foot in 1992. Many of these recent sales, however, are distress sales.

On the residential side, in contrast, a recovery has been going on for some time, at least in parts of the District. However, the increase in housing starts has been neither steady nor evenly distributed (Figure 5). The housing recovery in New Jersey has been particularly weak; housing starts there are only about 40 percent of their 1987 level. Although some of the builders in southern New Jersey have recently indicated improvement in activity, they have also expressed concern that rising lumber prices (which have gone up 40 to 50 percent in a few months) could choke off the recent rise in housing demand in the area. Most of the improvement in housing has been in the single-family market. With high vacancies and falling real rents, there has been little incentive to invest in rental housing. But there are some signs that the rental market is stabilizing. In

1992 landlords offered fewer incentives, such as one-month's free rent or free parking, to renters.

FIGURE 5
Housing Starts
U.S. and Three District States



Data are three-month moving averages.
Source: U.S. Dept of Commerce for U.S. data; F.W. Dodge for state data
Shaded area represents recession.

BANK LENDING IN THE DISTRICT

Bank lending was very weak in the District in 1990 and 1991, as it was in the nation as a whole, as the recession reduced loan demand and as deteriorating asset quality led banks (and regulators) to be more conservative in evaluating lending opportunities. Real estate lending was especially limited in the face of declining property values. The cost of financial intermediation rose because of increased capital requirements and higher deposit

insurance premiums, and the deterioration in loan quality increased the perceived risk of default. These factors led, despite weak loan demand, to a widening of spreads between loan rates charged by banks and their cost of funds.

I believe that we have started to see signs of an improved environment for bank lending in the District. We seem to be moving from a credit crunch to credit caution. Banks have increased their capital positions and reduced their net charge-offs during the past two years, and nonperforming loans as a percent of total loans declined last year. Consequently, the region's banks are now in a better position to increase their lending as loan demand picks up.

Loans by banks in our region have, in fact, increased somewhat during the past year in all categories of lending: real estate, consumer, and commercial and industrial. Banks also reported at the beginning of this year that they are beginning to see stronger loan demand from middle-market firms and small businesses. What's more, banks are becoming more active in seeking out lending opportunities. For example, at a recent meeting of builders in southern New Jersey, some bank loan officers attended the meeting—something we had not seen during the previous two years. (In another region of the District, one developer even reported receiving a phone call from a banker asking if the developer was interested in borrowing money!) Banks in the region also are no longer tightening credit standards, and some banks reported an easing of their loan terms. I expect to see further increases in lending over the next year.

Nonetheless, there remain obstacles to the resumption of normal borrowing relationships, especially for small and medium-size businesses. In particular, we must find ways to facilitate the so-called "character" loan by easing up, where prudent, on excessive documentation and other costs that fall disproportionately on small businesses.

SUMMARY OF DISTRICT ECONOMY

Overall, District economic activity has shown improvement since September of last year. The unemployment rate has declined in each of the District's three states, and employment levels are up in the District as a whole. Unfortunately, employment has not risen very much since the end of the national recession. What's more, some large firms have announced major layoffs that will affect our District. The District's growth has lagged the rest of the nation during most of the past two years, and I expect this situation to continue during 1993. Even though I expect employment to increase in each of the District's three states, the improvement is likely to lag behind gains in the nation as a whole. Among the states in our District, growth in New Jersey is likely to be weaker than in Delaware and Pennsylvania.

MONETARY POLICY

Let me now turn from the District to monetary policy. The Federal Reserve, against a background of weak economic growth and lessening inflationary pressures, has brought short-term rates down to their lowest levels in about 30 years. The federal funds rate has declined by almost 7 percentage points since early 1989 (Figure 6). Monetary policy began to ease more than a year before the onset of the 1990 recession; it eased substantially during the recession; and it continued to ease during the sluggish recovery. By this point in past recession/recovery periods, the federal funds rate had, on average, risen from its low point a few months after the trough of the business cycle (Figure 7). In contrast, in this most recent recession/recovery period the federal funds rate has continued to decline since the trough of the recession in March of 1991. This further decline of short-term interest rates reflects a continued easing of monetary policy that has been entirely appropriate given the weak growth of employment and real GDP through much of this recovery. Because employment

FIGURE 6
Discount Rate and Federal Funds Rate
 1989-1993

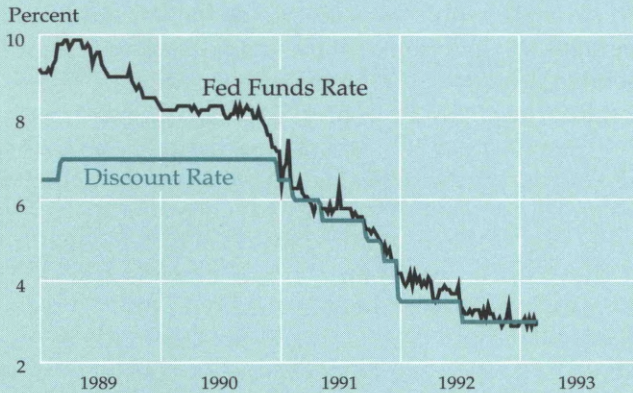
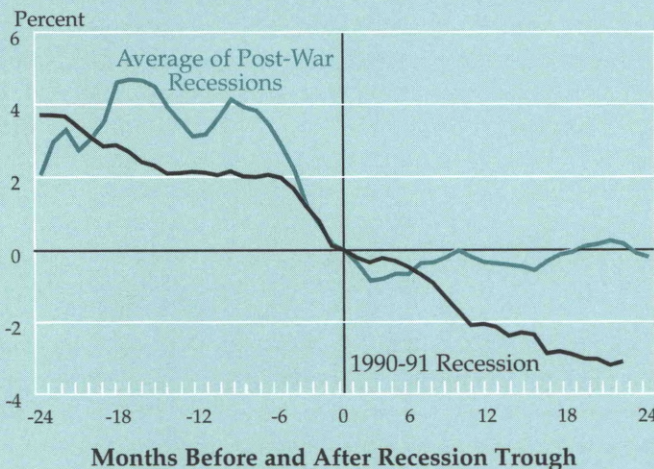


FIGURE 7
Federal Funds Rate Relative to Its Levels
at Recession Troughs
 1990-91 Recession vs. Post-War Recessions*



*Average of recessions from 1960 to 1989, excluding 1980 recession.

and real GDP growth have been weaker during this recovery than in previous ones, monetary policy has been unusually accommodative in continuing to bring down short-term rates to try to get the economy growing at a more sustainable pace. With core inflation (that is, the CPI excluding food and energy) somewhat above 3 percent during the past two years and short-term rates falling to around 3 percent, short-term real rates (that is, short-term rates adjusted for core inflation) have been close to or a little below 0 percent since the trough of the recession, whereas in previous recessions the real federal funds rate has typically risen by now and become positive.

The pattern of declining short-term interest rates during this recession/recovery period has been in marked contrast to the behavior of M2 money growth. M2 growth has been very sluggish in comparison to past recoveries despite the continued easing of monetary policy. Since M2's relationship to economic growth has been changing in ways that we do not fully understand, M2 has become a less reliable guide for monetary policy. Indeed, the pace of economic activity in 1992 was much faster than could have been anticipated

using the historical relationship between M2, income, and interest rates.

The pace of economic activity improved substantially over the last two quarters of 1992, and, as noted in Chairman Greenspan's testimony to this Committee on February 19, the central tendency of the governors' and Reserve Bank presidents' forecasts is for real GDP to grow 3 to 3.25 percent during 1993, with the unemployment rate continuing to decline to around 6.75 to 7 percent. In light of the still substantial degree of slack in the economy, I would not be concerned by somewhat faster growth than this.

Much of the growth in output during 1992 reflected sharp gains in productivity rather than gains in labor input. This high rate of productivity growth is welcome news in one sense, in that it improves our nation's competitive position in world markets. But these productivity gains over the past two years have meant that employment has not risen very much so far during this recovery. Productivity gains as large as those in 1992 are unlikely to persist in 1993, and consequently I expect that employment growth will be more substantial this year than last.

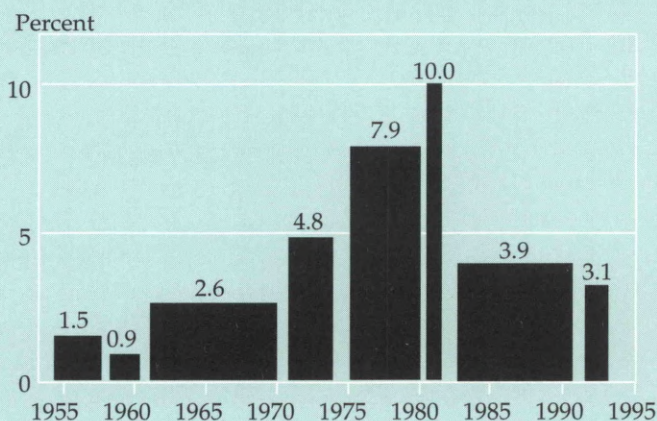
One factor that will be especially important in contributing to continued, and perhaps even stronger, growth during 1993 is the recent decline in long-term interest rates. By the end of last year, long-term interest rates had already declined substantially from their peak in early 1989. The continued easing of monetary policy in 1990, 1991, and 1992, along with

reduced private sector credit demands as the economy went into recession, contributed to these reductions in long-term interest rates.

The decline in actual inflation and in expectations of future inflation was another very important contributor to the decline in long-term interest rates over the past several years. Unlike the expansions of the 1970s, when the rate of inflation rose in stepwise fashion from one business cycle to the next, average inflation rates have not exhibited a tendency to accelerate during the long expansion of the 1980s and the recovery so far in the 1990s (Figure 8).

Not only did actual inflation remain relatively low in 1991 and 1992, but expectations of long-term inflation fell as market analysts came to believe that the economy would not experience a resurgence of inflationary pressures. Based on a survey of economic forecasters in business and academia, the rate of inflation expected to prevail over the next 10 years fell

FIGURE 8
Inflation During Business Expansions
Consumer Price Index



Note: Average annual inflation rates from business cycle trough to business cycle peak, except for last bar, which shows 1991 trough to end of 1992.

nearly a full percentage point from about 4.4 percent in early 1990 to 3.5 percent last month (Figure 9). This reduction in expected inflation undoubtedly has been a major factor in helping to reduce long-term bond and mortgage rates.

But at the current 3.5 percent level, long-term expected inflation is still somewhat above the actual rate of 3 percent CPI inflation experienced over the past two years. I expect inflation will decline below 3 percent in 1993 and 1994, helping to bring expected inflation down further and helping to keep long-term interest rates low.

Proposed changes in fiscal policy also have contributed to low long-term rates. The Administration's long-term deficit reduction proposal has received a generally favorable reaction in financial markets. Evidently, the markets view it as a credible plan to reduce the federal government's future demands for credit.

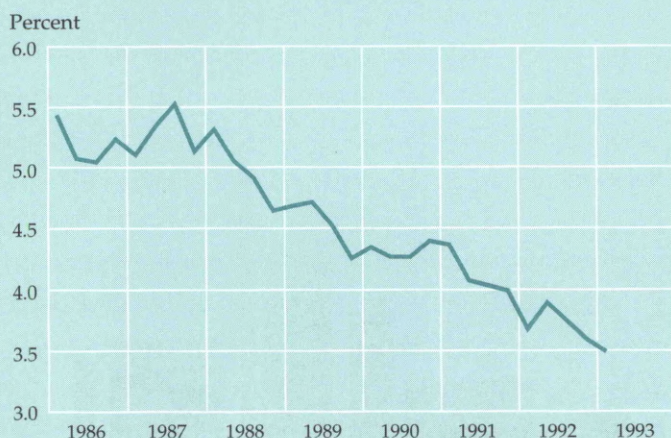
This has resulted in a significant reduction in long-term interest rates in recent weeks. This reduction should be a big help to the housing market and other interest-sensitive sectors of the economy during 1993. Consequently, I am more optimistic about the future path of economic growth and employment than I was at the beginning of the year.

Nonetheless, the economy continues to face some serious obstacles to growth. A major concern is that employment is not rising commensurately with the rise in economic activity. Further increases in employment would help ensure that an expansion in the economy will be self-sustaining. In addition, several structural impediments to the economy remain with us. The overhang of commercial office space, still high debt burdens of some households and firms, substantial cutbacks in defense spending, and the continued restructuring and lay-

offs of workers by some firms, all will continue to hold back the growth of the economy to some extent in 1993. Keeping long-term interest rates low will continue to be important in helping to ease the debt burdens of firms and households and in offsetting some of these other impediments to economic growth.

The objective of monetary policy is to help maximize sustainable growth in output, jobs, and living standards. Keeping inflation low is a necessary ingredient for maximizing sustainable economic and job growth. Low inflation promotes long-term planning and investment by keeping long-term interest rates low. We now have inflation rates

FIGURE 9
Long-Term Expected Inflation



Source: Expected CPI inflation rate over next 10 years, based on survey of business and academic forecasters. Prior to 1991/Q2, Richard Hoey's Decision-Makers Poll; 1991/Q2-1991/Q3, Livingston Survey; 1991/Q4-1993/Q1, Survey of Professional Forecasters (Federal Reserve Bank of Philadelphia).

back to levels of the 1960s, and these levels will help to keep long-term interest rates low. Reducing the federal budget deficit is another critical ingredient to achieving low long-term interest rates. For that reason, the current focus of fiscal policy on deficit reduction is a welcome

development. In combination, these policies—both fiscal and monetary—will help to support expansion of the economy while also supporting improved living standards and low inflation over the long term.

The Proconsumer Argument for Interstate Branching

*Paul S. Calem**

Interstate banking in the United States, an impossibility for many years, became a reality in the 1980s with the passage of state laws authorizing bank holding companies to expand across state lines. All but two states now allow an out-of-state holding company to acquire an in-state bank, and most large banking organi-

zations now have subsidiaries in several states. However, a significant barrier to interstate expansion still exists. It is not yet permissible for individual banks to establish branch networks that cross state boundaries. Interstate expansion is possible only at the holding company level.

This remaining obstacle to interstate banking is critical because it can raise banks' costs of expanding interstate and also limit the potential benefits to consumers. Maintaining an independent, out-of-state subsidiary can be more costly for an institution than operating a

* Paul Calem is a senior economist and research adviser in the Research Department of the Philadelphia Fed. He thanks Gary Bosco of the Conference of State Bank Supervisors for providing information on states' branching laws.

cross-state branch network.¹ And branch networks provide particular convenience benefits to consumers. Most important, while consumers can deposit funds into their accounts at any branch of their bank, they cannot make deposits via an out-of-state affiliate of their bank.

Removal of the legal impediments to interstate branching surely would lead to the creation of interstate branch networks, in part because some bank holding companies currently operating interstate would choose to merge subsidiary banks. This geographic expansion would benefit consumers of banking services. Consumers in multistate areas would gain easier access to their bank accounts and related services. In addition, interstate branching would be procompetitive. For instance, blanket repeal of federal interstate branching restrictions would enable national banks to enter out-of-state markets by establishing new branches there.² Such de novo entry (as opposed to entry via acquisition) would tend to make a market more competitive, especially in the case of markets that, prior to entry, had been dominated by a small number of institutions. As a result, consumers in these markets would likely be offered more favorable rates and fees.³

¹For elaboration on this point, see Mengle (1990) and Svare (1992).

²Whether restrictions on interstate branching by national banks will be repealed without conditions remains to be seen. Some proposals would repeal existing federal restrictions but allow individual states to pass laws that restrict interstate branching. Given such authority, some states might opt to forbid the establishment of de novo interstate branches. See Mengle (1990) for discussion of alternative proposals.

³The relationship between structure, conduct, and performance in banking markets has been studied extensively. There is general agreement that markets dominated by a few institutions tend to be less competitive, with banks in those markets offering lower deposit rates and having higher fees and loan rates. See, for example, Calem and Carlino (1991) and Hannan (1991).

Despite these potential benefits to consumers, interstate branching proposals have generally been opposed by consumer advocates.⁴ In part, this opposition has arisen because the benefits have not been thoroughly articulated. More important, opponents of interstate branching fear that it would lead to domination of local markets by large multistate banks. They are concerned that these institutions would be less willing to lend to small local businesses and would be less responsive to community needs in general.

This article examines the various pros and cons of geographic deregulation, focusing on the potential impact of interstate branching on consumer convenience, competition, and credit availability. There are, of course, other matters relevant to interstate branching. For example, by lowering the costs of geographic expansion, interstate branching may enable banks to reduce the riskiness of their loan portfolios through further geographic diversification.⁵ My intention, however, is to examine only those issues that directly affect retail and small-business customers. Indeed, recent debate over interstate branching has emphasized such consumer issues.⁶

THE CURRENT STATUS OF INTERSTATE BANKING

Banking deregulation during the 1980s loosened the constraints on interstate banking considerably. Unlike other major regulatory initia-

⁴See, for example, the statements by representatives of the Consumers Union, the Consumer Federation of America, and the U.S. Public Interest Research Group before the Subcommittee on Consumer Affairs and Coinage, U.S. House of Representatives (U.S. Congress 1991).

⁵For discussion of this issue and other considerations related to interstate branching, see Mengle (1990) and U.S. Congress (1991).

⁶See U.S. Congress (1991).

tives during this period, such as the lifting of ceilings on deposit interest rates, interstate banking reform occurred at the state rather than the federal level. Since 1956, the Douglas Amendment to the federal Bank Holding Company Act has prohibited interstate acquisitions by bank holding companies, except where authorized by the acquired bank's home state. During the 1980s, most states changed their laws to permit entry by out-of-state bank holding companies.

Only two states, Hawaii and Montana, have yet to adopt a law allowing entry by an out-of-state holding company.⁷ Thirty-five states now permit entry on a nationwide basis, with the stipulation (in most cases) that the entering bank's home state have a reciprocal law. Fourteen states (plus the District of Columbia) allow entry on a regional reciprocal basis.⁸

One significant limitation of these interstate banking laws is that most states do not allow out-of-state holding companies to establish de novo bank subsidiaries in the state. Rather, entry by out-of-state banking organizations is restricted to acquisitions of existing banks. Only 19 states allow de novo entry.⁹

Geographic deregulation during the 1980s

⁷ Hawaii permits entry by institutions from Guam, American Samoa, and several other Pacific territories, subject to reciprocity.

⁸ The District of Columbia also allows entry on a nationwide basis for institutions outside the D.C. region that meet certain community reinvestment and job creation requirements. For details on each of the state laws, see "State Laws Gain Renewed Significance as Congress Stumbles," Banking Policy Report, January 6, 1992, pp. 10-14, and "A Look at Laws Granting Interstate Powers to Banks," *American Banker*, March 20, 1992, p. 8.

⁹ The states allowing de novo entry are Arizona, Colorado (effective July 1, 1993), Connecticut, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nevada, New Hampshire, New Jersey, New Mexico, New York, Ohio, Pennsylvania, Rhode Island, South Dakota, Texas, and Vermont.

resulted in numerous interstate mergers and acquisitions, transforming the structure of the banking industry. One dramatic consequence of this merger activity has been the creation of so-called "superregionals." Huge multistate organizations emerged from consolidations involving two or more large banks, as in the case of NationsBank Corporation in the South, or through the acquisition of many smaller banks by a major institution, as in the case of Banc One Corporation in the North Central region.

A list of the 25 largest banking organizations in the U.S. and the states in which they operate bank subsidiaries (Table 1) shows that almost all large banking organizations now have subsidiaries in several states.

Many smaller organizations also have expanded interstate. For example, 14 bank holding companies headquartered in Pennsylvania or New Jersey operate out-of-state bank subsidiaries. These institutions (Table 2) range in size from \$240 million to \$52 billion in assets; seven of them have less than \$2 billion in assets.

Restrictions on Interstate Branching. While bank holding companies can now cross state lines, various legal obstacles preclude interstate branching by commercial banks.¹⁰ Foremost among these is the McFadden Act, a federal law dating from 1927 that rules out interstate branching by national banks.¹¹ The

¹⁰ Federally chartered thrifts, on the other hand, are no longer subject to such a restriction. The Office of Thrift Supervision, in April 1992, adopted a rule allowing full nationwide branching for healthy federally chartered savings and loan institutions.

¹¹ For an overview of the history of branch banking in the U.S., including further discussion of the McFadden Act, see Mingle (1990). A loophole in the act allows a national bank to relocate its headquarters up to 30 miles, even across a state line. U.S. Bancorp recently exploited this loophole to branch from Oregon into Idaho. See "Fed Gives Interstate Issue a Push by Easing Bank Relocation Rule," *American Banker*, February 27, 1992, p. 1.

TABLE 1
25 Largest Banking Organizations and States
in Which They Operate Bank Subsidiaries
 (as of 12/31/92)

Name of Institution	Total Assets (millions \$)	Region ^a
1 Citicorp	213,701.0	AZ, CA, CO, DE, FL, MD, ME, NV, NY, SD
2 BankAmerica Corp.	180,814.0	AZ, CA, ID, NV, OR, TX, WA
3 Chemical Banking Corp.	134,655.0	DE, NJ, NY, TX
4 NationsBank Corp.	119,805.0	DC, FL, KY, MD, NC, SC, TN, TX, VA
5 J.P. Morgan & Co., Inc.	102,941.2	DE, NY
6 Chase Manhattan	95,862.3	AZ, CT, DE, FL, MD, NY
7 Bankers Trust New York Corp.	72,448.0	DE, FL, NY
8 Banc One Corp.	61,331.6	IL, IN, KY, MI, OH, TX, WI
9 Wells Fargo & Co., Inc.	52,536.9	CA
10 PNC Financial Corp.	51,523.0	DE, KY, NJ, OH, PA
11 First Union Corp.	51,326.6	FL, GA, NC, SC, TN
12 First Interstate Bancorp, Inc.	50,863.1	AK, AZ, CA, CO, ID, MT, NV, NM, OR, TX, UT, WA, WY
13 First Chicago Corp.	49,281.0	DE, IL, WI
14 Fleet Financial Group, Inc.	47,121.5	CT, MA, ME, NH, NY, RI
15 Norwest Corp.	44,557.1	CO, IA, MN, MT, ND, NE, SD, WI, WY
16 Bank of New York Co., Inc.	41,023.0	DE, NY
17 NBD Bancorp, Inc.	40,843.2	FL, IL, IN, MI, OH
18 Barnett Banks, Inc.	39,631.0	FL, GA
19 SunTrust Banks, Inc.	36,647.2	FL, GA, TN
20 Wachovia Corp.	33,356.1	DE, GA, NC, SC
21 Bank of Boston Corp.	32,346.1	CT, FL, ME, MA, RI
22 Mellon Bank Corp.	31,540.7	DE, MD, PA
23 First Fidelity Bancorporation	31,481.6	NJ, NY, PA
24 National City Corp.	28,963.5	FL, IN, KY, OH
25 Comerica, Inc.	26,660.0	CA, MI, OH, TX

^aExcept in the case of PNC Financial and Mellon, the Delaware subsidiaries of institutions listed in the table are limited-purpose banks.

TABLE 2
Banking Organizations Headquartered in NJ or PA That
Have Out-of-State Bank Subsidiaries^a

(as of 12/31/92)

Name of Institution	Total Assets (millions \$)	Locations of Subsidiaries
PNC Financial	51,523.0	DE, KY, MA*, NJ, OH, PA
Mellon Bank Corp.	31,540.7	DE, MA*, MD, PA
First Fidelity Bancorporation	31,481.6	CT*, NJ, NY, PA
CoreStates Financial Corp.	23,774.4	NJ, PA
Midlantic Corp.	14,423.1	NJ, NY, PA
UJB Financial Corp.	13,794.6	NJ, PA
Meridian Bancorp, Inc.	12,221.1	DE, NJ*, PA
Susquehanna Bancshares	1,727.9	MD, PA
F.N.B. Corporation, Inc.	1,698.6	OH, PA
Commerce Bancorp, Inc.	1,428.0	NJ, PA
B.M.J. Financial Corp.	655.1	NJ, PA
State Bancshares	557.4	NJ, PA
Vista Bancorp	336.9	NJ, PA
Glendale Bancorporation	236.7	NJ, PA

^a Limited-purpose banking subsidiaries are not considered.

*As of this writing, this institution has signed a deal to acquire a bank in this state. Total assets reported in the table do not reflect this proposed transaction.

Federal Reserve Act applies this constraint to state-chartered banks that are members of the Federal Reserve System. Moreover, all but five states generally prohibit the operation of in-state branches by out-of-state banks.¹²

Proposals to permit nationwide interstate branching were considered by Congress during 1991. These measures were included as part of comprehensive proposals to restructure regulation of the banking industry. For instance, the

Treasury Department submitted a banking reform bill that would have authorized interstate

¹² According to the Conference of State Bank Supervisors, out-of-state banks are allowed to establish branches in Alaska, Massachusetts, Nevada, New York, and Rhode Island (but in Massachusetts and Rhode Island, only entry via branch acquisition is permissible). These laws, in effect, authorize entry by state-chartered banks that are not members of the Federal Reserve System. In addition, "Florida

branching by national banks. In addition, the bill would have allowed banking organizations to engage in a broader range of financial activities, and it would have permitted nonfinancial firms to own banks within a "diversified holding company" structure. But comprehensive restructuring was put on hold. Instead, Congress decided to grapple with the more pressing issues of deposit insurance reform and recapitalization of the FDIC's bank insurance fund.

In 1992, Treasury tried to rally support for a narrower bill that would have permitted nationwide branching and limited insurance activities. Because of disagreements among bankers and between the banking and insurance industries over the specifics of such a bill, no bill was introduced. Nevertheless, interstate branching remains a key topic on the banking reform agenda, one which Congress is likely to revisit in the future.

INTERSTATE BRANCHING AND CUSTOMER CONVENIENCE

One need not be an economist to surmise that branch networks provide convenience in

allows an outsider to branch into the state via merger or acquisition if its home state has a reciprocal law" (*American Banker*, December 16, 1992, p. 2.)

I am aware of at least one instance in which a state regulatory agency approved an interstate branch acquisition in a state where such transactions are permitted only under exceptional circumstances. This was the case in Pennsylvania in February 1992, when the state Department of Banking and the FDIC allowed Wilmington Trust Company, a Delaware Bank, to merge with a failed Pennsylvania bank and operate its sole office as a branch. The department has not yet ruled on whether current state law would allow Wilmington Trust to establish additional branches in Pennsylvania now that it has obtained a foothold.

There are a few interstate bank branches around the country that were established before either state or federal laws forbade them and that have been "grandfathered," i.e., permitted to remain in operation. For instance, Midlantic Bank, a New Jersey bank, operates a "grandfathered" branch in downtown Philadelphia.

the form of greater access to accounts and related services across the geographic area covered by the network. Clearly, then, interstate branching would enhance the convenience of bank customers who frequently cross state lines. In addition, interstate branching would benefit businesses that require banking services at diverse locations in more than one state. A further potential convenience benefit is somewhat more subtle. Economic reasoning and empirical evidence indicate that interstate branching will tend to have a favorable impact on branch coverage, i.e., on the total number of bank branches serving a given area.

Enhanced Convenience for Consumers in Multistate Areas. Anyone who frequently crosses a state line, for work, for shopping, for business or pleasure, stands to benefit from interstate branching. Interstate branching would provide these customers with convenient access to their accounts and related banking services.

Current restrictions on interstate branching adversely affect such customers in two ways. First, these restrictions may keep some banking institutions from expanding interstate, since expansion at the holding company level can be more costly. Second, interstate banking at the holding company level cannot provide the same level of convenience as interstate branching. In particular, a consumer cannot deposit funds into his or her account through an out-of-state affiliate of his or her bank, and certain account-specific services such as check-cashing may not be obtainable at branches of an affiliate.¹³

Bank branching is important to customers for a number of reasons. First, small-business customers are very dependent on branch banking, both for teller transactions and for special

¹³ The McFadden Act (as it has been interpreted) also prevents a bank from accepting deposits through out-of-state ATMs. Thus, repeal of the act would enable consumers to deposit funds into their bank accounts at out-of-state locations through ATMs.

services such as night depository, account reconciliation, and financial counseling.¹⁴ Second, despite teller machine networks, the typical retail customer regularly visits a brick-and-mortar branch to conduct transactions.¹⁵ Third, consumers may save on transactions fees by using automated teller machines located at branches of their banks, since banks usually charge higher fees for transactions at ATMs that are “nonproprietary” (owned by other banks).¹⁶

The number of people in the U.S. living and working in multistate areas who are apt to benefit from interstate branching is substantial. Six consolidated metropolitan statistical areas (CMSAs) and an additional 28 metropolitan statistical areas (MSAs) cross state boundaries,

and approximately 66 million people reside in these multistate metropolitan areas, according to the 1990 U.S. Census.¹⁷

In addition to benefiting bank customers in localities that straddle state boundaries, interstate branching would be advantageous to customers who require banking services at diverse locations in two or more states, primarily businesses with multistate operations. Under current branching restrictions, such a customer may be pressed to maintain relationships with multiple banks. For instance, a business may have to maintain checking accounts at several banks, which may complicate the firm’s cash management and increase its fee expenses.¹⁸

Increased Branch Coverage. The value to a bank of adding a branch at a particular location depends on the branch’s potential to attract new depositors and borrowers and its potential convenience benefits to current customers. Legal restrictions on branching may prevent some banks from realizing their full branching potential. Locations where these banks would have established branches will be left unserved, unless other banks are willing and able to locate there, which will not always be the case.¹⁹ Under current restrictions on interstate branching, an out-of-state bank holding company can create a new bank subsidiary to operate a branch. But creating a new bank subsidiary can be more costly and of less convenience value

¹⁴ According to a 1989 survey, more than 20 percent of small-business owners or officers visit their branch daily on behalf of the company. Forty percent are in the branch once a week or more; 88 percent report that branch employees know them by name; only 3 percent never visit a branch. Other small-business employees also make frequent branch visits on behalf of their company. See Trans Data Corporation (1989a).

¹⁵ According to a 1989 survey, 95 percent of consumers visit a branch at least once each month to conduct transactions. Per household, the average number of trips to a branch is about three per month; branch visits are more frequent among higher income households. Close to half of the respondents (47 percent) reported that they do not use teller machines, and of these households, almost 60 percent indicated that “nothing could get them to use an ATM.” See Trans Data Corporation (1989b).

¹⁶ According to a 1988 survey, less than 20 percent of ATM-offering banks and thrifts (having more than \$750 million in deposits) charged “us-on-us” transaction fees, and only 1 percent planned to add such fees in 1989. However, over 60 percent of such institutions charged for “us-on-others” transactions, and 12 percent more planned to begin charging such fees in 1989. The mean “us-on-us” transaction fee for institutions charging such fees was 21 cents, while the mean “us-on-other” fee for institutions charging such fees was 70 cents. See Trans Data Corporation (1988).

¹⁷ Consolidated metropolitan statistical areas and metropolitan statistical areas are constructs defined by the U.S. Office of Management and Budget.

¹⁸ According to Nakamura (1993), “in general, large firms have multiple relationships with banks. [Surveys of large corporations] show how complex these relationships can be.” In part, these multiple banking relationships are a consequence of restrictions on bank branching.

¹⁹ Other banks may not attach as much value to the additional branch or may have to incur higher costs to operate the branch.

than adding a branch to an existing network.

Thus, branching restrictions tend to reduce total branch coverage. By this reasoning, we can expect that repeal of interstate branching restrictions would have a beneficial impact on branch coverage because banks would establish branches at previously unserved locations as they expand interstate.

Empirical support for this line of reasoning is found in studies that investigate the factors determining bank branch coverage. Evanoff (1988) analyzes 1985 data on branch coverage for each county in the 48 contiguous states. He finds fewer branches per square mile in states with legal restrictions on branching, holding constant other factors such as whether the county is rural or urban. Similarly, Calem and Nakamura (1993), using 1990 data and controlling for a wide range of factors, find reduced branch coverage in states with highly restrictive branching laws. They find that, on average, branching restrictions entailed one less branch in non-MSA counties and 13 fewer branches in urban counties, holding county population, population density, and other factors constant.²⁰

INTERSTATE BRANCHING AND COMPETITION

Some opponents of interstate branching have argued that branching restrictions are procompetitive, as they prevent large banks from acquiring smaller banks and turning them into branches. Thus, these restrictions help keep banking markets from becoming too concentrated.²¹ This argument is less than convinc-

ing, for two reasons. First, many of the mergers or acquisitions that would take place under interstate branching would occur in unconcentrated markets or would be between banks operating in distinct markets or between banks that are subsidiaries of the same holding company. In general, such consolidations would not substantially raise concentration in banking markets. Second, federal bank regulators and the U.S. Department of Justice have the authority to block any acquisition or merger deemed to have anticompetitive effects. Hence, branching restrictions are not needed to prevent excessive market concentration.²²

On the contrary, economic reasoning suggests that the lifting of interstate branching restrictions would benefit consumers by furthering competition in banking markets. The potential for banks to expand their branch networks across state lines could enhance competition in several ways. First, banks would be able to engage in nonprice competition more efficiently; some banks would be freed from having to provide convenience in forms that are more costly and less satisfactory than branching. The cost-savings would be passed on to consumers through lower prices. Second, for reasons discussed below, a bank establishing an extensive, multimarket branch network might opt to institute uniform pricing (uniform fees and interest rates) across disparate local markets by aligning prices in concentrated markets with those in competitive locales. Thus, branching tends to reduce price differentials between concentrated and competitive mar-

²⁰ Non-MSA counties in states without restrictive branching laws had a mean of 9 branches, while MSA counties in those states had a mean of 58 branches.

²¹ Market concentration refers to the number and size distribution of firms in a market. More concentrated banking markets tend to be less competitive (see footnote 3).

²² Under the Bank Merger Act and the Bank Holding Company Act, federal bank regulators must analyze the competitive effects of proposed mergers and acquisitions of banks and bank holding companies. If a proposed merger is expected to have a substantially adverse effect on competition, the merger application would be denied. In addition, the Justice Department has the authority under antitrust statutes to block anticompetitive mergers or acquisitions.

kets. Third, in many instances banks will choose to branch interstate by establishing *de novo* branches, thereby reducing concentration in the targeted markets. Let us elaborate on each of these arguments in turn.

Branching and Nonprice Competition. In markets where branching restrictions impose inconveniences on bank customers, banks may be compelled, through competition, to partly “compensate” their customers for these inconveniences. Such nonprice competition could take the form of longer banking hours, more tellers per branch, or other amenities that would mitigate the loss of convenience due to limited branching.

Providing such services drives up bank costs and results in higher fees and lower deposit interest rates for bank customers. Nevertheless, many bank customers will prefer some such nonprice “compensation” for lack of branching, even if they have to pay for it with higher fees. Banks would compete for these customers by providing them with the various amenities.²³

In this sense, interstate branching restrictions may engender inefficiency in the provision of banking services, at least in markets that straddle state boundaries. Such restrictions may force banks to substitute less suitable and more expensive forms of convenience for their customers, who, in turn, would have to pay higher fees or accept lower deposit interest rates. With the lifting of such restrictions, nonprice competition would become more efficient. Through interstate branching, banks would be able to provide their customers with

greater accessibility and convenience, at a lower cost.²⁴

Branching and Intermarket Price Differentials. For several reasons, a bank having an extensive, multimarket branch network might opt to institute uniform pricing across disparate local markets by aligning prices in concentrated markets with those in competitive locales. One important motive for a bank to centralize pricing decisions is to economize on managerial or coordination costs. Uniform pricing may also enable the bank to save on advertising costs. In addition, the bank may want to institute uniform pricing across a multimarket area as a benefit to customers who reside in the area’s largest banking market (the regional economic center), many of whom may regularly visit and conduct transactions at other localities in the area. A bank may be motivated to do so if the regional economic center is also the area’s most competitive banking market.²⁵

To the degree that branching motivates uniform pricing across multimarket areas, it tends to reduce price disparities between concentrated and competitive markets. Thus, when banks can branch freely across local markets, deposit interest rates in concentrated markets tend to be higher, and fees and loan rates lower, than they would be in the absence of branching. Through branching, competition is “exported” to concentrated markets. In this way, allowing banks to branch interstate would be procompetitive.

The preceding argument establishes in theory that bank branching furthers competition. But is this effect of branching on competition sig-

²³ Of course, there may be some customers for whom limited branching imposes minimal inconvenience. These customers would not require compensation for lost convenience. A bank may choose to specialize in serving these customers by defining itself as a “no-frills” bank, offering lower fees and/or higher rates but few amenities.

²⁴ I am grateful to Sherrill Shaffer for suggesting the idea that branching restrictions may cause inefficient nonprice competition.

²⁵ For a formalization of this argument, see Calem and Nakamura (1993).

nificant in practice? Empirical evidence indicates that it is. In particular, comparison of unit banking states to branching states with respect to within-state, cross-market differences in bank deposit interest rates indicates larger differentials in unit banking states. This is precisely what one would expect to find if branching is accompanied by consistency in pricing across local markets.

Table 3 reports statistics pertaining to within-state, cross-market differences in money market deposit account interest rates. The statistics are based on Federal Reserve survey data from 1985.²⁶ We compute the mean and standard error of these interest rate differentials for randomly selected pairs of banks from states that, in 1985, had severe restrictions on branching (pairs from "unit banking states"), and we do likewise for all other pairs (drawn from "branching states").²⁷ Paired banks are drawn from distinct markets within the same state. As indicated in the table, cross-market interest rate differentials are larger in unit banking

states.²⁸ This finding is consistent with the view that branching reduces price disparities across local markets.²⁹

Additional evidence is found in Mester (1987). Mester's study examines how competition among S&Ls varies across local markets in California. The study presents evidence that competition is "exported" to concentrated markets where rival S&L branch networks meet. Specifically, S&L deposit interest rates are found to be lower in markets (counties or MSAs) that are highly concentrated, but this effect is less pronounced if the market contains local branches of statewide institutions.

Interstate Branching and De Novo Entry. Nationwide interstate branching would further stimulate competition to the extent that it promotes de novo entry. In contrast to entry

²⁸ The difference between the two means is statistically significant at the 1 percent level.

²⁹ Calem and Nakamura (1993) confirm this finding in the more rigorous context of a multivariate analysis and repeat the analysis using 1990 data, obtaining qualitatively the same result.

²⁶ Data are obtained from the Federal Reserve's 1985 Monthly Survey of Selected Deposits and Other Accounts. We report statistics based on bank MMDA rates averaged over August, September, and October.

²⁷ As recently as 1985, 13 states had severe restrictions on bank branching: Colorado, Illinois, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, North Dakota, Oklahoma, Texas, West Virginia, and Wyoming. In each of these states, more than 97 percent of statewide deposits were in banks with fewer than 10 branches. Since then, each of these states has eliminated or at least relaxed its in-state branching restrictions.

TABLE 3
MMDA Interest Rate Differentials
for Randomly Paired Banks
(Cross-Market Pairs)

	Unit Banking States	Branching States
Mean Rate Differential	.38	.22
No. of Pairs in Sample	48	114
Standard Error	.06	.02

via acquisition of an existing bank or branch, the establishment of a *de novo* bank or branch has an immediate, direct impact on market concentration, increasing the number of competitors.

Would the elimination of the legal constraints on interstate branching lead to substantial *de novo* entry into local banking markets? Very likely the answer is yes, assuming that these restrictions are lifted unconditionally or not in a way that would result in legal obstacles to *de novo* entry. *De novo* entry via branching can be less costly than entry at the holding company level via the creation of a new bank subsidiary, which, in turn, generally is less costly than the establishment of a new institution directly by investors. Hence, elimination of legal constraints on interstate branching would expand the number of potential *de novo* entrants into any given banking market.³⁰

Recent history provides evidence that easing of geographic constraints on banks is a stimulus to *de novo* entry. In a carefully executed, empirical study covering the period 1976-1988, Amel and Liang (1993) find a substantial, positive relationship between the number of *de novo* bank branches established in a state and the lifting of restrictions on in-state branching or on entry by out-of-state bank holding companies.³¹

IMPACT ON CREDIT ALLOCATION

Much of the controversy surrounding interstate branching concerns the impact it may

³⁰ Similarly, repeal of the Douglas Amendment, to allow a bank holding company to establish a *de novo* subsidiary in any state, would eliminate an additional, important barrier to entry.

³¹ Amel and Liang also find that *de novo* bank entry into local markets declined subsequent to relaxation of state-wide branching restrictions, presumably because branch entry is a less costly substitute for bank entry. However, bank entry did not decline in this case as much as branch entry increased.

have on the allocation of credit. Opponents of interstate branching fear that large multistate institutions will be less oriented toward small businesses and will siphon funds away from local community needs. Therefore, to the extent that small independent banks are replaced by these large institutions, small businesses will suffer.

There may be some truth to the notion that smaller banks are more oriented toward small-business lending than larger organizations. To some degree, all banks function as "information specialists," uniquely suited to evaluate credit risks and monitor borrowers.³² Thus, banks in general lend to a more diverse group of borrowers than, for instance, the bond market. Naturally, however, there are differences among individual banks with respect to their informational roles. In general, small banks produce small-business loans more efficiently than large banks, while large banks have a comparative advantage at lending to medium-size or large borrowers.³³ Empirical evidence shows that small businesses depend more heavily on small or medium-size banks.³⁴

³² See Calem and Rizzo (1992) for discussion of (and empirical evidence on) the role of banks as information specialists.

³³ At large banking organizations the lending process tends to be more streamlined, with lenders relying more heavily on standardized underwriting formulas. This favors large and medium-size firms, which are better able to supply information in a standardized form.

In a large multistate banking organization, local branch personnel typically have little discretion in their decision-making, while nonlocal personnel who are less constrained may be less well informed about or less sensitive to the needs of the local economy. Community banks, on the other hand, tend to be more flexible, better able to acquire and respond to specialized information about small local borrowers.

³⁴ For example, according to Danielson (1992), Barnett Banks (a Florida-based superregional) "claims relationships with 42 percent of Florida companies with annual

But are small institutions in danger of disappearing from the banking scene? Large institutions may, indeed, enjoy a cost advantage relative to small, community banks, in part because lending to small business may be a more costly activity (involving higher expenses per dollar loaned). Also, many small banks may have to pay more for deposits because they do not offer the convenience of a branch network (although others may attract sufficient deposits by offering more personalized service as a substitute for convenience). Large banks also may enjoy economies of scale with respect to advertising and marketing activities. Nevertheless, small banks will continue to coexist with large institutions, even under interstate branching, as long as they have a critical role to play in small-business lending. That is, small banks would remain profitable because small businesses would be willing to pay for their services.

Thus, there is little reason to believe that interstate branching will bring about the demise of independent community banks. To the extent that these banks are particularly responsive to the needs of small businesses and local communities, there will be enduring demand for their services, and they will continue to occupy profitable niches.

Indeed, thus far, fears that unfettered geographic expansion by large banking organizations would lead to the demise of community banks have proven groundless. For example, banks in California have enjoyed unrestricted statewide branching since 1927, and the state has had a regional interstate banking law since 1987; five of the 25 largest banking organiza-

sales exceeding \$50 million, and with 30 percent of firms with sales from \$5 million to \$49 million annually. Its share with smaller companies, however, is only 12 percent, reflecting small bank strengths in this vital market."

Nakamura (1993) argues that smaller banks have a comparative advantage at lending to small borrowers. He summarizes existing empirical evidence and presents new evidence in support of this view.

tions in the U.S. currently operate subsidiaries there. Nevertheless, California has 442 banking institutions having less than \$1 billion in assets, including 343 community banks with less than \$200 million in assets, and these banks appear reasonably profitable.³⁵ Another example is Florida, which has permitted statewide branching for most of the last two decades, and which has had a regional interstate banking law since 1984.³⁶ As reported by Danielson (1992), "four superregionals now control more than half of the state's deposit base. But these regional giants face stiff competition from more than 300 community banks." Community banks have also held their own vis-a-vis superregionals and other large banks in North Carolina, which, like Florida, has long had statewide branching and has had regional interstate banking since 1984. In North Carolina "roughly 90 banks with assets less than \$1 billion registered an average return on assets of 1.05 percent for the first three quarters of last year exactly the same as the nine banks with assets of \$1 billion or more."³⁷

Further, while smaller banks may be somewhat more oriented toward small-business lending than larger organizations, it is certainly not

³⁵ Only 18 banking organizations in the state have more than \$1 billion in assets. These numbers are as of December 31, 1992.

According to Zimmerman (1990), California's community banks earn returns on assets "roughly comparable to those of larger rivals." According to Zimmerman (1992), after 1990, as the recession took hold and earnings at California banks declined across all size categories, larger banks suffered the steepest declines.

³⁶ Until 1990, Florida permitted statewide branching only through merger.

³⁷ See Bill Atkinson, "Small Carolina Banks Thrive in a Land of Giants," *American Banker*, February 9, 1993, p. 6. Another state where community banks have held their own, despite statewide branching by large banks, is New York. See King (1985).

the case that large banking organizations have no stake in lending to small businesses. In fact, according to Svare (1992), a number of large interstate banking institutions, such as Albany-based KeyCorp and Minneapolis-based Norwest, have strategically targeted consumers and small to midsize businesses. These institutions have sought to maintain flexibility and a local orientation through decentralized decision-making.

Large banks also engage in small-business lending as a way to meet their responsibilities under the federal Community Reinvestment Act (CRA). The CRA requires that every bank meet the credit needs of its entire community, to a degree consistent with safe and sound banking practices. Large banks' efforts to comply with the CRA generally include lending to small businesses and funding community development projects.³⁸ These efforts are likely to increase in the future because regulators are placing greater emphasis on banks' CRA obligations. If, however, multistate banks come to dominate some local market and act contrary to the interests of the local community, that case can be addressed through regulatory enforcement of the CRA.

While interstate branching may have the potential to harm local borrowers, it also has the potential to benefit them. In particular, a multistate bank may be in a better position to import funds into a community to finance a major local project. First, the geographically diversified bank can tap into its deposit base outside of the local community as an alternative to the national funds markets. Second, larger banks may have access to larger amounts of funds in the national markets, at lower cost, as compared with small, community banks, holding other factors (such as bank capital

ratios) constant.³⁹ Smaller banks may be perceived as greater credit risks by the funds markets because their asset portfolios tend to be less diversified and because they are less well known.⁴⁰

CONCLUSION

Removal of legal barriers to interstate branching would benefit consumers of banking services. Consumers in multistate areas would gain more convenient access to their accounts and related services. In addition, elimination of these barriers would enhance competition in banking, benefiting consumers through more favorable interest rates and fees. Also, interstate branching may facilitate the importation of funds into areas where credit demand is particularly strong.

Interstate branching raises some concerns regarding domination of local markets by large multistate banks that would be less oriented toward community credit needs. These concerns have been overstated, however. The evidence indicates that as long as there is sufficient demand for the credit services of community banks, there will be a profitable niche for these banks to occupy. And most large interstate organizations will seek to remain responsive to the needs of local customers.

As multistate organizations increase in number, size, and breadth, a few of them may become insensitive to community credit needs.

³⁹ For theory and evidence on the relationship between bank size and access to the federal funds market, see Allen and Saunders (1986) and Allen, Peristiani, and Saunders (1989).

⁴⁰ In addition, small-business borrowers, along with other small-bank customers, will obtain the convenience benefits described previously if small banks choose to branch interstate. It seems very likely that some small banks in multistate locales will establish out-of-state branches, just as some small holding companies have chosen to establish out-of-state subsidiaries (recall Table 2).

³⁸ For a detailed discussion of the CRA and related issues, see Calem (1989).

But through existing regulations governing community reinvestment, regulators have the ability to safeguard community interests. On balance, available evidence indicates that the removal of interstate branching restrictions would be advantageous to consumers.

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