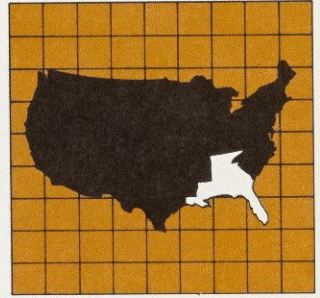


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Economic Review



FEDERAL RESERVE BANK OF ATLANTA

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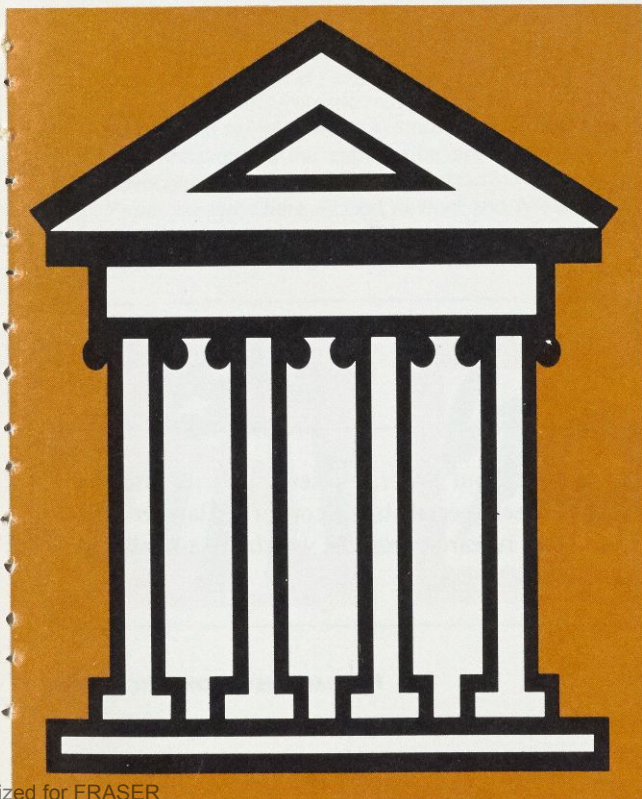
BANKING A New Game in Southeast

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NOW PRICING Perspectives and Objectives

WORKING PAPER REVIEW History of Supply-Side Theory and Practice



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NEW GAME IN TOWN

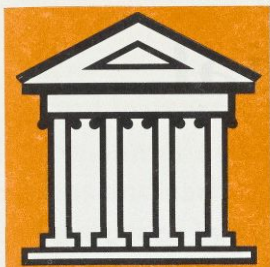
PERSPECTIVES FOR DISINFLATION

BLACK YEAR

PERSPECTIVES AND OBJECTIVES

HISTORY OF SUPPLY-SIDE
THEORY AND PRACTICE

The purpose of the *Economic Review* is to inform the public about Federal Reserve policies and the economic environment and, in particular, to narrow the gap between specialists and concerned laymen. For more specialized readers, the *Review* also summarizes our basic research projects, which are available in complete form in our Research Paper and Working Paper series.



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Associate Director: William N. Cox
Business Editor: Gary W. Tapp
Production and Graphics:
Susan F. Taylor and Eddie W. Lee, Jr.

A Primer on Financial Institutions in the Sixth District States

by B. Frank King

Savings and loan associations, mutual savings banks and credit unions are gaining significant new powers to serve customers. When they gain these powers, they will be able to begin competing with commercial banks for several new kinds of consumer business. More importantly, they will be able to offer a broad line of consumer services, formerly the exclusive province of commercial banks.

New Powers

The Depository Institutions Deregulation and Monetary Control Act, signed in March 1980, did much to provide the opportunity for four distinct types of financial institutions to offer virtually identical services to consumers. All depository institutions in all parts of the country were granted powers to offer NOW accounts to individuals (see Table 1). Federally insured credit unions were allowed to offer share drafts. These powers complement each type of institution's already existing powers to offer time and savings deposits or their equivalent.

On the lending side, Federally chartered savings and loan associations received new powers to offer second mortgages, credit cards, and consumer instalment credit—direct and indirect, secured and unsecured. They were also allowed to offer trust services and operate remote automated service facilities. Many states are changing their laws to give state chartered thrift institutions comparable powers. Federally insured credit unions had earlier been empowered to offer long-term residential mortgages. Thus, commercial banks, savings and loan associations, mutual savings banks and credit unions will have

parallel powers in consumer lending and peripheral services as well as parallel consumer deposit powers.

At least the early development and implications of this new competition among banks, thrift institutions and credit unions will be influenced by what these institutions, individually and collectively, look like today. Information on these institutions may be found in various places; the problem in making comparisons is that the pertinent details for all three types of institutions are

Table 1. Changing Powers of Depository Institutions Under Federal Regulations

Power	Institution		
	Banks	S&Ls	Credit Unions
Transactions Accounts	■	▨ ¹	▨ ²
Time and Savings Accounts	■	■	■
Consumer Instalment Loans	■	▨	■
Second Mortgages	■	▨	■
Credit Cards	■	▨	■
Long-Term Residential Mortgages	■	■	■
Trust Powers	■	▨	■
Remote ATMs	■	▨ ²	■

■ existing power
 ▨ new power

¹Already allowed in New England, New York and New Jersey

²Permanent authority

Savings and loan associations, credit unions, and commercial banks will have parallel consumer deposit and consumer lending powers beginning in 1981. The dimensions and early development of the new competition in the Sixth District will be influenced by the comparative size, structure, and powers of these institutions before deregulation.

seldom presented in one place. To facilitate such comparisons, this article presents in tabular form the basic structural elements of these institutions in the Sixth Federal Reserve District states. In addition, it outlines some of the outstanding features and differences in the structures of those institutions.

Areas of Competition

Although banks offer a broader line of consumer financial services than either savings and loan associations or credit unions, they already compete with them for some types of consumer business (see Table 2).¹ On the

deposit side, a few savings and loan associations offer telephone bill payment systems that are at least partial substitutes for demand deposit balances at commercial banks. In addition, 144 of the region's 2,673 credit unions currently offer share drafts, which are also a demand deposit substitute. Nevertheless, banks still hold the predominant volume of transaction account business done by the three types of institutions.

The story differs, however, when we consider consumer time and savings accounts. All three institutions offer these, and in three southeastern states, savings and loans and credit unions combined hold a majority. In Florida they hold 70 percent.

Lending competition also exists among the three types of institutions, but it is done on a

¹Since no mutual savings banks have headquarters in the region, they will be ignored in the presentation.

Table 2. Percentage of Various Types of Consumer Business in Savings and Loan Associations, Credit Unions and Commercial Banks (December 31, 1979)

	<i>Total Deposits and Share Accounts</i>			<i>Consumer Time and Savings Deposits</i>			<i>Consumer Loans</i>			<i>Single-Family Residential Mortgages</i>		
	<i>S&Ls</i>	<i>Credit Unions</i>	<i>CBs</i>	<i>S&Ls</i>	<i>Credit Unions</i>	<i>CBs</i>	<i>S&Ls</i>	<i>Credit Unions</i>	<i>CBs</i>	<i>S&Ls</i>	<i>Credit Unions</i>	<i>CBs</i>
Alabama	22	5	73	35	8	57	1	24	75	88	n.a.	12
Florida	51	2	47	67	3	30	3	21	76	94	n.a.	6
Georgia	32	3	65	51	5	44	2	15	83	89	n.a.	11
Louisiana	26	2	72	47	4	49	2*	17	81	89	n.a.	11
Mississippi	19	3	78	32	4	64	1*	12	87	82	n.a.	18
Tennessee	22	3	75	36	4	60	2	14	84	80	n.a.	20

*Estimated.

more specialized basis. Credit unions, with very small contributions by savings and loan associations, hold at least 13 percent of the consumer loans on the books of the three types of institutions in each state in the region and as much as a quarter of those loans in Alabama and Florida. Savings and loan associations, with negligible contributions by credit unions, hold at least four-fifths of the single family residential mortgages made by the three types of institutions in each state of the region.

Comparative Size and Structure

The region has a combined total of 4,957 banking organizations, savings and loan associations and credit unions (see Tables 3, 4 and 5).² A majority of these institutions are credit unions: banks make up the second largest of the three groups. Tennessee, Louisiana and Florida have particularly large numbers of credit unions relative to the other institutions. The credit unions do not typically operate branch offices, while the banks and savings and loan associations generally do. Thus, these latter institutions are found in many more places in the region. Banks overall have greater office density, with up to five times as many offices as savings and loans, as in Tennessee, and not less than one and one-third times as many offices, as in Florida.

Though credit unions are most numerous, they take a back seat to both other types of institutions in both aggregate and individual size. In the aggregate, banks exceed the other institutions in deposits in each state in the region except Florida. There, savings and loan associations have a higher total. Banks have the largest edge in Mississippi. Credit unions bulk small, accounting for less than 3 percent of total deposit and share liabilities of the three types of institutions in each state except Alabama.

When we observe individual institutions, banks' dominance in size largely disappears. The median savings and loan association exceeds the median banking organization in total deposits in four of the region's six states.

²Each multibank holding company is considered a single banking organization although it owns more than one bank. Groups of institutions under the same noncorporate ownership are considered to be individual institutions because we lack complete information on this form of organization. (Since Tables 3, 4 and 5 contain much more detailed information than the discussion in the text, they are presented separately at the end of this article.)

In Florida and Georgia the race is not close. The median savings and loan association is more than seven times larger than the median banking organization in Florida, almost three times larger in Georgia. In addition, savings and loan associations are among the ten largest depository financial institutions in each state but Louisiana. Individual credit unions, on the other hand, are generally quite small. The median union has share accounts of considerably less than \$1 million in each of the region's states.

Institutions with lower population and personal income per office generally offer more convenience to persons and institutions that demand their services. In a more dynamic context, these lower numbers may identify the institutions that have taken most advantage of their expansion potential. Generally, banks have lower population and personal income per office figures than savings and loans and credit unions. Savings and loan associations generally rank next-to-lowest.

Credit unions and savings and loan associations are much more concentrated in metropolitan areas than are commercial banks. Only Mississippi—the District state with the least population in metropolitan areas—has a majority of credit unions headquartered outside standard metropolitan statistical areas (SMSAs). The volume of credit union shares is even more concentrated in metropolitan areas. Savings and loan associations are almost as concentrated in the metropolitan areas as are credit unions. Again, only in Mississippi are a majority of these institutions, their offices and their deposits located outside metropolitan areas.

Banks are much less concentrated in the cities. A majority of banks in each of the six states have offices outside of SMSAs. Although a majority of bank offices and deposits are in metropolitan areas in each state except Mississippi, the banks' percentages are generally much lower than those of credit unions or savings and loans.

Commercial banks may organize multibank holding companies in Alabama, Florida, Georgia and Tennessee. Savings and loan associations and credit unions may not join multi-institution organizations; however, savings and loans may engage in statewide branching. Although only Florida has even close to a majority of its banks in multibank companies, a majority of bank deposits in

10 Largest Depository Financial Institutions by State

Mississippi

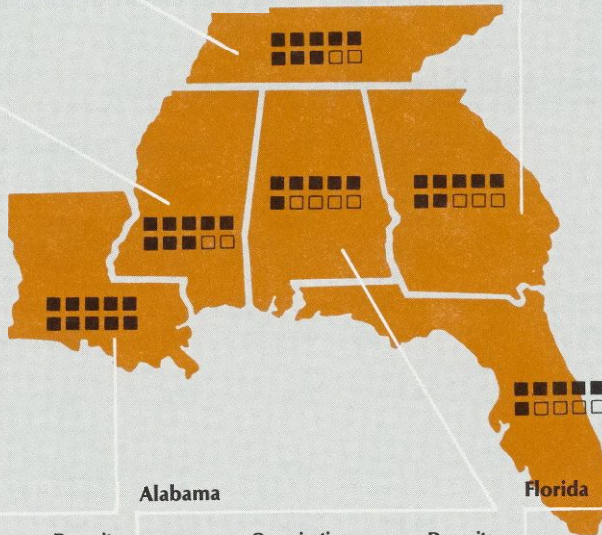
Organization	Deposits (mil. \$)
■ Deposit Guaranty National Bank, Jackson	1,132
■ First National Bank of Jackson	1,009
□ Unifirst Federal Savings and Loan Association, Jackson	492
■ Grenada Bank	391
■ First Mississippi National Bank, Hattiesburg	328
■ Bank of Mississippi, Tupelo	293
■ Hancock Bank, Gulfport	283
■ Mississippi Bank, Jackson	258
□ First Magnolia Federal Savings and Loan Association, Hattiesburg	236
■ Peoples Bank and Trust, Tupelo	181

Tennessee

Organization	Deposits (mil. \$)
■ First Tennessee National Corporation, Memphis	2,145
■ Tennessee Valley Bancorp, Nashville	1,513
■ First American Corporation, Nashville	1,500
■ Third National Corporation, Nashville	1,429
■ Union Planters National Bank, Memphis	765
□ Leader Federal Savings and Loan Association, Memphis	760
■ Ancorp Bancshares, Chattanooga	644
■ National Bank of Commerce, Memphis	567
■ United American Bank in Knoxville	473
□ Home Federal Savings and Loan Association, Knoxville	410

Georgia

Organization	Deposits (mil. \$)
■ The Citizens and Southern National Bank, Savannah	3,030
■ Trust Company of Georgia, Atlanta	2,067
■ First Atlanta Corporation	1,974
□ Georgia Federal Savings and Loan Association, Atlanta	1,286
□ Fulton Federal Savings and Loan Association, Atlanta	894
□ Decatur Federal Savings and Loan Association	865
■ The Fulton National Corporation, Atlanta	806
■ First Railroad and Banking Company, Augusta	481
■ National Bank of Georgia, Atlanta	348
■ CB&T Bancshares, Columbus	340



■ Commercial Banking Organization
□ Savings and Loan Association

Louisiana

Organization	Deposits (mil. \$)
■ Whitney National Bank of New Orleans	1,354
■ Hibernia National Bank in New Orleans	737
■ First National Bank of Commerce, New Orleans	713
■ First National Bank, Shreveport	577
■ Commercial National Bank in Shreveport	542
■ Louisiana National Bank of Baton Rouge	530
■ American Bank and Trust Company, Baton Rouge	465
■ Bank of New Orleans and Trust Company	443
■ Calcasieu Marine National Bank, Lake Charles	429
■ Fidelity National Bank of Baton Rouge	405

Alabama

Organization	Deposits (mil. \$)
■ Alabama Bancorporation, Birmingham	2,128
■ First Alabama Bancshares, Montgomery	1,529
■ Southern Bancorporation of Alabama, Birmingham	1,518
■ Central Bancshares of the South, Birmingham	1,456
■ First Bancgroup-Alabama, Mobile	658
■ Southland Bancorporation, Mobile	606
□ City Federal Savings and Loan Association, Birmingham	476
□ First Southern Federal Savings and Loan Association, Mobile	451
□ Jefferson Federal Savings and Loan Association, Birmingham	375
□ Guaranty Savings and Loan Association, Birmingham	236

Florida

Organization	Deposits (mil. \$)
■ Southeast Banking Corporation, Miami	3,873
■ Barnett Banks of Florida, Jacksonville	3,287
■ Sun Banks of Florida, Orlando	2,553
□ Amerifirst Federal Savings and Loan Association, Miami	2,056
■ Florida National Banks of Florida, Jacksonville	1,873
□ First Federal Savings and Loan Association of Broward County	1,824
■ Flagship Banks, Miami Beach	1,601
■ Atlantic Bancorporation, Jacksonville	1,538
□ Dade Savings and Loan Association	1,466
□ Florida Federal Savings and Loan Association, St. Petersburg	1,390

(December 31, 1979)

Alabama, Florida and Georgia are held by banks in multibank companies.

Comparing the data on median size of institutions in each state with the sizes shown on our listing of each state's ten largest depository institutions (see page 7) indicates a considerable size disparity within both banks and savings and loan associations. Credit unions share the size disparity. With few exceptions, the three largest of each type of institution in each state hold more than a quarter of that type of institution's business in the state, the five largest hold more than 35 percent, the ten largest hold more than 45 percent and the twenty largest hold more than 60 percent.

Taken together, these pieces of information on commercial banks, savings and loan associations and credit unions present a broad

outline of the structure of these institutions. In this region, these three types of financial institutions are already active in each state. In some lines of consumer business, and in some states, commercial banks already hold smaller shares of markets for consumer financial services than savings and loan associations. When aggregated, banks are generally the largest institutions; however, individually, savings and loan associations are more often than not larger than commercial banking institutions. Credit unions are generally quite small. Within each type of institution, however, size disparity is very large.

Commercial banks have a substantially greater number of offices than do savings and loan associations or credit unions (compare Tables 3, 4 and 5). The banks, however, are much less concentrated in metropolitan areas than the credit unions and savings and loans. **ER**

Table 3. Commercial Banks, Sixth District States (December 31, 1979)

	<u>Alabama</u>	<u>Florida</u>	<u>Georgia</u>	<u>Louisiana</u>	<u>Mississippi</u>	<u>Tennessee</u>
Banking Organizations	247	328	399	256	183	307
Bank Offices	895	1,540	1,280	1,025	851	1,351
Banks	317	586	439	258	183	352
Deposits of All Banks (\$ billion)	13.5	36.1	17.3	18.5	9.2	18.5
Deposits of Median Banking Organization (\$ million)	18.1	21.0	15.6	35.3	23.3	19.6
Population per Bank Office (thousand)	4.1	5.8	4.0	3.9	2.9	3.2
Personal Income per Bank Office (\$ million per annual 1979)	29.3	49.2	30.5	29.3	17.6	23.8
Percentage of Banks Headquartered in SMSAs	37.9	76.5	26.2	35.6	15.9	31.8
Percentage of Bank Offices in SMSAs	58.4	82.7	53.8	53.4	21.3	55.2
Percentage of Bank Deposits in SMSAs	64.7	87.7	64.3	69.2	36.1	67.3
Percentage of Banks in Multibank Holding Companies	24.9	48.6	12.3	1.2	0.0	15.3
Percentage of Deposits in Multibank Holding Companies	60.1	69.3	53.6	0.4	0.0	42.1
Percentage of Deposits Held by:						
3 Largest Organizations	38.5	26.9	40.8	15.1	27.2	28.1
5 Largest Organizations	54.1	36.6	48.3	21.1	34.8	39.7
10 Largest Organizations	63.7	52.9	55.8	33.5	45.7	52.1
20 Largest Organizations	68.9	66.5	61.6	48.6	56.5	60.4

Table 4. Savings and Loan Associations, Sixth District States (December 31, 1979)

	<u>Alabama</u>	<u>Florida</u>	<u>Georgia</u>	<u>Louisiana</u>	<u>Mississippi</u>	<u>Tennessee</u>
Associations	62	122	98	125	59	98
Association Offices	240*	1,137*	392*	315	201	270
Savings Capital (\$ billion)	4.1	39.6	8.6	6.6	2.3	5.5
Savings Capital at Median Associations (\$ million)	31.4	156.0	42.9	24.5	18.3	23.6
Population per Office (thousand)	15.3	7.8	13.1	12.8	12.1	16.2
Personal Income per Office (\$ million)	109.5	66.5	98.1	95.4	74.5	118.4
Percentage of Associations Headquartered in SMSAs	54.8	75.4	37.8	60.0	23.7	41.8
Percentage of Offices in SMSAs	69.2	78.5	65.3	74.9	42.3	66.7
Percentage of Deposits in SMSAs	80.4	92.5	72.0	80.1	45.0	80.4
Percentage of Savings Capital Held by:						
3 Largest Organizations	32.1	13.7	35.4	12.0	38.5	28.0
5 Largest Organizations	42.8	20.8	41.9	19.4	47.4	38.6
10 Largest Organizations	60.2	34.7	53.1	32.4	64.0	56.6
20 Largest Organizations	77.7	54.7	67.2	53.2	80.8	73.8

*As of September 30, 1979

Table 5. Credit Unions, Sixth District States (December 31, 1979)

	<u>Alabama</u>	<u>Florida</u>	<u>Georgia</u>	<u>Louisiana</u>	<u>Mississippi</u>	<u>Tennessee</u>
Federally Insured Credit Unions	303	384	342	491	234	231
Share Accounts at All Federally Insured Associations (\$ billion)	.9	1.8	.7	.6	.3	.7
Share Accounts at Median Federally Insured Associations (\$ million)	.6	.6	.4	.3	.2	.6
Population per Credit Union (thousands)	12.1	23.1	15.0	8.2	10.4	19.0
Personal Income per Credit Union (\$ million)	86.6	197.1	114.2	62.0	64.1	139.2
Percentage of Federally Insured Credit Unions in SMSAs	70.6	88.3	63.2	75.8	39.3	61.0
Percentage of Shares of Federally Insured Credit Unions in SMSAs	85.0	90.6	82.6	85.6	68.2	87.2
Percentage of Shares Held by:						
3 Largest Federally Insured Credit Unions	29.8	23.5	29.1	12.8	34.8	25.2
5 Largest Federally Insured Credit Unions	38.0	31.8	36.4	17.3	42.4	38.4
10 Largest Federally Insured Credit Unions	49.4	43.8	48.1	26.2	57.6	53.6
20 Largest Federally Insured Credit Unions	65.7	60.0	60.6	39.2	70.6	68.7
State Insured Credit Unions	0	238	124	0	0	326

Southeastern Farmers Face Bleak Prospects

by Gene D. Sullivan

Although all the 1980 farm crops may not be marketed until well into 1981, it is already apparent that southeastern farmers will have sustained a sharp loss in gross income in 1980, resulting from a combination of several factors. The most widely recognized source of difficulty is the prolonged drought and record-breaking high temperatures that plagued most of the area from early June through September. Although prices advanced as the extent of potential crop shortages became recognized, the combination of extreme heat and moisture deficiency reduced crop yields severely enough to cut into prospective crop income.

Livestock producers also encountered problems from the drought, but their major difficulties occurred before the onset of dry, hot weather when a large increase in output depressed prices of products and caused producers, especially of hogs and broilers, to chalk up substantial losses during the first half of the year. Those low returns were then aggravated by the dry weather which shortened feed supplies and raised costs of livestock rations when returns were already depressed. In addition, extreme heat increased animal stress and resulted in slower rates of gain and/or reduced productivity. Death losses also rose, shrinking further the

Table 1. Planted Acreages of Selected Crops in 1980 and Indicated Changes from 1979.
Southeastern farmers expanded acres planted for crops.

	Sixth District States			United States		
	Planted Acreage 1980	Increase or Decrease from 1979		Planted Acreage 1980	Increase or Decrease from 1979	
	(000 acres)	(000 acres)	%	(000 acres)	(000 acres)	%
Soybeans	15,375	+ 315	+ 2	70,280	- 1,306	- 2
Corn	3,624	- 39	- 1	83,478	+ 3,467	+ 4
Cotton	2,486	+ 238	+ 11	14,338	+ 390	+ 3
Wheat	1,970	+ 943	+ 110	80,925	+ 9,367	+ 13
Peanuts	815	- 2	- 0	1,545	- 5	- 0
Rice	805	+ 65	+ 9	3,310	+ 310	+ 10
Oats, Barley, and Rye	736	- 101	- 12	24,106	- 1,177	- 5
Grain Sorghum	357	+ 60	+ 20	15,844	+ 445	+ 3
Total	26,168	+ 1,479	+ 6	293,826	+ 11,491	+ 4

Source: USDA, *Acreage*, June 1980.

When all the returns for 1980 are in, southeastern farmers will have suffered heavy financial losses. A long drought and blistering temperatures reduced yields, while higher energy and interest costs pushed overall production costs sharply higher. Price increases for most crops were not enough to make up for the losses in revenue.

volume of livestock products that southern farmers had for sale during the summer.

Production Costs Up Sharply

At the same time that drought was reducing income, other factors contributed to a rapid escalation of production costs during 1980. The abrupt rise in energy costs spread to a broad range of farm inputs. In addition, interest costs reached unusually high levels during the spring when farmers typically borrow heavily to purchase inputs for the upcoming season's crop production.

Southeastern farmers had planned to expand significantly output of several crops during 1980. Although some price declines early in the year were attributed to the embargo on exports to Russia, prospective returns remained sufficiently high to more than cover variable costs of production, so farmers expanded 1980 plantings of soybeans, cotton, rice, and grain sorghum. (U. S. farmers differed mainly by reducing soybean and expanding corn acreage. See Table 1.) Wheat acreage had already been expanded dramatically during the fall of 1979 in response to the unusually attractive prices existing during the planting season. Fortunately, the wheat

Table 2. Acreage of Selected Crops for Harvest in 1980 and Changes from Acreage Planted.
After the drought, acres harvested dropped sharply in the Southeast and nation.

	Sixth District States			United States		
	Acreage for Harvest 1980	Increase or Decrease from Acreage Planted		Acreage for Harvest 1980	Increase or Decrease from Acreage Planted	
	(000 acres)	(000 acres)	%	(000 acres)	(000 acres)	%
Soybeans	14,165	- 1,210	- 8	67,307	- 2,973	- 4
Corn	2,757	- 867	- 24	71,193	- 12,285	- 15
Cotton	2,415	- 71	- 3	13,287	- 1,051	- 7
Wheat	1,635	- 335	- 17	71,627	- 9,298	- 11
Peanuts	789	- 26	- 3	1,495	- 50	- 3
Rice	857	+ 52	+ 1	2,869	- 441	- 13
Oats, Barley, and Rye	212	- 524	- 71	16,928	- 7,178	- 30
Grain Sorghum	186	- 171	- 48	12,147	- 3,697	- 23
Total	23,016	- 3,152	- 12	256,853	- 36,973	- 13

Source: USDA, *Acreage*, June 1980, and *Crop Production*, October 1980.

crop was largely mature before the onset of the drought, and it escaped the yield reductions suffered by summer-growing crops.

But even before the planting season had been completed, dry weather was already beginning to impact major crops other than wheat. Soybeans that were to be planted following the wheat crop either did not emerge to a stand or were never planted because of a lack of moisture. The corn crop was rapidly withering during the crucial fruiting stage, and considerable acreage was either cut for silage or was abandoned. Acreages of other crops were abandoned as well, so that the October 1980 survey of crop production revealed that acres for harvest were 12 percent lower than the planted acreage reported in June. (U. S. acreage dropped by 13 percent — see Table 2.) Corn acreage in District states was down by 867,000 acres in October, and soybeans were 1,210,000 acres below the plantings reported in June.

If yields in 1980 had reached the average level of the previous three years and if crop prices had remained at their spring-time levels, southeastern farmers would have realized substantially higher incomes from most crops in 1980 than in 1979.

But the drought that grew progressively more severe as the summer unfolded sharply reduced crop production prospects. Abandonment of planted acreages combined with sharp yield reductions on remaining acreages to reduce production of most crops both from expected levels at planting time and from levels obtained in 1979 when fewer acres were planted.

Final figures for 1980 yields, as well as incomes, will not be available until 1981, but yields of District soybeans are estimated to be down about one-third from 1979's level, and total 1980 production in District states is off by slightly more than a third in spite of an increase in acreage planted (see Table 3). U. S.

Table 3. Production of Selected Crops in 1979 and Indications for 1980.

The drought severely cut production of most crops; much of wheat crop was mature before drought's onset.

Sixth District States			United States		
1979	Indicated October 1980	Increase or Decrease from 1979 to 1980	1979	Indicated October 1980	Increase or Decrease from 1979 to 1980
(000 units)		%	(000 units)		%
Soybeans (bu.) 407,472	260,560	- 36	2,267,647	1,757,272	- 23
Corn (bu.) 209,846	121,684	- 42	7,763,771	6,466,622	- 17
Cotton (bales) 2,778	2,138	- 23	14,629	11,589	- 21
Wheat (bu.) 22,536	54,630	+ 142	2,141,732	2,361,621	+ 10
Peanuts (lb.) 2,495,385	1,409,660	- 44	3,980,440	2,500,860	- 37
Rice (cwt.) 29,027	30,495	+ 5	136,667	142,808	+ 4
Tobacco (lb.) 229,075	241,686	+ 6	1,526,682	1,788,823	+ 17
Grain Sorghum (bu.) 6,562	7,042	+ 7	814,308	547,060	- 33

Source: USDA, **Crop Production**, October 1980.

production was reduced by about one-fourth, part of which reflected a reduction in acreage.

The corn crop, damaged most severely in the Southeast, suffered a one-third reduction in average yields per acre in District states and a 42-percent reduction in total output from 1979's level. Planted acreage was nearly the same as a year ago, but abandonment was heavy, so that acreage to be harvested for grain dropped 10 percent from a year ago. Total U. S. production is estimated to be 17 percent below a year earlier in spite of a 4-percent increase in plantings.

Cotton yields were down 30 percent in District states, and total production fell by 23 percent from 1979's level, even though acreage harvested was 13 percent above a year ago. It is estimated that total U. S. production will fall by about the same proportion, reflecting heavy damage to the crop in the major producing areas of the Plains states.

Peanut production was cut by about 40 percent in both the District and the nation, and through October average prices had not risen enough to offset much of the loss.¹ Gross income in the District is indicated to be down nearly \$225 million from 1979's level. Damage was also inflicted on yields of rice, tobacco, grain sorghum, and hay crops, but so far, these reductions do not appear to be as large or as consequential as those for corn, cotton, peanuts, and soybeans.

Production Costs Exceed Returns for Most Crops

The ultimate damage to growers from reduced output depends upon what happens to prices received and the income from the sale of the crop. Prices for nearly all southeastern crops rose after the onset of the drought, and these increases offset some of the indicated reductions in income that would otherwise have occurred (see Table 4). The price of soybeans increased 26 percent from its seasonal average level during 1979. Several other crops also had large price increases: 22 percent for grain sorghum, 23 percent for cotton, and 22 percent for corn. Prices of

wheat, rice, tobacco, and peanuts registered relatively small changes from a year ago.

Since production losses were substantially greater than price increases for both soybeans and corn, indicated income reductions from 1979's levels for those two crops alone exceed \$670 million (see Table 5). But the price gain for cotton nearly offset the production decline, so income losses were not so large. Large production gains and relatively stable prices for wheat raised indicated income for that traditionally rather insignificant crop by \$136 million. In total, however, cash receipts from eight major District crops fell by an estimated \$760 million in 1980, which compares with a much smaller decline expected at planting time and a gain of nearly \$1.0 billion from 1978 to 1979.

The outlook for net returns of southeastern crop farmers is considerably bleaker than that for total returns. Expenditures for 1980 crops rose sharply not only because of the increase in acreage planted but also because of a brisk rise in costs of production items from early 1979's levels. Fuel costs in March of 1980 were nearly double the level of a year ago, and all costs were up an estimated 20 percent or

Table 4. Average Prices Received for Selected Crops, Sixth District States.

Most prices rose after drought, partially offsetting income reductions caused by lower production.

	Season Average 1979	Harvest* 1980	Increase or Decrease from 1979 to Harvest 1980
	(\$ per unit)		%
Soybeans (bu.)	6.28	7.92	+ 26.1
Grain Sorghum (cwt.)	4.28	5.24	+ 22.4
Wheat (bu.)	3.86	4.09	+ 6.0
Cotton (lb.)	.64	.79	+ 23.4
Corn (bu.)	2.85	3.47	+ 21.8
Rice (cwt.)	11.00	10.45	- 5.0
Tobacco (lb.)	1.418	1.483	+ 4.6
Peanuts (lb.)	.207	.209	+ 1.0

¹Brisk increases in peanut prices were reported in late November, but industry spokesmen state that most of 1980's crop was marketed under contracts arranged in advance of the price upturn.

*The average of prices received during September and October.

Source: USDA, **Agricultural Prices**, various months, 1980.

more from the comparable year-earlier period. Thus, the reduction in total crop revenue is combined with a sharp increase in production expenditures, resulting in net losses for most of the major crops grown in 1980.

Based on recent price levels and yield projections, southeastern tobacco producers can expect a positive net return in 1980, but losses face producers of seven other crops (see Table 6). The major losses will be suffered by producers of soybeans, corn, cotton, and peanuts. The deficits will range from \$180 million to \$410 million per crop, although the impact is more severe for producers of peanuts and cotton since their relative numbers are fewer. Altogether, producers of

eight major crops will incur losses estimated at \$1.2 billion from their production efforts in 1980. In other words, projected revenue from crop production will fail to cover 20 percent of total costs (with land costs excluded).

The picture is different for U.S. farmers, primarily because yield reductions for most crops have been proportionately less than price increases for crops. Although cotton, peanut, and grain sorghum producers will incur heavy losses, corn and soybean producers will realize substantial net returns over cost because of the large increase in prices in response to the proportionately smaller decline in production. Producers of wheat, tobacco, and rice will also realize profits. For

Table 5. Prospective Income from Selected Crops in 1980 (estimated in October) compared with 1979 Levels.

Price increases were not enough to keep prospective income for most crops from dropping between June and October.

Sixth District United States		Actual 1979	June 1980	Prospective October 1980	Increase or Decrease from 1979 to June 1980		Increase or Decrease from 1979 to 1980	
					(\$ mil.)	%	(\$ mil.)	%
			(\$ mil.)		(\$ mil.)			
Soybeans	2,559	2,138	2,064	- 420	- 17	- 495	- 19	
	14,037	12,252	13,531	- 1,785	- 13	- 506	- 4	
Corn	598	548	422	- 50	- 8	- 176	- 29	
	18,569	19,959	19,529	+ 1,390	+ 8	+ 960	+ 5	
Cotton	853	1,014	811	+ 160	+ 19	- 42	- 5	
	4,108	4,176	4,417	+ 68	+ 2	+ 309	+ 8	
Wheat	87	210	223	+ 123	+ 142	+ 136	+ 156	
	8,181	6,679	9,659	- 1,502	- 18	+ 1,478	+ 18	
Peanuts	516	468	295	- 47	- 9	- 221	- 43	
	822	813	528	- 9	- 1	- 294	- 36	
Rice	319	368	319	+ 48	+ 15	0	0	
	1,503	1,628	1,492	+ 125	+ 8	- 11	- 1	
Tobacco	326	373	358	+ 47	+ 14	+ 32	+ 10	
	2,174	2,575	2,653	+ 401	+ 19	+ 479	+ 22	
Grain Sorghum	14	30	21	+ 16	+ 116	+ 7	+ 50	
	1,897	2,114	1,602	+ 216	+ 11	- 295	- 16	

Sources: USDA, *Field Crops, Production, Disposition, Value, 1978-1979*, April, 1980; *Acreage*, June 1980; and *Crop Production*, October 1980.

the eight crops in total, the aggregate net return is estimated to be \$6.2 billion, equivalent to nearly 13 percent of total production costs (land excluded).

Livestock Income Depressed

Through the first half of 1980 at least, incomes of southeastern livestock producers have also been depressed. Cash receipts from livestock dropped 4 percent below the comparable year-ago level, after growing by 16 percent in 1979. Producers in Alabama, Georgia, and Mississippi (states most heavily dependent on swine and broiler production) suffered the greatest income losses.

The major reason for falling incomes can be traced to price declines in response to large increases in production (see Tables 7 and 8). Red meat production during the first three quarters in District states grew by 8 percent (with increased hog production offsetting the drop in cattle) over the comparable period in 1979. Prices of hogs and calves averaged 16 percent lower during the same period. Cumulative broiler production and average prices held

Table 6. Projected Total Costs and Returns, Selected Crops, 1980.

All District crops shown except tobacco face net losses for 1980.

	Sixth District States		United States	
	Total* Cost	Total** Return	Total* Cost	Total** Return
	(\$ mil.)	(\$ mil.)	(\$ mil.)	(\$ mil.)
Soybeans	2,476.0	2,063.6	9,727.5	13,531.0
Corn	813.3	477.2	17,958.6	19,529.2
Cotton	1,150.8	810.7	5,152.1	4,416.8
Wheat	224.2	223.4	8,084.0	9,659.0
Peanuts	474.8	294.6	811.6	527.7
Rice	333.2	318.7	1,294.4	1,492.3
Tobacco	256.5	358.4	1,830.9	2,652.8
Sorghum	56.7	20.7	2,362.5	1,602.2
Total	5,785.5	4,567.3	47,221.6	53,411.0

*Excluding land cost.

**Average price at harvest times indicated production.

Sources: USDA, **Acreage**, June 1980, and U.S. Senate Committee on Agriculture, Nutrition and Forestry, **Committee Print 63-5970**, July 1980.

Table 7. Production of Livestock and Products .

Hog production led livestock increases.

	Sixth District States			United States		
	Jan. - Sept. 1979	Jan. - Sept. 1980	Increase or Decrease from 1979 to 1980	Jan. - Sept. 1979	Jan. - Sept. 1980	Increase or Decrease from 1979 to 1980
	(Total Live Weight, except when indicated) (1,000 pounds)		%	(Total Live Weight, except when indicated) (1,000 pounds)		%
Hog Slaughter	1,314,652	1,554,979	+ 18	15,393,796	17,198,807	+ 12
Commercial Cattle Slaughter	954,240	908,488	- 5	26,610,653	26,746,229	+ 1
Young Chicken Slaughter	4,182,916	4,215,198	+ 1	11,428,821	11,581,620	+ 1
Total Poultry	*	*	*	14,027,260	14,358,129	+ 2
Eggs (Mil. Dozen)	973.0	944.5	- 3	4,255.6	4,313.8	+ 1
Milk Production (Mil. lbs.)	5,966	6,044	+ 1	93,797	97,174	+ 4

Sources: USDA, **Livestock Slaughter; Poultry Slaughter; Eggs, Chicken, and Turkeys; and Milk Production**, various months, 1980.

*District data not available.

about even with a year ago, although prices sagged sharply in response to heavy production during the spring.

Precise cost data are not available for livestock producers, but it is certain that production costs increased with the expansion in output. Prices paid for production items averaged 10 percent or more above the year-ago level throughout the first half of 1980. Spokesmen for the swine and broiler production industries verify that producers were incurring heavy losses during the first half of the year.

Gross estimates indicate that, when the final figures are in, total income from broilers, eggs, and cattle, accounting for two-thirds of total income from livestock, will be down by 10 percent in 1980. Receipts from hogs will show little or no gain in spite of a large

increase in output. Income to milk producers, about 15 percent of total livestock income, is protected by government price guarantees, and it will rise by 10 percent in 1980 due mostly to an increase in prices. On balance, total receipts from the livestock sector are estimated to be down 5 percent or more from 1979's level.

1980 Losses are Heavy

In summary, southeastern farmers experienced a year of heavy financial losses in 1980.

Crop production was cut sharply by the extended period of drought, and price increases for crops were not sufficient to make up for the losses in revenue. Livestock producers were already suffering economic adversity resulting from overproduction and low prices before the advent of the drought. With the dry weather, feed supplies were reduced, costs were raised, and livestock growth rates were retarded.

In addition to increased expenditures incurred to expand production of both crops and livestock, costs were also increased by a sharp jump in prices of farm inputs. Unless prices should increase by a substantially greater margin before all the output is marketed, farmers in the Southeast will experience rather large net losses from 1980's production. It now appears that loan carryovers from 1980 will be large because of insufficient cash receipts to repay money borrowed for the 1980 production season. Without special assistance, some farmers are likely to be unable to continue their operations into another year because indebtedness will exceed the value of assets available for securing loans.



Table 8. Average Prices Received for Livestock and Products, Sixth District States.

Most prices fell in response to production increases.

	Jan.-Sept. 1979	Jan.-Sept. 1980	Increase or Decrease 1979 to 1980
	(average price)		%
Broilers (¢ per lb.)	26.3	26.4	+ 0
Calves (\$ per cwt.)	90.89	76.12	- 16
Hogs (\$ per cwt.)	42.91	36.14	- 16
Eggs (¢ per doz.)	62.96	59.12	- 6
Milk (\$ per cwt.)	12.76	13.92	+ 9

Source: USDA, *Agriculture Prices*, various months, 1980.

Deregulation: The Attack on Geographic Barriers

with John M. Godfrey

Geographic restrictions seriously affect banks' ability to compete with S&Ls and nondepository institutions. In response to questions, Research Officer John M. Godfrey explains how the restrictions evolved and how banks were able to partially circumvent the barriers. He also outlines the timing and direction of the changes most likely to be made in the geographic restraints.

Q "Deregulation" has become a focus of controversy in banking recently. Some observers think the recent legislation has not gone far enough, while others believe it may have gone too far. What is the basic thrust of "deregulation" in the banking industry?

A The primary aim of deregulation in any industry is to establish a "level playing field" for all competitors. The recent deregulation of the transportation industry, for example, created more competition on the basis of price and service and reduced geographic restraints. Legislative deregulation came to transportation, however, only after many barriers had already crumbled or had been circumvented by aggressive firms. Now, with the phasing out of restrictions on consumer services and other products, deregulation is occurring for depository institutions. Recognizing that many of the distinctions between depository institutions have been reduced in recent years, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980. This Act is a first step toward establishing a "level playing field" for regulated depository institutions.

But the Act still does not address a growing problem in the financial industry: There are still many nonregulated firms, such as finance companies, money market mutual funds, and financial service companies. In other words, the Act puts domestic commercial banks on a more "level playing field," but it still does not free them to play on the entire field. A variety of restrictions contribute to this problem, the most significant of which are the geographic restraints.

This topic is especially germane now because the International Banking Act of 1978 required President Carter, after consulting with the Attorney General, the Secretary of the Treasury and the three bank regulatory agencies, to report to Congress his recommendations on the relevance of geographic restrictions on banking. The White House report was initially due in September 1979 and was transmitted to Congress in January 1981. Whatever the President's recommendations and the subsequent actions by Congress, they will have important implications for banks and bankers. Banks have the technology and the incentive to compete. But a major restraint is legislatively imposed geographic barriers set by the federal and state governments.

Q

What is the relationship between federal and state geographic restraints on banking, and how did these restraints develop in the first place?

A

Historically, federal regulators have deferred to state branching regulations. The present federal restrictions have been in place for more than 50 years, with only slight modification. Initially, national banks were prohibited from operating more than one full-service office. Many state-chartered banks were free to branch according to state regulations. With a more dispersed society in the 1920's, national banks operated at an increasing disadvantage relative to the full-service branch operations of state banks in some areas. Increasingly, national banks began to convert to state charters. The McFadden Act of 1927 partially rectified this competitive imbalance by permitting national banks to operate branches within their respective city limits if state law allowed state banks this freedom. And the Banking Act of 1933 allowed national banks to branch to the same extent permitted to state banks by state law. Since 1927, however, McFadden has led to more restrictions on banks because it defines a branch as "any place of business...at which deposits are received, or checks paid, or money lent." Accordingly, the courts have limited sites for bank automatic teller machines (ATMs) to branch locations. And while national banks may operate interstate loan production offices (LPOs), they cannot actually "make" a loan or dispense the funds from that LPO. As a result of McFadden, all national banks are restrained by the various branching laws of the 50 states.

State branching regulations, then, are the controlling factor in bank branching. These state regulations range from statewide branching—in 22 states—to unit banking—in 11 states. The remaining states allow only some form of limited branching. In addition, the multibank holding company is prohibited in 10 states, generally the same states that prohibit branching. There has been some liberalization at the state level over the last twenty years. For example, Florida, a unit banking state, moved to county-wide branching in 1977 and statewide branching in 1980. Geographic expansion, however, remains limited. As a result, of the 14,700 banks in this country nearly 5,800 are located in the 11 unit banking states.

Interstate banking was effectively curtailed in 1956 by the Douglas Amendment to the Bank Holding Company Act. The Act prohibited the acquisition of a bank in any but a bank holding company's home state unless expressly authorized by state law. Twelve interstate banking operations were "grandfathered." Several, like California-based Western Bancorporation, with 22 banks in 11 western states and over \$21 billion in deposits, have significant interstate operations. Currently, Iowa allows new acquisitions by one out of state bank holding company, and Maine allows bank holding company acquisitions from states that allow acquisitions by Maine bank holding companies.

Q

Earlier, you mentioned that banks are not “playing on the whole field.” How serious is this problem for banks?

A

These restrictions are quite severe when you consider that present geographic restrictions on the bank’s major competitors are generally much lighter or nonexistent. Federal savings and loan associations can branch statewide,

even in states that limit banks to a single office or limited facilities. This disadvantage may not have seemed so crucial to banks previously, but it will when S&Ls begin to offer NOW accounts. Banks located in unit or limited branching states will operate at a considerable competitive disadvantage vis-a-vis S&Ls. And banks are even more handicapped in competing with those nondepository institutions that are not regulated as to geographic expansion, such as finance companies, money market mutual funds, and brokerage firms.

Q

Despite these handicaps, some banks seem to be operating across geographic boundaries. How are they managing to get around the restraints?

A

Since the McFadden definition of a branch has effectively prohibited banks from establishing out-of-state deposit-gathering facilities, interstate bank expansion has focused mainly on lending. Major bank holding companies have established or acquired mortgage lending and commercial and consumer finance companies that operate in many states. Banks, for example, have established loan production offices to serve their corporate loan customers. Generally, however, these actions have resulted in more expensive and less efficient ways of serving customers than full-service operations.

More recently, the International Banking Act of 1978 expanded the banks’ ability to establish branches of Edge Act corporations

through which they can serve the international credit and deposit needs of domestic and foreign customers at many U.S. locations.

As a result, despite the aforementioned restrictions, the banking industry has found a variety of methods to expand toward nationwide proportions. Two major bank holding companies, for example, have achieved extensive national coverage. Each has about 400 offices that are located in roughly 40 states. So, interstate banking has already arrived for some domestic banking organizations, and they will have a head start when interstate restrictions are removed.

Foreign banks, too, have extensive operations, although the recent International Banking Act limits their ability to operate and expand interstate under more favorable conditions than domestically chartered banks. The ability of foreign banks to operate across state boundaries in ways prohibited to domestic banks has highlighted the need to revise the interstate banking regulations, especially in emergency situations.

Q

Not all bankers seem to favor deregulation. What are the major issues in the discussion?

A

Many bankers fear that if the restrictions were lifted, they would lose their protected markets. The results, they feel, would be damaging not only to local bankers but to the communities they serve. Other observers, however, argue that lifting the barriers would result in greater competition and, therefore, greater public benefits. Research into these issues, unfortunately, has not yet produced conclusive results. The debate and the research go on, but the trend toward lowering geographic barriers—in banking as in other industries—seems to be inevitable.

I can't examine in detail here all the issues raised by geographic deregulation, but let me review several of the most often cited issues. For example, when banking organizations enter a new market, there are likely to be short-term price benefits for the public. And,

generally speaking, a relaxation of restrictions results in an increase in the number of banking offices and a wider variety of banking services.

On the other side of the fence, some argue against relaxing these restrictions on the grounds that it would lead to a concentration of banking resources. Of course, it is true that "measured" concentrations would increase at the state levels. But there are adequate public policy safeguards to prevent undue or excess concentration, and increased statewide concentration does not preclude meaningful competition in local markets.

Underlying all of this debate is the fact that, because of our longstanding restrictions, we have far more banks than other countries have. Unless the present restrictions are phased out in an orderly manner, there could be a sharp contraction in the number of independently operated banks. This would not be entirely desirable. We would probably want to avoid the situation where, as in Canada, West Germany, and the United Kingdom, commercial banking is dominated by a handful of large banks.

Q

What are the chances of that happening in the U.S.?

A

If the experience in such longstanding statewide branching states as California and North Carolina is a guide, community banks can successfully compete. More recently, when New York and Virginia relaxed their branching laws, smaller banks still remained. A reasonable balance might be possible where our banking structure could evolve into a number of large nationwide organizations and a large number of strong regional and local banks.

Even the often cited fear that branching will eliminate the independent bank and deprive the local community of adequate funds seems unfounded by past experience. Bank costs decline only slightly as size increases. Therefore, large banks do not necessarily have significantly lower costs than most

banks, although the very smallest banks quite likely do have higher costs. And the various "High Performance Banking" studies show that banks in the \$25-100 million size range earn significantly higher profit margins than the larger urban banks. Therefore, unless large banks adopt predatory prices, well-run and reasonably able independent bank managers should be able to remain competitive with adequate earnings. In the event a community bank is acquired by a holding company, past acquisitions show that these banks continue to service local borrowers and generally lend out a higher proportion of their funds.

Despite the evidence that points to increased public benefits of liberalizing geographic barriers, the task will not be easy. We must recognize that a large number of independent banks and bankers have long operated under a protective umbrella of geographic restraints. They have strong views on this subject and many legitimate concerns. These concerns must be reconciled in any political discussion.

Q

Keeping in mind that there are political issues as well as regional and local controversies involved, what might we realistically expect to see in the way of relaxation of these geographic restraints?

A

I see us moving toward three basic changes, which, taken together, seem to promise a reasonable compromise between completely eliminating all geographic barriers and maintaining the status quo.


First, I believe we will see bank holding company acquisitions across state lines. This most likely will come in three directions because of the potential for excessive concentration if all restraints were immediately relaxed.

1. Allowing interstate acquisitions in contiguous states or within a region.
2. Allowing the largest bank holding companies to enter only the larger metropolitan markets and only by *de novo* entry or acquisitions of the smaller banks in such markets.
3. Allowing domestic and foreign banking organizations to bid for financially troubled or failing banks.

Second, I look for some changes aimed at improving retail banking services within metropolitan areas by relaxing these geographic restraints in two steps.

- a. Instead of classifying ATM/EFTS as branches, Congress could allow these services within “natural” market areas at first—including crossing local and state political boundaries, then within a region—and, finally, nationwide.
- b. Banks might later be allowed to establish full-service branches throughout their “natural” market areas. This would be the most controversial change, since it would directly raise the issue of states’ control of bank branching.

Finally, I think Congress may permit nationwide wholesale banking by allowing loan production offices to “make” business loans on site.

The removal of these barriers will not be easy, nor will they all come quickly. They all involve the removal of a protective barrier for some banks and bankers, and this is an important consideration. But the trend toward relaxation of geographic restraints seems inevitable, and the changes I have outlined suggest the direction in which public policy seems to be moving. 

NOW Pricing: Perspectives and Objectives

by William N. Cox

Banks tend to see NOW accounts as an old product with a new feature and thus seek to maintain the traditional profitability of the checking account. Thrift institutions, on the other hand, see NOWs as a new product which will allow them to become full-service financial institutions. Thus, S&Ls may price NOWs as a loss leader in hopes that NOWs will bring along other business from new customers.

It has been fascinating, these past few months, to watch southeastern bankers and S&L executives prepare for NOW accounts. Almost all of them admit without hesitation that they have decided to offer NOW accounts just as soon as NOWs become legal at the beginning of 1981.¹

Ask about the terms of their NOW accounts, however, and the answers have sometimes turned vague. "We're going to price NOWs so we don't lose money on the deal," say many bankers. "NOWs are a chance for us to diversify into the retail banking business," say some of the S&Ls. Beyond such generalities, even those who have decided how they plan to price have been likely to say, "we're considering several options," or "we aren't sure yet."

From our own conversations, however, we have an idea of what the cards will look like when everyone shows his hand. Commercial banks in urban markets generally will offer charge-free NOW accounts to

customers maintaining minimum balances of at least \$1,000, sometimes in the \$1,200 to \$1,500 range, and sometimes even higher. Savings and loan association minimums in urban markets, on the other hand, will often be \$500 or less, and sometimes in the \$250 to \$300 area, but sometimes less. Some will offer the alternative of charge-free checking with a substantial balance, typically \$2,000 or \$3,000, in a savings account. These minimum balance levels required for the charge-free checking will probably be the principal dimension of bank-thrift competition. Banks and thrifts alike will pay their customers 5 1/4 percent—the highest interest rate permitted by the Depository Institutions Deregulation Committee. The balances on which this rate will be paid will be tabulated in various ways, however. All will deduct service charges from below-minimum accounts—charges such as 15 cents a check or \$4 a month.

This is an interesting situation. Banks and thrift institutions will be offering similar, if not identical, products, yet from what we hear, banks will typically be requiring minimum balances of \$1,000 or more, (for charge free checking), while the thrifts will be saying

¹A December survey of Sixth District depository institutions indicates that more than 90 percent of both savings and loan associations and banks will offer NOW accounts in early 1981.

\$500, typically. Presumably, they can't both be right. Let's examine the disparity more closely, trying to see why it exists and whether it will persist. The differences, as we shall see, basically reflect different perspectives and objectives.

The Banks' View

To the banker, a NOW account is nothing more than a checking account with an additional wrinkle: It pays interest. It is the same product at a higher cost—the cost of paying interest. So the banker, in figuring how to operate in the NOW environment, tends to focus his attention on the cost elements of the checking account product and to look for ways to offer NOWs just as profitably as checking accounts.² The interest-bearing NOW account should be worth more to the customer than an ordinary checking account, so he should be willing to pay more for it, either by meeting a higher minimum-balance requirement, paying higher service charges, or both.

Pursuing this profit-maintenance objective, many banks have analyzed their traditional checking account business in terms of size of balances held and number of checks written. As a representative example, suppose a bank figures it can earn 10 percent after satisfying reserve requirements, by relending the money held in checking accounts. Many bankers are figuring, in addition, that the average household checking account costs the bank about \$60 a year to operate.³ If the banker finds his checking account balances average about \$800 and if he can earn about 10 percent on those balances by relending them, then he nets about \$20 a year on the account: \$80 of interest revenue less \$60 of costs.

When he looks at NOWs, he says something like, "How can I continue to earn \$20 per account if a customer converts to a NOW account?" His operating costs will probably still average about \$60 a year. He expects to clear only 4 3/4 percent of the assumed 10 percent now, however, since he has to pay the NOW customer 5 1/4 percent. So he

figures that to cover his \$60 cost and keep a \$20 profit, his NOW account balances must average about \$1,830.⁴ Then he has to decide how to set a minimum balance level (for free checking) that will attract that average balance of about \$1,830. This is a question of judgment, but the chances are our banker will filter out the low-balance accounts by picking a minimum balance of at least \$1,000. Below such a balance, the banker will require his customer to defray some of the costs of servicing the account by paying explicit service charges.

Looking at his \$1,000-plus minimum balance requirement, our representative banker expects that many of his high-balance checking accounts will be converted to NOWs, but he feels he has priced them dearly enough to maintain his profit. He fully recognizes and expects that some of his lower-balance accounts will move to the S&L across the street, but he accepts this prospect because he feels he cannot profitably convert them to NOW accounts.

This perspective represents fairly typically the thinking of many bankers around the District: (1) NOWs are viewed as an old product with an additional feature, (2) the focus of price-setting is on the NOW account rather than the NOW customer, and (3) the objective of pricing is to maintain the profitability traditionally associated with checking accounts.

The S&Ls' View

Many savings and loan associations view the NOW pricing problem quite differently. To all of them, NOWs are unfamiliar. To many, they are a very attractive product, since S&Ls have never been permitted to offer checking accounts in the Southeast. NOWs present an opportunity to become full-service family financial institutions, allowing them to diversify from their traditional savings-and-mortgage orientation.

Many savings and loan association executives, accordingly, are inclined to focus on the NOW banking customer. They view NOWs as the most important element in a bundle of

²For an example, see Michele Fernstein, "Advice from Northeast: You Can Live with NOWs Profitably," *ABA Banking Journal*, August, 1980.

³From Federal Reserve functional cost accounting data. Account maintenance costs vary principally with the number of accounts, rather than the level of balances or the number of checks written.

⁴Net return is 10% minus 5 1/4% = 4 3/4%. If we assume a reserve requirement of .08, 92 percent of the average balance needs to yield \$80. $\$80 / (.0475 \times .92) = \$1,830.66$.

family financial services offered to the customer, including not only savings instruments, mortgages and NOWs, but also consumer loans, second mortgages, charge cards, travelers' checks, and perhaps even trust services. Recent legislation has broadened the ability of thrifts to offer such functions.⁵

In focusing on the retail banking customer and figuring how to lure him away, many S&L people are inclined to agree with their banker friends about one thing: Banking relationships generally involve a great deal of customer loyalty.⁶ Most customers who change banks do so because they are unhappy with the service, but they will remain loyal even though they realize another bank is offering the same services a bit more cheaply. People tend to regard banking as a professional relationship, like their relationships with their doctors or lawyers.

Customer loyalty implies three things to S&Ls about NOW pricing. First, if an S&L wants to pull accounts out of banks, it will have to price NOWs much more attractively than banks. Slightly more attractive pricing will not overcome customer loyalty enough to move any checking accounts out of banks. Second, customer loyalty implies that S&Ls can gain if they can differentiate their NOW product image from NOW accounts offered at banks, particularly if that image appears more

modern or convenient. Customers are more likely to move, many S&L planners are saying to themselves, if their customers think they are offering something the banks aren't. This is why S&Ls have been generally more interested than banks in offering features like debit cards and check truncation with NOWs, whereas banks tend to want their NOWs to look like traditional checking accounts.

The third implication of customer loyalty is that if S&Ls are able to attract bank customers with attractively priced NOWs, those customers may bring their loan business, savings accounts, safe deposit boxes, and other business along to the new institution. Many S&Ls, therefore, are inclined to price NOWs aggressively on a break-even basis, or even as a loss leader, thinking that they will profit from the other business NOWs may bring along.

The contrast is sharp. Whereas the typical bank will price NOWs to maintain the profitability associated with traditional checking accounts, the S&L has a different objective. Instead of seeking to clear (in our example) \$80 a year in total cost plus profits per account, it might seek to offset only variable costs, which it estimates at about \$35, expecting NOWs to make no initial contribution to fixed costs or profits.⁷ If the S&L hopes that the variable costs of NOW accounts will average only \$35 a year, it will conclude (using

⁵B. Frank King, "A Primer on Financial Institutions in the Sixth District States," this issue.

⁶Most of the NOW accounts opened at S&Ls will come from bank checking customers. Murphy found that NOW customers at thrift institutions were similar in many characteristics (education, income, etc.) to bank checking customers and that about four-fifths of them had had bank checking accounts previously. (Neil B. Murphy and Lewis Mandell, "Reforming the Structure and Regulation of Financial Institutions: The Evidence from the State of Maine," *Journal of Bank Research*, October 1979.)

⁷For a more detailed analysis of costs from the standpoint of the savings and loan association, see Kenneth E. Reich, "How to Evaluate Conflicting Views on NOW Accounts," *Savings and Loan News*, May 1980.

the same kind of average-balance calculations we did earlier for the bank) that its NOW balances must average about \$800.⁸ Shooting aggressively for that average balance might lead an S&L to charge a minimum balance of \$500.


What Then?

Such a wide difference in pricing cannot persist for long in a competitive economy. That's what economic theory tells us, anyhow. The gap should close. Because of customer loyalty, however, it will not close entirely.

Theories aside, there are a good many reasons to expect S&Ls eventually to raise their minimum balance requirements on NOW accounts. Aggressive S&Ls are likely to find their estimates of variable costs were too optimistic—partly because of unexpected start-up costs, partly because of inflation, and partly because banks and thrifts are bidding against each other for the people and machines to process checks and maintain records. The 5 1/4-percent rate ceiling will probably go up too as the deregulation process proceeds. S&L managers will eventually want NOW accounts to make some contribution to overhead and profits. But S&L minimum balance requirements will probably not need to match those at the banks, since

many thrift institutions in New England have remained profitable while offering cheap NOW accounts.

On the other side of the gap, banks may eventually find they want to cut their minimum balance requirements, but not by much. Most banks are under pressure from regulators to maintain capital-to-asset ratios. It is difficult to raise capital by issuing new stock in today's market, so the only remaining way to produce the capital additions necessary for asset growth is through the retention of profits. Nonmember banks, moreover, will generally face rising reserve requirements over an eight-year phase-in period.⁹ The costs of maintaining checking and NOW accounts are rising. So for all these reasons, banks will probably cut their minimum balance requirements some, but not much.

How much they cut them will depend largely on how many customers they lose to S&Ls, and some of these customers will represent the loss of profitable business other than NOW accounts. Most banks are not set up to analyze in advance how much other business the loss of lower-balance NOW accounts will cost, but the results will be available in a few months.¹⁰ If this related loss in business is substantial, minimum balances will come down and the gap will narrow from the bank side as well. 

⁸ $\$35 / (.0475 \times .92) = \800.92 , assuming an 8 percent reserve requirement. It is also possible that thrifts' costs will be lower if banks have already invested heavily in customer service enhancements (such as additional branches or automatic teller machines) as a substitute for explicit interest payments and must continue to amortize those investments, whereas the thrifts can design their implicit-plus-explicit interest capabilities from scratch in a NOW environment. Presumably, these earlier investments in implicit services by banks are worth something to the customer, who should be willing to hold a higher minimum balance because of it. (See P. Lloyd-Davies, "The Effect of Deposit Ceilings Upon the Diversity of Bank Locations," Bank Structure and Competition, Federal Reserve Bank of Chicago, 1976). As Michael R. Asay ("Effects of NOW Accounts on Earnings and Competition in Commercial Banking: A Review of Theory and Financial Economics, Board of Governors, Federal Reserve System, April 1979) points out, however, the customer may even prefer implicit interest in the form of services because such interest is not taxable.

⁹Unlike most other accounts, NOWs will be subject to a full reserve requirement immediately. However, in light of the overall phase-in of reserve requirements, vault cash will likely exceed reserve requirements for several years at most nonmember banks and thrifts.

¹⁰Some bankers point to the NOW experience in states like Connecticut and New York, where banks have been successful with high minimum balances. In these states, unlike all the Sixth District states except Florida, banks and thrifts also compete with noninterest-bearing checking accounts. Thrifts there do not have to use NOWs as the primary means of enticing bank customers. (See William N. Cox, "Now Accounts: Applying the Northeast's Experience to the Southeast," September/October issue of this Review.)



Working Paper Review

The following article is a staff review of a more complete study in the Federal Reserve Bank of Atlanta Working Paper series.

Robert E. Keleher
William P. Orzechowski

Supply-Side Effects of Fiscal Policy: Some Historical Perspectives

In a previous Research Paper (reviewed in the September/October 1980 Review) Robert Keleher outlined the basic principles of the supply-side view and suggested how that view applies to fiscal policy. In a new Working Paper reviewed here, Keleher and William P. Orzechowski respond to suggestions that the supply-side view is a novel, untested theory by showing that the approach actually represents a return to classical principles of public finance, developed and implemented in the nineteenth century.

A fundamental premise of "supply-side" economics is that changes in fiscal policy, and especially changes in tax rates, have important effects on incentives, aggregate supply, and economic growth. While the supply-side approach is having a significant impact on current policy discussion, it has nevertheless been seen by many economists as a new, untested idea or as a temporary fad. In this lengthy Working Paper, Robert E. Keleher, Senior Financial Economist, Federal Reserve Bank of Atlanta, and William P. Orzechowski, Assistant Professor of Economics, George Mason University, show through an extensive review of economic doctrine that the supply-side view is neither novel nor a fad. The authors demonstrate, in fact, that supply-side economics is essentially a return to the fiscal orthodoxy of the nineteenth century. Supply-side principles, which originated with the

attacks of the physiocrats, Hume, Smith and other economists on mercantilism, were explicitly endorsed and utilized by most important public finance scholars for over a century before the Great Depression.

In contrast to much conventional macroeconomic analysis, which focuses primarily on the aggregate demand impacts of changes in fiscal policy, supply-side proponents emphasize that tax rate changes have important repercussions on the incentives of individuals to supply labor and capital to the market. Keleher and others have described the fundamental assumptions of the supply-side view in previous Working Papers; in this study, the authors focus on the historical development of that view.

The supply-side view originated in the eighteenth century with the attacks of the French physiocrats against mercantilism. The mercantilists, whose principal goal was a strong nation state (including, in their view, a large stock of precious metals), endorsed policies to effect a trade surplus. They subsidized exports, for example, and taxed imports. They also believed that higher tax rates, by lowering (after tax) wages, would stimulate work effort and consequently contribute to the production of exports and hence a trade surplus. High tax rates, then, were not at all inimical to the mercantilist view.

Although both the physiocrats and David Hume identified important elements of the supply-side view, neither developed a complete, fully consistent set of supply-side principles. Adam Smith, writing in 1776, was the first to articulate a supply-side theory fully removed from vestiges of mercantilist thought. To increase wealth, Smith believed, a country must emphasize production, aggregate supply and growth, not the money supply or aggregate demand. Accordingly, Smith advocated positive incentives (including tax policies) to stimulate the supply of capital and labor into the production process. Smith called high direct taxes on

wages “absurd and destructive,” since they led to decreased employment and decreased production.

The authors show that Smith also recognized that as tax rates rise from low levels, output initially increases because efficiency gains stemming from the provision of public goods outweigh the adverse effects of these tax rate increases. As tax rates continue to increase, however, the balance shifts in favor of the disincentive effects of high tax rates, and output begins to decline. Moreover, because of Smith’s subsequent influence, his supply-side fiscal principles became the orthodox view for nineteenth century economists and, as such, can scarcely be accused today of being radical or novel.

Building on and refining the arguments of the physiocrats, Smith, and others, J. B. Say and James Mill developed Say’s Law, which, as J. J. Spengler notes, “dominated economic thinking until...World War I.” A central theme of Say’s Law is that it is production and aggregate supply (not the growth of the money supply) that create wealth and economic growth. Thus, the Law places emphasis on the stimulation of production and aggregate supply and on the encouragement of factor supplies—not on stimulating demand or consumption. Some of the most significant implications of Say’s Law relate to governmental fiscal and especially tax policy. Given that Say’s Law indicates that it is production and aggregate supply rather than demand and expenditure that create growth and wealth, the tax (and expenditure) policies in harmony with the law are those which foster aggregate supply (rather than aggregate demand). If taxes adversely affect aggregate supply or factor inputs, for example, supporters of Say’s Law indicate that these taxes should be either eliminated or minimized. Since advocates of Say’s Law recognized that high tax rates would work to destroy the incentives to work, save, and invest, and hence would adversely affect supplies of factors of production, they often recommend a lowering of these tax rates. Such a lowering of tax rates was often identified with increases in aggregate production and increases in tax revenues.

After identifying Say’s Law as a cornerstone of the supply-side view, Keleher and Orzechowski discuss the contributions to supply-side thinking of some later economists, including John Stuart Mill, J. R. McCulloch, and Sir Henry Parnell. These nineteenth century writers, for example,


documented many historical cases where tax rate increases were associated with tax revenue decreases. Interestingly, McCulloch suggested that one sure way to recognize when tax rates are excessive is to identify when a great deal of circumvention activities (smuggling, evasion, fraud) is taking place. (Today, this activity is associated with the growth of the so-called underground economy.)

Although supply-side principles were often stated in the literature, politicians normally did not embrace these concepts. The administration of William Gladstone in Great Britain (from the 1840’s to the 1890’s), however, was an exception. This administration was one of the first examples of the formal application of supply-side principles. Gladstone’s program was successful; it included large reductions in tax rates, rapid economic growth, and the elimination of budget deficits. Not only were these principles implemented as early as the mid-nineteenth century, but they were recognized (as the authors show) as the dominant view of fiscal policy in economics textbooks in the late nineteenth and early twentieth centuries.

Events in the interwar period disrupted the century-long dominance of the supply-side view. The collapse of aggregate demand in America in the 1930’s led many economists to reject Say’s Law and to adopt positions “which classical economists would have labeled as mercantilist.” The Keynesian Revolution encompassed a dramatic shift from encouraging supply to stimulating demand, and from long-run economic growth to short-run stabilization of the business cycle. Taxation was seen, not as a means of funding government spending, but as a method of ensuring general economic and monetary stability. “What would appear as heresy in 1910,” the authors conclude, “had become orthodoxy and was embraced by the new economics.”

An example of the subordination of supply-side principles appears in the “modern” discussion of saving. Since proponents of the “new economics” considered saving a leakage to the income-expenditure flow, they (like the mercantilists centuries earlier) came to view savings as adversely affecting the level of economic activity. Consequently, they often endorsed government policies which were oriented toward the stimulation of consumption and discouragement of saving.

In their concluding section, Keleher and Orzechowski point out the similarities of the

1970's to those conditions of the mercantilist era which led classical economists to reject the demand-oriented framework of mercantilist writers. Both periods saw high and increasing tax rates, government regulation and intervention into the economy, a growing underground sector, and low rates of productivity and growth. The result has been the revival of the long dormant supply-side view. In order to foster growth, its proponents argue, work, saving, investment, and honesty should be encouraged instead of nonwork, consumption, and tax avoidance. Hardly a new approach or an untested fad, the supply-side view is well-rooted in classical macroeconomic analysis. In fact, the authors show that it actually represents a return to the classical principles of public finance. 

Supply-Side Effects of Fiscal Policy: Some Historical Perspectives, by Robert E. Keleher and William P. Orzechowski, August 1980, 68 pp. Bibliography.

A copy of this study is available upon request to the Research Department, Federal Reserve Bank of Atlanta, P.O. Box 1731, Atlanta, Georgia 30301.

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