Voice
of the Federal Reserve Bank of Dallas
El Paso · Houston · San Antonio

March 1978

The Federal Reserve and the Economy

Excerpts from an address by

Ernest T. Baughman, President
Federal Reserve Bank of Dallas

At Shreveport, Louisiana, on the occasion of the Meeting of the Board of Directors of the Federal Reserve Bank of Dallas

February 9, 1978

There are many live economic and banking issues we could discuss today. You can tick them off as well as I. This is a time of rapid change in both the United States and the world, and rapid change tends inevitably to be heavily interlaced with unresolved problems—areas of disagreement. In that respect, at least, this is a great time to be alive. There are challenges readily at hand sufficient to test the mettle of the best of us. Tempting though it is to address national and international issues, I would like to discuss briefly today the role, structure, and performance of the Federal Reserve System. First, however, a word about this meeting.

The boards of directors of Federal Reserve banks and branches occasionally meet in communities away from the Reserve Bank city, and this is one of those occasions. Such meetings enable Federal Reserve directors and officers to have direct, face-to-face conversations with local residents; to develop a better feel for the economy of the area; and in a sense, to report to the community on Federal Reserve responsibilities, activities, services, and problems.

Dr. Charles Beaird, a resident of this community and publisher of the *Shreveport Journal*, is Deputy Chairman of the Board of Directors of the Federal Reserve Bank of Dallas. At the end of this year, he will have completed his second three-year term on the Board, and it is customary that individuals are not elected or appointed to more than two successive terms. So, this meeting is also in recognition of Dr. Beaird's service on the Board of the Federal Reserve Bank of Dallas and an expression of appreciation to the Shreveport community for granting us a piece of his time and access to his special knowledge and sound counsel.

As you know, the Constitution of the United States lays on the Congress the responsibility to coin money and regulate the value thereof. But the Congress, after many years of study and debate, concluded the ongoing, day-to-day management of the country's monetary affairs could not be done effectively by the Congress itself. However, there was a great diversity of views as to how the matter should be handled.

Banking had not been held in high repute by the early settlers of this country. A number of the state constitutions, particularly in the Midwest, declared banking to be an illegal activity. The view that a central bank was not authorized by the Constitution would be subversive of the rights of the states and dangerous for the liberties of the people, was not unknown. This, and similar views, deferred for many years action to establish a central bank and greatly affected its structure and role when it was authorized by act of Congress in 1913. Thus, the Federal Reserve System is unique in the world. It is quite unlike its predecessors in Europe, which the Congress had studied extensively. It reflects the blending of a great diversity of very firmly held views.

Out of the compromising and reconciling of views there emerged a regional system of Federal Reserve banks, instead of one central bank, planned to be responsive to credit needs of each geographical area of the country but with provision for coordination at the national level by a Board of Governors. The regional concept was very important in the minds of those who designed the System. In fact, one of the key objectives was to provide for the holding of the reserves of the commercial banks regionally, instead of allowing them to flow into the money-center banks in eastern financial centers, primarily New York.

The regional feature is woven into the law establishing the Federal Reserve System in a number of other respects as well. Discount rates for each regional district were to be established by the boards of directors of the respective Reserve banks. No more than one member of the Board of Governors could be appointed from any one Federal Reserve District, and Board members must come from a variety of occupational backgrounds. A Federal Advisory Council was provided, consisting of one representative from each Federal Reserve District, appointed by the Board of Directors of the Federal Reserve Bank, such Council to meet at least once each quarter to advise the Federal Reserve Board on topics of interest to the Board and other matters. The regional flavor was reiterated in 1935, when amendments to the act provided a Federal Open Market Committee—to consist of five of the presidents of regional Federal Reserve banks, selected on a rotating basis, and the seven members of the Federal Reserve Board—to establish open market policy. It had become apparent at that time that open market policy had succeeded discount policy as the major instrument of monetary policy.

Another prominent issue was the private-public character of the Federal Reserve System. Should it be Government or private? Clearly, the coining of money was a Government function, but members of the Congress wanted to remove the function to some degree from the political arena. The Bank of England, among those studied by congressional committees, at that time was a private bank. The issue was resolved by causing the Federal Reserve banks to be patterned largely along "private" lines while the Federal Reserve Board was "public," with all its members appointed by the President with the advice and consent of the Senate.

Closely related to the public-private issue was the bank-nonbank issue. The System was to serve the public interest, but this was to be accomplished largely by influencing credit flows through the commercial banks. Clearly, the System needed the knowledge and experience of bankers and effective linkage to the banking community, but the structure must assure that the interests and views of the customers of banks and the general public would prevail in matters of public interest. These seeming contradictions were resolved in an ingenious and seemingly complex structure.

The seven-member Board of Governors is the top policy body in the System and exercises general coordination and surveillance of the Federal Reserve banks. Board members are appointed for terms of 14 years, one ending each second year. The jobs are full-time, and after serving a full term, a member may not be reappointed. In this handiwork are seen desires for geographic and occupational dispersion and, once confirmed, insulation from political and private influences.

A Reserve Bank is under the general direction of a Board of Directors, in addition to the general surveillance of the Board of Governors in Washington. Of the nine Reserve Bank directors, three are bankers, elected by member banks—one elected by small banks, one by middle-size banks, and one by large banks. Six are nonbankers. Three of these—usually businessmen actively engaged in agriculture, commerce, or industry in the District—are elected by member banks, and three are appointed by the Board of Governors. All must be selected without discrimination on the basis of race, creed, color, sex, or national origin and with due but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor, and consumers. Except for the three banker directors, directors may not be officers, directors, or employees of any bank. The Chairman and the Deputy Chairman of the Board of Directors are designated by the Board of Governors from among the three directors it appoints.

Responsibility for monetary policy instruments is located at various nodes within the System, with specific provision for regional inputs. Reserve Bank boards of directors are required to establish discount rates for loans to member banks at intervals no greater than 14 days, subject to the approval of the Board of Governors. Open market policy (the purchase and sale of Government securities and the most used of the monetary policy tools) is established by the Open Market Committee. Reserve requirments are established by the Board of Governors within ranges specified by law. The Board of Governors also establishes maximum interest rates on time and savings deposits and margin requirements on securities.

If this appears a complex organization, it's because it is. But it works, rather well, I think, and with a very broad base of representation from regions and economic and professional backgrounds. If the System were to be organized from scratch today, it probably would be structured differently, at least in some respects. It has been changed on occasion. Being a creature of the Congress, it can be changed at the discretion of the Congress at any time, and the Congress could prescribe monetary policy to be implemented by the Federal Reserve, if it chose to. Senator Proxmire has emphasized this point in recent days in the confirmation hearings on the appointment of Mr. Miller to the Board of Governors.

As might reasonably be expected, individual members of the Congress are persuaded the System would be improved if fashioned to conform more closely to their current individual views. The record reveals a continuous flow of such proposals. But basic changes in the structure or purpose of the Federal Reserve System have attracted the support of a majority of the Congress only infrequently. On balance, those changes probably have tended to strengthen the much-discussed "independence within Government" and regional representation within the Federal Reserve, not weakened them. The past may or may not be indicative of the future in these respects.

The Congress is again considering requiring audit of the Federal Reserve by the General Accounting Office, an investigative arm of the Congress. It is difficult to be unsympathetic to audits, especially of financial or public institutions. However, the Federal Reserve has opposed GAO audit because there is no demonstrated need and, therefor, it is unnecessary and would be a wasteful expense; it would encroch on the "independence" of the Federal Reserve, and it could be a source of serious problems in the handling of sensitive information for domestic financial institutions and foreign central banks and governments.

Thorough audit procedures are in place, and continuing attention is given to ways to strengthen them. The Board of Governors is audited by a public accounting firm, and its report is available to the Congress. The Reserve banks are audited by a Board of Governors' audit staff, with the audit procedures reviewed each year by one of the top public accounting firms in the country. In addition, each Reserve Bank has in-house auditors, who report directly to the Board of Directors through its Chairman and an Audit Committee and to the Board of Governors' audit staff. These ongoing in-house audit programs are necessary to assure adequate security of the large volumes of valuables received, processed, stored, and shipped and could not be dispensed with or curtailed if the GAO were to audit the Reserve banks, say, annually.

Clearly, the Congress has need for information to exercise its oversight responsibilities. This is recognized by the Federal Reserve, and every effort is made to be responsive to congressional requests while avoiding release of information that would have the potential to jeopardize individual firms, financial markets, or relations with foreign governments or officials.

As you know, the Federal Reserve System is self-supporting. Independence of the appropriations process is an important feature of its "independence" within the Government structure. There is some interest in the Congress to bring the Federal Reserve within the appropriations processes. Last year the Federal Reserve banks had net earnings of about $6 billion. Payments to the Treasury amounted to about $5.9 billion. The policy is that after the statutory dividend to member banks and additions to surplus to bring it to the level of paid-in capital, all net earnings are paid to the Treasury. Since the operating expenses of the Federal Reserve banks affect the payments to the Treasury, it is understandable that the Congress should be interested that the System is run efficiently.

Current expenses last year were $624 million, up about 4 percent from 1976. Given the rising wages and prices and substantial increases in volume of checks, currency, and wire transfers of money and securities, I believe this is a good showing. We are judicious in our expenditures, and we receive strong encouragement to this end from our directors and the Board of Governors. We have been making persistent efforts to improve efficiency without reducing service levels to member banks or the Treasury, and we have made progress. We are seeking ways to improve financial services and reduce costs. So here again, there is no demonstrated need to place the System on an appropriations basis, and doing so would surely tend to politicize the System and the making of monetary policy. Furthermore, I am firmly persuaded it would increase, not reduce, Federal Reserve Bank operating costs, assuming maintenance of current service levels.

Membership in the Federal Reserve System has been declining and is a matter of growing interest and concern. Against this background, the Board of Directors of the Federal Reserve Bank of Dallas established a Committee on Membership last year and directed it to review the situation in the District and recommend actions to resolve it if it were concluded such action was desirable. The Committee consists of Dr. Charles Beaird, Chairman; Frank Junell, San Angelo; and Gene Adams, Seymour. The Committee invited the banking associations in the District states—Louisiana, Texas, Oklahoma, and New Mexico—to participate in the discussions, and I am pleased to report they all accepted. Some very useful discussions have been held. Although the Committee has not yet reached conclusions and rendered a report, I believe you will be interested in the flavor of the discussions to date.

It was the judgment of the participants that bankers generally are agreed the country needs—and banking needs—a strong, effective, broadly based, and largely "independent" Federal Reserve System. There was consensus that most banks would choose to be a part of the System if the cost were nominal and the services responsive to banking needs. The major cost, it was agreed, is the reserve requirement, and it was concluded this cost should be reduced promptly to the minimum level consistent with effective monetary policy.

The "cost" of reserve requirements could be reduced or neutralized by reducing the level of required reserves, by paying interest on required reserves held at Federal Reserve banks (such a bill is before the Congress), or by authorizing banks to hold earning assets as reserves, say Treasury bills. I believe the time is ripe for action to reduce the cost of reserve requirements for member banks and that something probably will be done in 1978.

Discussions in the Directors' Membership Committee also indicated reserve requirements are not the full answer to declining membership. Apparently, the Federal Reserve Bank has not fully informed some banks about the services available from Federal Reserve banks. Th Committee urged the management of the Federal Reserve in the Eleventh District to do a better job of informing banks about its services and operations, and we are taking steps to do that.

The Committee's discussions also reflected rising resentment of the heavy flow of new regulations. Whether the recent heavy flow of additional regulations could have been avoided or should have been avoided is now a moot question. Whether much simpler legislation and regulations could have been devised to achieve the objectives of the Congress may also be moot. But progress is being made in some respects toward simplification of both underlying laws and regulations implementing them. Bankers and others can play an important role in this process. Opportunity is provided for public comment on both laws and regulations. All interested parties should let their views be known. I can assure you that comments are reviewed and weighed carefully, especially when they are specific as to better ways to achieve the desired purpose, problems that will be created, or reasons the proposed regulation or policy is or will be ineffective or unduly costly. The progress being made currently to simplify certain laws and regulations flows largely from suggestions supplied by both the regulated institutions and those the laws were designed to benefit. Hopefully, substantial improvements can be achieved.

But I will close these remarks with the observation that monetary policy in 1978 will call for deft and difficult decisions as we attempt to find and maintain a posture that will contribute to moderation of inflation while maintaining economic growth and achieving balance in international payments. Our economic problems are difficult, and the solutions are neither simple nor obvious. Your advice and counsel will be welcome at all times. Hopefully, as we or our successors look back upon our handiwork of today, it will be said "You know, those folks did a pretty good piece of work."

Automatic Transfers from Savings to Checking Accounts Proposed

A revised proposal to permit automatic transfers between savings accounts and checking accounts has been published by the Federal Reserve Board for comments. Originally proposed in March 1976, the amendment to Regulation Q would permit the automatic transfer of funds from an individual's savings account to his checking account to ensure a minimum balance in the checking account or to cover overdrafts.

The revised proposal differs from the earlier one in two main respects. First, whereas the earlier proposal would have required an individual to forfeit 30 days' interest on the funds transferred, the current proposal limits the penalty to the interest actually earned during the previous 30 days. Therefore, the amount of the penalty would depend on the interest policies of the depositor's bank. If, for example, interest is accrued or paid after a certain date and the funds are transferred prior to that date, no interest would be forfeited because no interest would have been earned. Also, if funds are transferred after being on deposit less than 30 days, the penalty would be no more than the amount earned during the time the funds were on deposit.

Second, the proposal does not require a minimum amount of funds that may be transferred. The earlier proposal required that transfers be made in multiples of not less than $100. Nothing in the proposal, however, would prohibit a member bank from establishing its own minimum transfer amounts.

The proposal, when implemented, would merely authorize automatic transfer service. Whether the service is offered and on what terms would be entirely voluntary for banks and their customers. However, it would be available only to individuals, not to businesses or governments.

The purpose of the proposal is to improve service and reduce costs for both individual bank customers and the Federal Reserve System. Costs would be lower for individual depositors because the interest penalty on transferred funds would be less than the charge for checks returned because of insufficient funds. Costs would be reduced for the Federal Reserve because the number of returned checks would decrease. Returned checks involve hand processing and multiple handling, so they are expensive to the System. The cost to the Federal Reserve of processing each returned check is about five times the cost of a regular check.

If the automatic transfer proposal is implemented, the effective date will be 60 days after adoption. Questions regarding the proposal may be directed to the Consumer Affairs Section of the Dallas Reserve Bank, (214) 651-6171.

Securities Trading Data to Be Required of Bank Trust Departments

Proposals to require trust departments of banks to maintain more detailed records of securities transactions and establish internal written policies and procedures for such transactions have been published by the Federal supervisory agencies for comments. The proposals were made, in part, in response to a report on bank securities activities published June 30, 1977, by the Securities and Exchange Commission.

The Board of Governors' proposal would amend Regulation H to require that certain information concerning securities transactions be retained by state member banks for six years. The proposed required records include itemized daily records of purchases and sales, receipt and disbursement of cash, the account for which each transaction is made, and a description of the securities and their purchase and sale prices.

In addition, it is proposed that the banks have to establish written policies and procedures for such areas as the assignment of responsibility for supervising employees trading in securities, provision for fair and equitable matching of buy and sell orders from different customers, and requirements that bank employees handling securities transactions for customers report their own securities transactions.

Compliance with rules of the Municipal Securities Rulemaking Board will satisfy all the Board's proposed requirements.

Marketing Costs Boost Food Prices

By Alan M. Young

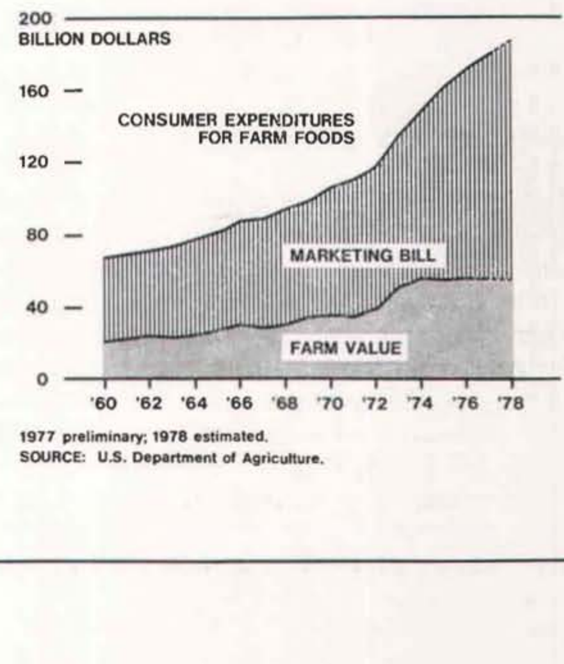
American consumers will again pay more for food in 1978. Prices of food at retail outlets may rise 4 to 6 percent this year, compared with an increase of about 6 percent last year. Costs related to food processing and marketing services—such as labor, packaging materials, transportation, and energy—will continue to rise. But average prices received by farmers for food products are expected to be essentially unchanged from 1977. Hence, the higher food prices being found at grocery stores are traceable to the inflationary pressures on marketing costs.

Food expenditures rise . . .

Consumer expenditures for food have been climbing for many years. In 1977, food expenditures were an estimated $180 billion, more than $2^1/_2$ times the $67 billion spent in 1960. Even though population growth has contributed to the larger volume of food expenditures, prices and the ability to buy food have increased much faster than the demand for food. Per capita food consumption has increased only 9 percent since 1960, while per capita disposable personal income is currently more than three times greater. Food expenditures per person as a share of income declined from 20.0 percent in 1960 to about 16.7 percent in 1977. Nevertheless, food is still a major component of the typical household budget, accounting for almost a fourth of total expenditures.

Increased affluence has influenced consumer diets. As people have become more able to afford the food they want, they have bought not only more food but also appreciably more expensive

Spending on food increases sharply, as value of farm output holds steady



1977 preliminary; 1978 estimated.
SOURCE: U.S. Department of Agriculture.

foods. Moreover, the food stamp program and other food assistance programs have also added to demand for many years. Lower-income groups have been able to upgrade their diets by purchasing higher-priced and higher-quality foods.

On an increasing scale, Americans have substituted meats and other high-quality items for cereals and fresh potatoes. For example, since 1960, per capita consumption of beef and poultry has risen about 44 percent and 57 percent, respectively, while consumption of cereal and bakery products has declined 3 percent.

As incomes rise, consumer demands for marketing services increase; this, in turn, makes food more expensive. Only a small portion of all foods purchased by consumers, mainly fresh fruit and vegetables, moves from farms to retail stores without significant change in form or nature. Most foodstuffs are packaged, canned, frozen, or cooked before they reach the stores where they are sold. The services involved in processing these foods, including elaborate ready-to-serve dishes and fully prepared meals, have been spurred by higher incomes and by social changes—such as growing urbanization, an increase in the number of working women, and the desire to avoid kitchen chores.

The food marketing industry also has a strong incentive to increase the service component of the product sold. There is a biological constraint on how much food people can ingest; therefore, an increase in the volume of food marketed mainly results from population growth. Expansion in industry profits may be achieved by product differentiation through providing various marketing services.

Marketing costs for food items depend on the costs of resources used to perform the often complex marketing functions after a commodity leaves the farm. As marketing services are added to the product, the farm value share of the retail food dollar declines. Processing and distribution costs are usually a larger proportion of the retail costs of crop products than animal products. While the farm value generally represents the largest part of the retail price for meat, poultry, and dairy products, the maketing bill accounts for well over half the retail price of most grains, fruits, and vegetables.

Rising disposable personal incomes and the increasing number of women in the work force have also encouraged eating more meals away from home. In 1977, away-from-home expenditures for food exceeded $56 billion, more than three times the amount spent in 1960. These expenditures accounted for about a third of the total food bill last year, compared with about a fourth in 1960. Food purchased at restaurants is more expensive relative to the farm value of the raw materials than food prepared and consumed at home. Marketing costs constituted four-fifths of away-from-home food expenditures in 1977. Conversely, the marketing cost component of home-prepared food was about three-fifths of expenditures.

Costs related to the processing and distribution of all U.S. farm-produced foods at the time and in the form, package, and place preferred by American consumers accounted for nearly 70 percent of the total retail value of food last year. These marketing costs have tended to increase over time with rising wage rates, and increases have been largely independent of trends in farm product prices. Where population growth and the general rise in income have always tended to push up food expenditures, processing and distribution costs have been largely responsible for pushing food prices higher.

. . . as marketing costs increase . . .

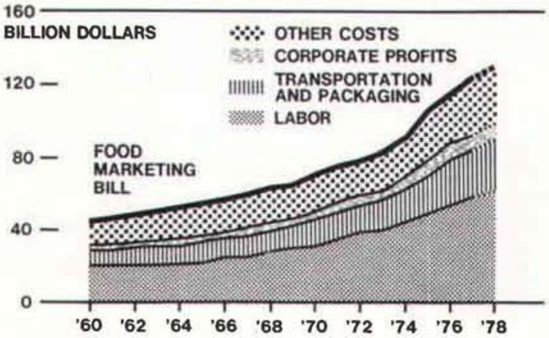
The difference between what farmers receive for food products and what consumers pay for the food at retail counters—that is, the marketing bill—has, on average, increased more than the general rate of inflation in the economy. Between 1960 and 1977, for example, the consumer price index for all items rose 205 percent. The marketing bill rose 278 percent in the same period. Costs of food packaging materials, labeling, energy, labor, transportation, and most other inputs used by food marketing firms have increased sharply in recent years. And too, Government regulations related to pollution control systems, safer working conditions, and sanitation of processing and handling facilities have boosted marketing charges.

A close examination of the individual components of the marketing bill indicates direct labor has been the biggest factor in the rise. About half the current costs of food marketing firms are for direct labor. Part of the increase in labor costs is reflected in the larger number of man-hours needed to provide the input required to meet the growing demand for more convenience foods and more packaging. The number of man-hours required for marketing farm food products increased a third between 1960 and 1977.

Another reason labor costs have climbed so rapidly in recent years is that wages, salaries, and benefits have advanced faster than the productivity of labor in food marketing. Since 1960, labor costs per unit of food produced have more than doubled. And these costs are generally passed on to the consumer through higher retail prices.

Preliminary estimates point to labor as receiving more than farmers from total food expenditures in 1977 and 1978. Estimates of direct labor costs for the two years are $58.8 billion and $63.2 billion, respectively. By contrast, the farm value of food expenditures is estimated to be about $56 billion in both years. Recent and upcoming wage negotiations and pending cost-of-living adjustments in food and related industries will push up labor costs 7 to 8 percent this year. New wage settlements in 1978 will attempt to protect workers from further inflation and loss of purchasing power. Moreover, the increase in the minimum wage, raised to $2.65 per hour this year, and the higher social security withholding rates will also add to labor costs of marketing firms.

Labor costs rise much faster than other marketing costs



1977 preliminary; 1978 estimated.
SOURCE: U.S. Department of Agriculture.

Packaging containers and materials—metal cans, plastics, glass, and paperboard—are the second most costly component of the marketing bill, representing slightly more than an eighth of the total. While costs of materials have risen sharply, increased use of materials in order to market a larger volume of farm products and changes in the mix of materials have also expanded packaging expenses. Total costs of food containers and wrapping materials rose nearly 7 percent in 1977 to $16.0 billion, compared with $5.4 billion in 1960. For 1978, trade analysts are projecting an increase to about $17 billion.

Transportation is another important marketing expense—the third largest component of the marketing bill. Shipping costs amounted to over $10 billion in 1977 and are expected to exceed $11 billion this year. These expenditures compare with $4.1 billion in 1960.

Profits of companies marketing food make up only a small portion of the total bill. Profits ordinarily comprise a small proportion of food prices, with retailers generally relying on sales volume to generate acceptable profits. After-tax profits of food companies were about $4.6 billion in 1977, or 2.5 percent of total sales. Changes in profit margins have little effect on the total marketing bill. Nevertheless, in 1978, gross profits of food

Preliminary estimates point to the labor involved in marketing as receiving more than farmers from total food expenditures in 1977 and 1978.

companies may increase about 2 percent, owing to continued growth in food expenditures and because of weakness in the value of farm-produced foods as a result of large supplies.

Other components of the marketing bill—including business taxes, energy, advertising, depreciation, rent, repairs, and interest—rose only slightly in 1977. But they may sum to $32 billion in 1978, which is 4.6 percent above last year and 241 percent above the 1960 level.

. . . and farm prices stabilize

Of course, the cost of food is also influenced by changes in farm production and supplies. Since 1960, farm value as a proportion of food expenditures has averaged about a third.

Domestic supplies of basic foodstuffs are determined by farmers' planting decisions, Government programs, changes in technology, export developments, and weather conditions. As a result, farm commodity prices tend to be much more volatile than prices of many nonfood consumer goods.

Volatility in farm prices stems largely from the nature of demand for agricultural commodities. For most farm products, the quantity demanded is usually not very responsive to changes in product prices. As a result, a comparatively small shift in the supply of farm products can produce a sharp change in prices received by farmers. But changes in farm prices, while directly affecting farmers' income, generally have a relatively smaller influence on food prices than changes in unit marketing costs.

Short-term changes in consumer food prices may reflect substantial seasonal or cyclical changes in farm prices. In fact, farm prices can either lead or run counter to general food price movements. But longer-term changes in food prices are usually linked more closely to changes in the marketing bill, caused by changes in costs and profits of marketing firms. Farm prices fluctuate up and down, responding to supply-demand factors. However, "sticky" marketing costs may tend to keep consumer prices up even during periods of falling farm prices. Speaking more generally, a decline in farm prices may not lead to a proportionate drop in food prices.

Food prices continued to rise in 1977, despite a decline in farm prices

1977 preliminary.
SOURCE: Economic Indicators.

Moreover, while changes in farm prices partially affect the prices consumers pay, the impact usually comes after a lag. The lack of complete and immediate responsiveness of retail prices to changes in farm prices is explained, in part, by the fact that many commodities, such as vegetables and fruits for canning, are purchased from producers long before they are sold at retail as processed foods. Retailer and processor pricing policies that stress price stability and departmental profit margins, rather than pricing on an item-by-item basis, also cause retail prices to be relatively sticky.

Farmers have not shared in recent increases in retail food prices. The farm value of food expenditures has not grown proportionately with marketing costs. Since 1974 the farmers' share has plateaued at about $56 billion, while the marketing bill has climbed by a third. Bumper harvests and increased meat production have caused the average farm value of food to stabilize. Hence, recent increases in food prices are to be explained by the growth in marketing costs.

Food prices rose 3.1 percent in 1976, while prices for all farm products rose only 0.5 percent. Moreover, average farm prices fell 3.6 percent in 1975, and preliminary estimates indicate a 1.6-percent decline in 1977. In 1975, food prices rose 8.5 percent, and they were up about 5.7 percent in 1977. Consequently, the lower average farm prices since 1974 have actually cushioned the advances in food prices caused by higher marketing costs.

Consumers will continue to face rising food costs in 1978. But as in years just past, retail food prices will likely be boosted mainly by the increased cost of marketing services. Expanded agricultural production and the resulting weakness in farm prices should continue to moderate the amount of the rise.

Community Reinvestment Act of 1977 to Be Implemented

The Community Reinvestment Act, signed into law October 12, 1977, requires that regulated banks and savings and loan associations serve the convenience and needs of their communities for both deposit and credit services and that the appropriate supervisory agencies use their authority to encourage them to do so. The four Federal regulators of financial institutions—the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board—must have regulations implementing the act in effect by November 6, 1978.

The regulatory agencies are required, in their examinations of banks and savings and loan associations, to review "the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of the institution." That record must be taken into account by the agencies when evaluating an application for a charter, deposit insurance, a branch, office relocation, a merger, consolidation, and so forth of two or more banks or S&L's, or a holding company acquisition of such institutions.

Suggestions from the public on how to interpret and implement the new law are invited. Public hearings are scheduled in Washington, D.C., on March 15 and 16, in Boston on March 20, in Atlanta on March 23, in Dallas on March 27, in Chicago on April 5 and 6, and in San Francisco on April 12 and 13.

Comments are invited on any aspect of the law but particularly on issues such as:

• What is the difference, if any, between needs for credit and demands for credit?

• How should the terms "entire community" and "low- and moderate-income neighborhoods" be defined?

• How should the record of an institution in meeting community needs be weighted in relation to other factors, such as competition, safety and soundness, and other managerial and financial factors?

• What constitutes an institution's "record" of helping to meet community needs? Should it be the same for all institutions?

• In addition to decisions on applications, how may or should the agencies use their authority to "encourage" institutions to serve community needs?

• In making the assessment, what consideration, if any, should be given to the instiution's costs and sources of funds? To its rate of return on investment? To its liquidity?

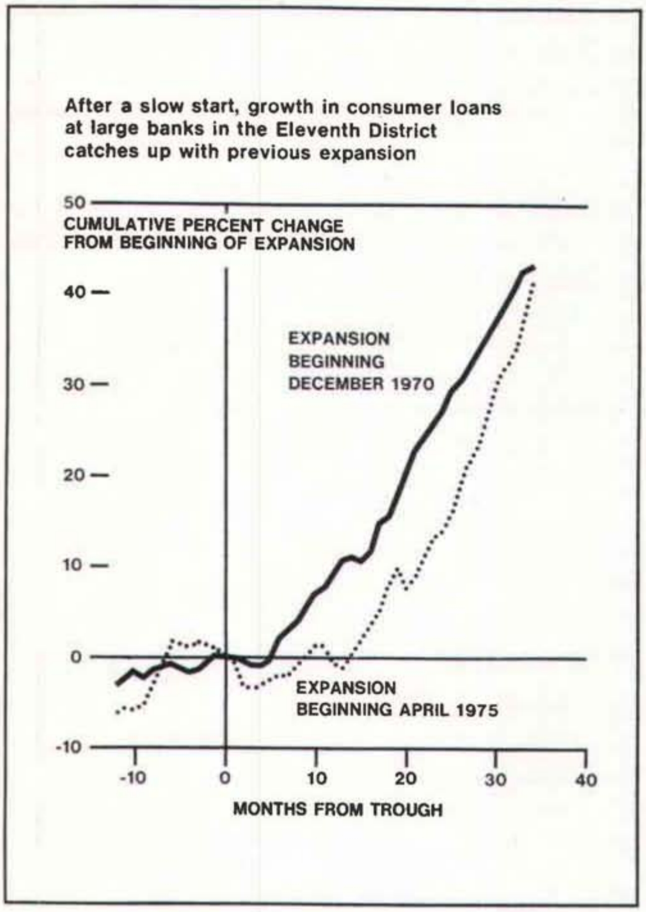
Improper Payments by Banks Prohibited

Cease-and-desist orders and referrals to law enforcement agencies will be used to end any practices involving improper political contributions and certain other questionable payments by banks and bank holding companies, the three Federal bank regulatory agencies have announced in a joint policy statement. The regulatory agencies also indicated that such practices could lead to denial of applications by banks and bank holding companies.

Effective January 13, 1978, such practices as compensatory bonuses to employees and improperly designated expense accounts may be treated by the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation as "unsafe and unsound banking practices." Excessive fees or salaries paid to officers, low or zero interest rate loans, and provision of equipment and services without charge to candidates for office may also be considered improper.

Consumer Borrowing Up at District Banks

Consumer loans at large commercial banks in the Eleventh District have increased 42 perecnt since the trough of the last recession, in March 1975. That almost matched the 44-percent increase in the comparable 34-month period following the trough of the prior recession in 1970. However, most of the loan growth in the current expansion has occurred much later than in the previous one. In fact, more than three-fourths of the loan growth in the latest 34-month period has come in the last 13 months, in contrast to less than half in comparable months of the previous expansion.



The slow growth in consumer instalment loans at the beginning of the current expansion probably reflected the tighter financial positions of most households. Double-digit inflation in 1974 severely buffeted household financial situations, and the high rate of unemployment made consumers more cautious borrowers against expected future earnings.

This caution against increasing debt was well conceived, as people found it more difficult to repay loans already made. The proportion of consumer instalment loans delinquent for 30 days or more rose to a record high of nearly 3 percent in the depths of the recession. As the recovery gained momentum, the annual rate of inflation slowed to about 6 percent at the beginning of 1977 from more than 12 percent in 1974. And the unemployment rate dropped nearly $1^1/_2$ percentage points during the same period to just over 7 percent. As a consequence, consumer purchasing power and confidence began to grow, and consumers became aggressive borrowers.

Personal income in the four Eleventh District states—Louisiana, New Mexico, Oklahoma, and Texas—rose about 11 percent last year. And although the rate of inflation remained high by historical standards, it was well below the rate that prevailed at the beginning of the recovery. The demand for consumer goods and services—and, in turn, the demand for consumer credit—increased sharply.

In 1977, consumers increased their instalment debt at large District banks by $312 million— a record 26 percent—lifting the total at these banks to $1.5 billion. That was considerably more than the previous record increase of almost 17 percent in 1972. Some slowing in the growth of consumption expenditures nationwide is generally expected this year. However, if there is to be a slowdown in consumption expenditures in the District states, it is not evident thus far and certainly was not reflected in consumer instalment loans at large District banks in January. These loans rose another $48 million that month, or 3 percent—the largest rate of increase for any month.

While higher personal income enabled consumers to step up their spending and to service a substantially larger volume of debt last year, the availability of credit was an additional factor in the growth in personal debt. Commercial banks in the Eleventh District found consumer loans increasingly attractive in 1977. Large net inflows of deposit funds sharply exceeded business loan growth during much of the year, and short-term interest rates generally increased slowly until midsummer.

Inflation continues to erode much of the growth in purchasing power of consumer income. But the rate of increase in prices is below the levels prevailing at this stage of the previous recovery, when consumer credit began to decline. The recent strong growth in consumer instalment credit and a sharp increase in mortgage borrowing suggest a relatively confident consumer. With the level of spending continuing moderately strong in the District, the demand for consumer credit should remain at a high level, although the rate of growth may slow as the year progresses.

The ratio of consumer instalment credit outstanding to personal income nationwide was 12.96 percent in October, or only slightly below the previous peak of 13.10 percent in February 1974. With such major nondiscretionary spending items as taxes, housing, food, and fuel taking increasing shares of income, consumers may not raise their debt-to-income ratio much further.

Consumers may also find credit funds at commercial banks somewhat tighter. Business borrowing has been moderate to strong since last August. Because the District economy remains strong, outlays for inventories and new plants and equipment should further increase business demands for external funds this year. Moreover, the financial calendar of the Federal Government will be heavy. As overall credit demands continue to strengthen, interest rates will rise further, increasing the cost of funds for banks. Consumers may become less willing to accept higher debt-servicing costs.

Mary G. Grandstaff

Net Earnings of Reserve Banks Reach $6.04 Billion

Net current earnings of the 12 Federal Reserve banks were $6,043 million in 1977; the corresponding figure for the Federal Reserve Bank of Dallas was $292 million. All net earnings in excess of statutory dividends to member banks and additions to surplus sufficient to bring it to the level of paid-in capital are paid to the U.S. Treasury as interest on Federal Reserve notes. The amount paid to the Treasury in 1977 was $5,937 million. Of this, $285 million was paid by the Federal Reserve Bank of Dallas.

Total expenses for the Federal Reserve banks, including losses and Federal Reserve Board expenses, were $848 million. The corresponding figure for the Dallas Reserve Bank was $44 million.

SUMMARY OF EARNINGS AND EXPENSES OF FEDERAL RESERVE BANKS, 1977

Item	Millions of dollars	
Current earnings		6,891
LESS:		
Net expenses	624	
Net losses	177	
Assessment for expenditures of Board of Governors	47	
Total expenses		848
Net earnings before dividends and payments to U.S. Treasury		6,043
LESS:		
Dividends paid	60	
Payments to U.S. Treasury	5,937	
Total dividends and payments to U.S. Treasury		5,997
Transferred to surplus		46

SOURCE: Board of Governors, Federal Reserve System.

Call Reports Revised

Revised reports of condition and income will be used for the December 1978 call date. The revisions will affect mainly banks with foreign offices. However, there will also be a number of changes for other banks with assets of $300 million or more and some relatively minor changes for smaller banks.

A description of the report revisions and revised reporting instructions will be sent to banks by the end of April 1978.

New member bank

First National Bank of Dimmit County, Carrizo Springs, Texas, a newly organized institution located in the territory served by the San Antonio Branch of the Federal Reserve Bank of Dallas, opened for business February 21, 1978, as a member of the Federal Reserve System. The new member bank opened with capital of $500,000 and surplus of $500,000. The officers are: William A. Beinhorn, Jr., Chairman of the Board; James W. Danner, President; and Charles W. Spencer, Senior Vice President and Cashier.

New nonmember banks

Valley Bank of Commerce, Roswell, New Mexico, a newly organized insured nonmember bank located in the territory served by the El Paso Branch of the Federal Reserve Bank of Dallas, opened for business February 1, 1978.

Town and Country Bank, Stephenville, Texas, a newly organized insured nonmember bank located in the territory served by the Head Office of the Federal Reserve Bank of Dallas, opened for business March 1, 1978.