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Fed Initiates Three Policy Actions

In view of accelerating inflation, continued rapid growth in money and credit, heightened speculation in commodity markets, and downward pressure on the dollar, the Federal Reserve initiated three policy actions in early October.

The discount rate was increased from 11 percent to 12 percent. This is the rate member banks pay when they borrow from their Federal Reserve Bank.

An 8-percent marginal reserve requirement on increases in "managed liabilities" of member banks—liabilities that have been actively used to finance continued rapid expansion in bank credit—was established.¹ This means that the cost of these sources of funds is increased insofar as the amount exceeds the aggregate level in a base period in September or \$100 million, whichever is greater. These liabilities include large time deposits, Eurodollar borrowings, repurchase agreements against U.S. Government and Federal agency securities, and Federal funds borrowed from nonmember institutions.

Finally, and possibly most important, a change was made in the method by which open market operations are conducted. This action places greater emphasis in day-to-day operations on the supply of bank reserves and less emphasis on confining short-term fluctuations in the Federal funds rate to a narrow range. Over recent years the Federal Open Market Committee has fixed a relatively narrow range for the weekly average

Federal funds rate as it has attempted to influence the pace of monetary growth. To help achieve better control over money and credit growth, the Federal Reserve will focus on the supply of reserves and permit much wider fluctuations in the Federal funds rate, day to day and week to week, in response to supply-demand forces in the market.

These actions will affect a number of banks in the Eleventh Federal Reserve District. The increase in the discount rate will affect any member bank that borrows from the Federal Reserve Bank of Dallas. During the fourth quarter of 1978, 81 member banks in this District borrowed at the discount window an average daily amount of \$110 million. The greatest number of banks to borrow in any three-month period occurred in the fourth quarter of 1974, when 93 member banks borrowed an average daily amount of \$136 million.

The 8-percent marginal reserve requirement on increases in the aggregate amount of managed liabilities will affect relatively few banks in the Eleventh District. For the most part, only the largest banks will exceed \$100 million in managed liabilities—the base amount above which the marginal reserve requirement is effective. Probably fewer than 40 banks in this District will be affected.

The change in open market operations will have a moderate effect on all banks that sell or purchase Federal funds, insofar as the range of rates for individual days and from day to day may be significantly greater than in recent years.

The package of policies, overall, is intended to reduce the recent rapid growth in total bank credit and money to slower, less inflationary rates.

1. This marginal reserve requirement also applies to U.S. branches and agencies of foreign banks with worldwide assets over \$1 billion and to Edge Act corporations.

From Hearings on Monetary Policy and Inflation

Statement by

**Paul A. Volcker, Chairman
Board of Governors of the Federal Reserve System
Washington, D.C.**

before the

**Committee on the Budget
U.S. House of Representatives**

September 5, 1979

Mr. Chairman, members of this distinguished Committee:

I am pleased to be able to participate in these hearings on the Second Concurrent Budget Resolution for fiscal 1980. I might say that on receiving your invitation, I felt it a bit incongruous that my first appearance before a committee of the House as Chairman of the Federal Reserve Board would occur in the context of consideration of fiscal, rather than monetary, policy. But the plain fact is that our nation faces serious problems that require interrelated governmental action, involving all of the main instruments of economic policy. No place are the interrelationships more important than in the area of fiscal and monetary policy. I hope that

our dialogue this afternoon will help throw light on the proper role for those instruments in today's setting.

Surveys and other evidence indicate that the most pressing economic concern of the American people today is the persistent and rapid rise of prices. In my judgment, that concern is not misplaced.

As you know, the acceleration of inflation this year can be traced in considerable part to so-called exogenous forces—the rise in food prices, and much more importantly, the decision of the OPEC countries to raise oil prices in an amount that, in absolute terms, approaches the increase in 1973 and 1974. But even in appraising these sources of inflationary pressure, I believe it would be wrong to consider them independent of more general inflationary pressures in the United States and elsewhere. For instance, the desire of oil suppliers to recover losses in real income implied by rising prices of other goods and the weakness of the dollar appeared to be one factor contributing to the OPEC pricing decision. Moreover, part of the challenge to economic policy today is to avoid to the extent possible a kind of "leapfrogging" process whereby rising prices and costs in one sector—energy is the notable case—set off a whole sequence of adjustments in wages and prices in other sectors as workers and business engage in a vain attempt to achieve and maintain levels of real purchasing power that simply cannot be sustained in an economy experiencing higher real energy costs

and virtually no growth in productivity.

To be sure, the impact of inflation is uneven. Those on fixed incomes suffer, while some people who are well positioned—either by clever design or by good luck—do manage to increase their wealth. Even for the fortunate, however, such a result is at best precarious, frequently built on heavy indebtedness or highly speculative investments. In an environment of virulent inflation, such as we find ourselves in today, there are no reliable havens, and so the discomfort of our citizens is hardly surprising.

Even these capricious effects on individuals and the related concern reflected in the surveys do not capture the insidious and debilitating effects of inflation and inflationary expectations on our economic performance and growth prospects. It is not entirely a coincidence that we can observe in these recent inflationary years a declining tendency in the profitability of investment. Calculations differ because of the accounting problems associated with changing prices. However, one estimate indicates that the annual after-tax return on corporate net worth, measured, as it reasonably should be, against the replacement cost of inventories and fixed assets, has averaged 3.8 percent during the 1970's, a period characterized by rapid inflation, as compared to 6.6 percent in the 1960's. At the same time, the uncertainty about future prospects associated with high and varying levels of inflation tends to concentrate the new investment that does take place in relatively short, quick payout projects. Or firms may simply delay investment commitments until the pressures of demand on capacity are unambiguously compelling—with the result that capacity pressures can become strong even before the labor force is fully utilized.

In other areas, inflationary expectations are reflected in a diversion of energies into essentially speculative activities—ranging from the “froth” of investing in art objects to the considered purchase, at the expense of heavy indebtedness, of larger or second homes as an inflation hedge. When returns from these activities are often judged greater than from usual patterns of work and saving, normal incentives are plainly distorted in a manner inconsistent with orderly growth.

Another obvious result of our distressingly poor price performance has been the recurrent weakness of the dollar in foreign exchange markets. During much of 1978, the cumulating decline in the value of the dollar abroad added an important

further element of uncertainty and instability to the United States and other economies. Following the vigorous program introduced in November of last year, the dollar rose somewhat against other major currencies, helped by an improvement in our current account and by indications of a relative strengthening of economic expansion abroad. But the value of the dollar internationally began to be questioned again as the trend of U.S. inflation worsened noticeably, and as many of our trading partners acted forcefully to retard inflationary tendencies in their own economies. Although the situation in exchange markets appears to have stabilized recently, that stability ultimately rests on our ability to cope with inflation.

We need to deal with inflation and a vulnerable dollar in the context of the slowing in domestic economic activity that developed in recent months. A moderation in the growth of aggregate demand was welcome this year—even essential—if the economy was to avoid the kind of pressures on capacity that could only aggravate inflationary forces. Policies of monetary and fiscal restraint were directed toward that aim. Now it is apparent that the drain of purchasing power implicit in the sudden run-up in our oil import bill and in energy prices generally—combined with the actual and feared shortages of gasoline—has led to a contraction of real incomes and final demands. During the second quarter, real gross national product fell, primarily reflecting a drop in consumer spending, and further declines in some areas of business activity continued into the summer. With sales falling, businesses have experienced some involuntary accumulation of inventories—most strikingly in the auto industry, but to a lesser degree in other sectors as well.

Our reading of the most recent economic indicators suggests that a correction of these inventory imbalances is well under way. Orders have been reduced, production schedules have been cut back, and hiring has slowed. These adjustments need not by themselves set in motion a deep or prolonged contraction in activity. Indeed, while the inflationary process itself has introduced important new uncertainties, some of the economic and financial dislocations and imbalances that usually have presaged severe cyclical declines have been avoided. To be sure, the transfer of income to foreign oil producers will continue to exert a depressing effect on aggregate demand over the near term. But the position taken in the

Board's midyear report to the Congress—that the economy should grow moderately in 1980—still seems reasonable.

In the present circumstance, we need to be especially cautious in interpreting any business forecast; there are vulnerabilities in the present situation on the downside, and there is also the possibility that the downturn will prove shorter and shallower than many now expect. The shaping of policy must appreciate and take account of the risks on both sides. For instance, the traditional response throughout the postwar period to any prospect of declining production and rising unemployment has been a sharp shift in monetary and fiscal policy toward expansion and the enhancement of aggregate demand—even at the risk of adding to inflation. A decade or two ago, with prices historically fairly stable, that risk was discounted. But now we have to face squarely the adverse consequences of premature or unduly large moves to stimulate the economy. In exacerbating the already serious problems of inflation and the dollar, such moves would also feed back on the underlying problems of investment, productivity, and growth.

Some observers have suggested that this situation presents an intractable dilemma for policy-makers: the need to sacrifice one set of economic goals in the pursuit of another. But this dilemma seems to me more apparent than real. Even in the relatively short run, premature stimulative actions could well prove ineffective rather quickly, and even counterproductive, as their force is dissipated in higher prices rather than real growth—in more uncertainty, rather than less. Ultimately the perceived “trade-off” between unemployment and inflation would only be worsened. That is the lesson of the 1970's, not just in the United States but elsewhere.

I think we would all agree that, over the years, labor and product markets have developed an increasing sensitivity to inflation. Expectations about inflation are an important factor in wage bargaining, in price setting for many goods and services, and certainly in interest rates. The plain danger is that actions rightly interpreted as doing little or nothing toward dealing with our underlying persistent problems of productivity and investment, but all too likely to produce more inflation, will in fact have only a small and short-lived expansionary effect, regardless of their intent. Our ability to avoid future instability in employment,

or to deal with chronic unemployment in urban areas and among our young, would be damaged, not enhanced.

Similar behavior dominates the foreign exchange markets: exchange rates usually respond quickly—and sometimes excessively—when incoming economic data or news about policy actions alters the outlook for inflation. Adverse repercussions on the dollar generate in turn new uncertainty and inflationary pressures, partly because of the direct effects on costs of imports and partly through the reduced competitive restraints on prices of domestically produced goods. We have tasted too much of the vicious circle of domestic inflation and external depreciation to want to see that pattern repeated. The dangers would extend beyond the domestic economy. Because of the dollar's role as an international store of value and medium of exchange—a role we cannot simply shrug off or dismiss consistent with our own interests and those of our trading partners—its instability could pose a major threat to the world system of finance and commerce and even to our political leadership.

Obviously, then, our current economic difficulties are tightly interwoven. They will not be resolved unless we deal convincingly with inflation. Progress won't come easily or suddenly; among other things the adjustment in prices of energy and petroleum-based products is far from complete. But what we can do—what we must do—is begin the process and prevent the inevitable rise in real energy prices from fanning out into an acceleration of general inflation.

Monetary and fiscal policies are not the only tools we should bring to bear. But both monetary discipline and fiscal discipline—policies that are seen to be disciplined—are absolutely basic to restoring and maintaining a greater sense of stability.

For its part, the Federal Reserve intends to continue its efforts to restrain the growth of money and credit, a growth that in recent months has been excessive in terms of our own 1979 objectives—objectives that have only recently been reviewed by our congressional oversight committees. Those efforts, combined with heavy credit demands, have had the visible consequence of some increases in short-term interest rates as the availability of reserves has been limited through open market operations. But I would also note that the impact on longer-term securities markets, generally considered more important for business decisions, has been small. We seem to have here

an illustration of the more general proposition that actions to deal with the sources of inflationary pressure should over time have a constructive influence in restoring more stable and healthier financial and economic conditions.

I frankly do not know whether needed restraint on monetary growth will be reflected in further increases in short-term rates; that will depend on the course of economic activity, credit demand, and other factors. But I do know that credit flows at present are generally well maintained, and no sustained decline in nominal interest rates can reasonably be expected in the absence of a discernible slowing in the underlying trend of inflation.

Meanwhile, the moves in the direction of fiscal restraint by the Congress and the Administration have been a key ingredient in setting the stage for a successful anti-inflationary effort. Substantial progress has been made in the past year toward reduction of the Federal budget deficit. Potentially more significant, in terms of the longer-range outlook, is the sense of greater control on spending that has been achieved by the efforts of this Committee and others.

Of course, the deficit has remained high, even after years of business expansion, and reductions in spending relative to GNP have been modest so far. Moreover, with the economy likely to be sluggish in the months ahead, the operation of automatic stabilizers could lead to a temporary widening of the gap between expenditures and receipts. That in itself need not be disturbing—if budgetary decisions do not seem to throw us off the track of restoring budget balance and restraining expenditures as the economy picks up. However, legitimate doubts would be raised by sizable new spending programs not matched by savings elsewhere; indeed, such an approach would directly challenge our ability to eliminate future deficits and could only add to skepticism over the commitment to contain inflation. Similar doubts would be aroused by a premature commitment to tax reduction—welcome as such reductions would be over a period of time. I believe that we should be particularly wary of tax reductions that might have a transitory effect in adding to the purchasing power of consumers but that would accomplish little or nothing toward stimulating investment, cutting costs, or improving work incentives. For these reasons, the members of the Federal Reserve Board believe both the Administration's budget proposals

and the Second Concurrent Budget Resolution recommended by the Senate Budget Committee represent a broadly appropriate and desirable commitment to hold the line on spending, to avoid premature tax cuts, and to contain the size of the deficit.

As I noted earlier, a broad range of uncertainty must be assigned to any forecast of economic events, particularly in view of the obvious vulnerability of the economy to a variety of exogenous forces. In that connection, we cannot entirely exclude the possibility of recessionary tendencies cumulating and intensifying, even if it would be wrong to have current policy decisions dominated by that single possibility. There is much more danger—in terms of aggravating the inflationary momentum—in prematurely anticipating the most unfavorable hypothesis than in dealing in the most orderly and effective way we can with the clear and present fact of inflation.

Should economic trends develop in a clearly unfavorable direction and action come to be needed to deal with sharp declines in output and employment, it would be crucially important that those actions be integrated with the longer-term needs of the economy. Specifically, any fiscal actions should be designed to minimize any inflationary impact in the short run while helping to deal positively with some of the sources of inflationary pressures in the long run. Cost-cutting and incentive-building tax reductions broadly meet this criterion; few spending programs do. We need to give much more weight than in the past to the need for both tangible capital formation and research and development, for these activities underlie productivity growth.

I need not emphasize that even well-designed tax reduction—reduction that could have important payoffs over time in improved productivity and reduced cost pressures—has a cost in terms of transitional deficits and increased competition in the credit markets. Tax reduction, however desirable over time, needs to be earned by a sustained commitment to spending restraint. Prematurely timed or poorly structured, the potential gains could be swamped by adverse effects in an inflation-prone economy.

The monetary and budgetary policies that I have discussed seem to us in the Federal Reserve essential if our commitment to controlling inflation and stabilizing the dollar is to have meaning. They would lay the groundwork for changing expect-

tations about inflation in the short run and for renewed growth and stability over a longer period of time. I would emphasize that other efforts, in the areas of wage-price policy, regulatory reform, and the encouragement of market competition, are important as well. We also must deal with our energy situation, one that today leaves us vulnerable to foreign sources of supply. But none of these policies, important as they are, can substitute for commitments to fiscal prudence and restraint on the money supply.

Public concern is high—but out of that concern grows awareness of the pressing need to solve our inflationary problem. Therein lies our opportunity. I would suggest the American people are coming to understand that there are no easy answers, but that failure to act consistently and forcefully can only lead to worse results, both for the vitality of our economy and for our world leadership. Your budget making is quite clearly a key element in the process.

Federal Reserve Board Solicits Comments on Proposed Amendments to Regulation T

Federal Reserve Regulation T deals with credit extensions by securities brokers and dealers to their customers. The regulation limits the amount of credit that may be extended to customers for purchasing or carrying securities, based on the amount of cash and margin securities in their accounts. The overall purpose of the margin requirements is to prevent the excessive use of credit for purchasing or carrying widely traded securities.

The Board of Governors of the Federal Reserve System has solicited comments on two proposals to amend Regulation T. The first proposal would permit brokers and dealers to extend credit on mutual fund shares that are fully paid for and deposited in a general account. Currently, only banks and Regulation G lenders are permitted to extend this credit. The Securities Exchange Act of 1934 established that credit cannot be extended on the initial purchase of these securities, and this

rule would not be changed by the amendment to Regulation T. Only mutual fund shares that are fully paid for would be affected by approval of the first proposal.

The second proposal would permit options specialists to both purchase and sell short the stock underlying the options in which they specialize, with a 25-percent margin requirement. No maintenance requirement is imposed in this revision unless the account, if sold out, would have an unsecured debit balance. Further proposed revisions would make it easier for options specialists to perform their market-making function.

Interested persons were invited to submit comments to the Board of Governors through October 15, 1979. Further information about specific features of the proposals may be obtained by contacting Consumer Affairs, Federal Reserve Bank of Dallas, (214) 651-6171.

Federal Reserve Board to Revise Truth in Lending Regulation

The Board of Governors of the Federal Reserve System is revising Regulation Z and issued a proposal on July 25 to amend various sections of the regulation. The revisions mainly pertain to the degree of accuracy and treatment of payment schedule variations in the calculation and disclosure of the annual percentage rate on loans to consumers.

One of the most important disclosures required by the Truth in Lending Act is the annual percentage rate, which provides a uniform standard consumers may use in comparing credit sources. It measures the cost of credit for a given transaction by expressing in percentage terms the relationship between the amount financed and the finance charge.

The Board is reviewing five issues: tolerance, number of decimal places, ignoring irregularities, accounting for irregularities, and reliance on charts and tables.

The following is a synopsis of the new revisions being examined by the Board:

1. **Tolerance.** The Board proposes that a uniform tolerance be applied in reporting the annual percentage rate for credit transactions. Currently, the rate has to be disclosed as either an exact figure or rounded to the nearest one-fourth of 1 percentage point. The Board favors a fixed tolerance of one-eighth of 1 percentage point in either direction from the exact annual percentage rate.

2. **Number of decimal places.** In the Board's view, specification of the exact number of decimal

places to be used in calculating and disclosing the annual percentage rate is unnecessary. However, with respect to open-end credit, the Board does encourage specifying the number of decimal places.

3. **Ignoring irregularities.** The Board proposes amending Regulation Z to permit all creditors, in making disclosures in closed-end credit transactions, to disregard the effects of rounding of payment amounts to whole cents and changing the dates of scheduled payments and advances that fall on a Saturday, Sunday, or holiday. In addition, the Board proposes to adopt a special rule to simplify calculation and disclosure of the finance charge and other credit terms by creditors in closed-end credit transactions assessing finance charges on a simple interest basis.

4. **Accounting for irregularities.** The Board is seeking a new method to determine the length of an irregular period, which, if adopted, would revise Supplement I of Regulation Z. However, creditors would not be bound to use this method in counting odd days, so long as their method for accounting for irregularities produces a rate within the tolerance limits of the regulation.

5. **Reliance on charts and tables.** The regulation now maintains that an annual percentage rate or finance charge error that results from an error in a chart or table used by the creditor does not violate Regulation Z. The Board proposes to extend this provision to include calculators and computers that have faulty hardware.

Family Budgets and Inflation: Spending More! Enjoying It Less?

By Mary G. Grandstaff

Most Americans always feel a strain on their budgets. For many, inflation draws the strings tighter. As prices continue to rise at rapid rates and the distribution of income deviates from its "usual" patterns, more and more consumers are surprised to find they must lower their level of living as expenses press upon their disposable income. The surprise is no less a shock, albeit less painful, to those situated so they can raise their spending levels apace with inflation than to those unable to do so.

The urban family budget figures published annually by the U.S. Bureau of Labor Statistics provide estimates for costs of three standardized levels of living—lower, intermediate, and higher. In each of these budgets, the hypothetical family consists of a husband that is an experienced worker and is employed full time, a nonworking wife, a boy in his early teens, and a younger girl. The budgets do not reflect how real families actually do or should spend their money, nor are they intended to specify any minimum income or standard-of-living levels. Instead, they reflect the assumptions made about the manner of living of the family at each of the budget levels. Costs of constant supplies of goods and services are adjusted to reflect the impact of inflation.

Analysis of the budget estimates indicates how rapidly the costs of these standardized levels of living have increased in recent years. The estimated intermediate-level budget for the urban family of four in the *United States* rose at an average annual rate of 8.1 percent between 1973 and 1978 to \$18,622. The lower-level budget rose at an average annual rate of 7.1 percent to \$11,546, while the highest budget rose at an 8.5-percent average annual rate to \$27,420.

The intermediate budget in the *four southwestern metropolitan areas* included in the Labor Bureau's annual family budget estimates averaged from \$16,211 to \$17,114 in the autumn of 1978.

According to the budget estimates, Houston had the highest intermediate cost of living among the four areas. Not far behind, though, were Baton Rouge, Dallas, and Austin, in that order.

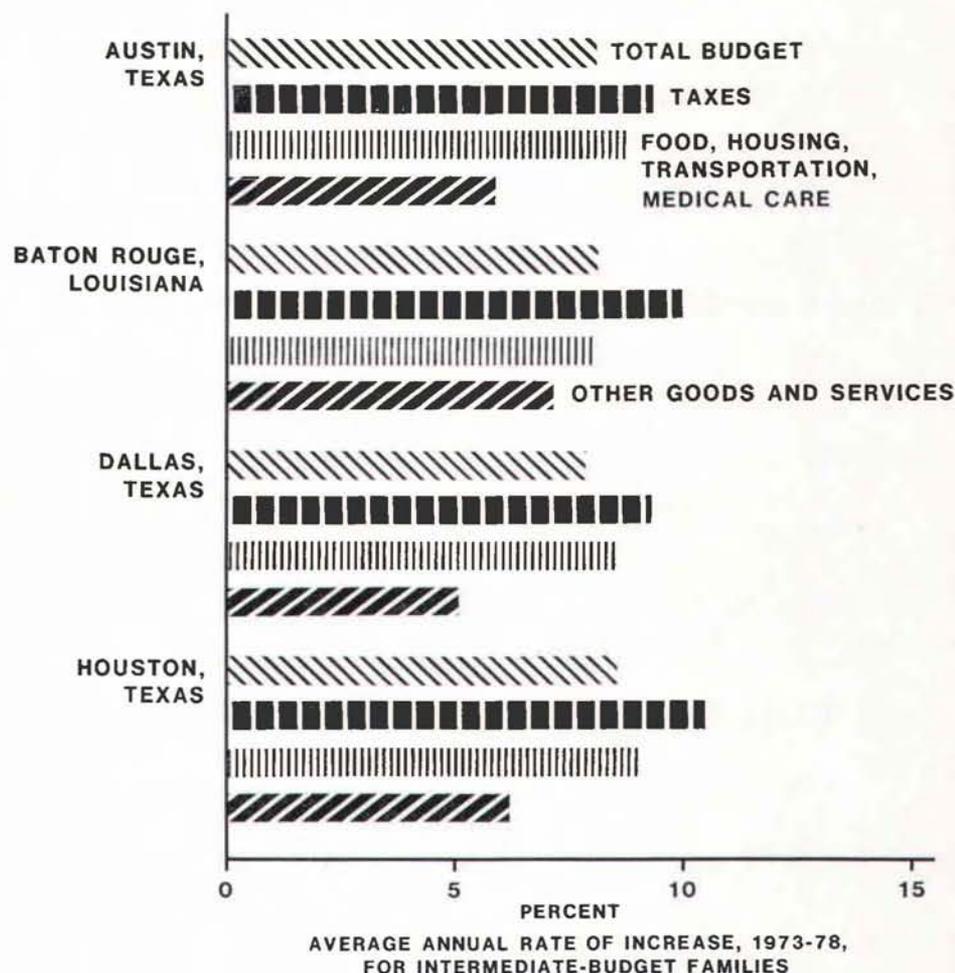
Between 1973 and 1978, the intermediate family budget rose at average annual rates of 7.9 percent in Dallas, 8.1 percent in Austin and Baton Rouge, and 8.6 percent in Houston. The higher-budget costs rose slightly faster, while lower-budget costs increased at slightly slower rates. Analysis of the data indicates, however, that costs of goods and services—consumption costs—did not always keep pace with total budget costs. Estimated costs for goods and services rose less rapidly than total costs in all four areas for higher-budget families and in each area except Austin for intermediate-budget families. For lower-budget families, on the other hand, costs of goods and services rose faster than the total budget because their income tax burdens were smaller.

Each year since 1973, the base and/or rate for social security taxes has risen. The increases have had the greatest impact on higher-budget families, but even lower-budget families have experienced higher growth rates for these taxes than for their total budget.

Inflation and the progressive nature of income taxes have also greatly boosted the tax burden for many consumers. Again, the higher-budget families have received the largest negative impact from higher income taxes. For these families, personal income taxes rose at average annual rates that were 3.9 to 4.5 percentage points faster than for total consumption costs between 1973 and 1978. For intermediate-budget families, personal income taxes rose at average annual rates 1.2 to 2.2 percentage points faster than those for consumption costs.

In most instances, inflation also increased the cost of basic necessities more rapidly than discretionary items. As a result, the proportion of

Higher taxes and increased prices of essential items have accounted for most of the growth in family budgets in four selected southwestern metropolitan areas



SOURCE: U.S. Bureau of Labor Statistics.

budgets allocated to less essential goods or deferrable items fell for all three budget levels in each of the four urban areas between 1973 and 1978. And the proportion of the budgets that covered essentials rose in each instance except in Baton Rouge; for the intermediate- and higher-budget levels there, the proportions of the budget allocated

for food and housing both declined. But generally, the most rapid price increases in recent years have occurred in medical care, housing, transportation, and, sporadically, food.

After the Peak?

Excerpts from an address by

**Henry C. Wallich, Member
Board of Governors of the Federal Reserve System
Washington, D.C.**

to the

**New York Society of Security Analysts
New York, New York**

August 27, 1979

The recession anticipated by the Fed's forecast is not of the V-shaped variety, as that of 1974-75, but of the saucer type, like most postwar recessions. I would like to say a few words about the general appropriateness of anticipating a recession at this time, somewhat independent of the specifics of the situation. If the expansion which began in the spring of 1975 peaked out in the first quarter of 1979, which remains to be seen, it would have lasted approximately four years. This would make it the longest peacetime expansion since World War II, well in excess of the average duration of cyclical expansions in peacetime, which has been of the order of 2 to 3 years. Our economy has been cyclical for as long as we have reliable records. We have learned that our ability to curb the business cycle is far more limited than what Keynesian economic theory, until quite recently at any rate, has sought to make us believe. In view of all this,

it does not seem to be unreasonable to say that the expansion had probably run its course and that a slowdown was "due."

The view that our economy is cyclical must contend, to be sure, with the historical fact that recessions do not fall into a single pattern. Inventory fluctuations, induced by speculative accumulation as the economy approaches capacity, have been the most frequent ingredient. Fixed-investment booms and recessions have also been a characteristic feature of many but not all cycles. Given the lags built into the productive process, periods of 2 to 3 years seem to be sufficient to allow substantial imbalances in either inventory or fixed investment or both to occur that need to be worked off. But it is quite possible for an expansion to proceed with sufficient moderation so that neither of these imbalances arises. The expansion then could go on without interruption as long as growth stays within potential.

The recent expansion has been characterized by an absence, broadly speaking, of the familiar inventory and investment excesses. It is significant, therefore, that contractive tendencies nevertheless are making themselves felt. This time it is consumption that is principally responsible for the slowdown. Weak consumption is in part the result of exogenous factors, such as the rise in energy prices. But endogenous factors, too, are weighing upon consumption, such as the mounting volume of consumer debt, the low saving rate, and very particularly the decline in consumer purchasing power resulting from earlier price increases. We must remember that the acceleration of inflation which cut into income and consumption began

well before the rise in energy prices. It goes back to 1978, when capacity limits were being approached. A demand-pull type of price rise originated then that was intensified by food and weather before impulses from the energy side took over. Thus, by a different mechanism which did not involve inventory or investment excesses, the cyclical character of the economy has once more asserted itself.

I believe that these cyclical characteristics of our economy need to be more clearly understood and better kept in mind if we want to avoid repeating the policy mistakes of the past. If we treat every recession as a unique event, surprising and explainable only by the failure to adopt simple and obvious remedies, we misread the facts. If we conclude that recessions are simply mistakes, due to nothing but the incompetence of economists or the ineptitude of policymakers, we are likely to take the wrong turn. We shall be driven to repeat the familiar sequence of policy switches since 1961, from fighting unemployment to fighting inflation and back to fighting unemployment, with each temporary objective inadequately attained while the temporarily neglected evil was gathering strength. In this way we have ratcheted ourselves up to very high rates of inflation and at times high rates of unemployment. A policy of less fine tuning and greater steadiness, keeping in mind both inflation and unemployment at all times, seems better suited to the short-run cyclical character of our economy.

Next, I would like to examine some particular features of our present situation. I shall begin with the very high rate of inflation, which implies a half-life for the dollar of something like 5 to 7 years unless materially brought down. As I noted earlier, this inflation has had both endogenous and exogenous origins, and at different times has reflected both demand-pull and cost-push. The demand-pull phase began late in 1978. By historical precedent, capacity utilization was still somewhat below the levels at which capacity pressures and supply limitations had tended to make themselves felt. In the past, these pressures have been felt at percentages in the high 80's for manufacturing and at about 90 percent for materials. On this occasion, pressure seems to have been felt in the middle 80's for manufacturing and high 80's for materials. Among the reasons for this seems to be obsolescence of some productive facilities owing to the rise in energy prices since 1973, and perhaps also

to environmental restrictions, as well possibly as defects in our methods of measuring capacity.

That oncoming shortage of capacity could be seen a long time ahead, beginning in 1975. Investment during the expansion that began in 1975 was low almost throughout its course. Business fixed investment averaged about 9.6 percent of GNP while numerous estimates suggested that continued growth at historic rates would require it to be of the order of 11 or 12. When, during 1977, unemployment declined dramatically without a commensurate increase in output or of capacity utilization while fixed investment accelerated, earlier concern about an impending capital shortage was temporarily muted. But the additional employment was mainly outside the manufacturing sector, and economic growth was associated with very low productivity gains. As it turned out, we were indeed reaching capacity limits both of labor and of capital. Policy moved too late to slow the economy down for a soft landing. In the last quarter of 1978, a final surge of activity and an acceleration of inflation made clear where the productive limits of the economy were situated.

Early in 1979, inflation received further impulses from food and weather, as already noted, combined with very poor productivity experience. Mounting energy costs took over thereafter and are still at work raising the producer and the consumer price indexes.

The only favorable development in this picture has been the moderate behavior of wages. Given the decline in real wages since early 1978, which has played an important role in the decline in consumption, it would not be surprising to see a strong effort on the part of wage earners to regain lost ground. But since that ground is lost not only to labor but to the entire economy as the OPEC "tax" and shrinking productivity eat away at domestically disposable income, an effort to maintain or increase standards of living would be doomed to failure. It could only contribute to further inflation. That this has not happened so far is one of the few elements of strength in our situation. That it may happen in the near future is one of our greatest dangers.

A similar risk existed in 1974, when the rate of inflation reached 12 percent. Wages accelerated very moderately following this development, as indicated by the 1975 rise of 7 percent in hourly earnings and of 8.5 in compensation per hour. The risk that these increases might go into wages was

avoided. In part this was probably due to the fairly tight policies maintained, at the cost of a substantial rise in unemployment. In 1976, inflation accordingly was cut by more than half, to a rate of 4.8 percent.

The evidence of the 1974-76 episode seems to show that inflation is capable of being reduced. Our aim during this new round of double-digit inflation must be to make possible a similar reduction by preventing the inflation from spilling over into wages, without a commensurate cost in unemployment. Once inflation does enter into wages, the wage-price spiral tends to prevent reduction in inflation, as the experience of the last 50 years makes clear.

Labor income in the aggregate did not suffer damage from the 1974-75 wage restraint, relative to the share of other income recipients. Labor's share in GNP was 61 percent in 1973, 62 percent in 1974, and 61 percent in 1975. Undoubtedly there were shifts within labor income between strong and weak bargainers.

An important ingredient in the present inflation outlook is the position of the dollar on foreign exchange markets. The impact of exchange rate depreciation on the domestic price level has turned out much larger than many observers expected. The need to maintain a strong dollar is enhanced accordingly.

Of the three principal factors that affect the exchange value of the dollar—the current account balance, inflation, and interest rates—only the first is clearly moving in favor of the dollar. Fortunately, it has also revealed itself as the most powerful, at least in the short run. Activity in the United States is decelerating while abroad it is still going at a good, although oil-diminished, rate. Our current account, by the end of the year, should be again moving toward surplus. It can be expected to go into surplus in 1980. Historically, the income effect, reflecting GNP movements, has always proved much stronger than the price effect, reflect-

ing the real exchange rate, in shaping the current balance. That should be decisive in the present situation, even if a stronger dollar, a higher rate of inflation, and worsened productivity exert some influence in slowing down the improvement. It has often been observed that relative price levels, as influenced by inflation differentials among countries, become significant only in the longer run and with considerable delays. It is worth remembering also, in this context, that the effective exchange rate of the dollar has depreciated, since March 1973, by about 17 percent in real terms and that its appreciation, since October 1978, again in real terms, has only amounted to about 3 percent.

Interest rate relationships have deteriorated for the dollar since the most favorable differential was reached in late 1978. At the present time, the differential between U.S. short-term rates and a weighted average of foreign short-term rates has been more than halved. It has been observed that as inflation began to accelerate in 1979 all over the world, most other countries raised their interest rates quite substantially while the United States raised discount and Federal funds rates more moderately. But it must also be noted that interest rate increases in other countries occurred in the context of expanding economies while the United States economy has been slowing down.

During the period in 1978 when interest rate differentials were moving in favor of the dollar, the beneficial results were disappointingly slow to materialize. Perhaps this has reflected a tendency of real interest rate differentials to move less favorably than nominal differentials. More to the point, however, seems to be that gains from investment at more favorable interest rates accrue only very slowly. Gains—or losses—from exchange rate movements can materialize very quickly. Where exchange rates are strongly influenced by other factors, therefore, the influence of interest rate differentials appears to be secondary.

Noncash Collection Service Modernized

Collection of matured corporate and municipal coupons for credit to member banks has been updated and improved to provide more timely and efficient service, effective October 9.

Formerly, the Federal Reserve banks acted as collection and distribution centers, receiving and sorting matured corporate and municipal coupons and then presenting them to the appropriate paying agents. That process involved substantial paperwork and, in some cases, long delays in collecting the funds; it required numerous accounting entries between Reserve banks and their depositors and excessive handlings.

Old concept paves new way

Studies by a Federal Reserve task force have concluded that procedures used routinely to clear millions of checks each day could be applied, with modifications, to collection of matured corporate and municipal coupons.

The new procedures are designed to achieve uniformity of service throughout the Federal Reserve System, increase the efficiency in coupon processing for all parties, decrease the number of accounting entries and reconciliation problems, and expedite the flow of funds from coupon collections through the banking network.

The "new trick" to coupon deposits is bulk processing, replacing individual handling of coupons. Under this concept, credit for incoming deposits is passed on a letter total basis rather than on each individual item contained in the deposit, even though the items may be presented to different paying agents. Credit to the depositor is divorced from receipt of payments for the items from the individual paying agents. Credit is passed to depositors on a fixed, preset time schedule. Envelopes are presented to paying agents in bulk form, and receipt of payment is monitored from total consolidated shipments to individual paying agents

instead of items from individual depositors. Paying agents can pay the value of the total collection letter in a single payment. Clerical efforts on both ends of the collection process are then reduced.

Credit availability schedule set forth

In submitting coupons for collection, depositors are required to send separate cash letters for each of the following categories:

- Matured city items
- Matured country items
- Future due city items
- Future due country items

For each category, there is a specific timetable as to when credit will be passed. The schedule is designed to (1) minimize coupon float, (2) encourage sending securities well in advance of maturity, and (3) encourage direct sending of securities by providing faster credit for items sent direct.

Further information

The Federal Reserve Bank of Dallas Circular 79-119, dated July 25, 1979, explains the proper manner for completing the standard forms and the accompanying transmittal letters. Any questions concerning the standard Coupon Cash Letter forms, or the Systemwide Cash Processing procedures in general, may be directed to:

Dallas Office

William Cheshier(214) 651-6179
Lola Martin(214) 651-6379

El Paso Branch

Jerry Silvey(915) 544-4730
Vicky Acuna(915) 544-4730

Houston Branch

James Lockhart(713) 659-4433
Dorothy Boaz(713) 659-4433

San Antonio Branch

Tony Valencia(512) 224-2141
Herb Barbee(512) 224-2141

“Fed Quotes”

Brief Excerpts from Recent Federal Reserve Speeches, Statements, Publications, Etc.

“Federal Reserve policy on foreign acquisitions of American banks is in accord with U.S. policy of welcoming foreign investment in general. We believe that our economy and our financial system benefit from foreign competition, and from foreign capital so long as the investment is subject to the same rules and regulations that apply to domestic companies. This principle of national treatment is embodied in the letter and spirit of the International Banking Act, and it underlies the exercise of the Federal Reserve’s responsibilities regarding foreign banking in the United States.

“It needs to be emphasized that there is a framework of law covering foreign acquisitions of U.S. banks and that recent acquisitions have been made in accordance with law. I refer to Section 3 of the Bank Holding Company Act. The Federal Reserve evaluates proposed acquisitions according to standards set forth in the Act; the financial and managerial capabilities of the acquiring company, the convenience and needs of the community to be served, and the effect on competition and concentration of resources in the United States. In my view, these are appropriate standards for assessing individual applications.

“When the foreign investor is an individual, rather than a bank or bank holding company, the standards are those of the Change in Bank Control Act of 1978, which took effect this past March. That Act requires individuals seeking to acquire control of a bank to give the relevant Federal bank regulatory agency 60 days’ prior notification. The proposed acquisition may be disapproved if it would substantially lessen competition, result in a banking monopoly in any part of the United States, jeopardize the financial stability of the bank or otherwise be contrary to the interests of the bank to be acquired.

“As to the impact of foreign acquisitions on the supply of banking services to meet the needs of U.S. industry and consumers, probably the best protection in this regard is the competitiveness of U.S. banking. All owners of banks are free to change the character of the bank’s business—for example, from retail to wholesale. However, banks that do not meet the needs of their community quickly lose business to those that do. As businessmen, foreign bankers can be expected to recognize that fact and act accordingly. Moreover, the Bank Holding Company Act requires the Board in acting on any proposed acquisition to consider the convenience and needs of the community being served. In this connection, the Board reviews the effects of an acquisition on the services offered by the bank being acquired and generally expects some showing of improved services. Further, foreign-owned banks—like domestic banks—are subject to the Community Reinvestment Act, which requires the Federal bank regulatory authorities to evaluate the extent to which a bank is servicing all elements of its community, and also the Equal Credit Opportunity Act, which prohibits discrimination in lending.”

Henry C. Wallich, Member, Board of
Governors of the Federal Reserve System
(Before the Subcommittee on Commerce,
Consumer, and Monetary Affairs, U.S. House
of Representatives, August 1, 1979)

"Activities giving rise to unreported income, whether earned from legal or illegal sources, have been called the underground economy. The scope and nature of the underground economy has an important bearing on U.S. tax policy and also may be relevant to the understanding of developments in the economy and financial markets. For these reasons, the Board welcomes any efforts that may be made to measure the extent of the underground economy."

"Even though the Federal Reserve's data on currency and demand deposits are highly accurate and measured on a consistent basis over time, there are no reliable estimates on what portion of the U.S. currency in circulation is held in the United States and what portion is held abroad. U.S. currency balances may be held abroad as a store of wealth and, in a few countries, such balances evidently even serve as a major medium of exchange. Therefore, fluctuations in the currency ratio may reflect changes in economic and political conditions abroad.

"Apart from variations resulting from currency held abroad, movements in the currency to deposit ratio also reflect domestic above-ground economic activity. In fact, as the IRS study noted, research by the Federal Reserve staff indicates that both the trend and cyclical movements in the currency to deposit ratio over most of the 1960s and 1970s can be explained adequately by movements in real income and consumption expenditures, prices, and interest rates—variables which are recognized as important determinants of currency and deposit holdings.

"Since mid-1974, however, the currency to deposit ratio has moved up more sharply than can be accounted for by movements in those determinants. The increase in the ratio appears to be a result of a downward shift in the demand for demand deposits and not an upward shift in the demand for currency. Currency holdings continue to be predicted accurately by movements in real consumption expenditures, prices, and interest rates. The weakness in demand deposit growth, on the other hand, appears to be associated with a variety of new developments in the money market. For households, innovations such as NOW accounts, ATS accounts, and money market mutual funds have become increasingly important substitutes for demand deposits. For business firms, sluggish deposit growth has reflected the growing use of cash management techniques and deposit substitutes such as security repurchase agreements.

"Thus, there are plausible explanations of the post World War II rise in the ratio of currency to deposits which do not rely on the growth of an underground economy. I do not mean to imply that the underground economy does not exist or that currency is not used more extensively as a medium of exchange for underground transactions. The point is that other factors affect the currency to deposit ratio, and they must be taken into account when separating above-ground currency holdings from underground currency holdings."

Nancy H. Teeters, Member, Board of
Governors of the Federal Reserve System
(Before the Subcommittee on Oversight of the
Committee on Ways and Means, U.S. House
of Representatives, September 10, 1979)

Profitability of Bank Loan and Investment Functions: Large Variations Among Banks

By Mary G. Grandstaff

Bank profitability depends largely on earnings received from interest-bearing assets and net costs and expenses associated with acquiring and maintaining them. As with any profit-oriented firm, bank managements must know the relative net earnings on the various types of income-producing assets in order to maximize their profits.

The proliferation of bank services in the past decade, however, has made it increasingly difficult for many banks to classify incomes and expenses by activity type. The Functional Cost Analysis (FCA) Program conducted annually by the Federal Reserve Bank of Dallas provides participating member banks with important income and expense data for a number of major bank functions, including investments and various types of loans. These data not only enable a participating bank to determine the relative profitability of each function but also provide comparisons with the average experience of other participating banks in the same general deposit size and similar functions.

The FCA Program provides income and expense data for five funds-using functions: investments, real estate mortgage loans, instalment loans, credit-card loans, and commercial, agricultural, and other loans. An analysis of these data provides insights into the relative profitability of each function. That profitability depends on three factors: earnings

from the income-producing assets, expenses incurred in acquiring and maintaining them, and the cost of funds used to acquire them.

Cost of money

The cost of money at a commercial bank is determined by three factors: the amount of interest paid on available funds, operating expenses incurred in acquiring and maintaining them, and any nonportfolio income received from them. Determining the exact source of funds used for individ-

Considerable variation in cost of funds is evident among banks. Since cost of money is a major expense and one for which the variation bank to bank is substantial, it merits close attention. If a bank can reduce the cost of money without losing volume or reducing return on assets, it can improve profitability.

ual functions would be very difficult if not impossible. Therefore, the FCA Program uses a "pool-of-funds" method in allocating funds to the various funds-using functions. With this method,

an average cost of funds is calculated for each bank and applied equally for funds used in all functions at that bank.

Suppose, for example, that a bank had \$12 million in available funds—comprised of \$4 million in demand deposits, \$6 million in time and savings deposits, and \$2 million in nondeposit funds. Assume further that the net costs of obtaining and maintaining those funds were 3 percent, 7 percent, and 5 percent, respectively. With the pool-of-funds approach, the cost of funds for this bank would be \$640,000, or 5.3 percent of available funds. And using the pool-of-funds method, the cost of funds used for a \$10,000 loan or a \$10,000 security at this bank would be an identical \$530—5.3 percent of the volume of funds used. Therefore, the cost of funds has no impact on the relative profitability of a bank's individual functions. It does, however, have a sizable impact on a bank's overall profitability, as well as its profitability in relation to other banks of comparable size and operation.

Considerable variation in cost of funds is evident among banks. Since cost of money is a major expense and one for which the variation bank to bank is substantial, it merits close attention. If a bank can reduce the cost of money without losing volume or reducing return on assets, it can improve profitability. Opportunities apparently exist

for some banks to reduce their cost of funds. At the 83 banks that participated in the 1977 FCA study, cost of money ranged from 3.08 percent to 6.31 percent of available funds. And, on average, the cost of funds at the ten high-profit banks was more than a full percentage point lower than at the ten low-profit banks. This occurred even though the low-earning banks had a higher average ratio on income from service and handling charges on deposits and a slightly lower average interest expense ratio. It occurred because high-profit banks, on average, had considerably lower operating (noninterest) expense ratios on deposits.

Investment function

As with all the banking functions, individual banks experienced wide variation in profit levels on investments. Net earnings on investments ranged from 6.65 percent on the funds invested to a loss of 0.49 percent (Table 1). The ten banks with the highest net return on investments had average net earnings of 4.92 percent, compared with 1.13 percent at the ten least profitable banks. The spread reflected a combination of higher income ratios and lower expense and cost-of-money ratios at the high-profit banks.

Under the FCA Program format, earning assets in the investment function are classified as U.S. Government securities, tax-exempt securities and

Table 1

**EARNINGS ON INVESTMENTS
AT TEN BANKS WITH HIGHEST OR LOWEST
NET EARNINGS ON INVESTMENTS**

(From data for 83 member banks participating in 1977 Functional Cost Analysis Program, Eleventh Federal Reserve District)

Rank of bank's total deposits ¹	As percent of total investments				
	Total income	Operating expenses	Net yield before cost of money	Cost of money	Net earnings
High-profit banks					
61	11.764	0.289	11.475	4.826	6.649
52	9.399	.038	9.361	3.837	5.524
20	8.372	.101	8.271	3.292	4.979
63	9.767	.333	9.434	4.682	4.751
60	8.868	.110	8.757	4.098	4.660
12	7.822	.095	7.727	3.084	4.643
31	9.128	.183	8.944	4.328	4.616
78	7.863	.127	7.736	3.235	4.500
25	8.542	.101	8.440	3.973	4.467
23	8.586	.158	8.428	4.043	4.385
Average	9.011	.154	8.857	3.940	4.917
Low-profit banks					
70	5.891	.209	5.682	3.677	2.005
55	6.883	.248	6.635	4.763	1.871
13	6.877	.404	6.473	4.722	1.751
26	6.943	.008	6.935	5.290	1.645
71	6.749	.354	6.396	4.896	1.500
30	5.958	.174	5.784	4.410	1.375
50	7.057	.325	6.731	5.742	.989
79	6.056	.238	5.818	5.130	.688
76	6.415	1.603	4.812	4.826	-.014
83	6.632	.812	5.820	6.312	-.492
Average	6.546	.438	6.109	4.977	1.132

1. Demand deposits and time and savings deposits.

loans, other securities, and Federal funds sold. Some banks also had small amounts of other liquidity loans that were included in the investment function. Each of these types offers different rates of return, and an individual bank's management must determine the best mix of these investments for its own circumstance.

In making decisions on types of investments, it is important that a bank have some idea of its probable overall profitability. As an example, the book rate of return on tax-exempt securities generally is well below that of all other types of investments. However, the fact that income from these securities is tax-exempt can make them very attractive to many banks because adjusting the rate to a taxable basis usually makes such securities the highest-earning type of investment.

For the ten banks with the most profitable investment functions, for instance, the average rate of

return on tax-exempt securities was only 5.23 percent, compared with 7.23 percent on U.S. Government securities, 7.39 percent on other securities, 6.04 percent on Federal funds, and 7.62 percent on other liquidity loans. After adjustment for taxes, however, the tax-exempt securities yielded an average return of 10.05 percent—or well above all the other types of investments. While the low-profit banks also generally realized a somewhat higher rate on their tax-exempt securities after adjustment for taxes, the advantage was muted at these banks because of their lower tax brackets.

The high-profit banks generally placed the largest share of their investments in tax-exempt securities, apparently in an effort to reduce tax liabilities. On average, these securities amounted to slightly over three-fifths of all investments at the ten most profitable banks. The ten low-profit banks, on average, held less than one-fifth of their

investments in the form of tax-exempt securities, as they elected to hold larger proportions of their investments in U.S. Government securities and Federal funds.

The ten high-profit banks received investment income that amounted to 9.01 percent of the funds invested, compared with 6.55 percent at the low-profit banks. The more profitable banks also were able to hold their expense ratio on investments to less than half that of the low-profit banks. This was largely accomplished through higher productivity. Although the investment portfolio of the former averaged more than twice that of the latter banks, the number of officers and employees in this function averaged about 30 percent and 50 percent, respectively, lower at the high-profit banks.

Real estate mortgage loan function

Net earnings on real estate mortgage loans at the banks participating in the 1977 FCA study ranged from a net profit of 5.27 percent on the total portfolio to a net loss of 2.72 percent (Table 2). Mortgage loans were not offered by 9 of the 83 banks. As would be expected, the more profitable banks experienced higher yields and/or lower expenses and money costs.

The ten banks with the most profitable real estate mortgage loan functions reported an average income ratio on these loans that was 2.25 percentage points above the average for the ten least profitable banks. Moreover, expenses in relation to total real estate mortgage loans at the latter banks, on average, were four times greater than at the high-profit banks, and the cost of money was more than

Table 2

EARNINGS ON REAL ESTATE MORTGAGE LOANS AT TEN BANKS WITH HIGHEST OR LOWEST NET EARNINGS ON THOSE LOANS

(From data for 83 member banks participating in 1977 Functional Cost Analysis Program, Eleventh Federal Reserve District)

Rank of bank's total deposits ¹	As percent of total real estate mortgage loans				
	Total income	Operating expenses	Net yield ² before cost of money	Cost of money	Net earnings
High-profit banks					
54	10.778	0.804	9.643	4.376	5.266
20	10.569	1.593	8.348	3.292	5.056
12	9.000	.942	8.058	3.084	4.974
78	8.541	.458	8.083	3.236	4.848
52	9.260	.716	8.544	3.837	4.707
5	8.467	.526	7.940	3.368	4.573
11	11.066	2.322	8.744	4.205	4.539
51	9.753	.926	8.565	4.168	4.397
65	10.002	.609	9.080	4.707	4.374
63	9.130	1.028	8.970	4.682	4.288
Average	9.657	.992	8.598	3.896	4.702
Low-profit banks					
34	8.712	2.479	6.219	4.589	1.630
74	8.807	2.300	6.507	5.238	1.269
68	6.577	.418	6.159	5.212	.947
67	6.633	1.032	5.601	4.720	.880
6	7.639	1.438	4.949	4.412	.537
50	8.780	.551	5.273	5.742	-.470
13	7.406	.802	4.187	4.722	-.535
45	3.401	.454	2.883	5.034	-2.150
79	6.535	6.552	-.017	5.130	-5.147
61	9.563	26.047	-19.282	4.826	-24.108
Average	7.405	4.207	2.248	4.963	-2.715

1. Demand deposits and time and savings deposits.

2. Includes five-year average loss adjustment where applicable.

1 percentage point lower. Four of the ten least profitable banks managed to hold their expense ratios below the average for the high-profit banks, but their income ratios were fairly low and their cost of money was high. Three of the four experienced net losses in their real estate mortgage loan functions.

If quality of loans is equal, the expenses incurred in making and servicing mortgage loans usually do not increase proportionately with volume. Thus, large loans, as a rule, would be expected to be more profitable than smaller ones.

The average real estate mortgage loan portfolio at the ten high-profit banks was about 15 percent greater than at the ten low-profit banks. Nevertheless, the latter banks generally had an average of almost one more person allocated to the function. Each employee at the low-profit banks, on average, handled more loans, but the average size of those loans—\$50,220—was only about 70 percent as large as the \$71,614 average size at high-profit banks. If quality of loans is equal, the expenses incurred in making and servicing mortgage loans usually do not increase proportionately with volume. Thus, large loans, as a rule, would be expected to be more profitable than smaller ones. Size of loan appeared to be the predominant factor accounting for the differences between earnings at high- and low-profit banks.

Instalment loan function

Income received on funds invested in the instalment loan portfolio generally provides banks with the highest income ratio of all types of loans or investments. In 1977, these ratios ranged from 14.76 percent to 7.97 percent at banks that participated in the FCA Program. The ten banks with the most profitable instalment loan functions received income averaging 13.00 percent of funds used, while the ten low-profit banks obtained an average of 12.19 percent (Table 3).

Expenses associated with making and servicing these loans, however, also are usually considerably higher than for any other income-producing asset. In 1977, expenses for these loans ranged from 8.86

percent to 1.24 percent of total instalment loans. The high expenses for these loans are a direct result of a larger number of loans and their smaller size. As stated previously, the cost of an individual loan does not decline proportionately with a reduction in dollar amount. If other factors—quality, interest rate, and so on—are equal, the cost of making and servicing a \$100,000 loan may be little, if any, greater than the cost of a \$1,000 loan.

Instalment loans averaged \$2,039 in size at the ten banks with the most profitable instalment loan functions in 1977 and \$1,798 at the ten least profitable banks, a difference of only 13 percent. Moreover, the number and total dollar volume of instalment loans at the ten high-profit banks averaged about 40 percent and 60 percent, respectively, more than at the low-profit banks. Nevertheless, the average low-profit bank had about 40 percent

Personnel at the average high-profit bank handled about twice as many instalment loans in 1977—in both number and volume—as personnel at the average low-profit bank.

more officers and almost 25 percent more employees than the average high-profit bank. Consequently, personnel at the average high-profit bank handled about twice as many instalment loans—in both number and volume—as personnel at the average low-profit bank. Thus, high-profit banks had much lower average costs for making and servicing these loans.

The ten banks with the highest rate of profitability on instalment loans recorded average net earnings of 5.33 percent on these loans. Low-profit banks averaged a 0.39-percent net loss.

Credit-card loan function

The credit-card loan function at participating banks shows the widest variations of all functions in terms of profitability, mainly because of low volume and high expenses. Only 19 of the 83 banks reported credit-card loans, and data for some of these banks are meaningless. In some instances, volume was extremely low and expenses were very high, indicating that those banks may still

Table 3

**EARNINGS ON INSTALMENT LOANS
AT TEN BANKS WITH HIGHEST OR LOWEST
NET EARNINGS ON THOSE LOANS**

(From data for 83 member banks participating in 1977 Functional Cost Analysis Program, Eleventh Federal Reserve District)

Rank of bank's total deposits ¹	As percent of total instalment loans				
	Total income	Operating expenses	Net yield ² before cost of money	Cost of money	Net earnings
High-profit banks					
54	14.758	3.422	10.688	4.376	6.311
48	14.176	3.038	10.490	4.852	5.638
71	13.115	2.416	10.502	4.896	5.606
65	12.854	2.487	10.020	4.707	5.314
31	13.070	3.337	9.604	4.328	5.276
17	11.262	2.045	9.218	3.988	5.230
60	12.861	3.557	9.223	4.098	5.126
51	14.103	2.776	9.162	4.168	4.994
62	12.450	2.548	9.589	4.679	4.910
10	11.395	1.914	9.391	4.531	4.859
Average	13.004	2.754	9.789	4.462	5.326
Low-profit banks					
12	10.345	6.254	3.746	3.084	.663
61	13.276	7.387	5.248	4.826	.421
80	11.119	5.672	4.587	4.326	.262
74	12.273	7.105	5.168	5.238	-.070
24	12.325	7.408	4.269	4.367	-.098
55	13.900	7.843	4.579	4.763	-.184
50	11.891	4.377	5.165	5.742	-.577
73	12.397	7.544	3.584	4.335	-.751
67	12.686	8.855	3.603	4.720	-1.117
75	11.730	8.569	2.048	4.442	-2.394
Average	12.194	7.101	4.200	4.584	-.385

1. Demand deposits and time and savings deposits.

2. Includes five-year average loss adjustment where applicable.

have been in the introductory stages of offering this service.

With such limited data, conclusions regarding the credit-card function are somewhat hazy. Excluding two banks with extraordinary experiences, it appears that income on credit-card loans in relation to other types of loans was high—ranging from a low of 14.01 percent of total credit-card volume to a high of 43.55 percent.

As would be expected, the large number of these relatively small size accounts also makes them the most expensive type of loan for most banks. Again, excluding the extraordinary banks, expenses at most participating banks totaled between 15 percent and 49 percent of funds used.

Thus, the credit-card function is not profitable for all banks. However, 13 of the 19 banks with credit-card functions registered profits for the function. These profits usually were in the range

of 5 percent to 7 percent.

The credit-card function is a relatively new area for many banks—one of the major banking innovations of the 1960's. More experience with the function could result in improved profitability and use by a larger number of banks.

**Commercial, agricultural,
and other loan function**

As with the other three loan functions, the more profitable banks generally managed to have a higher income ratio and lower expense ratio on their commercial, agricultural, and other loan functions. Consequently, net earnings at the ten banks with the highest profits in this function averaged 4.38 percent of the funds invested in these loans, compared with an average loss of 0.95 percent at the ten low-profit banks (Table 4). And again,

Table 4

**EARNINGS ON COMMERCIAL, AGRICULTURAL,
AND OTHER LOANS AT TEN BANKS WITH HIGHEST
OR LOWEST NET EARNINGS ON THOSE LOANS**

(From data for 83 member banks participating in 1977 Functional Cost Analysis Program, Eleventh Federal Reserve District)

Rank of bank's total deposits ¹	As percent of total commercial, agricultural, and other loans				
	Total income	Operating expenses	Net yield ² before cost of money	Cost of money	Net earnings
High-profit banks					
68	15.875	1.997	13.506	5.212	8.294
45	12.024	1.264	10.535	5.034	5.501
59	9.046	.598	8.005	4.032	3.974
78	8.466	1.380	7.086	3.236	3.850
79	10.863	1.924	8.939	5.131	3.809
17	8.185	.442	7.743	3.988	3.755
14	8.874	.493	8.306	4.567	3.739
73	9.557	1.300	8.055	4.335	3.720
23	8.350	.594	7.744	4.043	3.701
67	9.430	1.123	8.203	4.720	3.483
Average	10.067	1.112	8.812	4.430	4.383
Low-profit banks					
62	8.776	1.965	5.232	4.679	.553
46	8.944	2.782	5.386	5.034	.353
47	8.962	3.651	4.262	3.950	.312
56	9.695	1.639	5.156	4.975	.181
69	8.886	3.597	4.111	4.058	.053
81	8.297	3.388	4.817	4.954	-.137
80	7.689	3.101	3.545	4.326	-.780
83	9.960	4.295	4.401	6.313	-1.911
13	8.532	2.158	1.967	4.722	-2.756
50	9.311	4.762	.394	5.742	-5.348
Average	8.905	3.134	3.927	4.875	-.948

1. Demand deposits and time and savings deposits.
2. Includes five-year average loss adjustment where applicable.

the higher profitability largely reflected higher productivity.

Although the average high-profit bank for this function had an 83-percent larger dollar volume of these loans than low-profit banks and a 65-percent larger number of loans, on average, high-profit banks made and serviced these loans with 40 percent fewer personnel. Average loan size at the higher-earning banks was \$18,271, or 47 percent greater than the \$12,459 average at low-earning banks. Nevertheless, personnel at high-profit banks, on average, handled 77 percent more loans than their counterparts at low-profit banks and 170 percent more in terms of dollar volume.

While instalment and credit-card loans may account for the largest number of loans, most banks normally hold the largest portion of their dollar volume of loans in the form of commercial, agri-

cultural, and other loans. The average size of individual loans in this function is usually well above that of consumer-type loans. (Real estate loans often may have a higher average size, but the number of these loans is very small in relation to commercial, agricultural, and other loans.)

Income from the function is not quite as high as that obtained on consumer-type loans because lending rates for commercial, agricultural, and other loans are generally lower. Expenses, however, are considerably lower because of the larger average loan size. As a result, net earnings from commercial, agricultural, and other loans usually are about in line with earnings on consumer-type loans and slightly less than earnings on real estate mortgage loans.

The foregoing discussion was not intended to suggest that banks should place more emphasis

on any particular type of interest-bearing asset. The relative profitability of functions changes in response to economic conditions and individual-bank growth. It is very important, however, that banks closely analyze the operations of all their

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major funds-using functions. The wide variations in profitability of all functions at banks participating in the FCA study suggest some may have opportunities, through closer analysis of functions and astute management, for improvement in various functions and, thus, overall profitability.

One interesting observation based on the results of the 1977 FCA study was that many banks placing very high in terms of profitability in one or more functions fell considerably lower in profit-

ability in other functions. Through close monitoring of functional profitability, banks can identify areas where changes can improve overall results.

Another observation obtained from the FCA study was that deposit size and age of bank have only minimal effects on profitability in any bank function. On average, the more profitable banks in each function tended to be somewhat larger and older than the lower-profit banks. The average deposit size of the high-profit banks for the loan and investment functions ranked from 41 to 52, while low-profit banks ranked from about 50 to 59. Nevertheless, several relatively small banks were among the most profitable for various functions, while some of the larger banks were among the least profitable. Similarly, some banks organized in the 1970's were among the most profitable for some functions, while some banks organized before the 20th century were among the least profitable.

It also should be pointed out that allocation of resources should never be solely dependent on profitability levels. Such factors as customer needs, market conditions, and risk are other major considerations. Thus, although it is important for a bank to evaluate the profitability of its individual functions, in the final analysis it is the overall performance of a bank in meeting its goals that is most important. And it is the objective of functional cost analysis to help the bank attain its goals with the highest possible level of profitability.

New member banks

First National Bank, Seminole, Texas, a newly organized institution located in the territory served by the Head Office of the Federal Reserve Bank of Dallas, opened for business September 24, 1979, as a member of the Federal Reserve System. The new member bank opened with capital of \$625,000 and surplus of \$625,000. The officers are: Marion C. Bowers, Chairman of the Board; Don W. Long, President; Robert Cosby, Cashier; and June Lange, Assistant Cashier.

First National Bank, San Benito, 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 October 1, 1979, as a member of the Federal Reserve System. The new member bank opened with capital of \$625,000 and surplus of \$625,000. The officers are: Randall P. Crane, Chairman of the Board; Robert B. Dunkin, President; and Betty Morgan, Cashier.

Collateral Procedures Liberalized at Fed's Discount Window

The Federal Reserve Bank of Dallas has implemented several changes intended to expand the pool of available loan collateral for member banks in the Eleventh District and simplify its handling. Some member banks, particularly larger banks, have occasionally had insufficient eligible collateral to handle their borrowing needs.

The changes are reflected in revised Bulletin 2, "Loans," which the Federal Reserve Bank of Dallas transmitted to the member banks on September 10, 1979. Some of the changes being implemented are:

- Loan participations and foreign paper can now be accepted as collateral.
- Member banks may now enter into off-premises custody arrangements with the Federal Reserve Bank of Dallas, in which they may agree to hold certain types of loan collateral on their own premises rather than transmit it to the Federal Reserve Bank or branch or to a correspondent bank, as in the past.

The new off-premises collateral arrangements apply to three types of collateral: one- to four-family residential mortgages, commercial and agricultural paper (including loan participations), and

Group I municipal securities. Discount window credit secured by one- to four-family residential mortgages and by "eligible" commercial and agricultural paper may be obtained at the basic discount rate. Advances secured by Group I municipal securities and "ineligible" commercial and agricultural paper may be obtained at the Section 10(b) rate, which is one-half of 1 percent over the basic discount rate.

Banks in the Eleventh District that are interested in further information or want to receive the necessary forms for use under the new collateral procedures may contact the following:

Dallas Office

Jesse Sanders, Bill Hayden (214) 651-6240

El Paso Branch

Robert Schultz (915) 544-4730, Ext. 41

Houston Branch

C. O. Holt, Jr. (713) 659-4433, Ext. 44

San Antonio Branch

Thomas Cole (512) 224-2141, Ext. 13