

FEDERAL RESERVE BANK OF NEW YORK



MONTHLY REVIEW

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Contents

The Business Situation	251
Monetary and Bank Credit Developments in the Third Quarter	255
The Money and Bond Markets in October	260
Bank Expansion in New York State: The 1971 Statewide Branching Law	266

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The Business Situation

Recent business statistics provide some favorable, though tentative, readings on the impact of the Administration's new economic policies. Price developments, particularly the September and October stability of industrial wholesale prices, attest to the effectiveness of the price freeze in that area. However, problems relating to survey techniques hampered efforts to assess the impact of the freeze on consumer prices, which recorded some increases in September. The rate of increase in compensation per man-hour in the private economy—the broadest measure of the behavior of wage costs—also slowed in the third quarter. The degree of this moderation was limited by the fact that these data only partially reflected developments during the wage freeze since it applied to only half the period.

The price freeze and the probable elimination of the excise tax on automobiles have given rise to a dramatic upswing in purchases of domestically produced automobiles. However, the overall pace of the business recovery remains on the sluggish side, as indicated by the relatively modest rise in real gross national product (GNP) in the third quarter. Part of this sluggishness stemmed from the depressing influence that the liquidation of excess steel stocks had on production and inventory spending. The reductions in personal income taxes and the establishment of the 7 percent investment tax credit that are now being considered by the Congress should help to strengthen the business recovery. While the recovery in production and employment has been particularly weak overall, the decline in the unemployment rate for the two most recent months to 5.8 percent in October is encouraging.

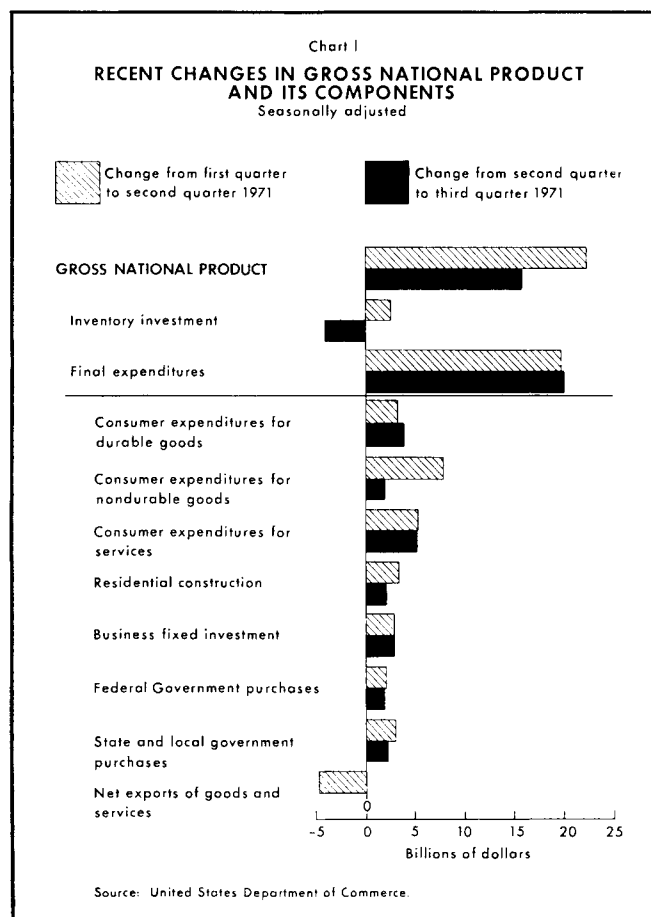
GROSS NATIONAL PRODUCT IN THE THIRD QUARTER

The market value of the nation's output of goods and services rose by \$15.9 billion (see Chart I) to a seasonally adjusted annual rate of \$1,059.0 billion in the third quarter. This gain, which amounted to about 6 percent

at an annual rate, followed the 9 percent rise that occurred in the second quarter. After adjustment for changes in the price level, the July-to-September increment in real GNP was approximately 3 percent in contrast to the 5 percent increase in real output posted in the preceding three-month period. Thus, the third-quarter performance of real GNP—like most other recent business statistics—continued to point to a relatively sluggish recovery. It should be noted, however, that a sizable portion of the data used in compiling these preliminary GNP estimates reflected events which occurred prior to the President's announcement of the new economic policies.

The slowing in the growth of nominal and real GNP was attributable to the reduced pace of inventory spending. According to preliminary estimates, inventory accumulation in the third quarter amounted to a modest \$1.6 billion (annual rate), compared with the \$5.7 billion rate in the April-June period, thus causing a \$4 billion drag on the third-quarter rise in overall GNP. The pattern of inventory spending over the two most recent quarters was greatly distorted by the behavior of steel buying. In the April-June period, such spending was artificially increased by fears that the industry would be struck on August 1, whereas during the third quarter it was limited by the liquidation of a sizable part of those excess stocks. The drag on GNP arising from the inventory sector may be largely completed during the current quarter. In fact, with inventory-sales ratios in most sectors at comfortable levels, a more robust pace of inventory spending could become a major stimulus to the recovery once the overhang of excess steel inventories is worked off.

The third-quarter rise in final demand—i.e., GNP less inventory accumulation—amounted to \$20 billion, a shade stronger than the increase posted over the April-June period. In real terms, final spending rose at a 4.7 percent annual rate. With the exception of the strike-distorted first quarter of 1971, this was the largest quarterly rise in real final demand in three years. The overall gain in final spending measured at prevailing prices was paced by relatively large increases in outlays for new residential



construction and by a strong gain in business fixed investment spending, while consumer spending registered a moderate increase.

Business fixed investment advanced by \$2.7 billion in the July-September period. This strength was somewhat surprising in light of the weakness in plant and equipment spending that has been indicated in most of the recent Government and private surveys of investment plans. In fact, over the two most recent quarters, business fixed investment spending has risen at an annual rate of about 10 percent. A sizable fraction of the overall strength in such investment during the third quarter reflected a stepped-up pace of business purchases of automobiles and trucks and, to a far less extent, a higher level of spending for farm equipment. In part, the strong showing of business spending on autos and trucks may have been spurred by the price freeze, which provided an incentive to purchase these goods while the freeze was

in effect to avoid future price increases. Similarly, the pending elimination of the excise tax on automobiles and small trucks may also have contributed to this higher level of spending.

Given the role that autos and trucks played in the third-quarter rise in business fixed investment, the strength in this spending component was not indicative of a turnaround in spending for new plant and equipment, where the general outlook remains weak because of the sizable amount of unutilized capacity that currently exists. The rate of capacity utilization in manufacturing actually decreased in the third quarter of 1971 and was below that which prevailed in the last quarter of 1970—the tentatively designated trough of the business cycle—despite the depressing impact of the auto strike on fourth-quarter production. The failure of the rate of capacity utilization to rise substantially by this stage of the business recovery contrasts sharply with the experience of the other post-Korean war recoveries (see Chart II). The current sizable volume of excess capacity will most likely dampen the near-term impact of the probable reestablishment of a 7 percent investment tax credit. Indeed, the recent McGraw-Hill survey of spending plans suggests that neither this credit nor the earlier liberalization of depreciation allowances has caused much step-up in investment plans.

Spending on residential construction continued its strong upward momentum in the third quarter, rising by \$2 billion to a seasonally adjusted annual rate of \$41.7 billion. While this was somewhat smaller than the gain posted in each of the previous three quarters, it brought the overall rise of home-building outlays since the third quarter of 1970 to a very sizable 45 percent. The prospects for continued strength in outlays for residential construction appear good. In particular, the substantial declines in long-term interest rates that have occurred since the President's August 15 speech should have a favorable impact on the availability and cost of mortgage credit.

Personal consumption expenditures rose \$11.2 billion in the third quarter to a seasonally adjusted annual rate of \$672.1 billion, about \$5 billion less than the gain recorded in the previous quarter. All of this shortfall occurred in purchases of nondurable goods; in contrast, consumer spending on durables accelerated in the third quarter, rising by about \$4 billion. With the exception of the strike-distorted first quarter of 1971, this was the largest quarterly gain since the third quarter of 1968. A sharp spurt in automobile buying after the President's August 15 speech was the major reason for the overall strength in durables spending during the quarter. Indeed, aided by the price freeze and by the probable elimination of the 7 percent excise tax, sales of domestically

produced cars rose markedly in the last half of the quarter, averaging a seasonally adjusted annual rate of better than 9 million units. Moreover, this surge continued into the current quarter, as sales of domestically produced cars ran at a seasonally adjusted annual rate of 10 million units in October. The decline in sales of imported cars from an annual rate of 1.8 million units in June to 1.3 million units in October apparently stemmed from the limited availability of imported vehicles that resulted from the long-shoremen's strikes. Thus, the data which are currently available do not provide much guidance on the extent to which the import surtax and recent movements in exchange rates may have resulted in an increase in the demand for domestic cars at the expense of imports.

Despite the slower advance in consumption spending in the third quarter, the personal savings rate (the proportion of disposable income that is not spent) dropped by a relatively large 0.5 percentage point to 7.7 percent—a figure which is still very high by historical standards. The decline in the rate reflected the fact that the growth in personal income and disposable income diminished in the quarter. In turn, the slower growth in personal income occurred partly because the second-quarter rise had

been inflated by a lump-sum retroactive social security benefit increase. The third-quarter gain in personal income may have also been limited by the wage freeze, although the precise impact of the freeze is difficult to ascertain. In the near term, however, disposable income will receive additional stimulus from the large military pay boost which will occur in the current quarter and from a series of personal tax reductions recommended by the President and now being considered by the Congress. This additional stimulus to disposable income may well help to trigger a still more expansionary pace of consumer spending.

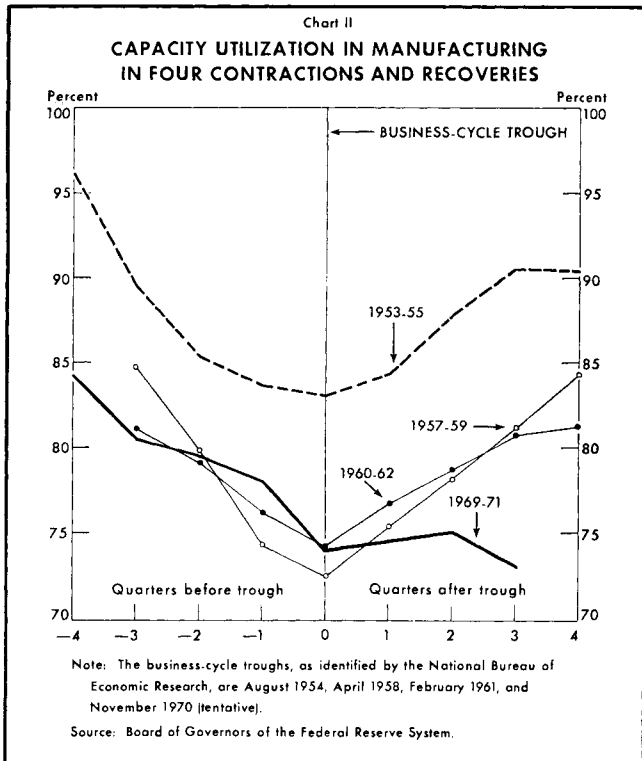
Government purchases of goods and services rose by \$4.2 billion in the third quarter, as Federal spending increased by \$1.9 billion while outlays by state and local governments posted a gain of \$2.3 billion. The July-September increment in state and local spending was relatively small by recent standards. This resulted from a slower rise in employee compensation—probably due in part to the wage freeze—and a weakening in expenditures on new construction.

Net exports of goods and services, according to preliminary and incomplete data, were in deficit by \$0.5 billion for the second consecutive quarter. Although these data may prove to be particularly unreliable because of the distortions arising from dock strikes, the recent behavior of the trade account does show a significant rise in the rate at which the United States economy is consuming imported goods. Indeed, spurred in part by the automobile strike and the threat of a steel strike, imports have risen by \$9.3 billion over the four quarters that ended in September 1971. In contrast, over the similar period terminating in September 1970, the rise in imports was only \$4.2 billion.

PRICES, PRODUCTIVITY, AND WAGES

During the third quarter, the implicit GNP deflator, which is the most comprehensive measure of price trends in the economy, rose at a 3.3 percent annual rate. This compares with the 4.0 percent rate of advance in the preceding quarter and represents the smallest rise since the second quarter of 1967. Since many of the underlying price data included in the deflator did not start to capture the effects of the freeze until September, comparatively little of the post-August 15 price developments show up in the average level of the deflator for the third quarter.

The deflator relies heavily, but not exclusively, on monthly wholesale and consumer price data. Although the freeze went into effect on August 15, the wholesale price data for that month describe almost entirely pre-freeze developments because of the timing of the survey

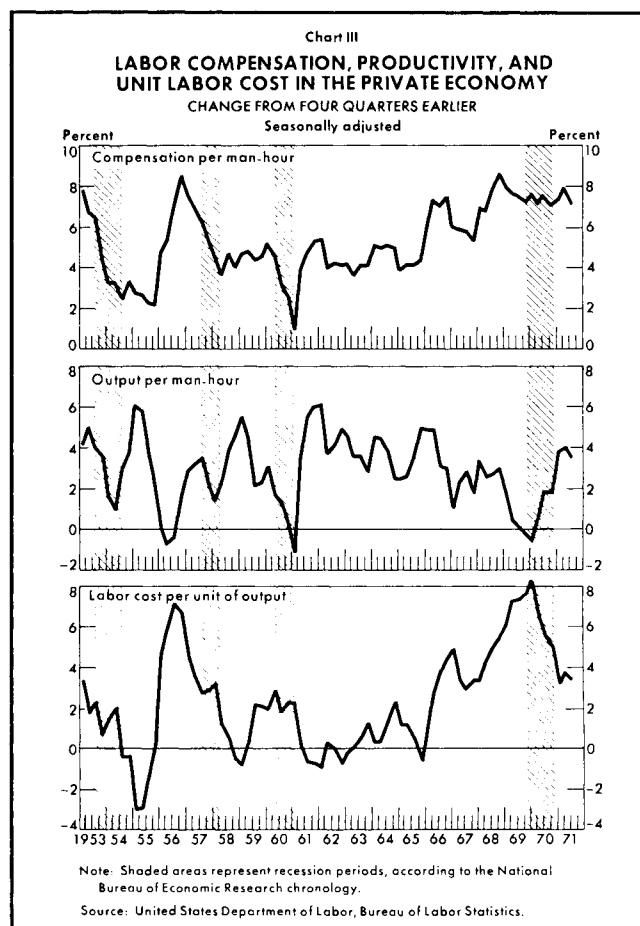


week. In September, wholesale prices actually eased on a seasonally adjusted basis, with prices of industrial commodities declining at a 1 percent annual rate after having risen at a 5 percent rate over the first eight months of 1971. In October, industrial prices again declined on a seasonally adjusted basis while agricultural prices rebounded. With the price freeze, however, normal seasonal adjustment procedures may be inappropriate. Thus, it is worth noting that without seasonal adjustment both the industrial and agricultural indexes were unchanged from their September levels.

The effects of the freeze on consumer prices were not so evident as in the wholesale area. The August consumer price index, which seems to have largely captured pre-freeze price movements, rose at a 5 percent rate. In contrast to the dramatic reversal of wholesale price movements during September, consumer prices rose at a still sizable 2.4 percent annual rate in that month. The September consumer price increases, which were not available in time to be incorporated into the third-quarter GNP deflator estimate, stemmed from a variety of sources. Since not all components in the consumer price index are priced each month, part of the September increase may have reflected higher prices on items which were included in the September survey but had actually risen in price prior to August 15. The September rise in the consumer index also included higher prices for certain items not covered by the freeze, such as college tuition, taxes, mortgage interest rates, and certain import prices.

In contrast to the deceleration observed in the rate of price increase for most of the major GNP components, the deflator for nonresidential structures soared at a 21 percent annual rate in the third quarter while that for residential structures climbed at a 14 percent rate. These two price groupings were responsible for about 1 percentage point of the 3.3 percent rise in the overall GNP deflator. While the structures deflators tend to be quite volatile on a quarterly basis, these third-quarter advances may be mirroring the rapid run-up over the first eight months of the year in construction labor costs and in building materials prices. In turn, the run-up in building materials prices may be primarily a result of the very rapid increases in demand and sustained high levels of activity in the area of residential construction. It is pressure for price increases of this type that will provide Phase Two with some of its greatest challenges.

In previous business cycles, the behavior of unit labor costs was a major factor in achieving price stability (see Chart III). The cyclical pattern of declining unit labor costs chiefly resulted from the pickup in productivity growth



that accompanied the recovery in production. In the past year and a half, the rate of increase in unit labor costs has slowed considerably. In the third quarter, however, this trend was obscured by unusual developments. On the one hand, agricultural output increased sharply, mainly reflecting a bumper corn crop. On the other hand, manufacturing productivity actually fell, primarily because of cutbacks among highly productive steelworkers.

The third-quarter data on major collective bargaining settlements underscore the severity of the inflationary pressures plaguing the economy. Based on preliminary data, the mean negotiated increase in wages and benefits during the third quarter was about 8½ percent over the life of the contract—essentially the same as for the first half of the year and only slightly below the 1970 rate of 9 percent. Almost all the major contracts expiring in the third quarter had been negotiated by August 15.

Monetary and Bank Credit Developments in the Third Quarter

During the third quarter of 1971, the growth of both the narrow and the broad money supply measures, M_1 and M_2 , showed a marked and progressive deceleration. To some extent, these developments resulted from the efforts of the Federal Reserve System to achieve more moderate growth of these aggregates following the extremely rapid increases posted in the second quarter. Beyond this, the slower rise in M_1 —currency plus demand deposits held by the public—may have reflected in part a decline in corporate cash balances during the August speculation against the dollar and a reduction in consumer cash balances in response to the new economic policies which President Nixon announced on August 15. The slower growth of M_2 — M_1 plus commercial bank time and savings deposits other than large negotiable certificates of deposit (CDs)—extended further in the third quarter the deceleration experienced in the second quarter. The tapering-off of the growth of consumer-type time and savings deposits may have been in response to the rise in open market interest rates through mid-August and may also have been related to the drop in the rate of personal savings that occurred during the period.

The growth of the adjusted bank credit proxy,¹ on the other hand, accelerated in the third quarter, reflecting strong growth in Government deposits and in CDs which are included in the proxy though not in the money supply measures. Total bank credit measured from the asset side continued to increase rapidly in the third quarter, posting a gain almost equal to that of the first half of the year. Virtually all of the growth in bank credit during the third quarter was in loans, in contrast to the first half

of the year when bank credit growth resulted primarily from the expansion of banks' securities portfolios. Interest rates generally declined after the mid-August announcement of the new economic policies, reflecting in part expectations that the rate of inflation would moderate.

THE MONEY SUPPLY MEASURES

The slower expansion of both the narrowly and broadly defined money supplies in the third quarter served to reduce their growth to rates more consistent with the goal of a noninflationary economic recovery. Thus, M_1 grew at a 3.0 percent rate, compared with a second-quarter rate of 11.3 percent, while M_2 grew at a 4.5 percent rate versus 12.6 percent in the second quarter (see Chart I). With this slowdown, the growth of M_1 and M_2 over the six months ended in September amounted to 7.2 percent and 8.6 percent, respectively.

Early in the year, the Federal Reserve had accepted strong money supply growth to compensate for the slow growth in the final quarter of 1970. Expansion of M_1 and M_2 at rates of 6.2 percent and 13.7 percent, respectively, over the six months ended in March did not appear unduly rapid in the early stage of the business-cycle recovery period. However, as the year wore on, it became increasingly apparent that the monetary aggregates were growing at rates that would be excessive if sustained for long.

The Federal Reserve last spring began to increase the pressure on member bank reserve positions in order to slow the expansion of the money supply measures. This pressure was reflected in a curtailment of the growth of nonborrowed reserves by early summer and in increased member bank borrowings at the discount window. The restrained provision of reserves was also mirrored in the increased Federal funds rate. This rate, which averaged 3.71 percent in March, rose to a level of 5.31 percent in July. Whereas nonborrowed reserves had expanded at a seasonally adjusted annual rate of 11.2 percent during the

¹ Total member bank deposits subject to reserve requirements and nondeposit sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

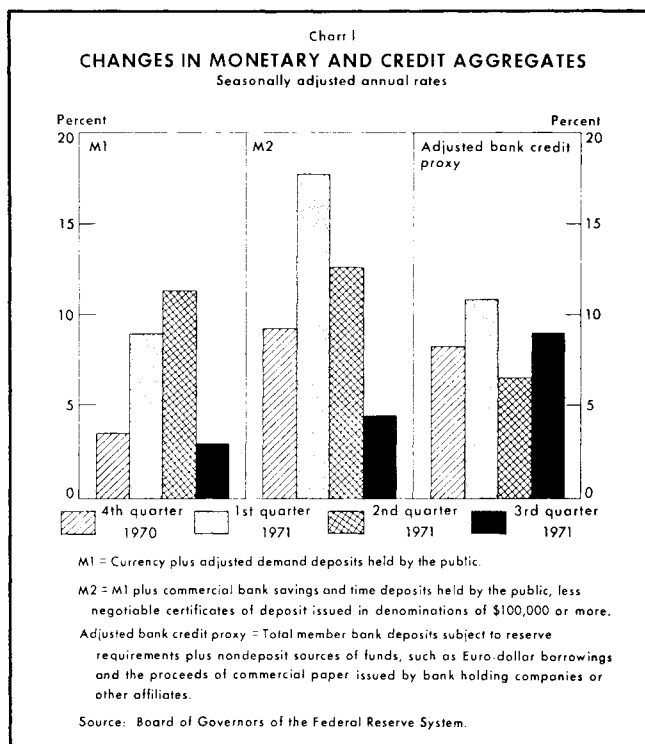
first five months of the year, they actually declined at an annual rate of 9.6 percent in June and July. Deceleration in the growth of the monetary aggregates followed, and the third-quarter increase in M_1 was the slowest quarterly gain since the fourth quarter of 1969.

There was a resurgence in the growth of reserves in August and September even as the expansion of M_1 halted. Nonborrowed member bank reserves increased at a seasonally adjusted annual rate of 23 percent during those two months, while M_1 declined slightly by 0.5 percent at an annual rate. This divergence resulted from a large increase in deposits not included in the money supply measures but subject to reserve requirements. For example, seasonally adjusted United States Treasury deposits at member banks rose by \$2.4 billion over the third quarter to \$6.3 billion in September. This represented a reversal of the trend in the first half of the year when these deposits—which are subject to the same reserve requirements as private demand deposits—declined by \$2.3 billion. In addition, the growth of large CDs accelerated in the third quarter. Such negotiable time deposits are also subject to reserve requirements but at a lower average rate than are demand deposits. CDs grew by \$3.8 billion

(seasonally adjusted) over the most recent quarter, compared with only \$2.6 billion in the first half of the year. The increases in these two types of deposits, especially Government deposits, absorbed a large quantity of reserves. As this experience illustrates, movements in member bank reserves and the money supply measures even over periods of several months are not necessarily closely related. Over the long run, of course, the trend growth of demand deposits in the money supply measures depends heavily upon the System's provision of nonborrowed reserves (adjusted for changes in reserve requirements).

The slowdown in the growth of M_1 during the third quarter of this year was not exclusively the consequence of the restraint of reserve availability by the Federal Reserve. It may also have stemmed in part from the massive flow of private dollar balances abroad during August, both before and immediately after the President's decision to suspend the convertibility of the dollar into gold and other reserve assets. This transfer of funds was reflected in the previously noted sharp buildup of United States Treasury deposits at commercial banks, as foreign central banks purchased special Treasury certificates of indebtedness with excess dollars absorbed in the exchange markets. The evidence indicates that this phenomenon was largely confined to the month of August, when Government deposits at member banks (seasonally adjusted) rose by \$2.6 billion. These dollar outflows tended to have a negative impact on the growth of M_1 , as corporations drew down their demand balances at commercial banks. This may be reflected in the \$1.2 billion drop in August of gross demand deposits held by non-financial businesses (not seasonally adjusted) at weekly reporting banks. By comparison, such deposits had been unchanged in August of last year. A substantial portion of the funds transferred indirectly to the United States Treasury, however, probably came out of new deposit balances created as a counterpart to the bulge in bank loans to businesses and to foreign banks, rather than out of previously existing money supply deposits. The continued weakness of M_1 in September—when it actually declined at a seasonally adjusted annual rate of 3.7 percent—occurred despite a marked diminution in the flow of dollars abroad and little further buildup in Treasury deposits.

Another factor that may have contributed to the slowdown in the growth of the money supply was a possible trimming of consumer demands for precautionary balances following President Nixon's enunciation of the Administration's new economic policies on August 15. It had become evident earlier this year that the demand for cash balances, particularly by consumers, was unusually



strong. For example, the Board of Governors of the Federal Reserve System survey of gross demand deposit ownership at weekly reporting banks showed that, over the twelve months ended in July 1971, consumer deposits advanced at a significantly more rapid rate than did total deposits.² Since the strength in consumer deposits was only partially explained by the rising volume of transactions, it appears that part of the growth in demand deposits was motivated by precautionary balance building in the wake of mounting uncertainties over unemployment and inflation. However, the desire to hold these precautionary balances may have been reduced after President Nixon's announcement of the ninety-day wage-price freeze and subsequent statements concerning Phase Two of his program to contain inflation. Some very tentative evidence in support of this view arises from the fact that gross demand deposits (not seasonally adjusted) held by consumers at weekly reporting banks declined by about \$1.8 billion in the two-month period ended in September. By comparison, such deposits had risen by \$0.6 billion in the similar two-month period last year. It should be noted, however, that survey data indicate a net rise in consumer deposits at all commercial deposits over the third quarter as a whole. (Deposit ownership data for banks other than weekly reporters are available only on a quarterly basis.)

While the reduced rate of growth in M_1 was a significant factor in the slowdown in M_2 , the growth of time and savings deposits other than CDs also decreased in the third quarter. Over the three months ended in September, these deposits grew at a 6.0 percent seasonally adjusted annual rate—the smallest quarterly increase since the fourth quarter of 1969 and well below the 20.9 percent growth experienced over the first half of the year. The markedly slower growth in time and savings deposits during the third quarter may have resulted in part from the decline in the rate of personal savings from \$60.9 billion in the second quarter to \$58.0 billion in the third. In addition, the upward trend of interest rates from March through mid-August may have gradually induced consumers to shift some of their savings away from savings accounts and into open market instruments.

BANK CREDIT PROXY AND NONDEPOSIT LIABILITIES

The adjusted bank credit proxy rose rapidly in the third quarter, growing at a seasonally adjusted annual rate of 9.0 percent as compared with the 6.5 percent rate of advance posted in the second quarter. The strength in the proxy during the third quarter, in contrast to the diminished rates of growth of the money supply measures, reflected the substantial increases in United States Government deposits and in large negotiable CDs, both of which are included in the proxy but not in either M_1 or M_2 . In total, these two types of deposits, seasonally adjusted, rose by \$6.2 billion over the quarter.

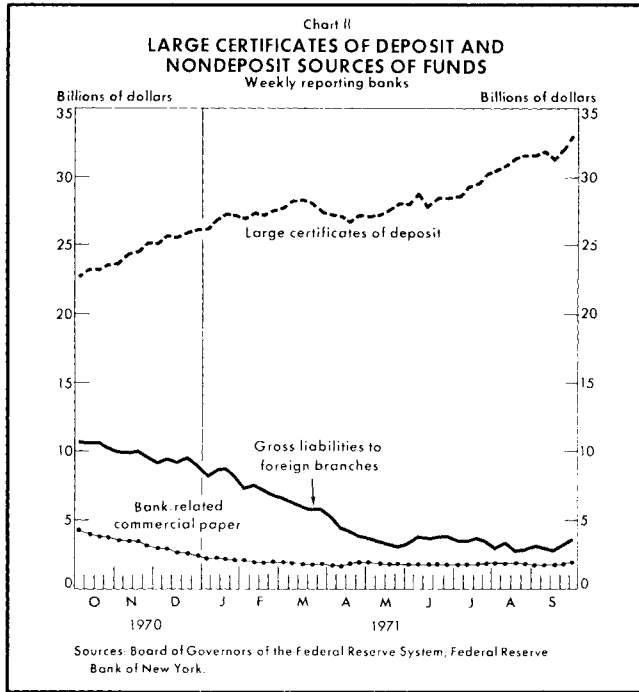
Much of the strength in CDs occurred in July and September. In July, it appeared that a major reason for the large increase in CDs was the reinvestment of the proceeds of a sizable stock financing. The \$2.1 billion increase in CDs in September primarily reflected the substantial yield spread of CDs over Treasury bills of comparable maturities. During most of September, three-month CDs, for example, were offered at rates ranging from about $\frac{3}{4}$ percentage point to a full percentage point above rates on Treasury bills of comparable maturity. Following the sizable influx of funds, a number of major banks began reducing their offering rates on CDs late in September.

Reflecting the strong inflow of funds in the form of CDs and Government deposits, banks were able to reduce further their reliance on nondeposit sources of funds (see Chart II). The two major nondeposit items are liabilities to banks' own foreign branches and bank-related commercial paper. Liabilities to foreign branches declined by a net of \$0.3 billion during the quarter to \$3.6 billion.³ These liabilities fell by \$0.6 billion in the third statement week in August, when the cost of such funds shot up as overnight Euro-dollar rates increased sharply in reaction to the uncertain value of the dollar in international exchange markets.

The Treasury decided not to renew its certificates of indebtedness to foreign branches of United States banks

³ The data on liabilities to foreign branches reported here differ from the data printed on page A30 of the *Federal Reserve Bulletin* in several ways. The series used in this article is based on weekly averages of daily figures rather than Wednesday levels. Moreover, it includes liabilities to branches in United States possessions, territories, Puerto Rico, and overseas military installations and also includes certain loans sold to branches outside the United States. These and other minor adjustments yield a series of liabilities that are subject to the reserve provisions of Regulation M. The series in the *Bulletin*, on the other hand, is directed toward the balance-of-payments impact of the liabilities.

² Inasmuch as the survey of demand deposit ownership dates back only to June 1970, no seasonal adjustment factors are available. For a description of the survey, see *Federal Reserve Bulletin* (June 1971), pages 456-67.



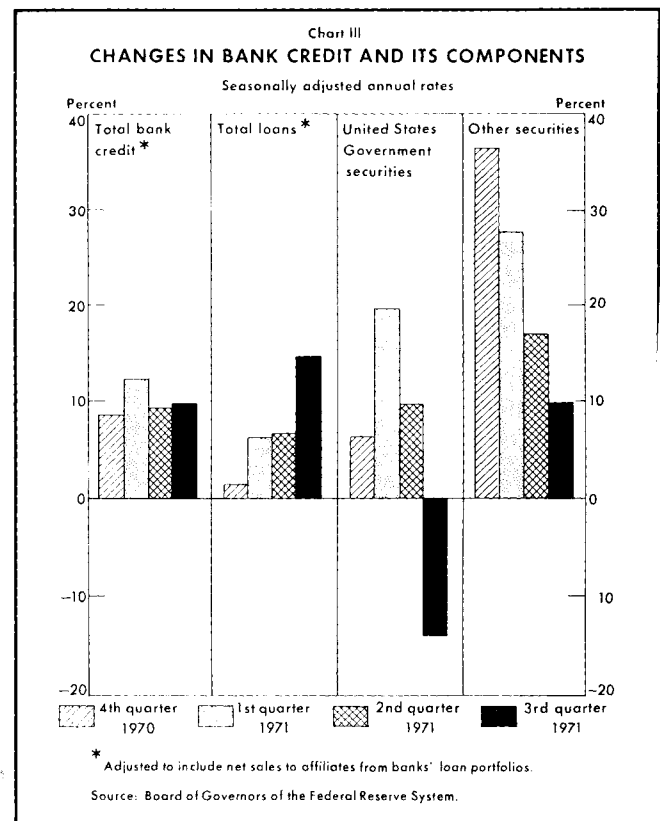
operations of nonbank subsidiaries rather than to provide funds for the banks themselves. The proceeds of bank-related commercial paper are subject to reserve requirements only if the funds are channeled to an affiliated bank. By the end of September, about half of the total outstanding bank-related commercial paper was nonreservable, compared with about a quarter at the end of March.

BANK CREDIT AND INTEREST RATES

Total bank credit at all commercial banks, adjusted for net sales to affiliates, advanced at a seasonally adjusted annual rate of 9.8 percent in the third quarter (see Chart III), a shade below the gain posted over the first half of the year. The growth in the components of bank credit, however, differed substantially in these two periods. During the six months ended in June, much of the overall strength in bank credit reflected a strong rise in investment holdings while the growth in total loans remained sluggish. In contrast, over the three months ended in September, aggregate investment holdings remained virtually un-

that matured after the middle of August. These instruments had originally been issued to absorb Euro-dollars in an attempt to reduce the flow of dollars to foreign central banks. Bank holdings of these securities had been counted in the calculation of the reserve-free base. Over the remainder of the quarter, \$2.1 billion of these issues matured and they were not replaced. To have maintained their reserve-free bases, banks would have had to increase their liabilities to foreign branches by the amount of the maturing issues. However, extraordinarily high Euro-dollar rates prevailed over the rest of August and served to discourage increased borrowing from that market. To be sure, as short-term Euro-dollar rates came down in September, banks partially rebuilt their liabilities to foreign branches but the increase was substantially less than the runoff of Treasury certificates. Thus, on balance, the banks have allowed their reserve-free bases to decline, making future use of this source of funds more costly.

The other major nondeposit source of funds, bank-related commercial paper, has fluctuated in a narrow range since March and remained roughly flat over the third quarter. At the end of September, the total amount of bank-related paper outstanding was \$1.9 billion. It should be noted that an increasing share of the commercial paper issued by bank holding companies has been used to finance

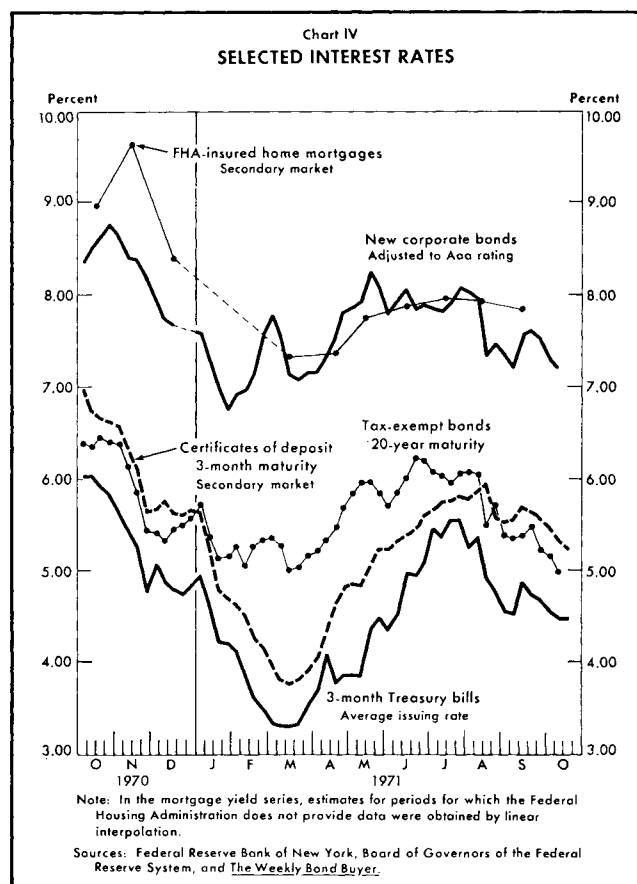


changed. Indeed, United States Government securities holdings declined at an annual rate of 14 percent, after adjustment for normal seasonal variation, while the gain in other securities holdings, consisting primarily of municipal securities and Federal agency debt, slowed to about 10 percent. The reduction in bank holdings of United States Government securities reflected the reduced need of the Treasury to borrow in domestic markets as foreign central banks provided funds through their purchases of special Treasury certificates of indebtedness. On the other hand, total commercial bank loans, adjusted for loan transactions with affiliates, rose at a seasonally adjusted annual rate of 14.7 percent, the largest quarterly percentage gain since the third quarter of 1968.

The dominant factor accounting for the growth of overall bank lending during the third quarter was the rapid expansion of business loans. Over the three months ended in September, business loans adjusted for net sales to affiliates advanced by 16.5 percent on a seasonally adjusted annual basis. Much of this rise appears to have been related to the international currency crisis. The bulk of the gain occurred in August when a 29.1 percent rate of expansion was recorded. Indeed, business loans at weekly reporting banks (adjusted for loan transactions with affiliates) rose by \$799 million during the week ended August 18 alone. Moreover, almost half of the increase during that week was in bankers' acceptances, most of which were related to foreign transactions, while loans to foreign industrial and commercial businesses and an unusually large unclassified residual accounted for the remainder. Presumably, foreign corporations borrowed dollars to exchange them for other currencies in anticipation of a depreciation of the dollar in foreign exchange markets. Apart from the huge bulge during August, however, it appears that business loan demand has remained sluggish.

Most other major categories of bank lending were relatively strong in the third quarter. Consumer, real estate, and agricultural loans all advanced more rapidly than they had in the first half of the year. On the other hand, loans to nonbank financial institutions declined over the quarter. The strength of consumer loans at commercial banks and the generally strong showing of consumer credit during the quarter were partly related to the surge in automobile buying that followed the August 15 announcement of the price freeze and the recommendation to eliminate the 7 percent excise tax on automobiles.

Prior to the President's mid-August statement outlining the new economic policies, most interest rates had moved higher, reflecting continuing market concern with the persistent inflation, the uncertain position of the dollar in



foreign exchange markets, and the Federal Reserve's more restrained provision of nonborrowed reserves. After the President's speech, however, most rates declined and closed the quarter well below the levels that had prevailed in early August (see Chart IV). These rate reductions, particularly those at the intermediate and longer end of the maturity structure, suggest that investors were hopeful that the new economic policies would dampen inflationary forces and would permit a more expansive monetary policy. In the short-term area, Treasury bill rates experienced a sharp drop, partly in response to the sizable increase in demand for bills from foreign central banks. Most other short-term rates were slower to respond to the changed environment but eventually did move lower.

The downward adjustment in corporate bond yields could reduce upward pressures on mortgage rates, thereby improving the prospects for continued strength in the home-building sector. Indeed, there are indications that home-financing costs are coming down. Although rates on conventional new-home mortgages rose again in Sep-

tember, average yields in the more sensitive secondary market for Federally underwritten home mortgages have been declining. Results of the mortgage commitment auctions of the Federal National Mortgage Association suggest that these yields continued to edge lower into November. Moreover, in late October and early November, several banks slashed their rates on home mortgages. Declines in bond rates tend to make mortgages a relatively attractive investment, especially for thrift institutions. Lower market rates also tend to improve the ability

of the nation's thrift institutions to compete for savings flows to channel into the mortgage market. The inflows of deposits to these institutions did slacken in the third quarter from the extraordinary pace of the first half of the year but remained very rapid by any other standard. Combined deposits at savings and loan associations and mutual savings banks increased at a 13.4 percent seasonally adjusted annual rate in the third quarter, down from the 22.2 percent and 17.5 percent rates of growth posted in the first and second quarters, respectively.

The Money and Bond Markets in October

Interest rates declined on a broad front during October as investors viewed optimistically the prospects for a reduction of inflationary pressures and a more accommodative stance of monetary policy. The continuing slowdown in the growth of the monetary aggregates also encouraged market participants. Money market rate declines were punctuated by a reduction in the prime business loan rate of commercial banks. In a related development, a few major banks announced that they were abandoning the traditional prime rate concept altogether in favor of a floating rate pegged to the ninety-day commercial paper rate.

In the capital markets, yields declined substantially during October. As measured by one widely followed index, municipal bond yields fell to the lowest level in more than two and one-half years. Yields on high-grade corporate bonds also declined but remained above their lows of the year reached in the first quarter. In both the corporate and the municipal bond markets, investor resistance to the lower yields stiffened as the month progressed, and yields rose somewhat toward the end of the month. Yields on long-term United States Treasury bonds also edged lower, while yields on short- and intermediate-term Treasury issues posted larger declines. On October 27 the Treasury announced the terms of its November refunding. The improved tone of the market encouraged the Treasury

to pre-refund four 1972 issues and to include in the offering a fifteen-year bond, the longest issue sold by the Treasury since 1965.

THE MONEY MARKET

The effective rate on Federal funds fell steadily from 5.43 percent in the statement week ended September 29 to 5.11 percent in the week ended October 27. The easing of reserve positions helped to take pressure off the Federal funds rate. Net borrowed reserves averaged \$223 million for the four weeks ended October 27 (see Table I), compared with \$310 million in the previous four weeks.

Rates on dealer-placed commercial paper and bankers' acceptances were reduced several times during the month by a total of $\frac{1}{2}$ percentage point in each case. Euro-dollar rates continued to descend from the dizzy heights reached during the international turmoil of mid-August. Three-month rates, which had risen as high as 10 percent at that time, had declined to $7\frac{3}{4}$ percent by late September and dropped further to about 6 percent by the end of October. Banks lowered their offering rates on large certificates of deposit (CDs) several times. Quoted rates on most maturities declined about $\frac{1}{2}$ to $\frac{3}{4}$ percentage point during October. These moves helped stem the inflow of new CD funds in the latter part of the month.

As market rates got progressively more out of line with the prime rate, expectations increased that the latter rate would be cut. On October 20, several large banks moved to reduce the prime rate by ¼ percentage point to 5¾ percent. Shortly thereafter, two major New York City banks announced that they would no longer maintain a fixed prime rate but would, in the future, tie their minimum business loan rate to a flexible market rate. At least initially, both of the banks set the rate ½ percentage point above the rate on dealer-placed ninety-day commercial paper. One bank chose the rate at which paper is offered to investors, while the other chose the rate paid by borrowers. Usually there is a ⅛ percentage point spread between these rates. The minimum business loan rate is to be altered, if necessary, once a week. Both the choice of market instrument and the spread may be subject to revision if conditions warrant. The minimum adjustment is ⅛ percentage point at one bank and ¼ percentage point at the other, and both initially set their minimum business loan rate at 5¾ percent. One rate floated downward to 5⅝ percent in early November, prior to a general reduction in the prime rate to 5½ percent on November 4.

In making the move to abandon the concept of a prime rate, first introduced in 1934, one bank cited the need for a commercial loan rate more immediately sensitive to market forces. In recent years, market rates have shown a much greater tendency to change by fairly large magnitudes in short periods of time. The prime rate has reflected these swings in market rates by becoming more flexible as well. As can be seen from Chart I, the prime rate was changed only twice during the years 1960 through 1965. From early 1966 through November 4, 1971, the prevailing rate was altered twenty-eight times by the major banks. Even so, the rate has retained some rigidity. Particularly at interest rate peaks and troughs, the prime rate has failed to move as far or as fast as it would have if it had been linked to the commercial paper rate. The result of such rigidity probably has been to exaggerate swings in the volume of bank commercial lending as well as commercial paper financing. Several other banks have expressed interest in adopting some sort of floating prime rate, and a few of them have also instituted such a plan.

M₁ continued to be weak in October, following the pattern of August and September. Based on preliminary data, M₁ decreased at a seasonally adjusted annual rate of 2 percent in October, a slightly smaller drop than September's 3.7 percent rate of decline. The expansion pattern of M₁ over the last few years has shown a tendency toward a relatively high growth rate around midyear, with the advances tailing off in September and October. A similar pattern seems to have emerged this year, which suggests the

possibility that seasonal money-holding patterns may be changing. Since seasonal adjustment factors are developed over a number of years, it takes time for any such alteration in behavior to become fully reflected in the seasonal factors.

Table I
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, OCTOBER 1971

In millions of dollars; (+) denotes increase
(-) decrease in excess reserves

Factors	Changes in daily averages— week ended				Net changes
	October 6	October 13	October 20	October 27	
"Market" factors					
Member bank required reserves	- 49	+ 126	- 204	+ 477	+ 350
Operating transactions (subtotal)	- 700	- 138	+ 453	- 362	- 747
Federal Reserve float	- 143	+ 83	+ 848	- 554	+ 234
Treasury operations*	- 139	+ 52	- 1	- 51	- 139
Gold and foreign account	- 37	+ 49	- 11	- 11	- 10
Currency outside banks	- 235	- 344	- 542	+ 263	- 858
Other Federal Reserve liabilities and capital	- 146	+ 21	+ 160	- 10	+ 25
Total "market" factors	- 749	- 12	+ 249	+ 115	- 397
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 691	- 357	+ 81	- 504	- 89
Outright holdings:					
Treasury securities	+ 547	-	- 166	- 239	+ 142
Bankers' acceptances	+ 4	+ 3	- 2	- 1	+ 4
Federal agency obligations	+ 39	+ 5	-	-	+ 44
Repurchase agreements:					
Treasury securities	+ 108	- 299	+ 193	- 193	- 191
Bankers' acceptances	+ 1	- 29	+ 21	- 27	- 34
Federal agency obligations	- 8	- 37	+ 35	- 44	- 54
Member bank borrowings	- 115	+ 140	- 117	+ 82	- 10
Other Federal Reserve assets†	+ 44	+ 64	+ 42	+ 47	+ 197
Total	+ 620	- 133	+ 6	- 375	+ 98
Excess reserves	- 129	- 165	+ 255	- 260	- 299

Member bank:	Daily average levels				Monthly averages
	October 6	October 13	October 20	October 27	
Total reserves, including vault cash.....	30,993	30,714	31,161	30,424	30,823‡
Required reserves	30,779	30,665	30,857	30,380	30,670‡
Excess reserves	214	49	304	44	153‡
Borrowings	309	449	332	414	376‡
Free, or net borrowed (-), reserves.....	- 95	- 100	- 28	- 370	- 223‡
Nonborrowed reserves	30,684	30,265	30,829	30,010	30,447‡
Net carry-over, excess or deficit (-)§.....	179	162	39	110	123‡

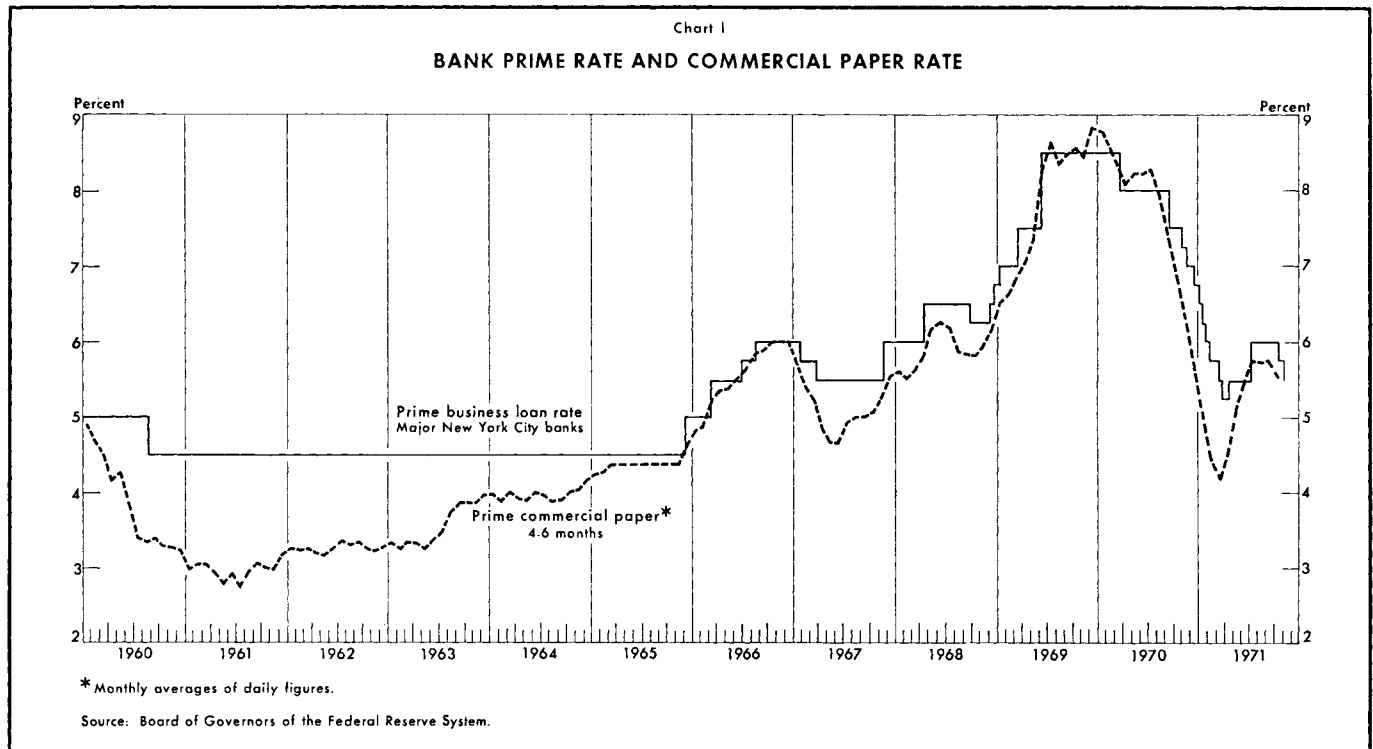
Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† Includes assets denominated in foreign currencies.

‡ Average for four weeks ended October 27.

§ Not reflected in data above.



Seasonal shifts have less of an impact on longer period growth rates, however. Over the six months ended in October, for example, M_1 grew at a relatively moderate annual rate of about 5 percent, compared with 11.8 percent during the six-month period ended in July.

M_2 advanced at an estimated 6 percent rate in October. The strength in this series came from a speedup in the growth of time and savings deposits other than large CDs. However, the 7½ percent growth in M_2 in the six months ended in October represents a marked slowdown from the 14.7 percent rate of advance recorded over the six months ended in July.

The adjusted bank credit proxy experienced a deceleration in October from its rapid advance in August and September. The proxy is estimated to have increased at a seasonally adjusted annual rate of 5 percent. The deceleration was largely accounted for by the more moderate growth in large CDs and by a decline in United States Government deposits at commercial banks. These deposits had risen dramatically in August when the Treasury issued \$5 billion of special certificates of indebtedness to foreign central banks. The level of Government deposits was reduced somewhat in late September and early October

partially as a result of a transfer of an extra \$1 billion to the Treasury account at the Federal Reserve.

THE GOVERNMENT SECURITIES MARKET

Prices of United States Government securities rose during October amidst optimism over the prospects for lower interest rates in the future. Expectations about the future interest rate path were further reinforced by President Nixon's announcement on October 7 that Phase Two would include a Committee on Interest and Dividends. The subsequent presentation to the Congress of the formal request for legislative action gave still further impetus to price advances in the Government securities market. These yield declines were steeper on short- and intermediate-term issues than on long-term bonds.

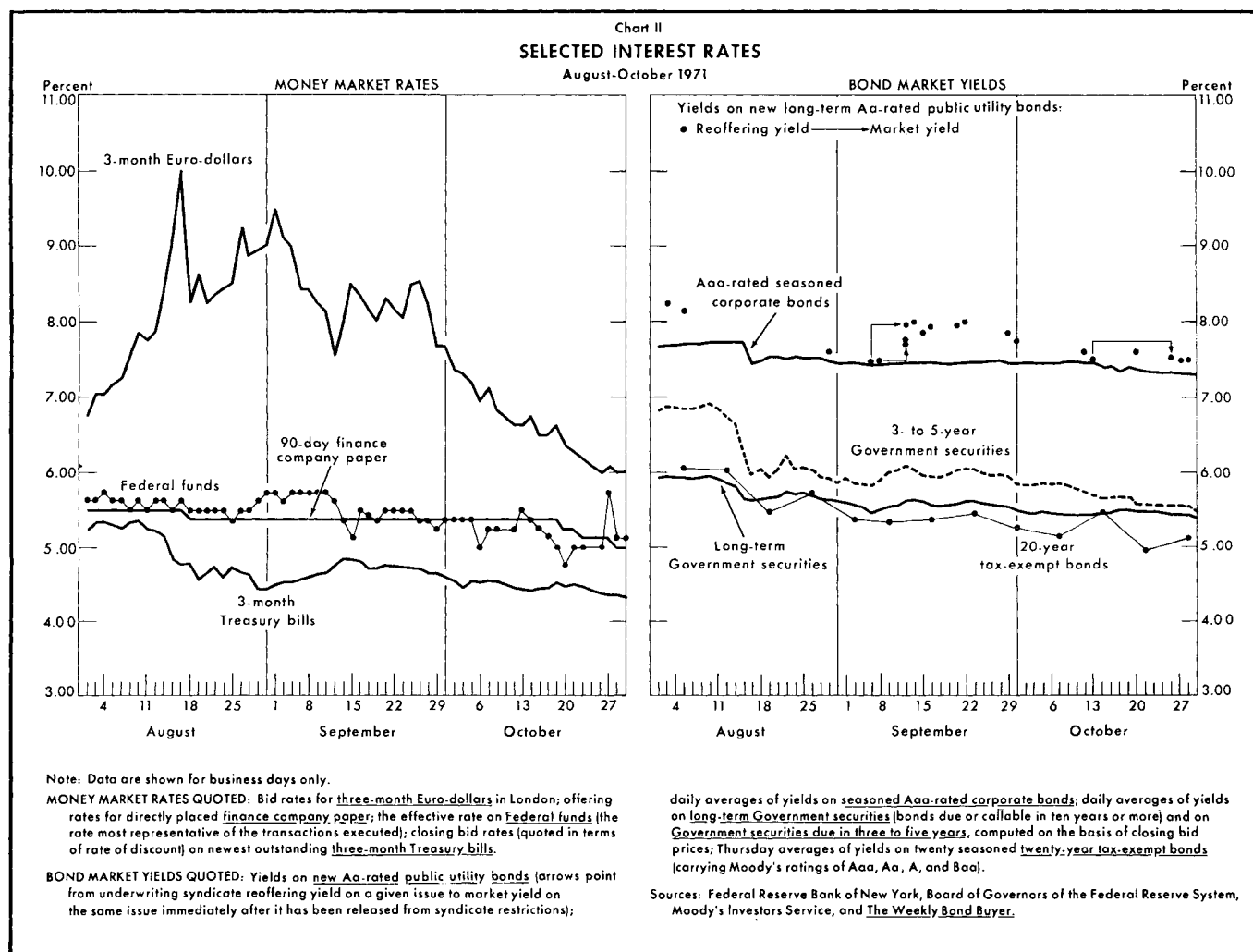
Although considerable uncertainty concerning the size of future Treasury financing remains, the immediate threat of severe disruption arising from the international sector has receded. Foreign central banks bought massive quantities of special certificates of indebtedness in the two weeks following the President's suspension of dollar convertibility into gold. All of these certificates can be redeemed

in advance of maturity. During September, fears were expressed that a wholesale redemption of these certificates could require the Treasury to replenish its account by borrowing in the domestic market, thereby depressing market prices. However, such apprehensions diminished during October when the level of certificates held by foreign central banks remained about constant. In October, the Treasury did redeem the remaining \$1.1 billion of special certificates of indebtedness that had been issued to foreign branches of domestic commercial banks for balance-of-payments reasons. Still, the Treasury's cash needs in October were lower than they have been in the corresponding month during the last few years.

In the one new cash financing for the month, an-

nounced October 12, the Treasury raised \$2 billion in cash through an auction of a three-year four-month 5 7/8 percent note. The issue was well received by market participants. Yields on outstanding three- to five-year Government securities continued to decline between the announcement date and the auction (see Chart II). Bidding on the issue, for which banks were granted 100 percent credit to their Treasury Tax and Loan Accounts, was active as \$4.6 billion of tenders was received for the \$2 billion of notes. The average price accepted was 100.89 for an approximate yield of 5.58 percent.

As the month progressed, interest in the forthcoming Treasury refunding helped to raise prices on the issues maturing in the next year, amid speculation that the refi-



nancing of the November maturities might include an advance refunding. On October 27, the Treasury announced that it was offering holders of \$7.9 billion¹ of maturing notes and bonds a choice of a seven-year 6 percent note or a fifteen-year 6½ percent bond. The new notes and bonds were priced to yield 6.04 percent and 6.15 percent, respectively. In addition, the new issues were made available to holders of \$13.5 billion of securities maturing in May and August 1972. Cash subscriptions in amounts up to \$10,000 were to be accepted for the bonds from individuals. This was the second offering of bonds since the Congress authorized the Treasury to market up to \$10 billion in bonds without regard to the 4¼ percent ceiling. The first, offered as part of the August refunding, yielded 7.11 percent and generated only limited interest as \$443 million of these bonds was taken.

The results of the refunding were announced on November 8. Of the \$3.8 billion of publicly held maturities, \$2.2 billion was exchanged for the new note and \$0.4 billion for the bond for an attrition rate of 33.5 percent. An additional \$3.1 billion of the notes and \$0.15 billion of the bonds were taken by holders of the 1972 issues eligible for pre-refunding. Individual cash subscriptions for the bond amounted to only \$24 million. The Federal Reserve and Government accounts will exchange \$2.6 billion of their maturing securities for the new offerings. To cover the attrition and raise additional cash, the Treasury announced the auction of \$2¾ billion of 4⅞ percent fifteen-month notes on November 9 for payment on November 15. In addition, the Federal Reserve and Government accounts exchanged their remaining \$1.5 billion of issues maturing in November for the new 4⅞ percent note at the average price.

Treasury bill yields fell following the Phase Two announcement on October 7, and prices were further buoyed by the Treasury decision to raise cash with a coupon issue rather than a tax anticipation bill. Foreign central banks continued to be net purchasers of Treasury bills. Marketable United States Government securities held in custody by the Federal Reserve for foreign central banks increased by about \$1,355 million in the four weeks ended October 27. This additional demand pressure on the market, of course, contributed further to the lowering of yields. Reflecting the fall in secondary market rates, the first two weekly auctions produced sizable yield declines. Aver-

Table II
AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS
In percent

Maturities	Weekly auction dates—October 1971			
	October 4	October 8	October 18	October 22
	Three-month	4.534	4.486	4.494
Six-month	4.743	4.595	4.635	4.530
	Monthly auction dates—August-October 1971			
	August 24	September 22	October 26	
	Nine-month	5.090	5.242	4.495
One-year	5.126	5.279	4.490	

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

age issuing rates on three- and six-month bills were respectively 19 and 38 basis points lower at the October 8 auction than they had been at the last auction in September. The rates of 4.486 percent and 4.595 percent for three- and six-month bills (see Table II) were the lowest new issue rates posted since May, when bill rates had been pushed downward because of heavy demand from foreign central banks. In spite of the large volume of bids, bill rates rose slightly at the October 18 auction but this was interpreted to be only a brief pause in the trend. Indeed, after the prime rate reduction, bill rates resumed their downward course. In the auction held Friday, October 22, in advance of the holiday weekend, rates dropped below their October 8 level. The average three-month rate was 4.443 percent and the average six-month rate was 4.530 percent.

OTHER SECURITIES MARKETS

Corporate bond prices advanced sharply in October after having exhibited a rather uneven performance in September. The rally began with the President's late-September announcement that the second phase of the new economic program would contain "teeth". There was a brief pause in the advance of bond prices around mid-month, as the market participants contemplated the large volume of new issues due to reach the market on October 19 and 20. However, Treasury statements on the

¹ Of this, \$3.8 billion was held by the public and \$4.1 billion by the Federal Reserve Banks and Government accounts.

good prospects for lower interest rates made in conjunction with the presentation to the Congress of the proposed package of Phase Two legislation and the reduction by several banks in the prime rate on October 20 gave renewed impetus to the market. By the final week of the month, however, a heavy calendar temporarily halted the price advance, particularly for utility bonds.

Despite the general enthusiasm about the long-term prospects for interest rates that was developing during the month, several corporate issues met with considerable resistance because of what the market considered to be overly aggressive pricing. A forty-year Aaa-rated Bell Telephone bond issue, marketed early in the month and priced to yield 7.55 percent, met with a cool reception, although sales were aided somewhat by the general market advance in anticipation of the Phase Two speech. Yet, a utility issue rated Aa offered a week later at a yield of 7.60 percent sold quickly, while another Aa utility marketed a day later to yield 7.50 percent did moderately well. In the final week, several issues were given only lukewarm receptions. Again, aggressive pricing was blamed. For example, a Bell Telephone offering containing a forty-year bond yielding 20 basis points less

than the earlier telephone issue elicited only slight interest initially. Underwriters were left with sizable unsold inventories at the end of the month, but these sold rapidly in early November.

In the early part of the month, price advances in the tax-exempt sector were even more dramatic than those of the corporate sector. *The Weekly Bond Buyer's* index of yields on twenty tax-free bonds dropped 25 basis points in the first two weeks of October to 4.99 percent. This was the lowest rate reached by this index since February 1969. Commercial banks, faced with large inflows of CDs and other time deposits, exhibited strong demand for the newly offered municipal securities. Eventually, however, it began to appear that yields had fallen so far that further declines were likely to come much more reluctantly. Indeed, the *Bond Buyer's* municipal index declined only another 2 basis points in the third week, then it turned around in the final week and climbed to 5.11 percent. Dealers' inventories mounted toward the end of the month. The Blue List of advertised inventories of tax-exempt bonds rose to \$970 million at the end of October, up \$234 million over the month to the highest level reached since December 1970.

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Bank Expansion in New York State: The 1971 Statewide Branching Law*

Commercial banking in New York State is rapidly becoming statewide in character. Only two decades ago, commercial banking throughout most of the state was marked by a large number of small, independent, locally oriented banks. However, during the fifties and increasingly since the midsixties, community banking has given way to regional and statewide banking—to more widely dispersed branch networks and to bank holding company systems that bridge the entire state. This trend toward wider area commercial bank expansion, larger banking organizations, and fewer banks in New York State will become even more apparent in the years ahead as banks respond to the new state banking law, enacted this past June, that permits statewide commercial bank branching in 1976.¹

This article traces the evolution of New York State's commercial banking structure during the past two decades and explains how developments in this period led to and ultimately prompted the passage of the state's new banking law. The article then examines the major provisions of the new banking legislation and explores their probable effects on the structure of banking in New York State.²

BANK EXPANSION IN THE 1950's

The geographical boundaries that contain commercial bank expansion in New York State today date from 1934 when the state legislature enacted the Stephens Act permit-

ting regional branching within the state.³ This act partitioned the state into nine banking districts within which commercial banks could branch and merge. Within banking districts, state law prohibits commercial banks from establishing a new (*de novo*) branch in any community (except New York City) which is "home office protected"—that is, in which an independent commercial bank is headquartered.⁴ The only way a bank may enter a home office protected community is by acquiring an existing bank through merger.

Most banking districts outside New York City include a major upstate city and its surrounding metropolitan area. The map (Chart I) shows the district boundaries and their relation to the seven Standard Metropolitan Statistical Areas (SMSAs) in New York State, as currently defined.⁵ The districts, as originally established, provided much less room for the expansion of New York City banks than banks elsewhere in the state. Banks in cities and towns outside New York City were permitted to branch and

³ Prior to 1934, expansion powers of commercial banks in the state were extremely limited. State-chartered banks in New York City had been permitted to branch within the city since 1898. A 1919 state law permitted state-chartered banks to establish branches in their home office communities, if the community had a population greater than 50,000. The McFadden-Pepper Act in 1927 authorized national banks to branch in their home communities if state law permitted state-chartered banks to do so.

⁴ New York Banking Law §105(1). Home office protection does not apply to communities with a population greater than one million. New York City is the only city in the state with a population over one million and thus is the only home office city in the state that is not protected.

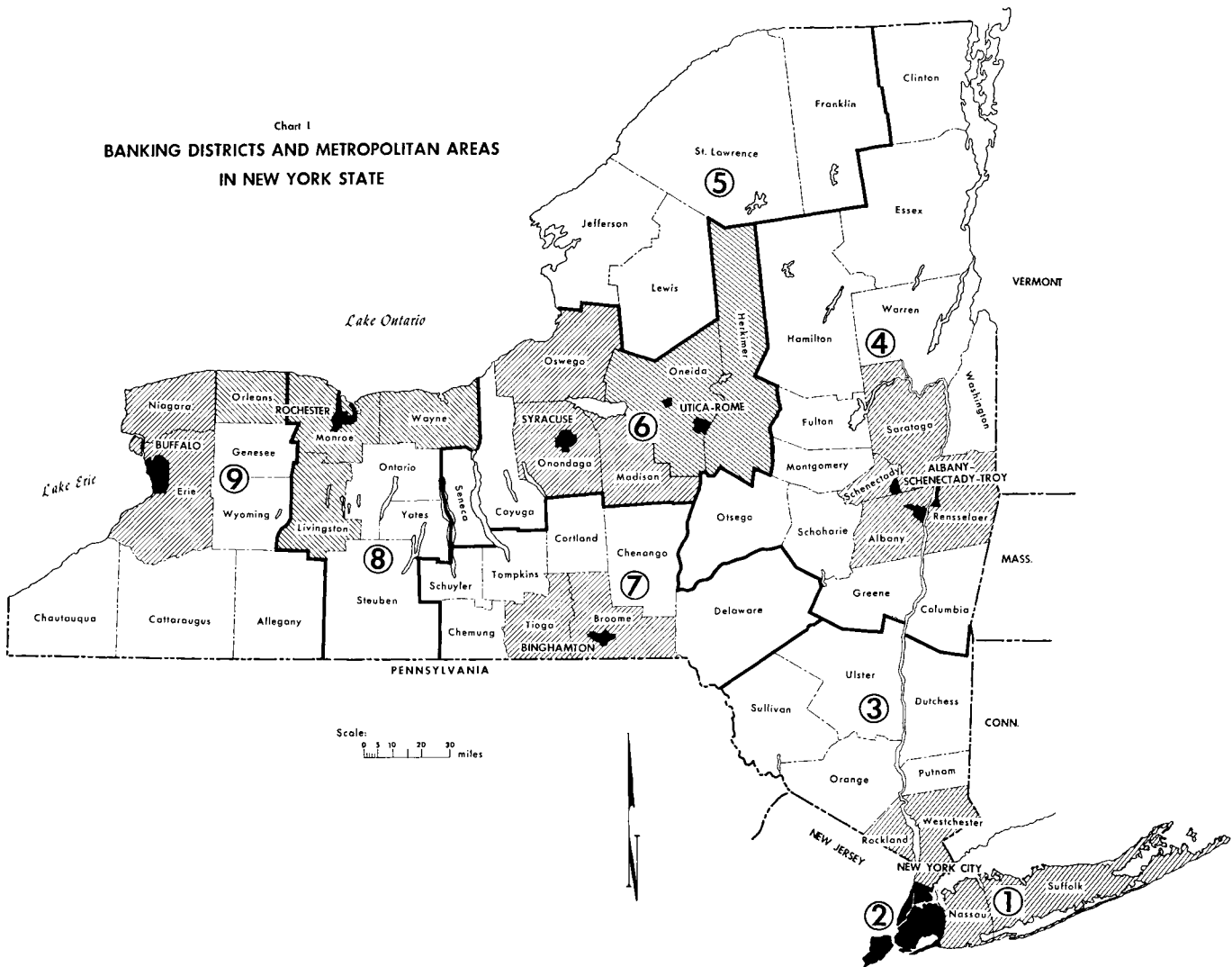
⁵ The Bureau of the Census defines a Standard Metropolitan Statistical Area as a county or group of contiguous counties that contains at least one central city of 50,000 inhabitants or more or "twin cities" with a combined population of at least 50,000. Other contiguous counties are also included in an SMSA if they are essentially metropolitan in character and are socially and economically integrated with the central city. On Chart I, the central cities are represented by blackened areas.

* Karen Kidder, Economist, Banking Studies Department, had primary responsibility for the preparation of this article.

¹ New York Laws of 1971, Ch. 380.

² The 1971 law also authorizes statewide branching for savings banks and savings and loan associations in 1976. However, this article focuses solely on the structural changes in the state's commercial banking industry.

Chart I
BANKING DISTRICTS AND METROPOLITAN AREAS
IN NEW YORK STATE



merge over broad, multicounty areas that at the time stretched far beyond their immediate trading areas. New York City banks, on the other hand, continued to be restricted to in-city branches only.⁶ This limitation reflected

the then widely held fears that New York City banks would come to dominate the state's entire banking system if not confined to the city proper. In signing the Stephens Act into law, Governor Lehman stated the act "contains solid, strong safeguards" against upstate penetration by expansion-minded Manhattan banks.⁷

OUTSIDE NEW YORK CITY. Banks outside New York City responded slowly to their newly created branching pow-

⁶ New York City consists of five counties or boroughs: New York (Manhattan), Bronx, Richmond, Kings (Brooklyn), and Queens. The first three comprise the Second Banking District and the latter two counties along with suburban Nassau and Suffolk counties on Long Island comprise the First District. Therefore, banks headquartered in Brooklyn or Queens may branch into Nassau and Suffolk counties.

⁷ Memorandum to the New York State legislature by Governor Herbert Lehman, May 21, 1934.

ers. Until the fifties, branching was largely local and confined generally to areas close to the home office. Inter-county branching was relatively rare. Only 21 banks outside New York City operated branches outside their head office county in 1950, and the number of such out-of-county branches totaled only 31. In fact, in 1950, only about one eighth of all banks in the banking districts outside New York City operated any branches at all. Nevertheless, these branch banks accounted for nearly three fifths of all commercial bank deposits outside New York City (see Table I).

During the fifties, however, commercial bank expansion gathered considerable momentum. Spurred by massive shifts of population and business activity from city to suburb, banks began to forge branch networks over wider geographical areas by expanding first into nearby communities, then across county lines. Eventually, branch systems of major banks in upstate cities embraced entire metropolitan, regional, and banking district areas, as these banks began to extend their branch networks to the fullest geographical extent permitted by state law.

By the end of 1960, about one bank in three outside New York City operated branches and these branch banks held seven eighths of the total bank deposits outside New

York City (see Table I). In addition, the number of banks outside New York City operating branches outside their home county rose to 36 in 1960, and the number of such out-of-county branches grew to 175. Mostly because of heavy merger activity, the number of banks outside New York City declined from 567 to 353 between 1950 and 1960. More significantly, the proportion of deposits held by the three largest banks in most upstate metropolitan areas increased appreciably between 1950 and 1960, evidence that large banks in upstate cities were well on their way toward capturing a major share of the available banking business within their metropolitan areas (see Table II). However, despite the decline in the number of banks and the rise in deposit concentration, the total number of banking offices outside New York City actually increased by 37 percent, from 835 to about 1,145 (see Table III). New branch establishments exceeded population growth during the fifties, so that population per banking office outside New York City declined by 5 percent to about 7,900.

IN NEW YORK CITY. A different situation prevailed in the New York City area during the 1950's. New York City banks were legally restricted from branching and merging beyond the city. Throughout the fifties the New York City banks pressed unsuccessfully for a legislative redistricting, so that they could enter the growing and profitable suburban markets. Not surprisingly, suburban bankers opposed their entry.

With the enactment of the Federal Bank Holding Company Act in May 1956, the New York City banks appeared to have won the relief they had been seeking. Although the 1956 legislation was regulatory in nature, the law also served, in effect, to remove the stigma that had been associated with abuses of unregulated holding company systems in the 1920's and 1930's. Indeed, six months after the passage of the legislation, First National City Bank proposed to organize a bank holding company with a large bank outside New York City (County Trust Company, White Plains) and thereby break out of its geographical containment.⁸ At this point, the New York State authorities had no control over the formation and expansion of bank holding companies. To provide the state legislature

Table I
BRANCH BANKS AND DEPOSITS HELD BY BRANCH BANKS
IN NEW YORK STATE BY BANKING DISTRICT*

In percent

Banking district	Proportion of branch banks			Proportion of deposits held by branch banks		
	1950	1960	1970	1950	1960	1970
Nassau and Suffolk	16	58	92	32	91	99
New York City	53	64	65	91	97	98
3	12	46	77	48	87	97
4	14	42	67	64	89	95
5	8	23	36	22	77	84
6	16	36	67	66	86	94
7	17	27	50	51	82	89
8	10	25	52	80	92	95
9	13	22	50	71	86	95
Total state	18	40	62	85	95	98
State outside						
New York City	14	36	62	59	87	96

* All data are as of the year-end except 1950 deposit data which are as of June 30.

Sources: Federal Reserve Bank of New York; *Polk's Bankers Encyclopedia* (September 1950).

⁸ Interestingly, one major statewide bank holding company—Marine Midland Banks, Inc., Buffalo—has been in existence for over four decades. This organization was established in the late 1920's, a period which witnessed the sudden emergence and spread of holding company banking across the nation. As early as 1930, Marine Midland controlled 16 banks and almost 4 percent of the commercial bank deposits in New York State.

Table II
DEPOSITS HELD BY THE THREE LARGEST BANKS IN
THE METROPOLITAN AREAS OF NEW YORK STATE*
 In percent

Metropolitan area	1950	1960	1970
New York City	42	46	48
Buffalo	75	92	94
Rochester	70	84	82
Syracuse	68	77	73
Albany-Schenectady-Troy	64	72	73
Binghamton†	53	90	89
Utica-Rome	52	81	93

* Data for 1950 are as of June 30; 1960 and 1970 data are as of the year-end. All metropolitan areas are the Standard Metropolitan Statistical Areas as currently defined by the Bureau of the Census.

† New York State portion only.

Sources: Federal Reserve Bank of New York; *Polk's Bankers Encyclopedia* (September 1950).

with additional time to consider permanent holding company legislation, the legislature passed a series of "freeze" laws beginning in 1957 to prohibit the further creation or expansion of bank holding companies in the state. In 1958, the Board of Governors of the Federal Reserve System denied First National City's proposal primarily on competitive grounds.

Finally, in 1960, the state legislature enacted the so-called Omnibus Banking Act, the first major banking structure legislation in New York State since 1934.⁹ This legislation not only terminated the freeze on bank holding company formation and expansion and provided for state regulation of bank holding companies but, in addition, granted New York City banks long sought entry into nearby suburbs. Among other provisions, the 1960 act permitted New York City banks to branch and merge across district boundaries into neighboring Nassau and Westchester counties and also authorized Nassau and Westchester banks to enter New York City.

BANK EXPANSION IN THE 1960's

New York City banks responded with enthusiasm to their newly created suburban branching powers. Between

⁹ The Omnibus Banking Act of 1960 was reenacted in 1961 because of certain procedural defects in the original act. For a further discussion of this act, see "New York State's 'Omnibus Banking Law'", *Monthly Review* (Federal Reserve Bank of New York, June 1960), pages 94-99.

the year-ends 1960 and 1970, over 100 *de novo* branches were established by New York City banks in Nassau and Westchester. These branches accounted for about three fifths of all *de novo* branches established in Nassau and Westchester counties during this period. Taking into account banking offices acquired through merger, New York City banks operated a total of about 135 banking offices in Nassau and Westchester by the end of 1970. In that year, New York City banks held about one quarter of the deposits in these two suburban counties. In addition, two Long Island banks entered New York City during the sixties and a third Long Island institution has recently proposed to enter the city.

While bank expansion in the state during the sixties through *de novo* branching was strongly paced, expansion through merger and acquisition faced increasingly strict legal and regulatory standards. The passage of the Bank Holding Company Act of 1956 and the Bank Merger Act of 1960 evidenced national concern over the competitive implications of bank expansion. These laws required, for the first time, prior approval by the Federal bank regulatory authorities for bank acquisitions by holding companies and for bank mergers. Several years later, in the landmark *Philadelphia National Bank* and *Lexington* cases, the Supreme Court established that bank mergers were subject to the antitrust laws.¹⁰ These events created a new legal and regulatory climate; banks would now have to consider such factors as competition and convenience and needs in formulating their expansion plans. Between 1960 and 1965, three major New York City banks proposed to form multidistrict banking organizations by joining with large banks outside New York City; all three proposals encountered opposition from the bank regulatory authorities on competitive or legal grounds.¹¹

As the decade progressed and pressures for wider area expansion powers mounted, banks again sought to test the state and Federal bank holding company laws. In the last half of the 1960's, five important banks in the state—

¹⁰ *United States vs. Philadelphia National Bank*, 374 U.S. 321, 356 (1963); *United States vs. First National Bank & Trust Company of Lexington*, 376 U.S. 665 (1964).

¹¹ In 1960, Bankers Trust Company proposed to form a bank holding company with County Trust Company, White Plains; in 1961, Morgan Guaranty Trust Company proposed a bank holding company with six upstate banks; and in 1965, Chase Manhattan Bank proposed to acquire Liberty National Bank and Trust Company, Buffalo. Interestingly, three of the six upstate banks included in the Morgan proposal have formed (or propose to form) their own bank holding company systems.

Table III
BANKS AND BANKING OFFICES IN NEW YORK STATE
BY BANKING DISTRICT*

Banking district	Number of banks			Number of banking offices†		
	1950	1960	1970	1950	1960	1970
Nassau and Suffolk	87	40	24	114	216	436
New York City	68	50	46	555	628	893
3	107	72	44	142	205	365
4	90	55	36	126	154	224
5	40	30	25	48	53	61
6	62	33	24	94	120	167
7	48	37	34	65	80	113
8	48	32	31	70	110	161
9	85	54	32	176	205	277
Total state	635	403	296	1,390	1,771	2,697
State outside New York City	567	353	250	835	1,143	1,804

* Data are as of the year-end.

† The number of banking offices comprises the total of home offices and branches.

three of the smaller New York City money market banks and two upstate banks—proposed bank holding company systems through the acquisition of small- and medium-sized out-of-district banks. The New York State Banking Board and the Board of Governors of the Federal Reserve System approved these proposals and thereby established the bank holding company as an effective vehicle for assembling statewide banking organizations that straddled district lines. Thus, with careful consideration of competitive issues, banks could now accomplish what was otherwise forbidden by banking district boundaries.

The growth and expansion of bank holding companies in New York State since the midsixties have been vigorous. In 1965, there were only three bank holding companies in the state having subsidiaries in more than one district. By the end of 1970 there were eleven such companies, including nine major companies.¹² In the brief span of five years, the number of banks controlled by these organizations increased from 17 to 62, the number of banking offices operated by the subsidiaries grew from less than

¹² The 1970 figures include bank holding companies proposed prior to the year-end 1970.

250 to almost 1,100, and holding companies' share of commercial bank deposits in the state climbed from 6 percent to 34 percent (see Chart II). Today, multibank holding companies encompass virtually the entire state. Indeed, all banking districts (except District 5) have at least five banks affiliated with holding companies. Moreover, five holding companies have gained representation in a majority of the state's nine banking districts (see Table IV).

At the same time that multibank holding companies expanded across district lines, branching activity within districts continued at a lively pace. This branching activity involved both independent and holding company banks. Outside New York City, the number of banking offices rose to about 1,800 between the year-ends 1960 and 1970; population per banking office declined from about 7,900 to 5,700 during this period. In the state as a whole, the number of banking offices climbed to nearly 2,700, almost twice the number in existence at the end of 1950 (see Table III).

Intradistrict expansion in the 1960's assumed a different character than in the 1950's in two important respects: the geographical extent of branching and the pace of merger activity. In the earlier decade, banks had branched primarily in their own communities and metropolitan areas. In the later decade, however, banks extended their branch networks well beyond their home communities. By the end of 1970, about 60 institutions outside New York City operated a total of about 425 branches outside their head-office county; only 36 banks had operated out-of-county branches at the end of 1960.

Moreover, expansion within districts during the fifties frequently involved the absorption of another bank through merger. As a result, deposits in many markets across the state became concentrated in fewer banks. In the new legal and regulatory environment of the 1960's, there were, in contrast, considerably fewer mergers. To be sure, the number of banks in the state continued to decline during the 1960's, but the absorbed banks were not being acquired by the state's largest organizations as had been the case in the previous decade. As a result of greater out-of-market bank expansion and a decline in merger activity, the increase in the concentration of deposits that occurred in markets during the 1950's was, for the most part, arrested in the 1960's (see Table II).

THE 1970 AMENDMENTS TO THE FEDERAL BANK HOLDING COMPANY ACT

In the last years of the 1960's, a development occurred that ultimately proved to be a significant factor in the enactment of statewide branching legislation in the state:

the rise of the one-bank holding company. At that time, many large banks throughout the country began forming one-bank holding companies by reorganizing themselves into a single bank subsidiary of a holding company parent. One-bank holding companies were then exempt from Federal and New York State regulation. By the year-end 1970, some 34 banks in the state, including the state's five largest banking organizations, had formed one-bank holding companies, largely for the purpose of expanding operations into fields other than banks' traditional depository and lending activities. Many of these activities were permitted neither to banks themselves nor to holding companies with more than one bank.

At the end of 1970, amendments to the Bank Holding Company Act of 1956 were enacted that brought one-bank holding companies under Federal regulation for the first time. These amendments made both one-bank and multi-bank companies subject to the same law. The 1970 legislation also provided greater leeway for bank holding companies to expand into fields closely related to banking.¹³

One of the reasons why the largest New York City banks had not formed multibank holding companies was to avoid further Federal regulation. Once registration of one-bank holding companies was required by law, there was no longer any special deterrent to the formation of statewide multibank holding companies—even if the regulatory authorities would allow only relatively small acquisitions. It seemed quite clear soon after the enactment of the Federal bank holding company legislation that, even without statewide branching, New York State was about to witness extensive statewide banking by bank holding companies. In fact, four New York City one-bank holding companies (First National City Corporation, Chase Manhattan Corporation, Chemical New York Corporation, and Manufacturers Hanover Corporation) have since announced specific proposals to form multibank companies by acquiring existing banks or establishing new ones.

In effect, the factors that spurred the development of multibank holding companies, including the 1970 Federal bank holding company legislation, were transforming the state's district boundaries into paper barriers. Indeed, holding company banking and particularly the 1970 bank holding company legislation played a catalytic role in bringing statewide branching to New York State.

THE 1971 STATEWIDE BRANCHING LAW

The new banking legislation in New York State, signed by Governor Rockefeller in June 1971, establishes a single banking district as of January 1, 1976. The 4½-year transition period before statewide branching becomes possible was designed to allow upstate banks ample time to prepare for the new competitive environment.

The 1971 law, like most other legislation, was a product of intense bargaining and compromise. Statewide branching was staunchly opposed by suburban bankers, notably in Suffolk County. However, in early 1971, the two largest banking organizations in the state—First National City Corporation and Chase Manhattan Corporation—each proposed to organize a new bank on Long Island which would provide a base for branching throughout Suffolk County, one of the fastest growing areas in the state. Long Island bankers were particularly concerned about such *de novo* entry into communities with home office protection. To quiet the opposition and at the same time to enlist the support of suburban banks for the statewide branching bill, three provisions were included in the bill that limit the ability of bank holding companies to form new banks and the ability of such newly formed banks to branch freely.

One provision, effective immediately, prohibits a bank holding company from setting up a new bank or acquiring a bank chartered less than five years in a home office protected community.¹⁴ Indeed, the threat of such *de novo* entry by bank holding companies was probably one of the most potent influences inducing the suburban bankers to seek compromise. The provision immediately foreclosed Chase Manhattan's proposal to establish a *de novo* bank in Garden City, Long Island. A second provision, also effective immediately, limits the number of *de novo* banks a bank holding company may establish to one per banking district. This restriction will terminate in 1976 when banking district lines are swept away. A third compromise provision restricts the branching powers of all newly chartered banks. A bank is prohibited from branching until it has been chartered for one year. Thereafter, it may establish only two branches a year until it has been chartered for five years. This provision expires in 1976.

In addition to these three provisions and the authorizing of statewide branching in 1976, the new banking law

¹³ See Alfred Hayes, "The 1970 Amendments to the Bank Holding Company Act: Opportunities to Diversify", *Monthly Review* (Federal Reserve Bank of New York, February 1971), pages 23-27.

¹⁴ Under prior law, such new bank establishments and bank acquisitions by holding companies were not subject to the home office protection rule.

also provides for a two-step reduction in the population limit of home office protected communities. The population ceiling will be lowered from one million to 75,000 beginning in 1972 and then to 50,000 in 1976. As a result, in 1972, five cities—Buffalo, New Rochelle, Rochester, Schenectady, and Utica—will become open to *de novo* branching by banks not having their head office in such a city.¹⁵ Thus, some new competition will likely be introduced into these five cities as “outside” banks, long barred from *de novo* entry, establish new branches there. In fact, several applications to establish *de novo* branches have already been filed with the bank regulatory authorities.

LOOKING AHEAD

Although the statewide branching provisions of the new law do not become effective until 1976, a considerable amount of commercial bank expansion is sure to take place over the next few years. Indeed, by the time statewide branching becomes permissible, the major effects of statewide banking on the state’s banking structure may have already been felt. Action by New York City bank-

ing institutions and by major upstate holding company organizations is already in progress.

In addition to the New York City one-bank holding companies that have already decided to become multi-bank institutions, existing multibank holding companies too will likely continue expanding their affiliations to establish themselves as truly statewide organizations. At the same time, upstate banks can be expected to take defensive action to protect their existing markets. Significant branching and merging activity as well as bank holding company acquisition activity may therefore take place upstate in anticipation of the entry by New York City organizations.

Bank regulatory authorities will have much to say about how the banking structure in the state will develop. Although Federal authorities will play an important role in this regard, their jurisdictional powers are limited.¹⁶ The New York State authorities, on the other hand, have the legal power to rule on mergers in which the surviving

¹⁵ Based on 1970 population data, home office protection would, however, not be removed from any additional cities in 1976 under this new provision.

¹⁶ The Federal Reserve System rules on bank mergers in which the surviving bank is state chartered and a member of the Federal Reserve System and also has jurisdiction over all bank holding company formations and acquisitions; the Comptroller of the Currency rules on bank mergers in which the surviving bank is a national bank; and the Federal Deposit Insurance Corporation rules on bank mergers in which the surviving bank is a state-chartered, insured bank and not a member of the Federal Reserve System.

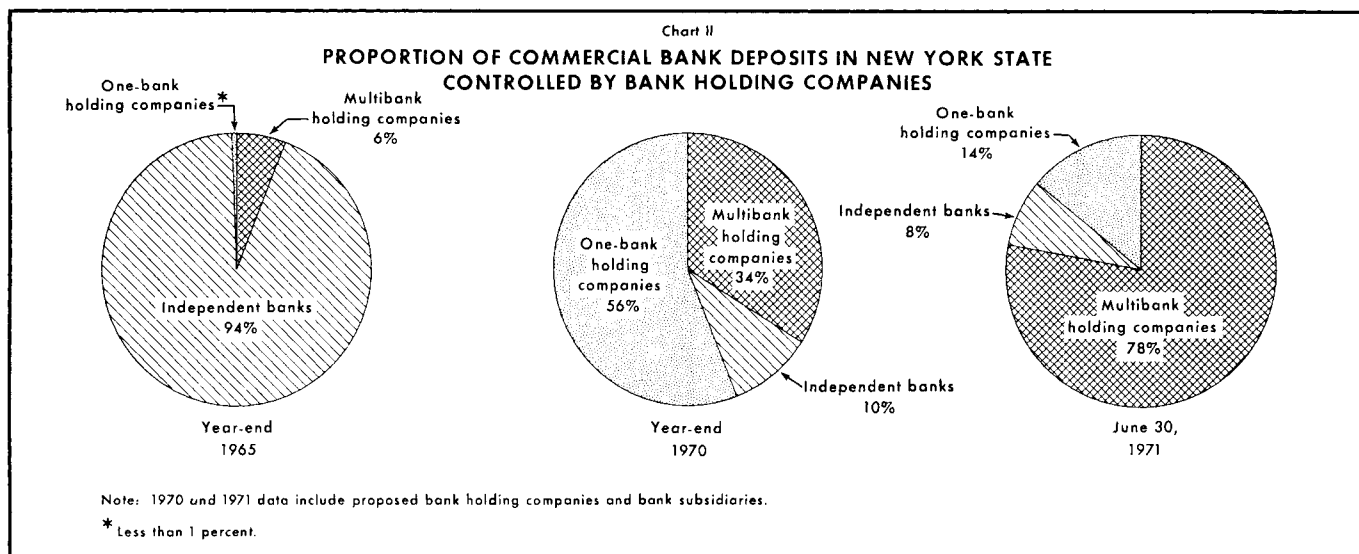


Table IV
TWENTY LARGEST BANKING ORGANIZATIONS IN NEW YORK STATE*

Banking organization	Headquarter location of principal bank	Deposits (in millions of dollars) †	Operating in banking district
Chase Manhattan Corp.	New York City	15,493	1, 2, 3, 6
First National City Corp.	New York City	13,412	1, 2, 3, 9
Manufacturers Hanover Corp.	New York City	10,229	1, 2, 3
Chemical New York Corp.	New York City	8,238	1, 2, 3
J. P. Morgan & Co., Inc.	New York City	7,640	2
Bankers Trust New York Corp.	New York City	6,650	1, 2, 3, 4, 7, 8, 9
Marine Midland Banks, Inc.	Buffalo	6,416	1, 2, 3, 4, 5, 6, 7, 8, 9
Charter New York Corp.	New York City	4,820	1, 2, 3, 4, 6, 7, 8, 9
Bank of New York Corp.	New York City	2,640	1, 2, 3, 4, 6, 7, 9
Franklin National Corp.	New York City (Brooklyn)	2,358	1, 2
CIT Financial Corp. (National Bank of North America)	New York City (Queens)	1,779	1, 2, 3
Lincoln First Banks, Inc.	Rochester	1,727	3, 5, 6, 7, 8, 9
Security National Bank of Long Island	Huntington	1,334	1, 2
First Commercial Banks, Inc.	Albany	1,286	3, 4, 6
United Bank Corp. of New York	Albany	1,191	4, 9
First Empire State Corp.	Buffalo	964	2, 9
Security New York State Corp.	Rochester	518	6, 7, 8, 9
United States Trust Co. of New York	New York City	404	2
Empire National Group, Inc.	Middletown	370	3
Long Island Trust Co.	Garden City	358	1

* Includes merger proposals and bank holding company formations and acquisitions announced prior to November 5, 1971.

† Deposit data are as of June 30, 1971; figures include deposits in domestic branches only.

bank is state chartered, on holding company formations and acquisitions, as well as on mergers involving a bank subsidiary of a holding company.¹⁷ The state thus has authority over the acquisition activity of all bank holding companies and all holding company banks, both state and national. Since almost every large bank in the state is a member of a bank holding company system, the Superintendent of Banks of the State of New York is therefore in a commanding position to shape the state's banking structure. Indeed, bank subsidiaries of all holding companies currently control about 92 percent of total deposits in the state (see Chart II).

¹⁷ This latter authority derives from the legal requirement that a bank holding company, with certain minor exceptions, must receive prior approval from the State Banking Board to vote the stock of a bank subsidiary in favor of merging or consolidating with, or acquiring the assets of, any bank. New York Banking Law §142(1).

William T. Dentzer, Jr., Superintendent of Banks in New York State, has in fact taken an avid interest in banking structure matters and has demonstrated a keen concern for preserving and fostering viable bank competition. Recent speeches and decisions in actual bank acquisition and merger cases indicate Mr. Dentzer's hard-line stance against proposals that might seriously lessen existing or potential competition, particularly those involving the expansion of upstate affiliates of New York City organizations. He has repeatedly stated that in the immediate future his aim will be to facilitate the establishment and expansion of new bank holding companies that might serve as effective competitors to existing organizations and to help promote the expansion of smaller bank holding companies into new markets. Indeed, it was primarily this interest in developing strong new competitors to existing systems that led Mr. Dentzer to request and support a reasonable transition period before the statewide branching provisions would become effective.

What then will be the result of increased statewide ex-

pansion in the years ahead? It seems fairly certain that the decline in the number of commercial banks (and banking organizations) in the state, which has been evident throughout the postwar period, will continue for years to come. Probably, there will emerge in the next several years some fifteen to twenty major statewide organizations, each having representation in most of the important markets of the state. Currently, thirteen major banking organizations in the state have subsidiaries (or have proposed to acquire or establish subsidiaries) in more than one banking district. After 1976, many of the holding companies may merge their bank subsidiaries into statewide branch systems or perhaps regional branch systems. This may take a number of years. Some bank holding companies may retain their multibank holding company forms.

The large New York City banking systems seeking statewide organizations are likely to be limited to "foothold" acquisitions. Therefore, there appears to be little danger that they will substantially increase their share of out-of-city deposits. Indeed, as of the middle of 1971, upstate subsidiaries of New York City holding companies controlled only about one eighth of total deposits in that area of the state while out-of-city affiliates of upstate holding companies controlled over one half of such deposits. Independent banks accounted for over one third of deposits outside New York City.

Despite the prospect of only fifteen to twenty statewide systems, well-managed independent banks should continue to exist. It is true that their relative importance in terms of total state deposits may decrease, but their significance in their local markets will not necessarily be dimin-

ished. It is likely that the small independent bank can also prosper alongside large branch banks and holding company banks.¹⁸ History has shown that small- and medium-sized banks play a significant innovative role and are important in maintaining a healthy competitive environment. Such banks are often more flexible than very large banks in adapting to local banking needs. Moreover, many banking customers prefer dealing with local institutions.

The reduction in the number of commercial banks and banking organizations should not mean a diminution of competition or a lessening of banking alternatives to the public. Quite the contrary, the removal of in-state geographical branching limitations and liberalization of the home office protection rules should actually increase the number of significant competitors in markets across the state that were formerly insulated from "outside" entry. In fact, the number of significant competitors in several important upstate cities has already increased as a result of entry by holding company organizations into new markets. With wise regulatory action, the new banking law should provide an effective vehicle for building a more competitive commercial banking structure in New York State.

¹⁸ Ernest Kohn, *The Future of Small Banks* (New York State Banking Department, 1966). Mr. Kohn found that the profitability of small banks in New York State outside New York City was not adversely affected by the entry of larger banks in their communities. The relative rate of deposit growth of most small banks was dampened somewhat by the entry of large banks, but the absolute level of deposits continued to rise.

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