FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

AUGUST 1973

Contents

The Business Situation 187

Monetary and Financial Developments in the Second Quarter 192

The Money and Bond Markets in July 197

Competition and the Changing Banking Structure in New Jersey 203

Volume 55 No. 8

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Business Situation

The expansion in economic activity has slowed in recent months, but inflationary pressures have remained extremely severe. In view of the persistent buildup in the backlog of unfilled orders, continued pressures on capacity, and rather widespread shortages of materials and skilled labor, much of the slackening in real growth probably reflects supply limitations. While consumer spending for durable goods and new housing moderated in the second quarter from the very high levels experienced earlier this year and in 1972, it is not possible at this time to determine whether a significant easing of consumer demand is under way. In any event, the price freeze may be temporarily boosting consumer expenditures, and further gains in business inventory and capital spending seem likely in the months ahead. During July the unemployment rate dipped to 4.7 percent, the lowest in more than three years, but both employment and the labor force were essentially unchanged from their June levels.

Price behavior remains a source of very serious concern. Over the first half of the year, both the implicit price deflator for gross national product (GNP) and the consumer and wholesale price measures climbed at the fastest rates in more than twenty years. While some improvement in the statistics as a result of the price freeze has already materialized, demand pressures remain excessive. The Phase Four controls program should serve to spread out the rise in prices as the freeze is ended, but inflation will remain a serious problem so long as aggregate demand continues overly strong.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

The market value of the nation's output of goods and services rose $28.5 billion during the second quarter to a seasonally adjusted annual rate of $1,271 billion, according to preliminary Department of Commerce statistics. Measured in current dollars, GNP climbed at a 9.5 percent seasonally adjusted annual rate, well under the pace of expansion in the first quarter. Nearly three fourths of the second-quarter advance in GNP reflected an increase in prices. After adjustment for the price rise, real GNP moved ahead at a 2.6 percent annual rate in the April-June period, the slowest advance since the 1969-70 recession. Along with the preliminary data, the Commerce Department released its annual revisions of the GNP data going back through 1970. The estimate of growth in real GNP in the first quarter of this year was revised upward to an exceptionally rapid 8.6 percent per annum. Due mainly to the strong growth in the previous quarters, the increase in real GNP over the four quarters ended in June stands at 6.2 percent (see Chart I).

To a considerable extent, the slowdown in the growth of economic activity in the second quarter may have resulted from capacity limitations and shortages of skilled labor. Many important industries—such as automobiles, rubber, paper, petroleum refining, glass, cement, aluminum, and steel—are reportedly running at, or near, capacity. Output growth has slowed most noticeably in industries known to be operating close to capacity. For example, motor vehicle production, which has been running at overtime rates, rose at only a 1 percent annual rate in the April-June quarter, after shooting up at a 26 percent rate in the first quarter. Also, iron and steel production, which has been near capacity levels for almost a year, actually declined in the past quarter. Overall industrial production expanded by a smaller amount in the second quarter than in the first and, according to the Board of Governors of the Federal Reserve System index, the growth of output slowed to less than a 4 percent rate in June.

The pace of inventory investment picked up in the second quarter, although the increase was quite modest (see Chart II). Incomplete data indicate that the annual rate of inventory accumulation on the national income accounts basis amounted to $5.3 billion in the April-June period as compared with $4.6 billion in the January-March period. Inventory spending thus contributed $0.7 billion

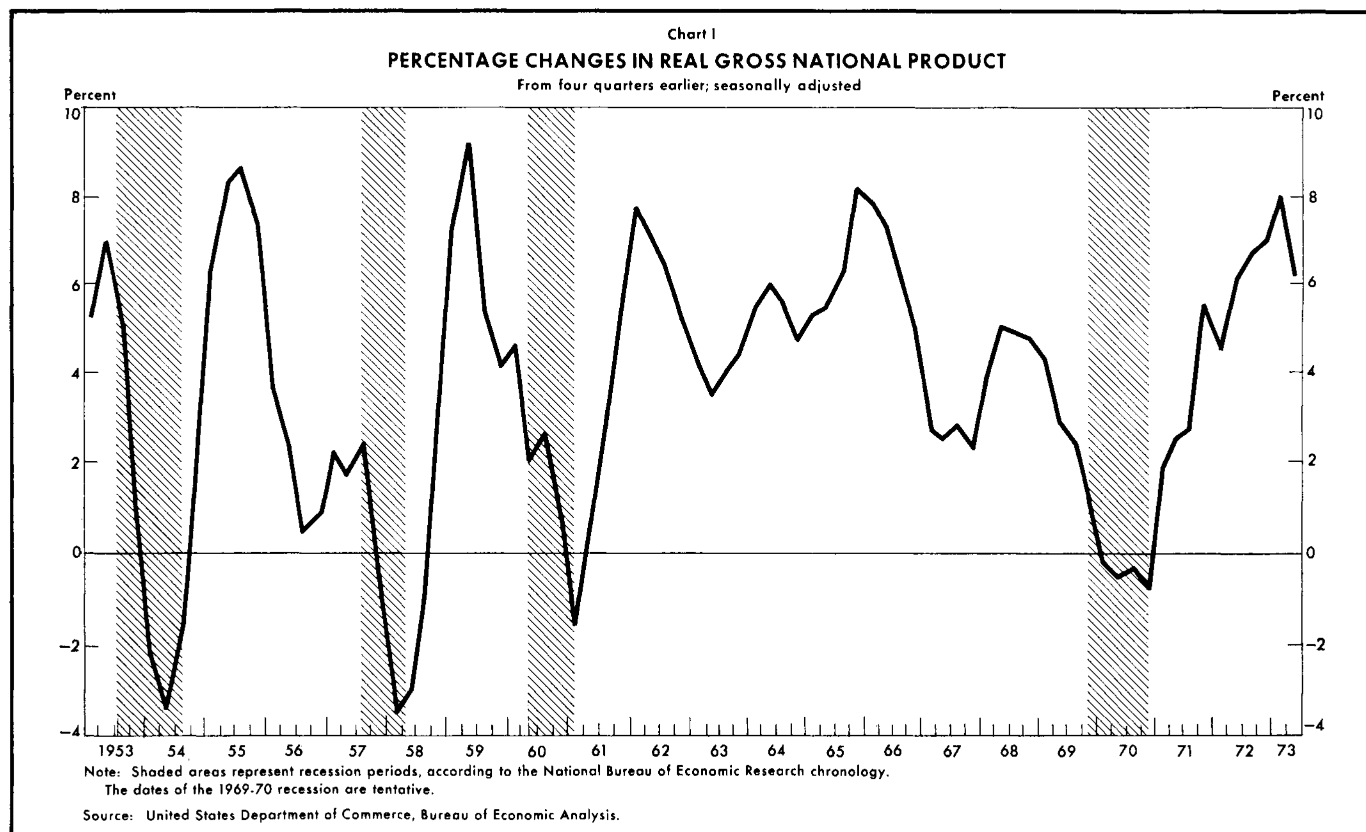
Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

to the growth of GNP. Larger inventory increases may well have been planned, but constraints on production and the high volume of sales may have prevented firms from realizing the desired additions to stocks. The ratio of the book value of total business inventories to sales dropped to extremely low levels in the first quarter, and hence considerable restocking of supplies was anticipated. Since the inventory-sales ratio still remains quite low by historical standards, prospects seem good for a further, sizable expansion in inventory spending in the months ahead.

The rise in final expenditures—GNP net of inventory accumulation—slowed in the second quarter. Final sales climbed $28 billion, down from the massive $46.8 billion advance of the first quarter. All the components of final spending moved higher, but most gains were relatively moderate. In particular, the increases in personal consumption and business fixed investment spending were considerably smaller than in the preceding quarter.

Personal consumption expenditures expanded by $15.7 billion in the second quarter, a sharp decline from the huge first-quarter advance of $26.8 billion. The increase in outlays on consumer durables shrank to $0.9 billion in the April-June interval following an enormous $9.3 billion burst in the initial quarter of the year. Indeed, after adjusting for higher prices, expenditures on consumer durables actually fell in the quarter as automobile sales and sales of other durable goods softened from their very strong first-quarter performance. The growth in spending on nondurable goods also moderated from the large increase in the previous quarter. On the other hand, the climb in outlays for services topped the gain of the first quarter.

The outlook for consumer spending in the months ahead is complicated by several factors. The price freeze, in effect on most products until August 13, could induce consumers to step up their purchases in the near term in anticipation of higher prices when the freeze ends. In July, domestic auto sales were at a healthy 10.3 million unit annual rate. On the other hand, increased uncertainty about the economic outlook may restrain consumer spending. Retail



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology. The dates of the 1969-70 recession are tentative.

Source: United States Department of Commerce, Bureau of Economic Analysis.

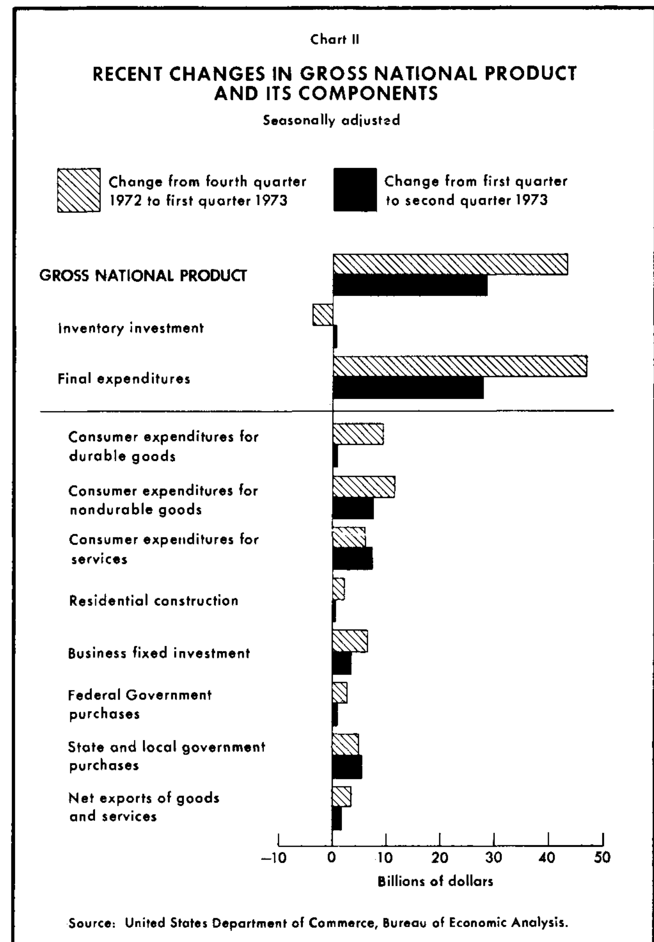
Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

sales remained below their March peak throughout the second quarter. Moreover, the University of Michigan's index of consumer sentiment has declined steadily since the third quarter of 1972 to reach in May its lowest level since the 1969-70 recession. According to the Michigan survey, consumers are concerned about both their personal financial circumstances and prospects for business activity in general. A more recent survey conducted by the Conference Board reported that consumers have reduced their plans to buy automobiles and homes from the high levels indicated in the spring.

In the latest revisions of the GNP data, the personal saving rate—the ratio of savings to disposable personal income—was significantly reduced for the past year, reflecting a larger rise in spending than previously reported. According to the revised estimates, the saving rate dropped sharply in the first half of 1972 and has changed little, on balance, since then. The slowdown of the growth in consumer spending in the second quarter was accompanied by a slight rise in the saving ratio to 6 percent, the rate that prevailed on average during much of the 1960's. By comparison, the saving rate stood at 5.9 percent in the first quarter of this year and at 5.8 percent in the second quarter of 1972.

Business fixed investment grew by $3.5 billion in the second quarter, only about half the strong expansion of the preceding three-month interval. This slackening was concentrated in spending for producers' durable equipment. In particular, purchases of trucks dropped off after a very strong performance earlier in the year. Notwithstanding this moderation, the expansion of business fixed investment was at a robust 17 percent annual rate over the first half of the year. This increase falls between the 13 percent expansion expected by the Commerce Department in its May survey of plant and equipment investment plans and the 19 percent rate projected in the McGraw-Hill spring survey which was supported in a special follow-up survey. In light of the diminishing reserve of unused productive capacity and the results of the capital spending surveys, it seems likely that investment outlays will remain strong in coming months.

Residential construction spending inched up by only $0.5 billion in the second quarter, providing additional evidence that the boom in housing is over. Other measures of housing activity confirm the slackening in home building apparent in the national income accounts and presage further weakening in residential building. Housing starts fell from an average 2.4 million units at an annual rate in the first quarter to a 2.2 million rate in the second quarter. Similarly, newly issued building permits were off 12 percent, relative to the first-quarter average.



Government purchases of goods and services contributed about $6.5 billion to the second-quarter GNP advance. Expenditures of state and local governments increased by a substantial $5.5 billion, $0.5 billion above the rise of the previous quarter. The recent rapid gains in state and local government spending undoubtedly reflect the favorable budget position of many of these governments and the receipt of funds from general revenue sharing. Federal spending moved up by a modest $1 billion in the April-June period. Defense spending accounted for only a small portion of this increase.

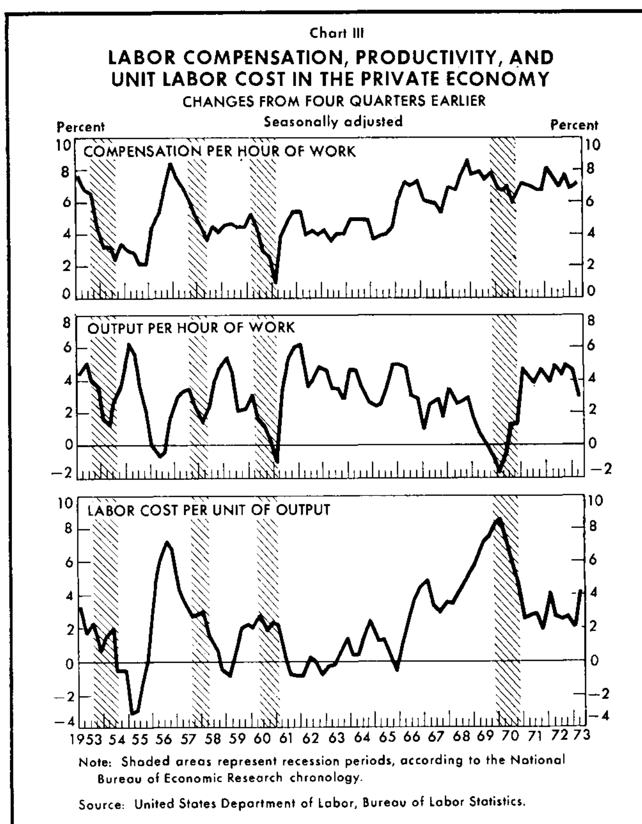
WAGES, COLLECTIVE BARGAINING AGREEMENTS, PRODUCTIVITY, AND EMPLOYMENT

The rate of wage gains continues moderate, on balance. During the April-June period, wage and benefit increases agreed upon in collective bargaining situations

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

involving 5,000 or more workers remained at about the moderate pace of the first quarter. Settlements concluded in the first six months of 1973 provided for mean life-of-contract wage and benefit increases at a 6.2 percent average annual gain, compared with a 7.4 percent rate in the previous year. The latest figures represent a decline from the extremely high 1970-71 rates, when wage and benefit growth averaged 8.9 percent over the life of the contract. (These data do not include the cost-of-living adjustments contingent on movements in consumer prices.) In addition, the recent contract negotiations have been settled without disruptive strikes. During the first six months of this year the percentage of working time lost because of strikes was the smallest in nine years, even though contract negotiations involve nearly as many workers as in the peak years of 1970 and 1971. Of course, the labor calm may not persist in light of the negotiations in major industries scheduled for later this year.

In the second quarter, compensation per hour of work in the private economy rose at a 7.2 percent seasonally adjusted annual rate, considerably smaller than the 9.4 percent expansion in the January-March period. Since the first-quarter compensation data were inflated by greater social security taxes paid by employers, the large difference between the quarterly figures exaggerates the deceleration. The second-quarter rise in compensation is the same as the gain experienced during the four quarters ended in June (see Chart III).



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.

Source: United States Department of Labor, Bureau of Labor Statistics.

The hourly earnings index—which is adjusted for inter-industry employment shifts and overtime in manufacturing —is the closest available approximation of basic wage rates for the private nonfarm sector's 51 million production workers. In July, the index rose at a 4.9 percent seasonally adjusted annual rate, bringing the growth over the most recent twelve months to 6.1 percent.

Productivity, as measured by output per hour of work in the private economy, showed no growth in the second quarter after rising at a 3.9 percent annual rate in the January-March period. Excluding the farm sector, where productivity changes tend to fluctuate widely from quarter to quarter, productivity fell slightly in the second quarter, the first decline since the fourth quarter of 1970. The drop in nonfarm productivity came after six quarters of growth considerably above the long-run trend rate of increase. The abrupt halt in the increase in productivity shown in the preliminary statistics seems inconsistent with the small moderation in the expansion of industrial production. Since there was no productivity improvement to help offset the continued rise in compensation per hour of work, unit labor costs moved sharply higher at a 7.7 percent annual rate, the fastest rise since the first quarter of 1970.

The labor market changed little from June to July. According to the monthly survey of households, both the civilian labor force and employment decreased slightly in July following the exceptionally large gains recorded during the preceding month. The overall unemployment rate slipped to 4.7 percent, its lowest level in more than three years; in comparison, the rate of unemployment was 5.6 percent a year earlier. During July, the jobless rate for adult males moved down to 3 percent from 3.2 percent in June. Meantime, the unemployment rate for adult women was unchanged at 4.9 percent, and the volatile teen-age jobless rate rose from 13.3 percent to 14.4 percent.

In the separate July survey of establishments, nonfarm payroll employment generally continued at the June levels. An increase in employment in the service industries was largely counterbalanced by a decline in manufacturing employment. While the number of workers on factory payrolls declined during July, the average workweek of manufacturing production workers advanced 0.3 hours to 40.9 hours. Overtime remained at 3.8 hours per week.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

PRICE DEVELOPMENTS

Prices continued to rise at unacceptably rapid rates up to the imposition of the price freeze on June 13. All of the major price measures—the implicit GNP deflator for the second quarter, the consumer price index, and the wholesale price index—gave clear signs of the severity of the inflation prior to the price freeze. While the freeze has already resulted in some improvement in the wholesale price index, it is doubtful that any abatement in underlying inflationary pressures has been achieved. The most severe price pressures have been concentrated in areas of extremely strong demand, such as food, fuel, livestock feed, and many unprocessed industrial nonferrous metals. In an effort to restrain the inflation, the Phase Four controls, scheduled for implementation on August 13, will allow only a dollar-for-dollar pass-through of cost increases in most industries. While the many special regulations covering specific industries considerably complicate the price picture, the narrow margin of idle productive resources in the economy suggests that inflationary pressures will remain strong.

According to the preliminary data, the implicit GNP price deflator surged at an extraordinary 6.8 percent seasonally adjusted annual rate in the second quarter, the fastest climb since the first quarter of 1951 when prices were affected by the Korean war. The rise in the April-June period came on the heels of the exceptionally large 6 percent rise in the initial quarter of the year. Rapid as these increases are, the fixed weight GNP price index, which is based on the composition of spending in 1967, has risen even more sharply in recent quarters. In the second quarter the fixed-weight index climbed at a 7.2 percent annual rate, and over the past year this index has advanced 5.5 percent. These figures probably give a better reading of the breadth and intensity of recent price pressures in the economy than does the implicit deflator.

At the retail level, consumer prices climbed in June at nearly a 7 percent seasonally adjusted annual rate. Over the first six months of 1973, consumer prices jumped at a 7.8 percent annual rate, the fastest rise in twenty-two years. Food prices have long been the chief culprit in the unsatisfactory consumer price situation. While the rate of increase in consumer food prices has braked from the extraordinary advance of the first quarter, these prices still moved upward at a very disturbing 11 percent annual rate in June. In the meantime, increases in the prices of nonfood commodities and services have been accelerating. The prices of gasoline, fuel oil, household durable goods, and used cars all rose sharply in June. Over the second quarter as a whole, prices of nonfood commodities climbed at a 5.3 percent annual rate by comparison with an increase in the first quarter at less than a 4 percent pace.

After skyrocketing over the first six months of the year, wholesale prices in July fell at a 17 percent annual rate, the steepest drop in twenty-five years. The first decline in the wholesale index in almost two years reflected a sharp plunge in the prices of farm products and processed foods and feeds. In turn, a drop in the price of soybeans, which have been subject to export controls, accounted for much of the decline in the agricultural commodities component. However, since the survey of wholesale prices was taken, the prices of many farm goods have climbed again, so that the improvement in the index is likely to be short-lived. The price freeze apparently has had some success in holding wholesale prices of industrial commodities steady; industrial prices rose at just a 0.7 percent annual rate in July.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Monetary and Financial Developments in the Second Quarter

During the second quarter of 1973 the growth of most of the monetary aggregates accelerated substantially. The narrowly defined money supply (M_1) rose at a 10.3 percent seasonally adjusted annual rate following a sluggish 1.7 percent gain from January to March. The growth in the broad money supply (M_2) also climbed significantly above its first-quarter pace. On the other hand, the rate of growth of the adjusted bank credit proxy slowed somewhat as the result of both a less explosive expansion in large-denomination certificates of deposit (CDs) than in the preceding three months and an actual decline in the level of United States Government deposits at member banks. Reserves available to support private nonbank deposits (RPD) expanded more rapidly than in the preceding quarter. Despite this gain in reserves, the effective rate on Federal funds rose sharply over the period as the monetary authorities resisted the rapid growth in the aggregates.

The expansion in bank credit slowed in the second quarter from its very rapid first-quarter pace. Business loans advanced at a very substantial 20 percent rate, but this was still only about half the rate of gain experienced in the first quarter. Commercial banks made a modest addition to their portfolios of United States Government and other securities in the April-June period, in contrast to the liquidation of such investments during the first quarter.

On balance, both short- and long-term interest rates rose over the second quarter. The rise in short-term rates was particularly sharp and was accompanied by successive increases in the Federal Reserve discount rate. Effective July 2, the discount rate was raised to 7 percent, equaling the record high established more than fifty years ago. Simultaneously with the announcement of this increase, the Board of Governors of the Federal Reserve System raised reserve requirements on most demand deposits at member banks. These moves, designed to restrain the continuing excessive expansion in money and credit, contributed to additional steep increases in short-term interest rates. By mid-July, rates on many of these instruments had reached or surpassed their peaks of 1969-70.

THE MONETARY AGGREGATES

M_1—private demand deposits adjusted plus currency outside commercial banks—grew at a rapid seasonally adjusted annual rate of 10.3 percent during the second quarter of 1973, following a modest gain of 1.7 percent in the preceding quarter (see Chart I). This acceleration brought the growth in M_1 for the year ended in June to a strong 7.4 percent. The major source of the second-quarter growth in M_1 was a 10.5 percent rise in its demand

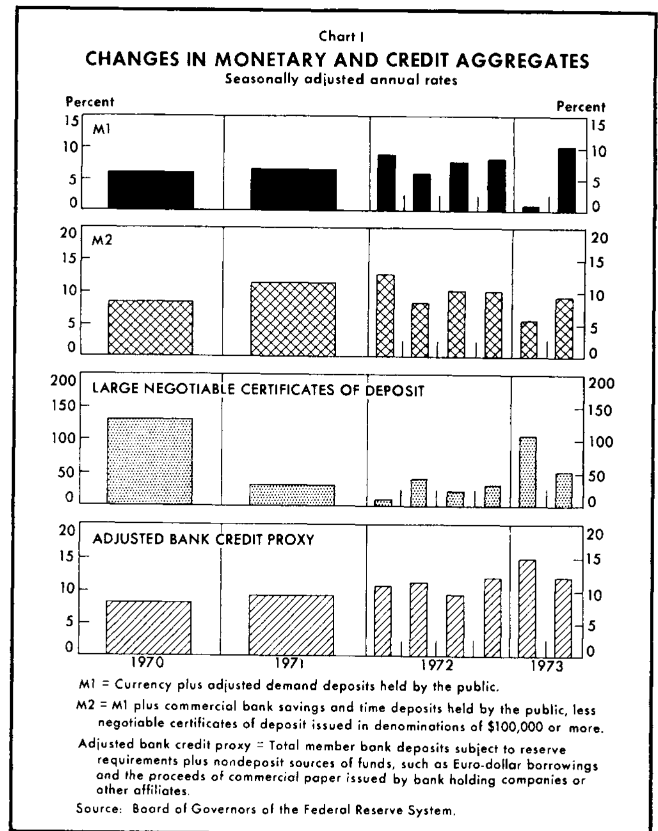


Chart I
CHANGES IN MONETARY AND CREDIT AGGREGATES
Seasonally adjusted annual rates

M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

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

Source: Board of Governors of the Federal Reserve System.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

deposit component. These deposits, which were essentially unchanged during the first three months of the year, advanced at an increasingly rapid pace over the April-June period. In addition, the currency component of M_1 grew substantially over the quarter. The larger than anticipated Federal income tax refunds during the period may well have been a factor in the strong M_1 growth. These funds were transferred from Treasury accounts, which are excluded from M_1, to private accounts and may at least in part have been added to checking and currency balances.

The growth of M_2—consisting of M_1 plus time deposits other than large CDs—also accelerated in the second quarter, though less strongly than M_1. Net flows into the time deposit component of M_2 have been slowing this year, primarily as a result of the substantial rise in short-term market interest rates in recent months. Compared with an increase of 13.3 percent in 1972, the gain in such time deposits amounted to 9.5 percent and 8.7 percent in the first and second quarters of 1973, respectively. This deceleration was more than offset by the growth in demand deposits, however, and M_2 expanded at a seasonally adjusted annual rate of 9.5 percent in the April-June period, up from 5.7 percent in the previous quarter. Over the first half year as a whole, M_2 advanced 7.7 percent at a seasonally adjusted annual rate.

In contrast to the money supply measures, growth in the adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—slowed somewhat in the second quarter. Nevertheless, the proxy expanded at a rapid 12.2 percent rate over the period after rising at a 15 percent pace for the first three months of the year. In comparison, the proxy grew 11.6 percent in 1972 and 9.4 percent in 1971. United States Government deposits at member banks, seasonally adjusted, fell by some \$2.4 billion over the second quarter as the Treasury made a revenue-sharing payment to state and local governments and refunded an unusually large amount of withheld income taxes. An additional factor contributing to the proxy's slowing was a marked deceleration in the growth of CDs outstanding at member banks. After climbing at an annual rate of 108 percent in the first quarter, CD growth slowed progressively from 83 percent in April to only 5.8 percent in June. CDs became an increasingly expensive source of funds to banks over the period—banks were bidding as high as 8.5 percent for three-month CDs by the end of June. In addition, the cost of CDs to many banks was boosted by the imposition of a marginal reserve requirement against additions to the amounts outstanding. To slow CD growth and thus bank credit expansion, effective June 7 the Federal Reserve applied an 8 percent reserve

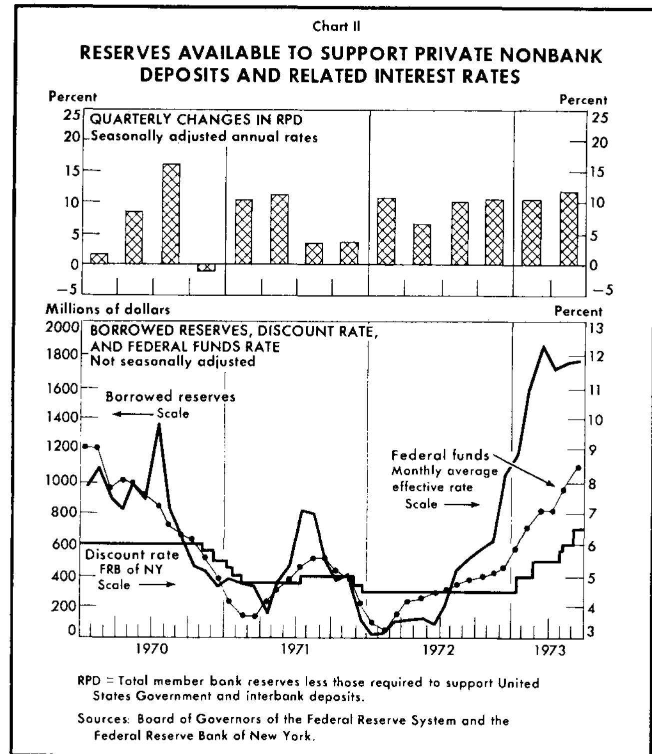


Chart II

RESERVES AVAILABLE TO SUPPORT PRIVATE NONBANK DEPOSITS AND RELATED INTEREST RATES

RPD = Total member bank reserves less those required to support United States Government and interbank deposits.

Sources: Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

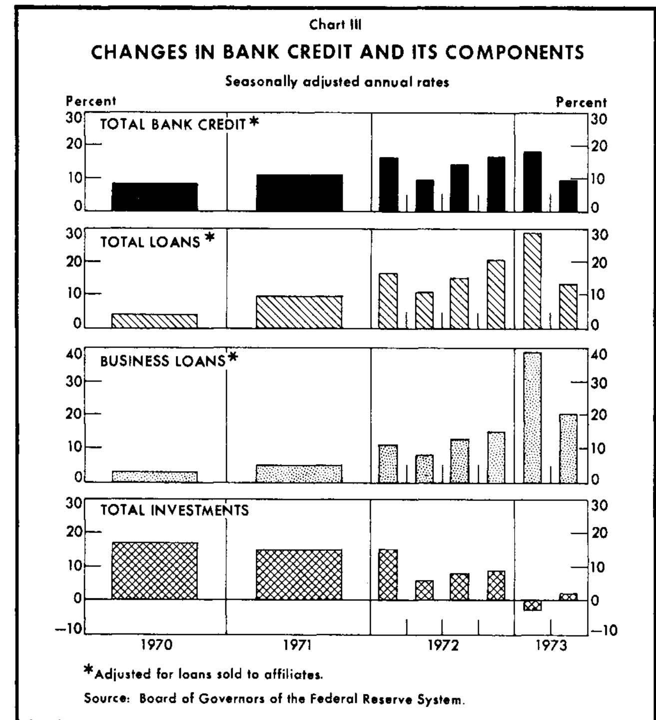
requirement—the existing 5 percent plus a supplemental 3 percent—to increases in the combined total of CDs and bank-related commercial paper above the level outstanding in a base period.[1] This regulation applies only to banks with such liabilities in amounts of \$10 million or more. The Board also removed Regulation Q ceilings from all maturities of large CDs to enable banks to restore a more balanced deposit structure, but only a small amount of lengthening had occurred by the end of June.

RPD expanded at a fast seasonally adjusted annual rate of 12 percent in the second quarter (see Chart II), following gains of 10.5 percent in the first quarter and 9.7 percent over the year 1972. The growth in RPD from April to June resulted from a substantial increase in nonborrowed reserves rather than from borrowing at the discount window. On a seasonally adjusted basis, nonborrowed reserves grew at a 17 percent annual rate in the second quarter, though the unadjusted rate was a quite

[1] See this *Review* (June 1973), pages 136-37 for details. Later, reserve requirements were also imposed on finance bills. See this *Review* (July 1973), pages 164-65.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

modest 1½ percent. Member bank borrowings from the Federal Reserve remained at quite a high level over the period. Despite the rise in the discount rate to 6½ percent early in June, there still was incentive for banks to borrow from the Federal Reserve rather than in the Federal funds market. The average effective rate on Federal funds climbed to 8.59 percent in the statement week ended June 27 from 7.11 percent three months earlier. Over the first six months of this year, the Federal funds rate increased by 3¼ percentage points, compared with a rise of only 1¼ percentage points over all of 1972.



BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

Total bank credit grew at a more temperate pace in the second quarter than over the preceding six months. Adjusted to include net loan sales to affiliates, bank credit increased at a 9.8 percent seasonally adjusted annual rate over the April-June interval, compared with rises of 18.4 percent and 16.4 percent in the first quarter 1973 and the fourth quarter 1972, respectively (see Chart III). While remaining quite strong, growth in loans to businesses, nonbank financial institutions, and consumers decelerated somewhat in the second quarter, and loans for purchasing and carrying securities continued the decline that began two quarters earlier.

Business loans rose 20.3 percent at an annual rate in the second quarter, still a very sizable increase but substantially less than the expansion in the preceding three months. On April 16 the Committee on Interest and Dividends approved a dual prime rate system under which the lending rate charged by commercial banks to large businesses is allowed to respond flexibly to changes in money market conditions provided that the changes are made gradually. Under this new system, the large business prime rate rose in several steps from 6½ percent at the end of March to 7¾ percent at the end of June. At the close of the quarter this rate was still ½ percentage point below the rate on prime dealer-placed four- to six-month commercial paper, but the substitution of bank loans for borrowing in the commercial paper market appears to have subsided. After falling by a total of $4 billion over the first four months of the year, nonbank-related dealer-placed commercial paper outstanding increased by $700 million during May and June.

Commercial banks increased their securities holdings at a modest 2.2 percent seasonally adjusted annual rate in the second quarter. This followed a small decline in the preceding three-month period when some holdings of United States Government securities were liquidated to meet the exceptionally strong loan demand. Over the first half of this year, banks reduced their holdings of securities at a 0.6 percent annual rate, compared with an 8.5 percent rise during 1972.

Interest rates on most short-term instruments leveled off or declined during April and early May but then rose steadily over the remainder of the period. After climbing by about 1¼ percentage points in the first quarter, the rate on three-month Treasury bills increased by an additional 1⅛ percentage points over the second quarter (see Chart IV), closing the period at 7.52 percent. The rate on four- to six-month dealer-placed commercial paper also rose by about 1⅜ percentage points from the end of March to the end of June, while the rate on ninety-day bankers' acceptances advanced by 1½ percentage points to 8¾ percent over the interval.

These increases in short-term rates applied further upward pressure upon long-term interest rates, but the relatively modest supply of new long-term bond issues continued to moderate the rise. New corporate bond offerings amounted to $5.6 billion in the second quarter, well under the total of $7.4 billion in the same quarter a year ago. State and local government bond issues totaled $5.4 billion in the three months ended in June, somewhat lower than the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

$6.2 billion raised in the comparable period of 1972. However, new issues of Federal agency securities were well above the borrowing of a year earlier. Rates on long-term United States Government bonds rose about 19 basis points in the second quarter. Corporate bond rates—as measured by the Federal Reserve Board's index of yields on recently offered utility bonds adjusted to an Aaa basis—rose 22 basis points over the quarter to 7.72 percent, reflecting a sharp rise in June. Rates in the municipal bond market were essentially unchanged, however, as The Bond Buyer index of twenty municipal bond yields was 5.25 percent at the end of June, compared with 5.26 percent in March.

THRIFT INSTITUTIONS

With the continued rise in market interest rates above those paid on deposits at savings and loan associations and mutual savings banks, deposit flows to these institutions slowed further during the second quarter (see Chart V). Deposit gains at savings and loan associations were at a seasonally adjusted 10.4 percent annual rate over the

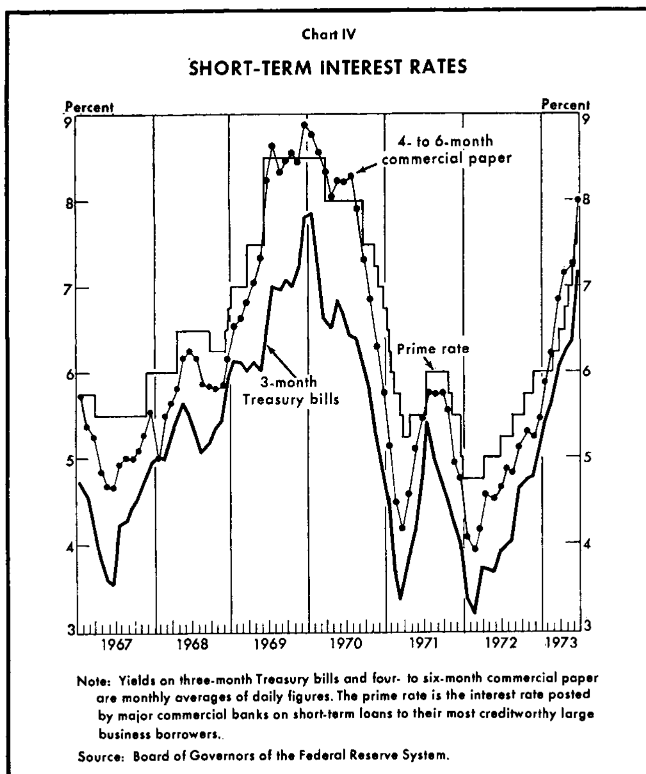


Chart IV
SHORT-TERM INTEREST RATES

Note: Yields on three-month Treasury bills and four- to six-month commercial paper are monthly averages of daily figures. The prime rate is the interest rate posted by major commercial banks on short-term loans to their most creditworthy large business borrowers.
Source: Board of Governors of the Federal Reserve System.

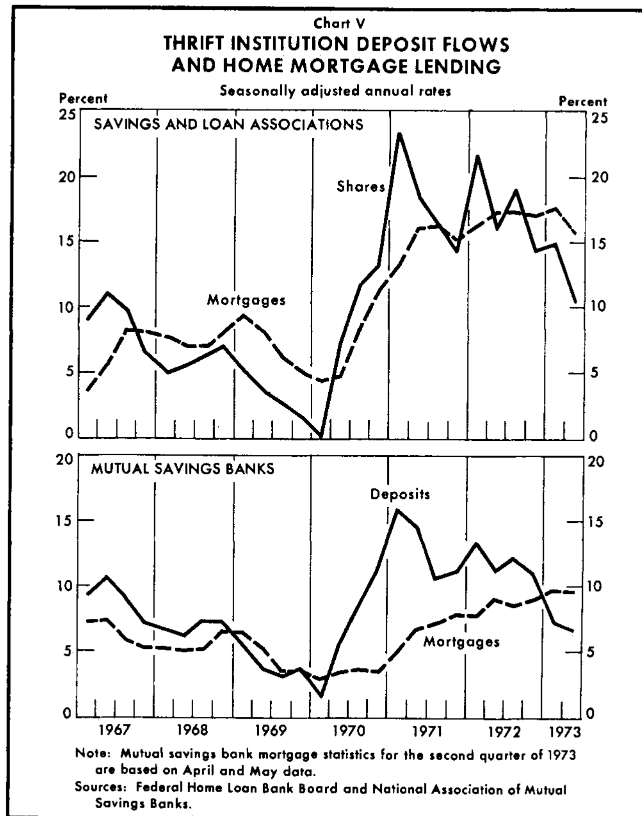


Chart V
THRIFT INSTITUTION DEPOSIT FLOWS AND HOME MORTGAGE LENDING
Seasonally adjusted annual rates

Note: Mutual savings bank mortgage statistics for the second quarter of 1973 are based on April and May data.
Sources: Federal Home Loan Bank Board and National Association of Mutual Savings Banks.

period, while deposits at mutual savings banks grew 6.6 percent. These increases were considerably smaller than the gains registered in the corresponding quarter a year earlier, but they are decidedly more rapid than in 1969 when market rates were only slightly higher than in the second quarter of this year. Early in July the interest rate ceilings on passbook accounts and other consumer-type time deposits at thrift institutions and commercial banks were raised,[2] but the spread between these and market rates remains quite large.

Despite the slowdown in deposit flows, there was little deceleration in the growth of mortgage holdings at the thrift institutions in the most recent quarter. In fact, mortgage holdings at savings banks rose more rapidly during the first half of 1973 than in 1972. Savings and loan

[2] See "The Money and Bond Markets in July", Table I (this *Review*), page 198.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

associations increased their mortgage lending at a substantial pace in the second quarter as well, and outstanding mortgage commitments at savings and loan associations remain very high. To maintain the high level of mortgage lending activity, the associations reduced their liquid asset holdings and raised their borrowings from the Federal Home Loan Banks to record levels.

Mortgage interest rates increased modestly in the second quarter. The effective rate on conventional mortgage loans rose from 7.68 percent to 7.76 percent over the period. Ceiling rates on Federal Housing Administration (FHA)-insured and Veterans Administration-guaranteed mortgages were increased by ¾ percentage point in early July, and some states have recently raised the permissible maximum rates for conventional mortgages. The higher rate on FHA-insured mortgages was not immediately effective, however, because of a Congressional delay in extending the agency's authority for providing such insurance.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Money and Bond Markets in July

Interest rates increased markedly during July, with yields on short-term instruments rising to record levels. Rates rose dramatically early in the month in the wake of Federal Reserve actions boosting the discount rate to 7 percent and raising reserve requirements on most demand deposits at member banks. While rates leveled off temporarily before midmonth in response to improvement in the international position of the dollar, they soon resumed an advance which persisted over the remainder of the period. The announcement, on July 18, of Phase Four of the economic controls program had little impact, as participants were convinced that the Federal Reserve would maintain its restrictive stance. Treasury bill rates climbed substantially over the month as a whole. Yields on Government coupon securities moved up as concern over inflation and pressures in the money market continued. As evidence of the Federal Reserve's restrictive stance mounted, market participants backed away late in the month from the Treasury's offering of $2 billion of notes due in 1977 and $500 million of twenty-year bonds. Prices dropped sharply, and public interest proved quite limited in the longer issue. Yields on corporate and tax-exempt bonds increased dramatically in July, particularly late in the month.

In response to the rapid rise in short-term interest rates and the potential danger of disintermediation, the Board of Governors of the Federal Reserve System, together with the Federal Home Loan Bank (FHLB) Board and the Federal Deposit Insurance Corporation (FDIC), on July 5 raised the ceilings on interest rates member banks and thrift institutions may pay on passbook savings and other consumer-type time deposits (see Table I). In a further effort to allow these institutions to be more competitive, a new category of consumer time deposit was established. This deposit is not subject to an interest rate ceiling; however, the deposit must have a minimum maturity of four years and have a minimum denomination of $1,000.

The growth of both M_1—defined as demand deposits adjusted plus currency outside banks—and M_2, which also includes time and savings deposits other than large certificates of deposit (CDs), slowed during July, but growth in recent months was still greater than desired. The growth of the adjusted bank credit proxy was at a more moderate rate in July than that during the past few months, largely as a result of a sharp decline in Treasury deposits at member banks. Large-denomination CDs outstanding increased substantially again in the month.

BANK RESERVES AND THE MONEY MARKET

Pressure in the money market increased considerably during July, as the Federal Reserve sought to restrict the growth in money and credit. The average effective rate on Federal funds rose from 8.59 percent in the June 27 statement week to 10.57 percent in the statement week ended August 1.[1] Average required reserves rose $1.2 billion above June levels, in part because of the increase in reserve requirements on member bank demand deposits which became effective in mid-July. The monetary authorities provided nonborrowed reserves reluctantly in reaction to this expanded demand for reserves. Consequently, member banks bid aggressively for Federal funds and stepped up their borrowings from the Federal Reserve Banks as well. Borrowings from the discount window averaged $1.97 billion in July (see Table II), compared with $1.79 billion borrowed in June. With the spread between the cost of Federal funds and Euro-dollars narrowing, banks also began to utilize the Euro-dollar market to a greater extent.

Other short-term interest rates also rose significantly in July (see Chart I). In attempting to attract additional funds, large banks have raised offering rates on short-term CDs considerably. These rates have risen to such an extent that some smaller banks are now investing in the CDs

[1] Beginning July 19, 1973 the daily effective Federal funds rate is calculated as a "weighted average", reflecting the volume of activity at each rate at which transactions occur. Previously, the effective rate was defined as the most representative rate for the day, usually the rate at which most transactions through Federal funds brokers occurred.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of large city banks, particularly in New York. The small banks are using large CDs as an alternative investment to supplying funds in the overnight market, and are thereby extending the maturity of their liquid assets. With the cost of funds rising sharply, commercial banks raised their prime lending rate for large business borrowers by 1 percentage point over the month in a series of ¼ percentage point steps. The prime rate reached a level of 8¾ percent at virtually all major banks by the month end. This represented the highest rate banks have charged their prime business customers since the practice of a publicized prime rate became common about forty years ago. Rates on commercial paper climbed steadily throughout the month. The rate on 90- to 119-day commercial paper advanced 1⅜ percentage points over the month and closed at 9⅞ percent. Over the past three months, the rate on such paper has risen a total of 2¾ percentage points. Thus, despite persistent increases in the commercial bank prime rate, bank loans have continued to be attractive in relation to borrowing in the commercial paper market. Rates quoted by dealers in bankers' acceptances increased by 1¼ percentage points over the month.

Table I

NEW INTEREST RATE CEILINGS ON SAVINGS DEPOSITS AND TIME DEPOSITS IN DENOMINATONS OF LESS THAN $100,000

In percent per annum

Institution and instrument	New maximum	Previous maximum
FDIC-insured commercial banks		
Passbook savings	5.00	4.50
Time deposits maturing in:		
90 days to 1 year	5.50	5.00
1 year to 2½ years	6.00	5.50*
2½ years and over	6.50	5.75
4 years and over (minimum denomination of $1,000)	no ceiling	5.75
FDIC-insured mutual savings banks		
Passbook savings	5.25	5.00
Time deposits maturing in:		
90 days to 1 year	5.75	5.25
1 year to 2½ years	6.50	5.75†
2½ years and over	6.75	6.00
4 years and over (minimum denomination of $1,000)	no ceiling	6.00
FHLB member savings and loan associations		
Passbook savings	5.25	5.00
Time deposits maturing in:		
90 days to 1 year	5.75	5.25
1 year to 2½ years	6.50‡	5.75†
2½ years and over	6.75‡	6.00
4 years and over (minimum denomination of $1,000)	no ceiling	6.00

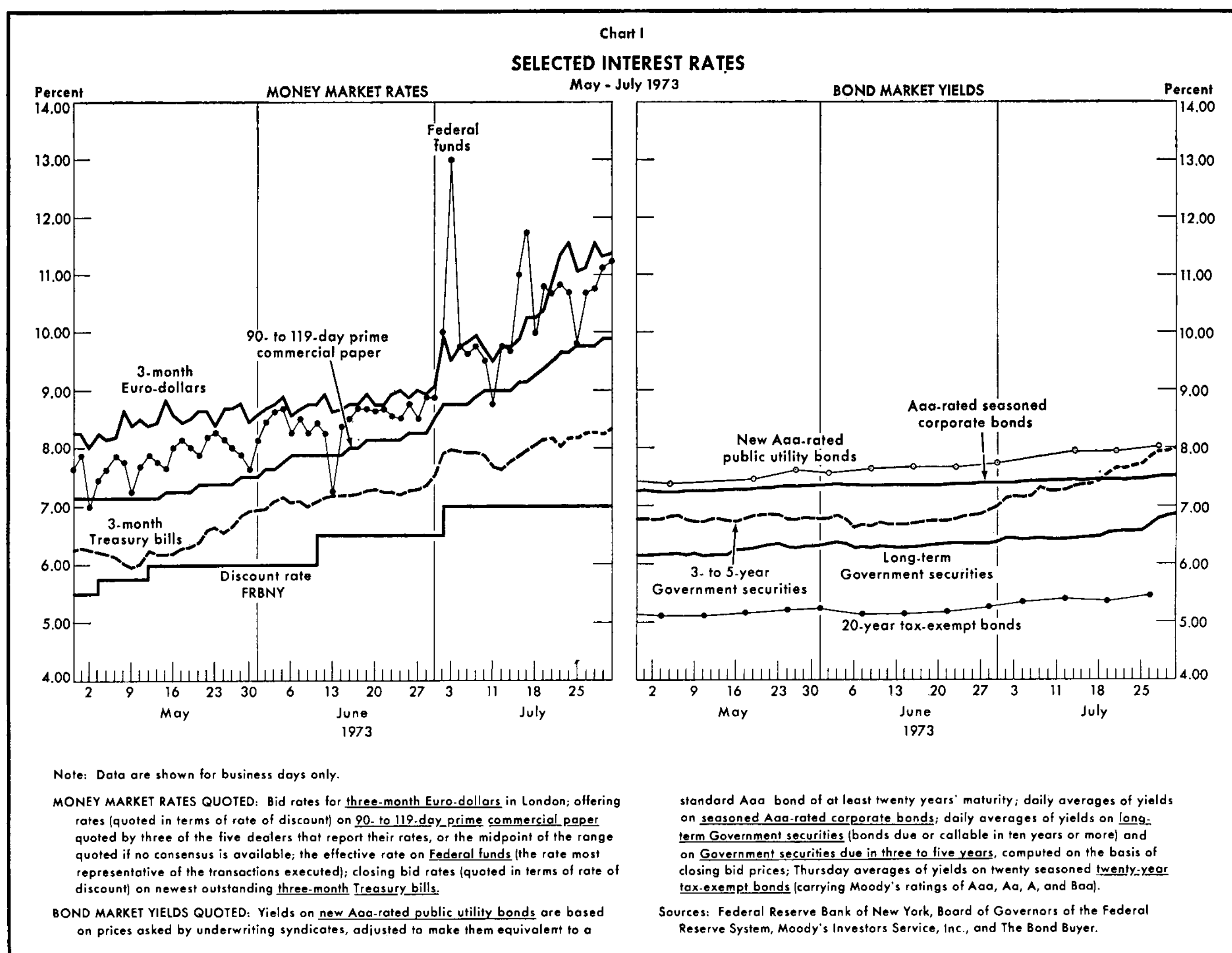
* 5.50 percent for one to two years; 5.75 percent for two years or more.
† 5.75 percent for one to two years; 6.00 percent for two years or more.
‡ Subject to varying minimum denomination requirements.
Sources: Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Federal Home Loan Bank Board.

In response to the pronounced increases in market interest rates in recent months, the authorities regulating depository institutions raised in July the interest rate ceilings that banks and thrift institutions may pay on passbook savings and other consumer time deposits. Specifically, on July 5 the Board of Governors of the Federal Reserve System raised the interest rate ceilings that member banks may pay on passbook savings accounts by ½ percentage point and on other time deposits of less than $100,000 by ¼ to ¾ percentage point. The new schedule of ceilings was made effective as of July 1 and applies to both single- and multiple-maturity deposits. Interest rate ceilings on consumer-type time deposits were last increased on January 21, 1970. Additionally, member banks were authorized to offer four-year time deposits with a minimum denomination of $1,000 without any interest rate restriction. Subsequently, the amount of such deposits that a bank may issue was limited to 5 percent of its total time and savings deposits. Penalty provisions for payment of time deposits prior to maturity were also modified.[2] The FDIC and the FHLB Board announced on the same day similar changes in interest rate ceilings for the institutions under their jurisdiction, with the exception that ceilings on passbook accounts at thrift institutions were raised by only ¼ percentage point. These increases in interest rate ceilings were taken both to enable the financial institutions to compete more effectively for consumer deposits and to provide consumers with a higher return in an environment where many interest rates have risen substantially.

Many banks and thrift institutions rapidly adjusted their rates to the new ceilings and introduced deposits of varying maturity, minimum balance, and interest rate to fill the "no ceiling" four-year deposit category. The most common rate offered on the new four-year certificates was 7 percent. With the increase in deposit ceilings, some

[2] Under the new rule, a bank may pay a time deposit at any time before maturity but only at the passbook rate for the period held, less three months interest.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the five dealers that report their rates, or the midpoint of the range quoted if no consensus is available; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa-rated public utility bonds are based on prices asked by underwriting syndicates, adjusted to make them equivalent to a standard Aaa bond of at least twenty years' maturity; daily averages of yields on seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, Inc., and The Bond Buyer.

states were induced to raise their ceilings on mortgage interest rates so that thrift institutions could meet, profitably, the demand for mortgage funds.

The monetary aggregates continued to grow at a rapid pace in July. Preliminary estimates indicate that M_1 advanced at a seasonally adjusted annual rate of about 5¾ percent in that month, bringing the growth over the past three months to 9¾ percent at an annual rate (see Chart II). Over the twelve months ended in July, M_1 has increased by 6¾ percent. The growth of time deposits other than large negotiable CDs has been moderating steadily throughout the year. The combined effect of the growth of these time deposits and M_1 resulted in an expansion of the broad money supply (M_2) at an annual rate of 5¾ percent in July. This is a somewhat slower pace than the growth experienced over the twelve months ended in July.

The adjusted bank credit proxy—which consists of daily average member bank deposits subject to reserve requirements and certain nondeposit liabilities—expanded at an estimated 9 percent seasonally adjusted annual rate in July. This is a somewhat slower pace than the 13.8 percent rate of advance experienced during the first half of the year. Much of the slowing in growth of the proxy can be attributed to the decline in Government deposits during July. The growth in large CDs remained strong. CDs increased at a rate of 46.5 percent in July by comparison with the explosive 87 percent annual rate of gain posted

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table II

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JULY 1973

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

Factors	Changes in daily averages—week ended				Net changes
	July 4	July 11	July 18	July 25	
"Market" factors					
Member bank required reserves	− 687	+ 159	− 744	− 521	−1,793
Operating transactions (subtotal)	−1,470	+ 709	+ 831	− 264	− 194
Federal Reserve float	− 485	+1,534	+ 129	− 528	+ 650
Treasury operations*	− 533	− 357	+ 776	+ 72	− 42
Gold and foreign account	− 31	+ 24	+ 3	− 124	− 128
Currency outside banks	− 253	− 381	− 239	+ 326	− 547
Other Federal Reserve liabilities and capital	− 167	− 111	+ 162	− 11	− 127
Total "market" factors	−2,157	+ 868	+ 87	− 785	−1,987
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+1,937	− 793	+ 250	− 22	+1,372
Outright holdings:					
Treasury securities	+ 732	+ 86	+ 171	− 112	+ 877
Bankers' acceptances	− 2	− 4	− 6	− 5	− 17
Federal agency obligations	—	—	—	+ 144	+ 144
Repurchase agreements:					
Treasury securities	+ 989	− 765	+ 92	− 25	+ 291
Bankers' acceptances	+ 52	− 33	− 6	+ 4	+ 17
Federal agency obligations	+ 166	− 77	− 1	− 28	+ 60
Member bank borrowings	+ 552	− 721	+ 42	+ 358	+ 231
Seasonal borrowings†	+ 18	+ 6	—	+ 11	+ 35
Other Federal Reserve assets‡	+ 97	− 8	+ 87	+ 61	+ 237
Total§	+2,526	−1,522	+ 379	+ 396	+1,779
Excess reserves‡	+ 369	− 654	+ 466	− 389	− 208

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash‡	33,280	32,467	33,677	33,809	33,308‖
Required reserves	32,687	32,528	33,272	33,793	33,070‖
Excess reserves§	593	− 61	405	16	238‖
Total borrowings	2,401	1,680	1,722	2,080	1,971‖
Seasonal borrowings†	111	117	117	128	118‖
Nonborrowed reserves	30,879	30,787	31,955	31,729	31,337‖
Net carry-over, excess or deficit (−)‡‡	100	216	17	227	140‖

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

* Includes changes in Treasury currency and cash.

† Included in total member bank borrowings.

‡ Includes assets denominated in foreign currencies.

§ Adjusted to include $112 million of certain reserves deficiencies on which penalties can be waived for a transition period in connection with bank adaptation to Regulation J as amended effective November 9, 1972. The adjustment amounted to $450 million from November 9 through December 27, 1972, $279 million from December 28, 1972 through March 28, 1973, $172 million from March 29 through June 27, 1973.

‖ Average for four weeks ended July 25.

‡‡ Not reflected in data above.

over the first six months of the year. Reserves available to support private nonbank deposits grew at an annual rate of 16.5 percent in July.

THE GOVERNMENT SECURITIES MARKET

Treasury bill rates rose sharply in July, largely in response to the increasingly restrictive stance of monetary policy. Bill rates moved dramatically higher early in the month in the wake of the increase in the discount rate and the rise in member bank reserve requirements announced in late June. In the weekly bill auction on July 2, the average issuing rates on both the three- and six-month bills were more than 70 basis points above the rates set at the previous auction. The issuing rate for the three-month bill advanced somewhat further over the rest of the month (see Table III) and finished 109 basis points above the rate set in the final auction in June. Similarly, the rate for the six-month bill at the July 30 auction was 118 basis points above its month-earlier level. The yield on 52-week bills in the July 24 auction was 8.393 percent, 116 basis points above the month-earlier level.

Bill rates steadied briefly in the second week of July, as some temporary improvement in the dollar in the foreign exchange markets bolstered investor demand. On July 10, the Federal Reserve announced increases in most of the reciprocal currency arrangements, or swap lines, that it maintains with fourteen foreign central banks and the Bank for International Settlements, and market participants were encouraged by this step. However, rates soon resumed their climb. The upward momentum of rates was little affected by the disclosure, on July 18, of Phase Four of the Administration's price controls program. It was expected that monetary policy would remain firm in any event. Against this background, bill rates advanced substantially over the remainder of the period to record levels.

The market for Treasury coupon securities was influenced by many of the same factors which affected the bill market. Prices were buoyed temporarily by developments in the foreign exchange markets but declined over much of the month. Yields on three- to five-year issues rose by an average of 99 basis points over the month as a whole, while yields on longer term issues increased by about 46 basis points.

On July 25, the Treasury disclosed the terms for refunding $4.7 billion of publicly held notes and bonds due to mature August 15. The Treasury announced that it would auction $2 billion of four-year 7¾ percent notes, $500 million of 7½ percent twenty-year bonds callable in fifteen years, and $2 billion of 35-day tax anticipation

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

bills. For the bond auction, the Treasury employed the technique, which was used in the two preceding bond sales, of awarding all of the bonds at the price of the lowest accepted bid.

Following the announcement of the refinancing, rates on short-term Treasury bills adjusted upward while the prices of intermediate- and long-term Government securities declined quite sharply. The price declines in the intermediate area were the largest on record. In the rapidly deteriorating market atmosphere, participants became increasingly cautious as the auctions approached, and the new notes and bonds met only limited demand. On July 31, the 7¾ percent notes were sold at an average issuing yield of 8.03 percent, considerably higher than had been anticipated when the refunding package was announced. The 7½ percent bonds, auctioned August 1, were issued at an average yield of 8 percent. The public subscribed to only $260 million of the bonds.

Table III

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—July 1973				
	July 2	July 9	July 16	July 23	July 30
Three-month	7.987	7.991	7.967	8.114	8.320
Six-month	8.011	8.019	8.023	8.272	8.476
	Monthly auction dates—May-July 1973				
	May 24	June 26	July 24		
Fifty-two weeks	6.818	7.235	8.393		

* 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.

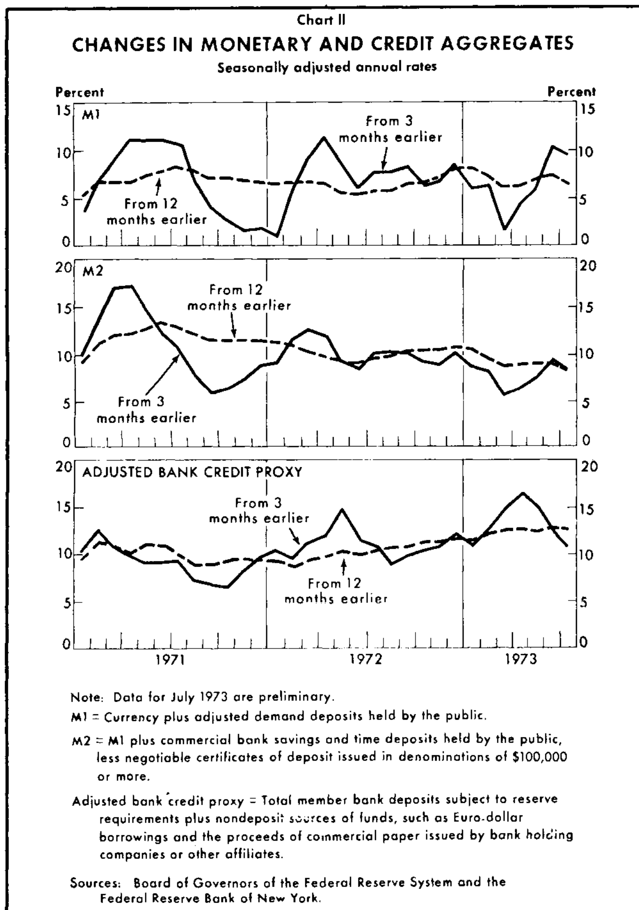


Chart II
CHANGES IN MONETARY AND CREDIT AGGREGATES
Seasonally adjusted annual rates

Note: Data for July 1973 are preliminary.
M1 = Currency plus adjusted demand deposits held by the public.
M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.
Adjusted bank credit proxy = Total member bank deposits subject to reserve requirements plus nondeposit sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.
Sources: Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

Prices of Federal agency securities declined during July amid continued heavy new-issue activity. Early in the month the Federal Land Banks offered three issues totaling $1.1 billion. These securities, priced to yield from 7.50 percent to 7.65 percent, received a mediocre reception. On July 12, the FHLB Board priced $500 million of 25-month bonds at 7.875 percent and $500 million of 37-month bonds at 7.80 percent. This offering failed to attract much investor interest. Other agency issues marketed later in the month similarly received unenthusiastic receptions.

OTHER SECURITIES MARKETS

Rising money market rates and continued pessimism about inflation exerted downward pressure on prices of corporate and municipal bonds during July. Despite light dealer positions, prices of older corporate issues moved lower over the month as investors remained cautious about committing funds to long-term securities amid expectations of further increases in short-term rates. New financing activity in the corporate sector was modest. On July 12, $125 million of twenty-year Aa-rated debentures was offered to yield 7.875 percent. This issue initially received a good reception, but sales subsequently encountered some resistance. Several relatively small utility bond issues offered during the month also sold slowly. During the final week of July, several utility issues were offered at the highest yields in over two years. Despite

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

these attractive returns, investor interest was generally unenthusiastic. One $75 million Aa-rated power company issue, priced to yield 8.50 percent in 2003, received lackluster support even though this return was 25 basis points above that of a similarly rated utility offering in the previous week.

Prices of tax-exempt bonds generally moved lower during July. On July 2, $86 million of Aa-rated bonds received a good reception when priced to yield from 4.40 percent in 1974 to 5.25 percent in 1997, about 10 basis points more than yields available on similar outstanding securities. The municipal calendar increased later in the month, but legal technicalities forced the postponement of one issue and this aided sales of the others, as municipal bond dealers were able to reduce their inventories. On July 10, $150 million of A-1 rated bonds was priced to return from 4.40 percent in 1974 to 5.90 percent in 2003. Despite the generous yields, there was only moderate interest in this issue. Several smaller tax-exempt issues marketed later in July met good demand. The fourth week of July was dominated by the offering of $331 million of New York City A/BB-rated (Moody's/Standard and Poor's) bonds priced to yield 5.98 percent. This offering received strong support. The Bond Buyer index of twenty tax-exempt bond yields climbed from 5.25 percent on June 28 to 5.48 percent on July 26. The Blue List of dealers' advertised inventories fell $111 million to $584 million over the month.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Competition and the Changing Banking Structure in New Jersey*

New Jersey is one of several states that in recent years have liberalized their banking statutes to permit commercial banks to expand through branching and merging over a widened geographical area within state boundaries. The 1969 Banking Act amendments substantially broadened the possibilities for increased competition in local New Jersey banking markets, not only by permitting commercial banks wider powers of expansion, but also by allowing for the first time the formation of bank holding companies that control more than one bank. The ability of banking organizations to expand may be broadened even further through legislation recently passed by the New Jersey legislature. If enacted, this legislation will modify significantly the state's home- and branch-office protection laws and permit statewide branching and merging by commercial banks.

This article reviews the evolution of banking structure in the state during the past two decades and assesses the impact of the 1969 legislative changes on the development of increased competition and on the quality and cost of services available to the public in New Jersey. Evidence of the initial impact of the legislative change was gathered by the Federal Reserve Bank of New York in mid-1971 from interviews held with 18 commercial banks in northern New Jersey. Additional evidence of the law's impact was obtained from a study of the behavior of the operating revenues and expenses of a group of banks selected from the Paterson banking market. Thus far, this evidence indicates that increased competition has improved the banking services available in the Paterson market without a significant adverse effect on bank profitability. The pending 1973 liberalization of the banking law can be expected to have similar benefits for the users of banking services in New Jersey.

NEW JERSEY BANKING LEGISLATION IN PERSPECTIVE

Effective in January 1969, the banking statutes of New Jersey were amended to allow commercial banks wider powers of expansion in three major respects.[1] First, the state was divided into three geographical banking districts within which banks may merge and establish new *(de novo)* branches (see map). Second, branch-office protection was lifted in communities having a population of 7,500 or more. Third, the formation of statewide bank holding companies was permitted, subject to the limitation that no company may control 20 percent or more of the total commercial bank deposits in the state. The first two provisions became effective in July 1969, while the third became effective with the enactment of the legislation early in 1969.

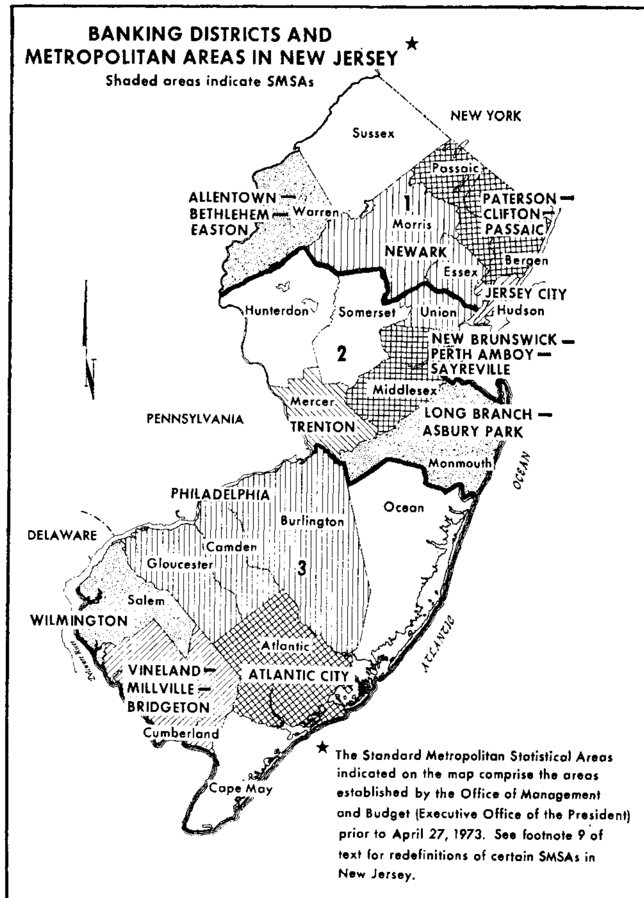
Prior to 1969, the authority of commercial banks in New Jersey to expand geographically was sharply limited by the Banking Act of 1948.[2] Although this legislation permitted commercial banks to establish new branches outside their home communities for the first time, the home- and branch-office protection features of the law severely

* Judith Berry Kunreuther, Economist, Banking Studies Department and Karen Kidder, Economist, formerly of that department, had primary responsibility for the preparation of this article. George Juncker, Economist, Banking Studies Department, also made a significant contribution to this article.

[1] State of New Jersey, Laws of 1968, chapters 415, 416, 418, and 426. The law also authorizes wider branching and merging for savings banks and savings and loan associations. This article deals with the changes affecting commercial banks.

[2] State of New Jersey, Laws of 1948, chapter 67.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



restricted the possibilities for expansion even within the boundaries of individual counties. Commercial banks were restricted to branching and merging only within the county in which the head office was located.[3] Within its home county, a commercial bank was permitted to establish a *de novo* branch only in communities that were not served by a home or branch office of a commercial or savings bank.[4] Thus, once a banking office was established in a community, that community became closed to any additional branches by "outside" banks. The only modes of entry for a bank seeking representation in a home-office protected or branch-office protected community were to acquire an existing bank through merger or to establish an affiliate bank. In addition, the formation of holding companies owning more than one bank was prohibited.

BANK EXPANSION PRIOR TO 1969

BRANCHING AND MERGING. New Jersey's restrictive banking law did not entirely inhibit bank expansion during the 1950's and 1960's, as attractive opportunities existed throughout most counties. Consequently, banks were generally able to respond to the economic growth occurring within their local markets, and the expansion of banks through mergers and the establishment of *de novo* branches remained vigorous during the decade of the sixties. About 70 mergers were consummated between the beginning of 1960 and the middle of 1969. Although the number of banks dropped from 258 to 230, the number of branches in New Jersey grew markedly during that period, more than doubling to 821. Openings of *de novo* branches accounted for nearly 90 percent of the net increase in branch offices; the conversion of home offices into branches through merger accounted for the remainder. By mid-1969, about 78 percent of all commercial banking offices were branches, compared with 63 percent in 1960 and only 34 percent in 1950. The rate of establishment of new branch offices substantially exceeded population growth during the 1960's so that population per banking office declined from 8,800 persons in 1960 to 6,800 in mid-1969. About 77 percent of all commercial banks in New Jersey operated branch offices by mid-1969, compared with 53 percent in 1960 and only 17 percent in 1950.

EXPANSION THROUGH ESTABLISHMENT OF DE NOVO BANKS. The formation of new banks also made a contribution to the expansion of banking facilities during the 1960's. More than 40 new banks were established in New Jersey between the beginning of 1960 and the middle of 1969, compared with only 13 new banks in the prior decade. The great majority of these *de novo* banks were located in the state's most rapidly growing suburban communities where population and economic growth were highest. The spurt in the chartering of new banks can be attributed to the appointment of James Saxon as Comptroller of the Currency in 1962. This appointment ushered in a period in which regulatory policies toward the chartering of new banks were liberalized considerably. Given the more lenient regulatory atmosphere, the reduction in the number

[3] The McFadden-Pepper Act (1927), as amended, which is still in force, permits national banks to establish branches if state law permits state banks to establish branches, subject to the same restrictions on location as those imposed by state law on state banks [12 U.S.C. 36(c)].

[4] A provision of the Banking Act of 1948, which was repealed in 1952, imposed limits on the maximum number of *de novo* branches a bank might establish in its home-office community if the community had a population of 80,000 or less.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of attractive sites open to branching may also have contributed to the increased activity in the establishment of new banks. Entry by means of a *de novo* bank often proved the only legal mode of access to an attractive area. Indeed, less than 100 of New Jersey's 567 municipalities were open to branching by outside banks by mid-1969, compared with approximately 220 such open municipalities in 1960 and 300 in 1950.

THE DEVELOPING PRESSURES FOR WIDER POWERS TO EXPAND GEOGRAPHICALLY

Throughout the 1950's and 1960's several fundamental transformations in New Jersey's demographic and economic development increasingly spurred the larger banks to seek powers to expand over a wider area. The wealth, population, commerce, and industry of New Jersey grew appreciably. Real per capita personal income increased by about 50 percent between 1950 and 1970. Rising incomes not only brought new customers into the market for banking services but also created new patterns of consumption and, hence, changing banking needs.

Population in the state increased almost 50 percent in the two decades since 1950, but more significantly it shifted toward the suburban areas outlying the central cities. Seven of New Jersey's ten largest cities experienced population declines during the 1950's and 1960's. Scores of commercial and industrial establishments were relocated in the suburbs and beyond, as evidenced in part by manufacturing employment which decreased in such urban counties as Essex, Hudson, and Mercer and increased in the suburban counties of Monmouth, Morris, and Somerset. In many instances, however, the rapidly growing suburban counties on the periphery of such urban centers as Newark and Jersey City remained legally inaccessible to the state's larger banks headquartered in those urban centers. County lines and the limited number of locations legally open to branching constituted significant constraints on the expansion of banking in New Jersey.

Pressure for wider powers to expand was also stimulated by the rising competition New Jersey banks were facing from the larger and more aggressive New York City and Philadelphia banks that were making increasing inroads in diverting a substantial volume of deposit and loan business from banks in New Jersey. To some extent, the New Jersey banks have been able to meet the credit demands and other banking needs of large business firms through correspondent arrangements with banks in New York and Philadelphia. Nevertheless, many of New Jersey's business firms, even those located entirely within the state, have sought loans and specialized services outside the state.[5] It was not surprising, therefore, that New Jersey banks were eager to expand their market areas and achieve a size that would enable them to compete more effectively with the larger institutions in neighboring states. However, expansion-minded banks were increasingly inhibited by tighter control over mergers as a result of Federal legislation governing bank mergers and the Supreme Court's landmark decisions in the *Philadelphia National Bank* and *Lexington* cases.[6]

RESPONSE TO THE 1969 BANKING ACT AMENDMENTS

The amendments to New Jersey's banking law enacted in 1969 gave banking in New Jersey an entirely new direction. The most striking change in New Jersey's banking structure during the past four and a half years has been the formation and rapid growth of bank holding companies. By mid-1973, nine multibank holding companies were in operation and one had proposed to operate. Eight of these companies were active or were proposing to be active in more than one banking district. These organizations would control 61 banks holding about 44 percent of all commercial bank deposits in the state.[7] In addition, several independent banks or one-bank holding companies are likely candidates for expansion elsewhere in the state outside their districts.

During the period of expansion by holding companies across district lines, branching and merging within districts also was vigorous. Between mid-1969 and the end of 1972, about 300 new branches of commercial banks were established and 52 bank mergers were consummated. The increase in *de novo* branches represented roughly one third the number of branches in existence at the time of the legislative change. Nearly 200 of the new offices could not have been opened prior to 1969 because they were

---

[5] Robert B. Platt, *Bergen County Survey* (unpublished survey undertaken by the Bank Examinations Department of the Federal Reserve Bank of New York, June 1965).

[6] The Bank Merger Act required for the first time prior approval for bank mergers by the Federal bank regulatory authorities. It also set forth the criteria to be followed by the authorities in ruling on bank merger proposals [12 U.S.C. 1828(c) as amended February 1966; 80 Stat. 7 (1966)]. The Supreme Court's decisions in these cases established the applicability of Federal antitrust laws to bank mergers. *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).

[7] Includes merger proposals and bank holding company formations and acquisitions announced prior to July 15, 1973.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

located either in formerly protected communities or outside the home-office county. The relaxation of branch-office protection, the creation of larger branching and merging areas, and the authorization of statewide bank holding companies under the 1969 legislation stimulated competition in banking markets throughout New Jersey, as banks that were well established in many communities faced new competitors for the first time.

Some evidence of the initial impact of the liberalization of branch-office protection was gathered by the Federal Reserve Bank of New York in mid-1971 from interviews held with 18 commercial banks in northern New Jersey.[8] The findings of these interviews attest to a number of procompetitive effects occurring in the two years following the law change. Perhaps the most obvious phenomenon was the dramatic increase in the number of banking offices in formerly protected communities. Between June 1969 and June 1971, communities that lost protection in New Jersey's northern banking district experienced an increase in banking offices of 56 percent. Offices in formerly protected communities in the central district increased 38 percent. In those same districts, communities where branch-office protection remained intact experienced increases of only 11 percent and 13 percent, respectively.

This growth in offices has provided consumers with the added convenience of more alternative banking locations. New and improved services are also provided in many banking offices. For example, a few of the banks interviewed raised their interest rates on deposits and lowered those on loans, while some banks extended their business hours and broadened the services offered at branch offices. However, only a few of those bankers interviewed claimed that improved services offered to the public were a direct response to the law change. Yet they all expressed heightened awareness of competitive pressures and acknowledged a greater concern with such intangible improvements as more services and more personal contacts with customers. The study concluded that nearly all of the 18 banks interviewed found it necessary to reexamine their banking services in the period following enactment of the new banking law.

Although banking institutions in New Jersey have concentrated their growth along traditional lines of banking services, product diversification has become an increasingly important objective. The enactment of the Bank Holding Company Act amendments of 1970 has provided bank holding companies with new opportunities to expand into fields closely related to banking. Several of New Jersey's bank holding companies operate, or have proposed to operate, nonbank subsidiaries in such areas as consumer and commercial finance, insurance brokerage, mortgage banking, data processing, and full-payout leasing of personal property.

IMPACT OF THE 1969 LEGISLATION ON REVENUES AND EXPENSES

In view of the fundamental importance of the legislative changes, further evidence was developed to shed light on whether the increased competition resulting from the 1969 changes affected the operating income and expenses of banks. It would not have been surprising to find that greater competition slowed the growth of bank revenues. Bank costs might also have been expected to rise with more intense interest competition for deposits or greater services to customers.

Evidence on this matter was developed for a group of member banks in the Paterson-Clifton-Passaic (Paterson) Standard Metropolitan Statistical Area (SMSA), which consists of Bergen and Passaic counties.[9] The Paterson SMSA was selected for study because it is one of the larger and more diverse of New Jersey's banking markets, with a mobile population and many vigorous banking organizations through which competitive pressures would be expected to be transmitted rapidly.[10] There is reason to believe, moreover, that competition in the Paterson market was particularly inhibited by the restrictions on entry and branching imposed by legislation in effect prior to 1969.

As indicated, the change in law enacted in 1969 per-

[8] George Budzeika and Rocco Magnotta, *Effect of the 1969 Liberalization of the Banking Law in New Jersey* (Banking Studies Department, Federal Reserve Bank of New York, March 1973). Banks interviewed were in the Second Federal Reserve District portion of New Jersey, including the northern and central districts but excluding Mercer County which is in the Third Federal Reserve District.

[9] On April 27, 1973 the Office of Management and Budget (Executive Office of the President) released a revised listing of SMSAs. Two SMSAs in New Jersey were directly affected by the redefinitions. Bergen County was deleted from the Paterson-Clifton-Passaic SMSA and added to the New York, N.Y. SMSA. Somerset County was added to the Newark SMSA. Data in this article have been compiled according to the definitions in effect prior to these changes.

[10] The Newark SMSA also is a major market area that witnessed a dramatic increase in *de novo* offices following the 1969 legislation. It was not chosen for this study partly because, as shown on the map, the 1969 law did not fully remove branching restrictions throughout the Newark SMSA. In addition, data management problems for Newark banks were less tractable than for banks in the Paterson market.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table I

AVERAGES OF SELECTED OPERATING RATIOS FOR TWENTY BANKS IN THE PATERSON MARKET AND ALL MEMBER BANKS IN THE SECOND FEDERAL RESERVE DISTRICT

Percentage of total assets for selected three-year periods

Category	1966-68		1969-71		1970-72	
	Paterson	Second District	Paterson	Second District	Paterson	Second District
Operating revenues	5.22	5.35	5.91	6.06	5.94	6.13
Rate of return on loans*	6.30	6.39	7.35	7.51	7.47	7.52
Gross loans	52.90	54.66	52.74	55.45	51.92	54.92
Net income after taxes†	.72	.69	.97	.86	.97	.85
Operating expenses‡	4.14	4.22	4.69	4.89	4.80	5.06
Salaries and wages	1.03	1.16	1.08	1.26	1.09	1.27
Pensions	.15	.15	.17	.19	.18	.20
Interest on time and savings deposits	2.04	1.96	2.29	2.16	2.38	2.26
Net occupancy expense	.19	.22	.20	.24	.21	.25
All other expenses	.72	.72	.93	1.04	.95	1.09

* Interest and fees on loans net of losses or recoveries as a percentage of loans.
† Net income includes securities gains and losses.
‡ Because of rounding, components do not necessarily add to totals.

mitted banks in the Paterson market to establish offices in areas previously closed to them and facilitated the entry of outside banking organizations into the Paterson market. Indeed, 54 new commercial bank branches, constituting nearly 20 percent of all *de novo* bank offices in the state, were established in the Paterson market between mid-1969 and the end of 1972. Three quarters of these offices could not have been opened before the change in the law. Moreover, about 30 percent of these new branches were established by banks headquartered in counties outside the market.

The performance of revenues and expenses of 20 sample banks in the Paterson market was examined both before and after the 1969 changes in law.[11] The banks' operating revenues and costs were expressed as percentages of total assets to analyze the revenue or expense per dollar of assets for banks of varying size. We expected that the performance of an average of these ratios over time would indicate how the sample banks adapted to changing conditions in the market.

To obtain a reference point for the average performance of the sample banks, their operating revenue and expense ratios were compared with a larger group of banks whose average behavior would not have been expected to reflect structural changes in the banking law. The most convenient base for such a comparison was provided by the data pertaining to all member banks in the Second Federal Reserve District, a large majority of which are located in New York State. Selected operating ratios for the Second District members and the Paterson market banks are shown in Table I for averages of three-year periods, both before and after the change in law. The 1969-71 and 1970-72 periods were examined separately to abstract from transitional effects in 1969, the year of the law change. Table II compares the ratios and notes changes in the relative position of Paterson banks after the new law took effect.

The average ratio of revenues to assets of the sample banks advanced somewhat more slowly than a similar ratio for all member banks in the Second Federal Reserve

[11] The sample comprised all banks that were headquartered in the market and were in existence as members of the Federal Reserve System throughout the period 1966-72. Adjustments were made to incorporate the data for banks that were merged with sample banks during the period under review. Because of data limitations, all nonmembers were excluded, as were member banks that absorbed nonmembers. The 20 banks included most of the major banking organizations in the Paterson market as well as a representative cross section of the smaller institutions.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

District following the 1969 change in the law. However, the relative lag in the average revenue ratio of the sample banks for the period 1970-72 was not the result of lower average earnings on loans, but rather reflected a small decline in the average loan-asset ratio (see Table II). The reduced growth in the revenue ratio did not adversely affect relative profits because the growth of the sample banks' expense ratio lagged even further behind the District average.

The relatively favorable behavior of costs of the sample banks following the 1969 legislation occurred despite an increase in the share of expenses accounted for by interest payments. As shown in the tables, interest expenses, which accounted for almost half the total operating expenses of the sample banks during the periods under review, increased more rapidly for the sample banks in the post-1969 periods than for all banks in the Second District. Such increased interest expenses are consistent with the more active competition for time accounts that developed in the Paterson market after 1969. The acceleration in the growth of such expenses was more than offset, however, by the relatively slower growth in such categories as salaries and wages, pensions, and all other expenses.

Thus, in the environment following the change in the law, enhanced competition did not decisively increase average operating expenses and, therefore, did not appear to have a materially adverse effect on the profitability of these institutions. Indeed, the relatively superior cost performance evidenced by the sample banks permitted them to widen their margin of after-tax income as a percentage of assets in the post-1969 periods, compared with the rate of return achieved throughout the Second District. In sum, it would appear that the easing of restrictions on geographic expansion by banks in New Jersey as a result of the passage of the 1969 legislation had little adverse effect on the profitability of the sample banks.

PROSPECTS FOR THE FUTURE

The legislative changes enacted in New Jersey in 1969 appear to have improved and strengthened that state's banking system. Institutions have been freer to operate branches or affiliates where there is need for them. Still, the 1969 legislation has been unduly protective of banking interests in several respects.

The continuation of home-office protection in all communities, regardless of the size of the banks or communities involved, has impeded the development of significant new competition in many of the state's largest urban

Table II

CHANGES IN SELECTED OPERATING RATIOS FOR TWENTY BANKS IN THE PATERSON MARKET AND ALL MEMBER BANKS IN THE SECOND FEDERAL RESERVE DISTRICT

Percentage of total assets for selected three-year periods

Category	Paterson less Second District			Change in spread	
	1966-68	1969-71	1970-72	1966-68 to 1969-71	1966-68 to 1970-72
Operating revenues	— .13	— .15	— .19	— .02	— .06
Rate of return on loans*	— .09	— .16	— .05	— .07	+ .04
Gross loans	—1.76	—2.71	—3.00	— .95	—1.24
Net income after taxes†	+ .03	+ .11	+ .12	+ .08	+ .09
Operating expenses‡	— .08	— .20	— .26	— .12	— .18
Salaries and wages	— .13	— .18	— .18	— .05	— .05
Pensions	.00	— .02	— .02	— .02	— .02
Interest on time and savings deposits	+ .08	+ .13	+ .12	+ .05	+ .04
Net occupancy expense	— .03	— .04	— .04	— .01	— .01
All other expenses	.00	— .11	— .14	— .11	— .14

* Interest and fees on loans net of losses or recoveries as a percentage of loans.
† Net income includes securities gains and losses.
‡ Because of rounding, components do not necessarily add to totals.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

centers and in the faster growing surburban areas. Retaining home- and branch-office protection has also had the effect of solidifying the market position that a number of banks have developed over the years. Moreover, the continuation of home-office protection for bank subsidiaries of holding companies affords a special advantage to the holding company form that might enable a few large banking organizations to enhance their positions in protected markets.

Prompted in part by these considerations, as well as by the evident benefits of the 1969 legislation, measures for further liberalization of restrictions on expansion by banks in New Jersey were introduced in the state legislature in 1972, and by mid-1973 new legislation had been passed by both houses of the legislature.[12] During the first year, the pending new legislation would permit statewide branching and merging and eliminate home-office protection from municipalities with populations of 50,000 or more. Home-office protection would continue to be eliminated gradually, with the population minimum being reduced by 10,000 a year until only municipalities with populations of 10,000 or less would retain protection. Two years after enactment of the proposed legislation, bank subsidiaries of multibank holding companies would not be afforded home-office protection. Branch-office protection also would be removed at that time.

For all practical purposes, statewide branching will largely ratify the transformation of the state's banking structure already being accomplished through the holding company movement (see Table III). It would seem unlikely to cause any institution to expand statewide that has not already decided to do so. Indeed, New Jersey now has many of the characteristics of a one-district state. Yet, the elimination of district lines will provide additional flexibility for banks operating near district boundaries, and will facilitate freer branching throughout economically integrated areas.

The key feature of the new legislation is the relaxation of home- and branch-office protection. At the time all the provisions of the legislation become effective, fewer than 50 municipalities with banking offices would still retain protection.[13] Removing protection from most of the state's cities and important growth areas in the suburbs can be expected to promote the same substantial *de novo* branching activity that occurred in communities which lost branch-office protection following the legislative revision in 1969. Communities in Burlington, Morris, Monmouth, and Ocean counties appear to be among the most likely areas for significant increases in banking offices. Population in

Table III

TWENTY LARGEST BANKING ORGANIZATIONS IN NEW JERSEY*

Banking organization	Deposits (millions of dollars)†	Number of banks controlled by organization	Operating in banking district
First National State Bancorporation, Newark	1,678.2	9	1, 2, 3
United Jersey Banks, Princeton	1,510.3	18	1, 2, 3
Midlantic Banks Inc., Newark	1,368.5	9	1, 2, 3
Fidelity Union Bancorporation, Newark	1,273.3	5	1, 2, 3
Heritage Bancorporation, Cherry Hill	774.1	3	1, 2, 3
Greater Jersey Bancorp., Clifton	677.1	3	1, 3
The National State Bank, Elizabeth	628.2	1	2
New Jersey National Corporation, Trenton	620.9	3	2, 3
National Community Bank of Rutherford	597.2	1	1
First National Bank of New Jersey, Totowa	487.7	1	1
First Jersey National Corporation, Jersey City	486.2	1	1
Princeton American Bancorp, Princeton	464.7	4	1, 2, 3
Bancshares of New Jersey, Moorestown Township	460.3	1	3
Warner Communications Inc., New York, N.Y. (Garden State National Bank, Hackensack)	416.8	1	1
First National Bank of South Jersey, Egg Harbor Township	379.8	1	3
The Central Jersey Bank and Trust Company, Freehold Township	354.5	1	2
United Counties Trust Company, Elizabeth	322.8	1	2
Franklin State Bank, Franklin Township	274.2	1	2
Peoples National Bank of New Jersey, Westmont	268.5	1	3
The First National Bank of Toms River	228.2	1	3

* Includes merger proposals and bank holding company acquisitions announced prior to July 15, 1973.

† Deposit data are as of December 31, 1972; figures include deposits in domestic branches only.

Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, and Federal Reserve Bank of Philadelphia.

[12] This legislation (Assembly No. 706 Committee Substitute with Senate Amendments) was passed by both houses and sent to the Governor of New Jersey in early April 1973. It also would authorize statewide branching and merging by savings banks. Other legislation has been enacted that provides similar privileges for state-chartered savings and loan associations.

[13] This figure is based on 1970 population data and December 31, 1972 banking-office data.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

each county grew at a rate greater than twice that of the state during the 1960's and, according to current projections, these four counties will continue to lead the state in population growth during the 1970's.

Many of the most attractive communities for bank entry have populations of less than 50,000 and thus opportunities for branching will be limited until the provisions of the law take full effect. However, all the major holding companies are now represented in, or poised on the periphery of, the fastest growing areas in New Jersey. Once the legal obstacles have been removed, the contest in securing the most attractive branch sites is certain to be keen.

Moreover, greater competition between commercial banks and thrift institutions can be expected as a result of the proposed law change. State-chartered savings and loan associations and mutual savings banks, which have not been able to expand through the holding company route, have been particularly restricted in their ability to enter areas in the state that have grown the most rapidly. (Federal savings and loan associations in New Jersey have not been so restricted inasmuch as these institutions for some time have had fairly wide branching powers granted to them by the Federal Home Loan Bank Board.) The proposed changes, therefore, may have a relatively greater effect on state-chartered savings banks than on commercial banks or Federal savings and loan associations. The amendments concerning state-chartered savings and loan associations have already been signed into law by Governor Cahill, and it is expected that many of these institutions soon will begin to take advantage of the expanded branching opportunities.

The proposed legislation promises to open new opportunities for commercial banks to compete in markets that have long been the preserve of only a few institutions. The public should ultimately benefit from the increased availability of banking offices at new locations and from the provision of new and improved banking services, possibly at lower costs.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis