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Important Issues for Bankers and the Central Bank

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An address before the seventy-first annual convention of the New Jersey Bankers Association in Atlantic City, New Jersey, on May 23, 1974.

I want to express my pleasure at being able to meet with you in Atlantic City today to speak on matters of mutual concern. These gatherings have always provided me with a welcome opportunity to see many old friends among New Jersey bankers and to meet others of you for the first time.

Many important changes have taken place in our national economy and in New Jersey's banking structure since I addressed this group in May 1970. On the national scene, the worst upsurge of inflation we have seen in many years has presented exceptionally difficult problems for policy makers. Before turning to these problems and the role of monetary policy in meeting them, I would like to take the opportunity to discuss some developments in banking structure in New Jersey that have been occurring as a result of the changes enacted in the state's banking statutes in recent years. I would like first to comment briefly on the opportunities this new legislation has given bankers to expand, compete, and diversify their operations. I would also like to call your attention to the added responsibilities these changes have placed on bankers and regulators alike.

Since 1969, we have witnessed in New Jersey the launching of multibank holding companies, the removal of barriers to statewide branching, and the phasing-out of nearly all of the branch-office and home-office protection features of the law. These legislative changes now provide banks and bank holding companies in New Jersey with broader opportunities than they have ever had before to expand into the state's most attractive banking markets. You are also aware, I'm sure, that these new laws allow banking organizations in the state to take advantage of the opportunities provided by the Bank Holding Company Act Amendments of 1970.

I would also like to emphasize strongly that bank regulators must consider each proposal by a banking organization to acquire a bank or nonbank firm in terms of its impact on the competitive structure and performance of the markets concerned. This appraisal must include an evaluation of the scope and substance of the benefits the proposed merger or acquisition would yield the public. My associates and I at the Federal Reserve are keenly aware that the prospective benefits from increased competition, better services, and more efficient flows of financial resources would be quickly lost if only a few large banking organizations were allowed to dominate the state's major banking markets. Both bankers and regulators alike have an obligation to contribute to a structure of banking in the state that will result in the greatest possible benefit to the public.

From the point of view of formulating your own plans, I think you may be interested in how the Federal Reserve Bank of New York evaluates each of the many proposals submitted to it by banking organizations. Each proposal undergoes a searching analysis from three distinct viewpoints.

Our economists undertake to determine whether the proposal would result in any loss of competition or, on the contrary, would contribute to an improvement in market performance. Our financial analysts study the terms of the transaction, the financial condition and management capabilities of the participants, and the ability of the combined organization to meet its future capital needs, particularly those of its bank affiliates. Our lawyers review each proposal to determine whether it is in full compliance with Federal banking and antitrust legislation, and whether all other legal requirements of the application have been met.

All three staff groups evaluate the benefits the proposal would offer the public either directly or indirectly in the form of improved services, lower charges, or more conveniently located facilities. I should point out that much of this evaluation takes place during the early stages of the application process, when we provide every opportunity for the applying organization to supply additional information.

Once our staff completes its analysis, it makes a recommendation of either approval or denial to a committee of senior officers at our Bank. A recommendation of approval must reflect the solid finding that the proposal would not seriously damage the competitive structure of the market, particularly where the institutions to be combined are represented in the same market, and would not result in unsound banking practices. We would not look with favor on any proposals that would consolidate competing firms with relatively large market shares, or eliminate a significant amount of future competition, or unduly diminish the possibilities for entry by outside firms. We would also discourage proposals that would tend to strain the financial or management capacity of the acquiring company or inhibit the capital growth of affiliated banks, and we would be particularly skeptical of proposals that held little or no prospects of benefit to the public interest. These are matters that also weigh heavily in the decisions of the Board of Governors, which has final authority over all holding company proposals and certain merger applications.

Within the framework of the process I have just described, many changes have occurred in the structure of banking in New Jersey since I spoke here four years ago. Branching and merging into previously protected territories, coupled with the growth of multibank organizations, have resulted in considerable geographic diversification of banking in New Jersey. Between mid-1969 and the end of last year, about 350 new branches of commercial banks were established. These new branches resulted in almost a 40 percent increase over the number of offices of commercial banks in existence during 1969. About two thirds of these new branches could not have been opened under the laws in existence prior to 1969.

These new offices have resulted in the introduction of competitive forces in many communities that long had been shielded from outside competition. Many of the acquisitions and mergers concluded by New Jersey's banking organizations since 1969 have involved entry into new markets, contributing to an improvement in the competitive environment in those markets. We have good reason to believe that the expanded competition in banking in New Jersey has increased the quality and quantity of financial services available to individuals and businesses in the state. We think that many more communities will benefit from an improved competitive atmosphere as home- and branch-office protection laws are further relaxed through 1977.

Statewide branching became effective only in August of last year when further revisions in New Jersey's banking statutes included the removal of the three banking districts within which branching and merging by banks in New Jersey had been confined until that time. By then, however, the development of statewide banking was well under way through the formation and growth of multibank holding companies.

As of early May, New Jersey had ten multibank organizations in operation. Including proposed acquisitions, they accounted for about 43 percent of the state's total deposits. Seven of these companies operate banking subsidiaries in more than one of the areas that formerly constituted a banking district, and the offices of these subsidiaries span fairly wide areas of the state. In addition, there were at least ten one-bank holding companies in operation, with just over 10 percent of total deposits of the state. Several of these companies are in the process of expanding the areas they serve either by acquiring additional banks or by branching or merging.

Banking in New Jersey retains a great deal of diversity in meeting the needs of individuals and businesses for financial services. There are about 160 independent banks that play an important competitive role in the state's major banking markets, and they control a slightly larger share of the state's total deposits than do the multibank organizations.

In retrospect, we think the development of diversified banking organizations with statewide operations has been of significant benefit to the public without any adverse consequences for banking structure in the state. Many of the holding company acquisitions have involved small- or medium-sized banks seeking to broaden their resource base through affiliation with larger organizations. At present, the five largest organizations account for close to one third of the state's total deposits, a far lower concentration of deposits than in many other states throughout the nation.

In the years ahead I think New Jersey bankers will continue to find attractive opportunities to merge and branch throughout the state, and to expand and diversify their financial services through the formation and growth of bank holding companies. These opportunities offer bankers the challenge of experimentation and innovation. I would urge those of you who are contemplating expansion to discuss these plans with your Reserve Bank. While we cannot make any commitments on behalf of the Federal Reserve, our officers who are close to the situation in New Jersey will be able to offer you useful guidance concerning the regulatory implications of your proposals.

Last year, as you know, we opened Regional Check Processing Centers in Philadelphia, Pennsylvania, and Cranford, New Jersey. I am sure that you are aware that both these RCPCs have experienced more than their share of problems, which, in turn, have had a direct impact on your banks. While both Philadelphia and New York anticipated some start-up problems, the period of adjustment has taken far longer than expected. We want to assure you that the senior officers in both Philadelphia and New York have been deeply concerned about these problems.

Several steps have been taken to improve the operations at the RCPCs: staffs have been increased and strengthened with experienced personnel, training efforts have been intensified, and work flows and the organizational structures have been improved to increase both productivity and controls. We are now operating close to normal levels and continuing to strive for further improvements in quality and efficiency. We thank you for your patience, understanding, and cooperation as we work together toward our goal of a more efficient check-clearing operation.

Let me turn now to some of the major economic problems we are all facing at this time and to the appropriate role of monetary policy in helping to meet these problems. There is no need to tell you bankers that pervasive and virulent inflation dominates the setting in which economic policies must be formulated. The causes of this condition are many, they have often been set forth at length, and I shall not take time today to cover this ground again. While a combination of special factors was of crucial importance, fiscal and monetary policies were not altogether blameless. Wage and price controls made a helpful contribution in 1971-72, as long as there was considerable slack in the economy, but they became worse than useless as aggregate demand outgrew available resources in late 1972 and 1973.

The net result of all this has been profound public disillusionment with the efficacy of official anti-inflationary policies, and widespread fear that inflation will continue unabated for years to come. Of course when such expectations develop, they tend to become self-fulfilling, as those who no longer have faith in the value of money try to protect themselves by buying anything and everything that seems to offer some promise of price appreciation. No doubt this psychology accounts, in the corporate world, for much of the heavy current demand for credit to purchase inventories and capital equipment; and among individuals we find an urgent search for new avenues of investment or speculation.

I hope this nation will refuse to succumb to the siren song of those who would meet this situation by accepting inflation as a way of life and establishing escalator or indexing practices for salaries, bonds, and other vehicles of income or savings. This may be a workable substitute for proper fiscal and monetary policies in a few rapidly developing countries—although not without some very considerable social costs—but I suspect that such a course would prove very dangerous for this country. Complete indexing of all claims probably could not be achieved as a practical matter but, even if it could be achieved ultimately, the transition would be costly. At any given time, claims on a substantial fraction of the real wealth and income payments of the country are outstanding in the form of long-term contracts fixed in nominal terms. While progressive indexing of new contracts could protect the parties to them, inflation would still cause disturbing and inequitable transfers of real wealth and income, owing to the continued existence of outstanding, nonindexed long-term contracts. I question whether the transition to comprehensive indexing could be accomplished within a democratic framework of social stability and reasonable equity. Even apart from its domestic drawbacks, I fail to see any attraction in indexing for the leading country of the Western world whose currency is still necessarily regarded as a prime foundation of that world's financial system. And the most serious objection to this automatic indexing is that it would vastly weaken the country's resolve ever to bring inflation under control.

It should not be an insurmountable task to make progress toward reduced inflation, provided enough people become convinced that the fight is worth fighting. I do not mean that a quick solution is possible, but I think it is imperative that we continue to lay the base for gradual improvement. Sound fiscal policy and restraint in setting wages and prices are of critical importance. There is now a good prospect of improvement in the Federal Government's debt management affairs, as the new Federal Financing Bank prepares to begin operations that should result in more orderly financing.

Certainly the Federal Reserve is determined that monetary policy will do its part in fighting inflation, as Chairman Burns said a few weeks ago in his fine statement before the House Subcommittee on International Finance. We must of course provide for enough money and credit growth to take care of gradual expansion of the economy and to prevent unacceptable levels of unemployment, but not so much as to feed the fires of inflation. During a period such as this, we recognize that you as commercial bankers have a difficult problem in deciding where to apply restraint. We rely on your judgment to prevent excessive pressures from falling on particular sectors of the economy.

Rising levels of unemployment would intensify the pressure for more expansionary monetary and fiscal policies. Yet the experience of recent years suggests that the low levels of unemployment we all would like to see may not be attainable through monetary and fiscal stimulus alone without exacerbating inflation. Even when aggregate demand is excessive, some willing workers will be unable to find employment if they reside in depressed areas or if they lack the particular skills that are in demand. Trends in the age and sex composition of the labor force appear to have worsened the "structural" unemployment problem over the past decade or so. This does not mean that the nation must passively accept socially undesirable levels of unemployment. It does mean that vigorous efforts—both by private organizations and by government at all levels—are needed to attack structural unemployment through improved and better funded training programs, more efficient fitting of available workers to available jobs, and perhaps some relaxation of minimum wage requirements for young workers and special carefully designed public employment arrangements. Such reforms would be much more likely to achieve a permanent reduction in unemployment than would excessive monetary stimulation and its inevitable concomitant—chronic inflation. They are needed not just to improve the economic performance of the country, but to help attack the social ills stemming from the lack of employment opportunities, particularly among the young in our central cities.

As for monetary policy, its goals are, of course, much easier to state than to translate into operational applications. As has been said so often, the central banker must still use a very large portion of judgment in reaching policy conclusions. He must always take account of a wide variety of factors, including the business outlook, price and wage prospects, the international scene, Treasury financing problems, developments in measures of money and credit and in interest rates, etc. The central banker must also be alert to the danger of undue credit stringency threatening the stability of financial markets. The Federal Reserve always stands ready to fulfill its essential role as lender of last resort—not only to the member banks but, in a broader sense, to the economy at large. This does not mean that bankers and businessmen will necessarily be spared the consequences of their own misjudgment. It does mean that the continuous functioning of the credit markets can be counted on.

There is no scientific way to determine exactly what percentage rate of growth in one or several money aggregates will best contribute to a given economic goal. Some of our critics would have us follow a very simplistic path with respect to growth in the quantity of money, paying little attention to the fact that velocity of money is neither constant nor dependably predictable. Money aggregates are of course important, but there are differences of view as to which of the various aggregates should get the most attention. Even our statistical measurement of them is still pretty rough; and I would again caution against reading much into sharp swings in growth rates over periods as short as a month or even a quarter. These swings could be smoothed out only at the cost of extremely violent interest rate changes; and it has never been demonstrated that short-run fluctuations in the monetary aggregates do any real harm to the economy, which seems to be affected more by longer term tendencies of money growth. Incidentally, it is worth noting that current Congressional hearings on the proposed Financial Institutions Act give promise of improvements in the structure and functioning of our financial system.

I would point out, too, that at certain times changes in credit growth may be just as important as those in money growth, or more so. I have been concerned about the very high level of aggregate credit demands this spring, which by themselves would seem to call for a cautious monetary policy. A surge in the demand for credit of this magnitude certainly requires careful attention to analysis of creditworthiness.

As you know, the Federal Reserve System has been moving toward greater reliance on market forces and less reliance on regulatory constraints in controlling credit. This trend was exemplified by the suspension of remaining Regulation Q ceilings on large-denomination certificates of deposit a year ago. I have long been an advocate of greater reliance on the market mechanism in allocating credit. This does not, however, relieve bankers of the responsibility of exercising restraint when demands for credit seem practically insatiable. If commercial and central bankers do not share this responsibility, there could well be mounting pressure on the Federal Reserve to reverse the trend toward greater reliance on interest rates in free markets for monetary and credit control. I think you will agree that self-restraint is preferable to regulation, however well intentioned.

I should like to add a word about certain international aspects of the present setting for policy. There is no doubt in my mind that overselling of the dollar in exchange markets within the past year or two contributed importantly to our domestic inflation, not only through the direct effects on import and export prices as stated in dollars, but —perhaps equally importantly—through the great psychological damage to the faith in money throughout the world, when the dollar, which did and does play such a big part in most countries' financial arrangements, seemed to be on a downward slide. The United States monetary authorities can never be indifferent to the valuation placed on the dollar by the exchange markets, and Federal Reserve intervention in those markets from time to time since last summer has been a very healthy development. Now that capital export controls are no longer in force, the possibility of large interest-induced flows of funds has been enhanced, and these too could encourage wide exchange rate swings.

Monetary policy has always had to give some consideration to international factors. This is truer than ever in a world of freer capital movements between countries, especially since vastly augmented receipts of the oil-producing countries are adding greatly to these international flows. In any event, in setting ourselves against continuing high inflation rates, we can rightly feel that we are contributing significantly to both domestic and world stability.

Let me conclude with a comment on the importance of adequate savings in the kind of world we face today. Not only energy shortages, but shortages of a great number of basic materials are seriously aggravating our inflation. Thus, investment in new capacity should be a goal of high priority—and, if this is not to exacerbate the inflation further, there must be adequate savings to finance the investment. This may well imply some sacrificing of consumption, or at least a willingness to forego as rapid gains in consumption as have been sought and achieved in recent years. But progress to this end calls for political understanding, and it also may call for fiscal and institutional changes to induce us to save a higher proportion of our national income. And there is a kind of circular process here, too, for a slower inflation rate is itself a necessary ingredient in providing an atmosphere conducive to larger savings. I think you will agree that the future we face is not an easy one; but I remain an optimist, and I believe that we can work together to make substantial progress against inflation a reality.

The Business Situation

Economic activity appears to have begun a recovery following the sharp energy-shortage-induced decline that marked the first quarter.* Industrial production expanded moderately in April, after having decreased over the previous four months. New orders for durable manufactured goods and retail sales both advanced in April, boosted by a resurgence in the demand for automobiles. At the same time, backlogs of unfilled durables orders continued to mount and, despite the sluggish first quarter, large increases in expenditures on plant and equipment appear to be in prospect for the year. However, these statistics have to be interpreted with some caution, as they are expressed in nominal terms and thus in part reflect the rapid rate of inflation. The one sector of the economy for which the outlook remains troubling is residential construction. The recent sharp runup in interest rates and the loss of deposits at thrift institutions threaten to prolong and, perhaps, deepen the housing slump. The Federal Government's newly announced measures to bolster housing may succeed in stabilizing housing activity at about current levels.

Price developments remained disturbing in April. While food prices declined during the month, most other prices continued to spurt ahead. At an annual rate, the increase in consumer nonfood prices topped 10 percent again in April and was about equal to the rate of increase over the previous six months. In the same month, wholesale industrial prices climbed at almost a 28 percent annual rate, this too being about equal to the average rate of increase of the past six months. Moreover, the price increases that have occurred since the last of the price controls were removed were not reflected in the April data. In the next few months, these post-controls increases are likely to maintain the rate of inflation at very high levels.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

In April, the Federal Reserve Board's index of industrial production rose at a 4.8 percent seasonally adjusted annual rate. In the four preceding months, total production had fallen at nearly an 8 percent annual rate, about 40 percent of which was directly attributable to the steep drop in automotive output. The April expansion in industrial output appeared to signal the end of the energy-shortage-induced declines of earlier months. Indeed, the production of motor vehicles and parts spurted at almost a 71 percent annual rate in April and accounted for almost two thirds of the rise in total output. Another healthy sign was the 9 percent growth in the production of iron and steel mill products. In contrast, during the December-to-March period, steel production had fallen sharply. Following the sizable decreases that had occurred since last October when the oil embargo began, total energy output remained virtually unchanged in April. Nevertheless, the gasoline situation has shown marked improvement. Whereas gasoline output had fallen over 45 percent at an annual rate from last October to January, it increased almost 30 percent from January to March.

Activity in the automotive sector of the economy picked up somewhat in April. Both production and sales increased for the first time in many months, rising to the highest levels since last December. New car assemblies rose 13.6 percent in April to a seasonally adjusted annual rate of 7.5 million units. This was, nevertheless, well below the 10 million assemblies averaged during the first six months of 1973. New domestic car sales rose 5.4 percent in April to a seasonally adjusted annual rate of 7.8 million units. A renewed interest in full-size models was primarily responsible for this stepped-up sales activity. Although greater availability of gasoline undoubtedly spurred pur-

* The revised first-quarter estimates indicate that gross national product (GNP) increased by $14.7 billion to a seasonally adjusted annual rate of $1,352.2 billion. The rate of increase in the implicit GNP deflator was revised upward to 11.5 percent per annum, and the rate of decline in real GNP was revised downward to −6.3 percent. According to the preliminary estimates released along with the GNP revisions, before-tax corporate profits increased $12.7 billion in the first quarter.

chases to some extent, dealer sales contests probably were also a contributing factor. Meanwhile, it also appears that the automobile inventories of retail dealers have finally been brought into line with sales. Inventories totaled 1.49 million units at the end of April, down from the November peak of 1.84 million. Moreover, dealers appear to have achieved a better balance in the mix of inventories between large and small automobiles.

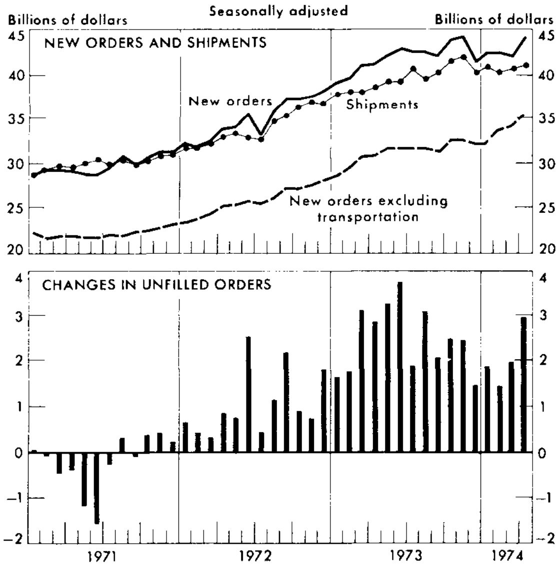
Seasonally adjusted new orders received by durable goods manufacturers posted a 4.9 percent, or $2.1 billion, gain in April (see Chart I). Large increases were recorded in orders for transportation equipment and for fabricated and primary metals, and these accounted for most of the overall advance. Despite the April rise, new orders for durable goods remained below the record levels attained late last year. However, in recent months, the behavior of this indicator has reflected the sharp reduction in the orders and shipments of automobile manufacturers. Excluding transportation equipment, new orders for durables have displayed a distinct upward trend throughout the year. As shipments were again below new orders in April, the backlog of unfilled durables orders mounted further.

The book value of manufacturers' inventories advanced in April at a $23.2 billion annual rate. This rate of accumulation was about the same as that of the previous month, and it was only slightly below the $25.6 billion increase averaged in the December-to-February period. According to disaggregated data, the buildup in inventories in recent months has not been evenly distributed among industries nor among inventories at different stages of fabrication. This unevenness is quite apparent, for example, in the inventory-to-sales ratios for manufacturing. For nondurable goods industries, the inventory-sales ratio in April remained at the near-record low levels of earlier months of the year. In contrast, the inventory-sales ratio for durable goods industries climbed further in April, rising to the highest level in over a year. However, the inventory accumulation by durables manufacturers does not appear to have been produced involuntarily by lagging sales, as the rise in inventories of durable finished goods has been relatively modest. Rather, most of the buildup has been in purchased materials and supplies and in goods in process, especially in the machinery industries. In view of the continued expansion in new bookings of these capital goods industries, this pattern of inventory accumulation is more symptomatic of economic strength than of weakness.

Chart I

ORDERS AND SHIPMENTS OF MANUFACTURED DURABLE GOODS

Seasonally adjusted



Source: United States Department of Commerce, Bureau of the Census.

PERSONAL INCOME AND CONSUMER DEMAND

Seasonally adjusted personal income advanced at a $7 billion annual rate in April. Farm income fell, as agricultural prices continued to decline, but this was more than offset by the increased social security benefits which took effect during the month and by the gains in wage and salary disbursements. Indeed, about half the overall April advance stemmed from the rise in private wage and salary payments, with disbursements in the manufacturing sector increasing $1.3 billion following their sluggish behavior of the previous four months. This increase reflected not only the disproportionately large number of collective bargaining agreements reached during the month but also the renewed strength in manufacturing employment.

Retail sales turned in a strong performance in April, rising at a 16.9 percent seasonally adjusted annual rate. Most of the gain was attributable to increased automotive purchases, as sales of other goods edged up only slightly. However, over the three months ended in April, retail sales rose along a broad front; total retail sales climbed at a 13.8 percent annual rate over this period, and the increase was rather evenly distributed among automotive, other durable, and nondurable goods. For the year ended April 1974, the growth in current-dollar retail sales amounted to 7.8 percent, down from the 13.5 percent increase posted during the previous twelve-month period. In view of the concomitant acceleration in consumer prices, the slowdown in retail spending was considerably greater in real terms.

The spurt in consumer prices, moreover, appears to have given rise to a shift in the composition of consumer spending. Evidently as a result of the sharply rising prices of food and energy, consumers have been devoting an increasingly smaller share of their budgets to purchases of durable goods, which tend to be postponable. In the event that the pace of inflation slows and other uncertainties in the economic situation fade, consumers may well return to their former spending patterns.

RESIDENTIAL CONSTRUCTION

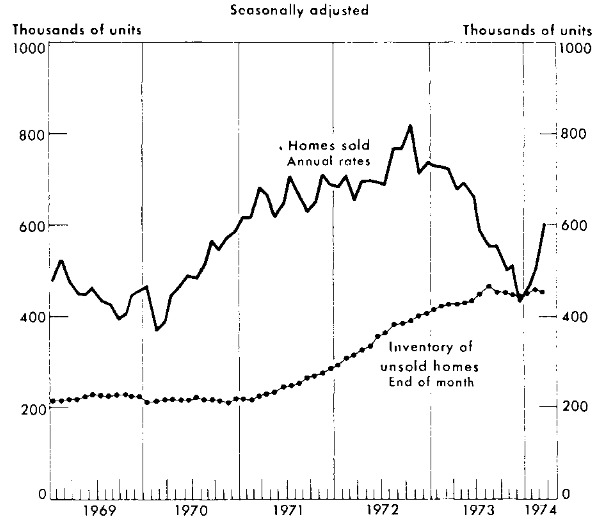
The prospects for a full-fledged recovery in residential construction from its recent slump have begun to dim, despite some signs of temporary improvement. Private housing starts rose in April to a seasonally adjusted annual rate of 1.63 million units, up from the previous month but about equal to the average of the first three months of the year. Merchant builders' sales of new one-family homes rose steadily over the first quarter to a seasonally adjusted annual rate of 600,000 units in March, the latest month for which data are available (see Chart II). This sales rate was almost 40 percent above the depressed December level and was the highest since last June. However, the inventory of unsold homes remained near the record level attained last August. Moreover, the leveling-off in these inventories over the past six months conceals a shift in their composition that does not augur well for home building. Since August, the percentage of homes completed but not sold has increased from 22 percent to 29 percent of total inventories while the proportion of unsold homes not yet started—that is, where a permit has been issued but ground not broken—has fallen to the lowest level in about three years. Hence, there is a relatively large volume of completed but as yet unsold homes on the market. This may account for the lethargic behavior of newly issued building permits in recent months.

In the near term, the recent runup in market interest rates is likely to have a severely constricting effect on mortgage availability. Indeed, the higher interest rates appear to have given rise to a large outflow of deposits at New York State savings banks in April. In that month, too, deposits at savings and loan associations rose at a 4.9 percent seasonally adjusted annual rate, well below the 10.2 percent rise posted in the first quarter of the year. Some tightening in the mortgage market is already in evidence. For example, between mid-March and early May, the average yield on four-month commitments on Government-insured mortgages at auctions conducted by the Federal National Mortgage Association jumped more than 1 percentage point to 9.48 percent, establishing a new record.

Chart II

NEW ONE-FAMILY HOMES

Seasonally adjusted



Source: United States Department of Commerce, Bureau of the Census.

With the slowing in thrift institution deposit flows, the Federal Home Loan Bank (FHLB) Board, in an attempt to encourage mortgage lending, has rescinded its previously announced increase in the proportion of liquid assets that savings and loan associations must maintain. In addition, the FHLB Board may soon act to allow savings and loan associations to issue negotiable large-denomination certificates of deposit (CDs). At present, savings and loan associations can issue only nonnegotiable CDs, which carry stiff penalties for early withdrawals. While this proposal, if implemented, will enable savings and loan associations to compete for funds, the impact on housing is far from certain, since usury ceilings in many states still may restrict mortgage lending. In those states without ceilings or with very high ceilings, potential home buyers may well balk at the high mortgage interest rates.

In addition to these FHLB Board actions, the Administration announced in early May that it would soon institute a new housing program. The program consists of an expansion of the "Tandem Plan" subsidies on Federal Housing Administration-Veterans Administration mortgages, further advances by the FHLBs to savings and loan associations at bargain rates, and a new FHLB program allowing the Federal Home Loan Mortgage Corporation to purchase conventional mortgages at below-market rates. Together, these three actions could pump as much as \$10.3 billion into the mortgage market. The extent to which this program will benefit the residential construction sector is in question, however. Thrift institutions will undoubtedly use only a portion of the \$10.3 billion to extend new mortgages. The rest will be used in one way or another to offset current and near-term deposit withdrawals. Moreover, whatever proportion of the \$10.3 billion is used to acquire new mortgages, some of these mortgages will doubtless cover new homes that are already built but not yet sold. While this would reduce the overhang of unsold new homes, builders may nevertheless be reluctant to begin constructing additional new units.

PRICES

Consumer prices, seasonally adjusted, rose in April at a 6.9 percent annual rate, the first time in four months that the rate of increase was below the 10 percent mark. However, the slowdown was almost entirely attributable to a 5.3 percent rate of decrease in consumer food prices, the largest drop in seven years. Prices of nonfood commodities, on the other hand, advanced in April at a 12.8 percent annual rate, a bit above the average increase of the previous six months. Evidently, the huge rise in wholesale industrial prices in recent months is being translated into increases at the consumer level. Once again, skyrocketing energy prices led the overall April rise, as prices of consumer power and fuel spurted ahead at a 24 percent annual rate.

At the wholesale level, prices of farm products and processed foods and feeds declined sharply in April for the second consecutive month. These prices dropped at an annual rate of nearly 36 percent in April. However, during the last year or so, monthly movements in wholesale farm prices have been quite erratic, registering extraordinarily large increases and decreases within the space of a few months. Furthermore, the April drop is attributable mainly to declining grain and livestock prices, and there are some indications that the fall in livestock prices may soon be reversed. Beef prices have declined in response to forces set in motion about six months ago, when large numbers of cattle were placed on feed. In recent months, the number of cattle placed on feed lots has fallen off dramatically.

In April, wholesale industrial prices shot ahead at a 27.8 percent seasonally adjusted annual rate. The advance in wholesale power and fuel prices slowed noticeably, but the increase in other wholesale industrial prices amounted to a disturbing 31.5 percent on an annual rate basis. By comparison, over the preceding three-month period these prices had risen at a 20.6 percent rate. The single most important factor behind the recent surge in wholesale industrial prices has been the soaring price of metals, particularly steel. This surge in wholesale industrial commodity prices is especially disconcerting, since additional price rises were announced as the final vestiges of wage and price controls were removed. These increases have not yet appeared in the major price indexes.

The Money and Bond Markets in May

After experiencing sharp increases over the past several months, interest rates were mixed in May. Reports that a large commercial bank was experiencing financial difficulties prompted some investors to favor high-quality debt instruments, thereby resulting in enlarged demand for securities of the United States Government. Yields on Treasury coupon securities declined by about 2 to 29 basis points over the month. By the end of the month, the market rate on three-month Treasury bills was down more than 80 basis points from its level at the end of April, while rates on longer term bills fell somewhat more modestly. A persistent scarcity of bills contributed to these declines. In the money market, most rates rose early in the month but subsequently moved slightly lower over the remainder of the period. Commercial banks, in a lagged response to the rise in short-term rates that had occurred earlier, raised their prime lending rate during the month in several ¼ percentage point steps to 11½ percent. In addition, the average effective rate on Federal funds advanced 80 basis points in May to establish a record monthly average level of 11.31 percent.

In contrast to rates in the Government securities market, yields in the corporate and municipal bond markets continued to drift upward in May. Over the month, the Federal Reserve Board's index of yields on newly issued Aaa-rated utility bonds increased 10 basis points to 9.08 percent and The Bond Buyer index of municipal yields rose 26 basis points to 6.08 percent.

During the month, the Board of Governors of the Federal Reserve System announced bench-mark revisions of the money supply measures to reflect data on nonmember bank deposits obtained from the December call reports. Because deposits at such institutions are not available on a current basis, they are estimated initially from data for "country" member banks. The latest revision also incorporates the most recent data on deposits of domestic agencies and branches of foreign banks. In the revision, the growth of the seasonally adjusted narrow money supply (M_1)—private demand deposits adjusted plus currency outside commercial banks—was boosted over that previously reported by 1.4 percentage points in the fourth quarter of 1973 to 8.9 percent at an annual rate and by 0.4 percentage point in the first four months of 1974 to 7.4 percent. Similar upward adjustments were announced for the growth of the broad money supply (M_2), which includes time and savings deposits other than large negotiable certificates of deposit (CDs) at weekly reporting banks. According to preliminary information, the growth of the monetary aggregates slowed appreciably in the first four statement weeks of May. However, taking a somewhat longer run perspective, growth in the aggregates has been rapid thus far this year.

THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

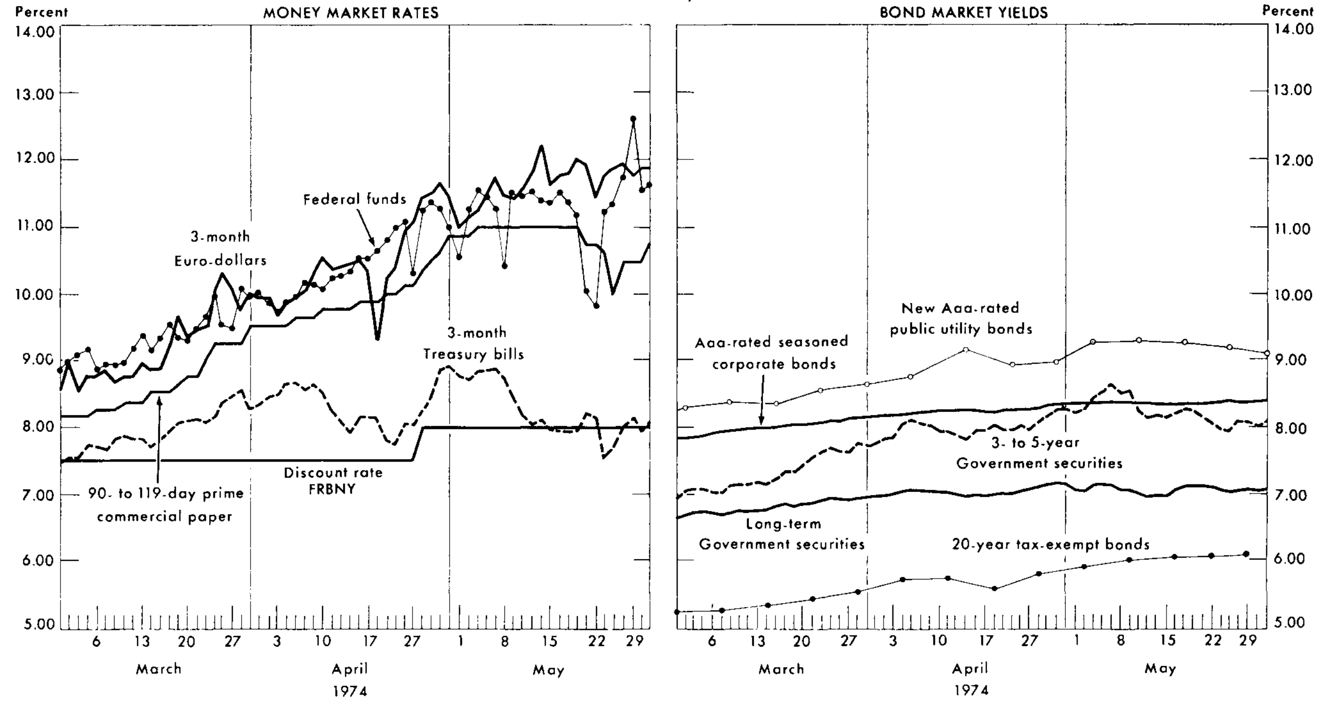
Rates on most money market instruments continued their upward spiral over the first part of May but then retraced some of this advance during the balance of the period (see Chart I). Rates in the commercial paper market were virtually unchanged from their closing levels in April, while bid rates on bankers' acceptances rose ½ percentage point. For the month as a whole, the effective rate on Federal funds averaged 11.31 percent, 80 basis points above April's average and the highest monthly level on record. In the face of persistent strength in the demand for business loans, most major commercial banks raised their prime lending rate in several steps during May to a historically high 11½ percent, up from 10½ percent at the end of April. Member bank borrowings from the Federal Reserve System rose sharply during the month. In part, this increase was attributable to the substantial amount of funds the System provided to the Franklin National Bank. On May 12, in reference to inquiries concerning this bank, George W. Mitchell, Vice-Chairman of the Board of Governors of the Federal Reserve System, indicated that the System stands prepared to advance funds to this bank as needed, within the limits of the collateral that can be supplied. Other banks also increased their use of the discount window, and borrowings averaged $2,489 million for the month (see Table I).

Commercial banks increased their offering rates on large negotiable CDs in the first part of the month to attract sufficient funds to meet the continued heavy demand for busi-

Chart I

SELECTED INTEREST RATES

March - May 1974



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-rated 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.

ness loans. As the month progressed, investors began to prefer CDs issued by the very largest commercial banks, and these banks sold such instruments in volume. At the same time, CD rates edged down from the peaks established earlier in the month. On a seasonally adjusted basis, CDs grew extraordinarily rapidly in the four statement weeks ended May 22 relative to their average of the preceding four-statement-week period. From the end of 1973, when the growth in business loans resumed its rapid pace, through May 22, the volume of CDs outstanding rose by about \$18.6 billion, compared with an increase in CDs outstanding of \$19.2 billion for all of 1973.

According to preliminary data, the growth of the monetary aggregates slowed in the first four statement weeks in May, following the rapid gains experienced in the preceding several months. However, relative to its four-week-average level in the period ended thirteen weeks earlier, M_1 grew at a seasonally adjusted annual rate of 9.2 percent in the four-week interval ended May 22 (see Chart II). From its four-week average of a year earlier, M_1 grew at a sizable 6.6 percent. The growth in M_2 also slowed over the first four statement weeks in May. However, the time deposit component of M_2 continued to advance at a rapid rate despite an increase in interest rates on competing market instruments relative to rates on consumer-type time deposits which are constrained at ceiling levels. Much of the recent growth in the time deposit component of M_2 may reflect increases in nonnegotiable

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1974

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

Factors	Changes in daily averages— week ended					Net changes
	May 1	May 8	May 15	May 22	May 29	
"Market" factors						
Member bank required reserves	— 752	+ 457	— 252	— 25	+ 322	— 250
Operating transactions (subtotal)	— 630	— 413	— 448	— 952	— 199	—2,642
Federal Reserve float	— 582	— 33	+ 79	+ 242	— 451	— 745
Treasury operations*	— 797	— 492	+ 253	— 292	— 171	—1,499
Gold and foreign account	— 74	+ 49	+ 17	— 66	+ 56	— 18
Currency outside banks	+ 932	— 104	— 576	— 729	+ 417	— 60
Other Federal Reserve liabilities and capital	— 109	+ 167	— 221	— 109	— 48	— 320
Total "market" factors	—1,382	+ 44	— 700	— 977	+ 123	—2,892
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+1,106	+ 482	+ 455	+ 87	— 694	+1,436
Outright holdings:						
Treasury securities	+ 475	+ 231	+ 83	— 395	+ 666	+1,060
Bankers' acceptances	+ 8	+ 6	+ 4	— 3	+ 9	+ 24
Federal agency obligations	+ 166	—	—	+ 200	— 4	+ 362
Repurchase agreements:						
Treasury securities	+ 264	+ 37	+ 282	+ 225	— 850	— 42
Bankers' acceptances	+ 56	+ 17	+ 15	+ 37	— 186	— 61
Federal agency obligations	+ 137	+ 191	+ 71	+ 23	— 329	+ 93
Member bank borrowings	+ 216	— 540	+ 360	+1,111	+ 517	+1,664
Seasonal borrowings†	+ 20	+ 8	+ 12	+ 18	+ 2	+ 60
Other Federal Reserve assets‡	+ 98	+ 50	— 83	— 369	+ 21	— 283
Total	+1,420	— 8	+ 732	+ 829	— 156	+2,817
Excess reserves‡	+ 38	+ 36	+ 32	— 148	— 33	— 75

	Daily average levels					Monthly averages§
Member bank:						
Total reserves, including vault cash‡	36,845	36,424	36,708	36,585	36,230	36,558
Required reserves	36,668	36,211	36,463	36,488	36,166	36,399
Excess reserves	177	213	245	97	64	159
Total borrowings	2,157	1,617	1,977	3,088	3,605	2,489
Seasonal borrowings	74	82	94	112	114	95
Nonborrowed reserves†	34,688	34,807	34,731	33,497	32,625	34,070
Net carry-over, excess or deficit (—)‖	118	100	101	134	105	112

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.
§ Average for five weeks ended May 29, 1974.
‖ Not reflected in data above.

large CDs at weekly reporting banks and negotiable CDs at nonweekly reporting banks. Like negotiable large CDs at weekly reporting banks, such deposits are exempt from Regulation Q ceilings. The adjusted bank credit proxy continued to advance rapidly in May. Over the first four statement weeks of the month, the proxy rose at a seasonally adjusted annual rate of 18 percent, in comparison with a 32 percent annual rate of increase recorded over the four previous weeks.

THE GOVERNMENT SECURITIES MARKET

Yields on Treasury securities fluctuated widely during May but, by the close of the month, most yields were below the levels that had prevailed at the end of April. In the first half of the month the market was dominated by the Treasury's refunding operation. The terms of the refunding were viewed as attractive, and the refunding attracted substantial demand, especially from small investors. The successful marketing of the new Treasury issues, together with the very good response to a large Federal Home Loan Bank (FHLB) offering, prompted a rally in the Government securities market. The market benefited as the month progressed from increased investor preference for high-quality debt instruments. The rally subsequently lost some momentum, and rates edged up after Chairman Burns reaffirmed the Federal Reserve's resolve to resist excessive expansion in money and bank credit.

Pressures on money market rates were a source of concern to the Treasury bill market over much of the month. Bidding was restrained in the monthly auction of 52-week bills on May 2, and a record average issuing rate of 8.42 percent was established, 54 basis points above the issuing rate in the previous such auction (see Table II). Rates on the three- and six-month bills in the first regular weekly auction of the month also advanced to record-high levels. Subsequently, with the conclusion of the Treasury refunding operation, investors displayed renewed interest in bills. This demand, together with Federal Reserve purchases for both the System and foreign accounts, pressed against very thin dealer inventories, and rates moved sharply lower through the middle of the month. Another factor favorably affecting the bill market was the anticipation that some investors would shift part of their portfolios into safer Treasury securities in view of the liquidity problems which had come to light. Some of this optimism was tempered, however, by underlying concern over pressures on interest rates. Hence, a cautious atmosphere persisted. The Treasury's announcement that it planned to raise some \$800 million in new cash through an auction on May 30 of a strip of bills was greeted favorably, since the financing was smaller than generally expected. The offering consisted of $100 million of bills maturing each week from September 19 through November 7, 1974; the auction resulted in an average issuing rate of 8.28 percent for the strip of bills. For the month as a whole, the market yield on the three- and six-month bills declined 82 and 50 basis points, respectively.

Yields on Treasury coupon securities followed the pattern of fluctuations in bill rates during the month. Investor activity diminished considerably prior to the refunding, as the rise in bill rates and indications that the heavy demand for loans at commercial banks was continuing unabated engendered a cautious atmosphere. Dealers were also apprehensive of taking on new issues prior to the refinancing because of the very high carrying costs relative to available yields. However, the strong technical position of the market and the attractive terms of the refunding provided some support.

On May 7, the Treasury auctioned $1.75 billion of 4¼-year 8¾ percent notes. Interest in this issue proved greater than expected, primarily because of the large volume of noncompetitive tenders that were attracted to the record-high coupon rate, and the average issuing rate was set at 8.73 percent. Interest in the 25-month 8¾ percent note and in the 25-year 8½ percent bond offered the following day was substantial. The issuing rate for the note was 8.73 percent, and the yield on the bond was set at 8.23 percent. About 40 percent of the entire refunding was awarded to noncompetitive tenders. Demand soon emerged from dealers who had been unsuccessful in obtaining these issues in the auctions. Thus, both the new issues and older outstanding issues of comparable maturity benefited in subsequent trading. As the month progressed, investors seeking high-quality investments turned to the Treasury market, and yields on most issues continued to move lower. Yields on intermediate-term issues closed the month down about 2 to 29 basis points, while yields on issues due in ten years or more ranged from 3 to 22 basis points lower.

Yields on Federal agency securities moved in tandem with yields in the Treasury coupon market, as a cautious atmosphere prevailed over most of the month. Evidence of the withdrawal of funds from thrift institutions mounted, giving rise to expectations of increased supplies of issues from the housing agencies. On May 10, the FHLBs sold $700 million of eighteen-month 9.10 percent bonds, $600 million of 3¼-year 8.80 percent bonds, and $400 million of five-year and $300 million of ten-year 8.75 percent bonds. While $1 billion of this $2 billion package

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—May 1974			
	May 6	May 13	May 20	May 24
Three-month	9.036	8.023	8.197	7.983
Six-month	9.006	8.031	8.440	8.205

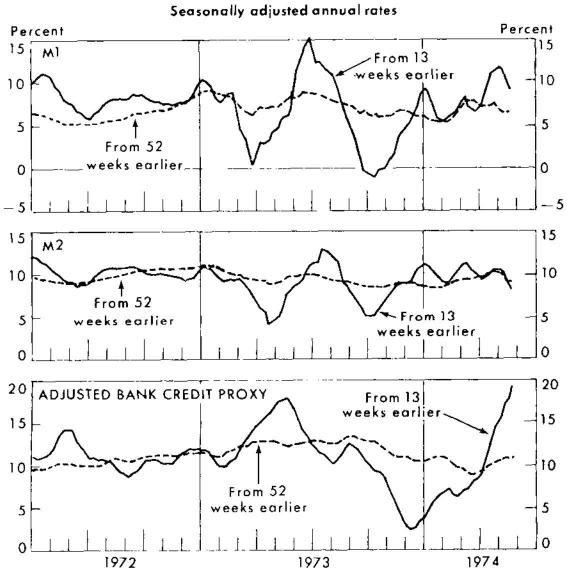
Maturity	Monthly auction dates—March-May 1974		
	April 3	May 2	May 29
Fifty-two weeks	7.886	8.421	8.248

* 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: Growth rates are computed on the basis of four-week averages of daily figures for periods ended in the statement week plotted, 13 weeks earlier, and 52 weeks earlier. The latest statement week plotted is May 22, 1974.

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.

was new money, the undertaking proved extremely successful, and the securities advanced to sharp premiums in subsequent trading. This sparked the agency market, and on May 16 the Banks for Cooperatives and the Federal Intermediate Credit Banks were able to sell quickly $351 million of six-month 8.90 percent bonds and $796 million of nine-month 9 percent bonds, respectively. Late in the month, the Federal National Mortgage Association sold three issues totaling $1.5 billion, $750 million of which was new money. The offering consisted of $500 million of thirty-month 8.45 percent debentures, $650 million of 3¾-year 8.45 percent debentures, and $350 million of six-year 8.50 percent debentures. The issues received good support in initial trading.

THE OTHER SECURITIES MARKETS

Concern over inflation and the escalation of short-term rates remained a dominant influence in the corporate and municipal bond markets, and yields rose over the month on balance. Early in the month, both markets were pressured by heavy supplies of new issues. Thereafter, prices of corporate securities fluctuated widely. Higher yields and hopes for an eventual downturn in rates caused some postponements and scaling-down of announced offerings. This alleviated some of the supply pressures from the corporate sector. However, concern over deposit outflows at mutual savings banks, which could cause those institutions to refrain from purchasing corporate issues, coupled with investor preoccupation with disturbing news of the financial condition of some electric utility companies dampened the market over much of the month. Indeed, the disparity in yields between industrial and utility bonds widened to historically broad dimensions.

The tax-exempt market exhibited strains as a result of the huge volume of new issues sold thus far this year. In the first four months of 1974, nearly $8.7 billion of tax-exempt securities was marketed, up 18 percent from the first four months of 1973. Volume remained heavy in May, and the market was further depressed by the lack of commercial bank interest in the new offerings. The Bond Buyer index of twenty municipal bond yields rose to 6.08 percent on May 30, the highest level since August 1971.

As the month began, one of the few Aaa-rated manufacturing corporations marketed $50 million of 25-year debentures priced to yield 8.52 percent. The issue was the company's first bond financing in the United States, and it was received enthusiastically. About a week later, two large industrial offerings generally sold well on a negotiated basis. However, around the same time, offerings of two utility companies located in large cities experienced only moderate receptions. Specifically, $35 million of A-rated thirty-year debentures was priced to yield 9.75 percent, about 7 basis points higher than similarly rated outstanding issues, and $25 million of A-rated bonds of similar maturity was priced to return 9.68 percent. The somewhat cautious investor response to these issues was generally attributed to ratings reductions for several large urban utilities. The atmosphere of investor sensitivity to the financial position of urban electric utilities persisted, and in the next week $100 million of A-rated thirty-year utility debentures attracted only limited interest when priced to yield 9.95 percent. These bonds had recently been downgraded from Aa. An A-rated nonurban utility issue offered the next day sold well, even though priced at a somewhat lower yield. Later in the month, as additional postponements materialized and relieved some of the supply pressures from the market, the American Telephone and Telegraph Company marketed $500 million of debentures priced to yield 8.80 percent in 2005. This is the highest return ever offered by the company on its long-term debt instruments. The issue sold out quickly, but it failed to stimulate the market for older outstanding issues. Two negotiated corporate issues, which were priced rather generously, encountered good receptions toward the end of the month.

In the tax-exempt market, the major long-term issues encountered mixed receptions during the month. Early in May, $125 million of highly regarded Aaa-rated bonds sold quickly when priced to yield from 5 percent in 1975 to 5.50 percent in 1989. Several days later, $146 million of Aaa-rated securities was reoffered to yield 5.30 percent in 1982. The return was 20 basis points higher than that on the comparable maturity of the previous Aaa-rated offering, and the issue sold out. Later in the month, an aggressively priced two-part offering—consisting of $25.2 million of Aa-rated bonds scaled to yield from 5.25 percent in 1980 to 6.10 percent in 1999 and $24.8 million of bonds priced to yield 6.25 percent in 2014—met some investor resistance. Shortly thereafter, a negotiated placement of $38 million of Aaa-rated revenue bonds priced to yield 5.92 percent in 2001 sold quickly. However, two lower rated competitive offerings did not fare as well. This response was indicative of the trend toward negotiated issues, which typically win better receptions in periods of tight money. Later in the month, $40 million of A-rated revenue bonds was offered on a competitive basis. The bonds were priced to return from 5.50 percent in 1975 to 7.10 percent in 2004. Investor interest was restrained despite the relatively generous yields. The Blue List of dealers' advertised inventories rose $142 million to $616 million by the end of the month.

Treasury and Federal Reserve Foreign Exchange Operations Interim Report*

By CHARLES A. COOMBS

Early in January, the dollar continued its strong advance in the exchange markets, spiraling upward against some currencies to levels prevailing before the February 1973 devaluation. The market's bullish appraisal of the dollar mainly derived from the favorable trends in the United States payments balance that had emerged during 1973 and the judgment that this country could better cope with the damaging consequences of the oil crisis than most other industrial countries. Later that month, however, exchange market sentiment abruptly shifted against the dollar and a steady slide in dollar rates developed over the following three months covered by this report. By the end of April, the dollar had fallen from its January peak by as much as 17 percent against the German mark and some other European currencies, while also depreciating considerably against both the Japanese yen and the Canadian dollar. As a result, more than three fourths of the dollar's improvement since October 1973 was eroded.

This adverse shift of market sentiment coincided with the complete elimination of United States capital controls on January 29 and the subsequent easing of European barriers against short-term capital inflows. Moreover, United States interest rates had already begun to fall off sharply while rates abroad held firm, and this swing in interest rate differentials temporarily provided a further strong inducement to outflows of United States funds into foreign markets. Foreign demand for dollar credit mounted as European countries rushed to launch medium-term borrowing programs to meet anticipated balance-of-payments deficits. In response to these pressures, claims on foreigners reported by United States banks, the bulk of which is short term, ballooned by a record increase of well over $6 billion during the three months, February through April. Even more disturbing, the energy crisis threatened to provoke a more rapid and pronounced deterioration in our trade balance than originally expected, while Germany showed a continuing trade surplus of surprising strength.

As this picture unfolded, the dollar came on offer, and dollar rates against most European currencies declined steadily during February to levels nearly 10 percent below the January highs. Such recurrent declines in dollar rates threatened to generate speculative pressures and disorderly trading, and the Federal Reserve accordingly resumed intervention on February 22. By the month end, the Federal Reserve had sold $91.2 million equivalent of marks, financed by drawings on the swap line with the German Bundesbank, of which $3.7 million was repaid with mar-

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, January 31, 1974	Drawings (+) or repayments (—) February 1 through April 30	System swap commitments, April 30, 1974
National Bank of Belgium	261.8	-0-	261.8
German Federal Bank	-0-	{+368.2 {— 3.7	364.5
Swiss National Bank	371.2	-0-	371.2
Bank for International Settlements (Swiss francs)	600.0	-0-	600.0
Total	1,232.9	{+368.2 {— 3.7	1,597.4

Note: Discrepancies in totals are due to rounding.

* This interim report, covering the period February through April 1974, is the third of a series providing information on Treasury and System foreign exchange operations to supplement the regular series of semiannual reports appearing in this *Review*. Mr. Coombs is the Senior Vice President in charge of the Foreign function of the Federal Reserve Bank of New York and Special Manager, System Open Market Account. The Bank acts as agent for both the Treasury and the Federal Reserve System in the conduct of foreign exchange operations.

ket purchases early in March. In addition, this Bank also sold $6.8 million equivalent of Belgian francs from System balances, as well as some $8.9 million equivalent of German marks and $15.8 million equivalent of French francs from Treasury balances.

Meanwhile, the divergent trend between the United States weakening trade position and the continued strength of Germany's export surplus had kindled renewed debate over German exchange rate policy. During March, speculation over a possible revaluation of the mark became the dominant factor in the market. The mark, now at the top of the EC snake, pulled other European currencies up against the dollar as it posted new gains almost daily. The Federal Reserve intervened intermittently but in sizable amounts to sell a further $225.5 million equivalent of German marks by the end of March, financed by additional drawings on the swap line with the Bundesbank. These operations were conducted in close coordination with the Bundesbank, which also supplied marks on a substantial scale both by buying dollars outright and by intervening in the EC snake arrangement. In other operations during March, this Bank sold $10 million equivalent of Belgian francs from System balances and $17.9 million equivalent of French francs from Treasury balances.

By April, interest rates in the United States had turned around and began to move upward sharply while rates abroad were on an easing trend, thereby progressively reversing earlier interest-arbitrage differentials adverse to the United States. Moreover, trade figures for March showed a more modest United States deficit than generally expected in the market and a slightly reduced surplus for Germany. Nevertheless, the market remained fearful of a possible revaluation of the German mark or disbanding of the EC snake. In addition, publication of first-quarter figures, showing a drop in United States output and a distressing acceleration of domestic inflation, prompted gloomy market reassessments of United States business and foreign trade prospects. Developments in the Watergate affair also exerted a depressing influence on the international value of the dollar from time to time. As the dollar fell still further, the Federal Reserve continued to intervene and sold $51.6 million equivalent of marks in April, financed by further drawings under the swap line with the Bundesbank.

Over the three-month period, February-April, Federal Reserve and Treasury intervention amounted to $427.5 million. Of this total, $368.2 million was financed by Federal Reserve drawings on the swap line with the Bundesbank. As of the end of April 1974, $364.5 million of these drawings remained outstanding. During the period under review, market conditions ruled out any repayments of outstanding System swap debt in Swiss francs and Belgian francs amounting to $971.2 million and $261.8 million, respectively.

Apart from the $1 billion increase in the Federal Reserve swap line with the Bank of Italy on February 1, already reported, the only other change in the swap network during the period was an increase in the Federal Reserve's swap line with the Bank of England from $2 billion to $3 billion, effective March 26. As of April 30, swap lines between the System and other central banks totaled nearly $20 billion.

An Analysis of the Public Benefits Test of the Bank Holding Company Act

By MICHAEL A. JESSEE AND STEVEN A. SEELIG*

This article investigates the nature of the public benefits required by the Board of Governors of the Federal Reserve System in connection with the applications of bank holding companies to acquire both banks and nonbanking firms. The findings are based on an inspection of the Board's orders in all bank and nonbank cases published in the *Federal Reserve Bulletin* since January 1971. In addition, approximately thirty nonbank orders published only in the *Federal Register* were examined.

The Board, in considering proposals of bank holding companies to acquire banks, is required by Section 3 of the Bank Holding Company Act as amended (hereafter referred to as the Act) to deny a proposed acquisition if its

> effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless [the Board] finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

In addition, the Board is required to consider the financial and managerial aspects of the proposal. Thus, it would appear that the Board could approve a proposed bank merger where the proposal would yield relatively modest benefits for the public's convenience and needs, provided any anticompetitive effects were not substantial and no adverse financial or managerial factors militated against approval.

The requirements relating to public benefits are stated somewhat more explicitly regarding proposed acquisitions of nonbanking firms by bank holding companies. Section 4(c)(8) of the Act requires the Board to determine if a proposed nonbanking activity is

> so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

In essence, the test contained in Section 4(c)(8) suggests that every nonbank acquisition must yield net benefits to the public for it to be approved.

To learn how the Board has interpreted these requirements relating to public benefits, we examined 434 orders where the Board approved acquisitions of banks and 104 orders where nonbank acquisitions were approved. As a control group, we studied 47 bank and nonbank cases in which the Board denied the proposed acquisitions.

SUMMARY OF FINDINGS

Analysis of the Board's decisions revealed six types of public benefits: (1) improvements relating to convenience and needs of the community to be served, (2) increased competition, (3) improved operational efficiency, (4) expanded financial resources for the firm to be acquired and/or the holding company, (5) improved management for the acquired firm, and (6) other benefits unique to the particular case.

* The authors are economists in the Banking Studies Department. They wish to acknowledge the substantial contribution of Leon Korobow, Manager, Banking Studies Department, to this article.

Benefits that improve public convenience or meet expanded needs were manifest primarily in the introduction of new financial services, the provision of an alternative or expanded source for presently offered services, or an expansion in the geographic scope of the services being offered. Increased market competition was viewed by the Board to result from *de novo* entry into either banking or nonbanking markets, reduction of rates charged on loans or other services, a strengthening of a small firm through affiliation with a bank holding company, and the reorientation of management policies from conservative to aggressive. Improvements from economies of scale and complementary expertise have also been recognized by the Board. The injection of new equity capital into a firm to be acquired as well as the acquisition of a financially weak firm also has been construed to be in the public interest. Improved managerial resources and the provision of needed management depth are still further benefits. Other benefits include the elimination of a specific unfair competitive situation, the lowering of management fees for subsidiary banks, and the continuation of a particular financial service being provided in an area. It is worth noting that all these public benefits are not mutually exclusive since, for example, an alternative or more efficient source of financial services may also stimulate additional competition.

In both bank and nonbank cases where the proposal was denied, the principal adverse effects cited by the Board comprised: (1) significantly reduced existing competition within a well-defined geographic market for a particular product(s), (2) probable elimination of significant amounts of future or potential competition in a particular market where alternative forms of entry (i.e., *de novo* or foothold entry) were feasible, (3) the accumulation of financial resources to such an extent as to lead to possible abuse of economic power, (4) a possible weakening of the holding company's ability to support the growth of its banking subsidiaries, and (5) covenants restricting competition.

We conclude from the examination of bank and nonbank cases undertaken in this study that the willingness of the Board to attach significance to the public benefits cited by an applicant was heavily dependent on the severity, or lack thereof, of any adverse competitive, financial, or managerial factors the Board perceived to be inherent in the application. Where the Board determined a proposal involved no seriously adverse competitive or other effects, it generally accepted the applicant's claim of probable benefits to the public and approved the acquisition. We believe it is particularly significant, however, that the Board appears never to have found, so far as we can tell, proposed public benefits sufficient to outweigh the adverse effects of a substantial reduction of competition, unsound banking practices, or undue concentration of resources. In view of the often unique circumstances of each case, it is difficult to generalize on the exact situation in which the Board would conclude that public benefits would outweigh or be outweighed by adverse effects. Our review of the Board's orders suggests, however, that approval has required increasingly substantial evidence or demonstration from applicants that their proposals would yield net public benefits, particularly in cases where significant adverse effects were present.

THE ROLE OF PUBLIC BENEFITS IN SELECTED BOARD ORDERS OF APPROVAL

The following discussion of the role of specific public benefits is organized by the type of benefit most frequently cited by the Board. A listing of these benefits by type is available in Table I. In general, these cases all involved applications that presaged no severely adverse consequences from the loss of existing, future, or potential competition, or significant danger to the public interest from unsound banking practices. Neither did they involve the weakening—financially or managerially—of the parties concerned. The Board's treatment of public benefits in cases where adverse factors were important is discussed in the next main section.

CONVENIENCE AND NEEDS. Improvements affecting the convenience and needs of the community are the most significant public benefits that have been accepted by the Board in its approvals of bank acquisitions and bank holding company formations. Such improvements have often taken the form of new services, or the expansion of existing services or facilities, thereby facilitating the economic growth of an area. The Board has been especially responsive to the introduction of new services not yet offered in a locale. However, it has also recognized benefits in the provision of an alternative source of services that are already provided in an area and has frequently stated that an alternative source of services would stimulate competition.[1]

[1] See, for example, Missouri Bancshares (71 FRB 143) and First Florida Bancorporation (73 FRB 183)—the former an alternative source for retail services, the latter a source of wholesale banking services. FRB refers to the *Federal Reserve Bulletin.* The number preceding FRB represents the year of the *Bulletin,* and the number following FRB is the page on which the order appears.

Table I

TYPES OF BENEFITS CITED BY THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM IN ORDERS OF APPROVAL OF BANK HOLDING COMPANY ACQUISITIONS*

Type of benefits	Bank	Nonbank
Convenience and needs:		
Providing an alternative source of services to a market	Missouri Bancshares, Incorporated (71 FRB 143)	Imperial Bancorp (72 FRB 503)
Increased lending capacity to support strong economic growth in an area	Southeast Bancorporation, Incorporated (71 FRB 41)	
or to stimulate growth in economically depressed areas	First Union Incorporated (71 FRB 531)	Marine Bancorporation (72 FRB 504)
Expansion of specialized credit services	[see Table II]	Mortgage: First Chicago Corporation (72 FRB 175). Consumer: First Bank System, Inc. (72 FRB 172). Commercial: Bank of Virginia Company (72 FRB 934). Agricultural: Western Kansas Investment Corporation, Inc. (72 FRB 737). Leasing: Provident National Corporation (72 FRB 933).
Geographic expansion of service		American Fletcher Corporation (72 FRB 741)
Improving allocational efficiency		First Union National Bancorp, Inc. (72 FRB 72)
Increased competition:		
Increased competition through *de novo* entry	Atlantic Bancorporation (71 FRB 689)	U.N. Bancshares, Inc. (73 FRB 204)
Reduction of rates charged on loans or other services	First National City Corporation (71 FRB 944)	Northwest Bancorporation (38 FR 14205)
Strengthening the competitive position of a small firm through affiliation with a larger bank holding company	First Florida Bancorporation (71 FRB 256)	
Increasing competition by changing a limited-service institution into a full-service firm	Barclays Bank DCO (71 FRB 45)	Bank of Virginia Company (72 FRB 934)
Changing a conservative firm into a more aggressive competitor	Barnett Banks of Florida, Inc. (71 FRB 529)	
Improved efficiency		
Economies of scale	First Security National Corporation (71 FRB 1005)	Zions Utah Bancorporation (72 FRB 72)
Complementary skills	First American Bancshares, Inc. (72 FRB 730)	
Improved financial resources:		
Acquiring a financially weak firm	State Street Boston Financial Corporation (73 FRB 526)	BankAmerica Corporation (73 FRB 687)
Improving the debt-to-equity ratio of the acquired firm	Continental Bancor, Inc. (71 FRB 676)	
Injecting a specific amount of equity capital into the acquired firm	Great Lakes Holding Company (71 FRB 545)	Manufacturers Hanover Corporation (73 FR 27659)
Providing "access to the greater financial resources" of the holding company	First Alabama Bankshares, Inc. (71 FRB 404)	Third National Corporation (38 FR 9686)
Improved managerial resources:		
Alleviating management succession problems	Depositors Corporation (71 FRB 36)	Northwest Bancorporation (73 FRB 701)
Providing management depth	First National Charter Corporation (71 FRB 37)	Zions Utah Bancorporation (72 FRB 72)
Other benefits:		
Correcting an unfair competitive situation		Newport Savings and Loan Association (72 FRB 313)
Preventing the termination of a financial service		American Fletcher Corporation (38 FR 14203)
Lowering management fees for subsidiary banks	Bank Securities Inc. (72 FRB 280)	

* All references are to the *Federal Reserve Bulletin* (FRB) or the *Federal Register* (FR).

Table II lists a sampling of the new services that bank holding companies have proposed to introduce in bank acquisitions.

In nonbank cases the introduction of new, or the extension of existing, services to a market is also cited as a public benefit, notably the provision of specialized credit services. For example, many of the recent approvals of acquisitions of mortgage banking firms by bank holding companies have been granted on the expectation that such affiliation would result in increased flows of funds into residential or low-income housing and urban renewal. In these instances, however, the applicant must indicate that the acquisition would not cause a reduction of credit to independent mortgage companies that may be customers of the bank affiliates of the holding company.[2]

Increases in the supply and availability, as well as reductions in the cost, of consumer credit to individuals have been cited frequently as significant public benefits in approvals of acquisitions involving consumer finance companies[3] and firms that extend second mortgages.[4] Further, acquisitions of commercial finance firms and factoring concerns have been granted on the expectation of expanded flows of commercial credit,[5] yielding benefits particularly for small businesses[6] and high risk enterprises.[7] Also cited by the Board as beneficial to the public are the provision of agricultural lending through the acquisition of agricultural credit companies[8] and the provision of personal property leasing services.[9]

The Board has held as beneficial the geographic expansion and the offering of new products by bank holding companies in the fields of mortgage, consumer, and commercial credit. Several applicants have specifically stated that their newly acquired affiliates would expand outside their respective current market areas.[10] In one order approving the acquisition of a mortgage banking firm,[11] the Board noted that an improved flow of funds would take

Table II

NEW SERVICES PROPOSED IN BANK ACQUISITION CASES

Service	Reference*
Trust services	Society Corporation (71 FRB 52)
Electronic data processing	Security New York State Corporation (71 FRB 133)
Increased and larger commercial lending	Commerce Bankshares, Inc. (71 FRB 146)
Bond portfolio management (internal)	Florida National Banks of Florida, Inc. (71 FRB 939)
New physical facilities	Boatmens Bancshares, Inc. (71 FRB 39)
Leasing	First National Charter Corporation (71 FRB 754)
Internal auditing	Florida National Banks of Florida, Inc. (71 FRB 939)
International services	Huntington Bancshares Incorporated (71 FRB 940)
Venture capital	Central and State National Corporation of Alabama (71 FRB 860)
Marketing (internal)	Florida National Banks of Florida, Inc. (71 FRB 939)
Urban and business development	First Virginia Bankshares Corporation (71 FRB 1022)
Federal Housing Administration and Veterans Administration loans	BancOhio Corporation (71 FRB 1035)
Overdraft checking and other deposit services	First Virginia Bankshares Corporation (72 FRB 288)
Accounts receivable financing	Shorebank Inc. (72 FRB 914)
Investment management services for small investors	First National Boston Corporation (73 FRB 759)
Municipal bond financing	Security New York State Corporation (71 FRB 133)
New branches	Merrill Bankshares Company (71 FRB 262)
Credit cards	State Street Boston Financial Corporation (73 FRB 526)
Wholesale banking services	First Florida Bancorporation (73 FRB 183)
International trade financing	Dai-Ichi Kangyo Bank, Ltd. (72 FRB 49)

* All references are to the *Federal Reserve Bulletin* (FRB).

2 See First Union National Bancorporation (72 FRB 72) and First Chicago Corporation (72 FRB 175).

3 First Bank System (72 FRB 172) and American Fletcher Corporation (72 FRB 741).

4 Bank of Virginia Company (72 FRB 934) and Dominion Bankshares Corporation (72 FRB 597).

5 Industrial National Corporation (72 FRB 171) and Bank of Virginia Company (72 FRB 935).

6 Citizens and Southern Holding Company (71 FRB 1037).

7 Lincoln First Banks (72 FRB 169).

8 Western Kansas Investment Corporation, Inc. (72 FRB 737).

9 Marshall and Ilsley Bank Stock Corporation (72 FRB 74) and Provident National Corporation (72 FRB 933).

10 First Bank System (72 FRB 172) and American Fletcher Corporation (72 FRB 741).

11 First Union National Bancorporation (72 FRB 72).

place from capital-surplus areas to those in deficit. Moreover, in the BankAmerica-GAC Finance case, the Board, on reconsideration of a revised application, determined that one of the benefits inherent in the acquisition would be a more efficient allocation of consumer credit.[12]

The introduction of more active lending and business development policies by banks has been held by the Board to be beneficial in those areas that have been economically depressed.[13] Also considered beneficial were the expansion of bank lending and the introduction of new credit services necessary to sustain the rate of economic expansion in those areas experiencing strong economic growth.[14] Providing a stimulus to the economic growth of an area has been cited as an important public benefit in several nonbank cases where the applicant argued that approval would result in increased flows of mortgage credit to depressed areas and would aid municipal governments in obtaining long-term funds.[15]

INCREASED COMPETITION. *De novo* entry into a market either by a bank or nonbank affiliate of a bank holding company has usually been regarded by the Board as an enhancement of competition, on the grounds that such entry adds "a new decision maker" to the market.[16] Also, in several cases the shift of a limited "loan production office", located off the premises of a subsidiary bank, to a full-service facility was held by the Board to be a stimulant to competition. These instances involved such nonbank firms as factoring companies[17] or mortgage banking firms,[18] which formerly had been acquired under Section 4(c)(5) of the Act prior to 1970 and operated as loan production offices.[19]

Rate reductions on banking and nonbanking services are regarded as an important direct benefit to the public and conducive to an improvement in the quality of competition in the markets for the services involved. In a number of proposed acquisitions of banks, applicants promised to reduce interest rate charges on loans below those charged by other banks in the market[20] or to eliminate fees or service charges on demand deposits,[21] or to pay more competitive rates on time and savings accounts.[22]

Reductions in interest rates on loans also have been viewed by the Board as a significant public benefit in nonbank cases.[23] Indeed, with regard to applications to acquire credit-life insurance underwriters or reinsurers, Regulation Y explicitly requires an applicant to demonstrate

> that approval will benefit the consumer or result in other public benefits. Normally such a showing would be made by a projected reduction in rates or increase in policy benefits due to bank holding company performance of this service.

The Board has approved applications which have provided for rate reductions of 2 to 20 percent below existing average levels for each state in which consumer credit is extended by the bank holding company.[24] Moreover, the Board has held that credit-life insurance subsidiaries of bank holding companies must refrain from issuing level term insurance to cover instalment loans, i.e., coverage in excess of the outstanding loan balance.[25]

The affiliation with a large bank holding company by a small bank that competes ineffectively with much larger

[12] 73 FRB 687. On July 27, 1973, the Board denied BankAmerica Corporation's application to acquire GAC Finance, Inc., on the grounds that the acquisition would result in reduced competition and an undue concentration of resources. On reapplying, the applicant proposed the divestiture of a significant amount of sales finance and commercial finance receivables and of all of GAC's offices that were competitive or potentially competitive with the applicant. The Board determined that such divestiture removed its initial objections to the acquisition on competitive grounds. Moreover, based on new information, the Board concluded "that [GAC] Finance must be sold . . . to a buyer of considerable financial strength to avoid the collapse of Finance and its parent, and possibly serious financial repercussions of a more general nature".

[13] New Mexico Bancorporation (71 FRB 134) and First Union Incorporated (71 FRB 531).

[14] Southeast Bancorporation (71 FRB 41) and Commerce Bancshares, Inc. (71 FRB 146).

[15] See, respectively, Marine Bancorporation (72 FRB 504) and Northwest Bancorporation (73 FRB 701).

[16] See, for example, Atlantic Bancorporation (71 FRB 689), Imperial Bancorporation (72 FRB 503), and U.N. Bancshares, Inc. (73 FRB 204).

[17] Bank of Virginia Company (72 FRB 934).

[18] United Virginia Bankshares (72 FRB 938).

[19] Subject to Board regulations and interpretations, limited-purpose subsidiaries can be acquired by bank holding companies under Section 4(c)(5), which allows the ownership of shares in firms that a national bank could own under Section 5136 of the Revised Statutes.

[20] First National City Corporation (71 FRB 944).

[21] First Holding Company (71 FRB 139).

[22] First National State Bancorporation (38 FR 6236) and Chemical New York Corporation (38 FR 31472). FR refers to *Federal Register*. The number preceding FR represents the volume.

[23] BankAmerica Corporation—GAC Finance, Inc. (73 FRB 687).

[24] See, for example, Fourth Financial Corporation (73 FRB 208) and Northwest Bancorporation (38 FR 14205).

[25] Fidelity Corporation of Pennsylvania (73 FRB 472). However, the Board has determined that the issuance of level term credit-life insurance is permissible in connection with single-payment loans (Winters National Corporation, Board Press Release, December 27, 1973).

banks in its market area has been recognized by the Board as strengthening the competitive position of the smaller bank.[26] Also, the formation of regional bank holding companies within a state has been viewed by the Board as a competitive stimulant to the larger statewide holding companies.[27]

Other examples of proposed actions the Board has regarded as beneficial to the public through the enhancement of competition include the following: (1) changing a foreign banking agency into a full-service bank,[28] (2) acquiring a conservative bank and reorienting its operating policies to make it aggressively compete for funds and expand its lending activities,[29] and (3) the severing of chain banking ties leading to reduced concentration of resources.[30]

IMPROVED EFFICIENCY. Both bank and nonbank acquisitions and holding company formations may give rise to operating efficiencies or economies of scale. On several occasions, the Board has taken the view that the organizational form of the bank holding company is conducive to such economies. In a case involving the "corporate reorganization of established interests and relationships" into a multibank holding company, the Board noted that

> Although Applicant proposes no significant changes in services to the public as a result of the proposed acquisitions, the convenience and needs of the communities involved should benefit from the improved economies and efficiencies of operation expected to result from the proposed restructuring of Applicant into a coordinated multibank holding company organization.[31]

Furthermore, in a concurring statement to the order approving The First National Bancorporation's acquisition of The Exchange National Bank of Colorado Springs,[32] Governor Mitchell cited various studies which indicate that significant economies of scale exist in banking, economies that tend to be passed on to the public through additional convenience in offices and facilities. He noted that "banking competition can only exist in a meaningful sense if at least some banking units have the capacity to broaden their services and make them more conveniently available. Their capacity to do so is a matter of realizing economies of scale."

Other references to such efficiencies are frequently found in Board orders, which often also refer to the "pooling of resources and complementary skills" allowing the holding company to utilize the expertise of one affiliate to expand the services of the other affiliates.[33]

IMPROVED FINANCIAL RESOURCES. The infusion of capital funds to a newly acquired bank or nonbank subsidiary is an often-quoted (indirect) benefit to the public. There have been several cases where the applicant holding company has promised a specific amount of capital contribution to the proposed bank[34] or nonbank affiliate.[35] More frequently, applicants have argued that affiliations of the proposed nonbank firms with bank holding companies would provide "access to the greater financial resources of applicant".[36]

This argument regarding access to a holding company's resources implies that the affiliation of a small bank-related firm with a large bank holding company gives that small firm an "assured" source of working funds at probably a lower cost than is obtainable as an independent firm.[37] It has been argued that this source of funds would be likely to be more "stable" than one obtainable independently.[38]

Finally, there are examples in both bank and nonbank cases where holding company affiliation was expected to result in the strengthening of a financially weak firm. In several bank[39] and nonbank[40] acquisitions, the acquired firm

[26] First Alabama Bankshares (71 FRB 404) and First Florida Bancorporation (71 FRB 256).

[27] First American Bankshares (72 FRB 730).

[28] Barclays Bank DCO (71 FRB 44).

[29] Barnett Banks of Florida, Inc. (71 FRB 529), United Missouri Bankshares, Inc. (72 FRB 655), and Missouri Bankshares (71 FRB 542).

[30] First National Bancorporation (71 FRB 345).

[31] First Security National Corporation (71 FRB 1005).

[32] 71 FRB 345.

[33] See, for example, First Alabama Bankshares (71 FRB 404) and First American Bancshares (72 FRB 730).

[34] Great Lakes Holding Company (71 FRB 545).

[35] First Arkansas Bankstock Corporation (73 FRB 28), Deposit Guaranty Corporation (73 FRB 593), and Manufacturers Hanover Corporation (73 FR 27659).

[36] See, for example, Third National Corporation (38 FR 9686), BankAmerica Corporation (73 FRB 687), and Northwest Bancorporation (73 FRB 701).

[37] Industrial National Corporation (72 FRB 171).

[38] See, for example, concurring statement in the BankAmerica-GAC order (73 FRB 687).

[39] State Street Boston Financial Corporation (73 FRB 526) and The First National Bancorporation (71 FRB 613).

[40] BankAmerica Corporation (73 FRB 687) and Zions Utah Bancorporation (72 FRB 72).

had been experiencing financial problems and eventually might have become insolvent. In one case the acquisition resulted in the revitalization of a credit office that would otherwise have been closed.[41] In another instance, the Board ruled that it was beneficial for the debt-to-equity ratio to be lowered in the case of an otherwise strong bank through the establishment of a debt repayment program scheduled by the applicant.[42]

IMPROVED MANAGERIAL RESOURCES. Another indirect benefit to the public is found in cases where the managerial resources of the acquired firm are to be substantially improved. Applications have been approved where it was found that the acquisitions would alleviate management succession problems[43] or provide needed management depth.[44]

OTHER PUBLIC BENEFITS. Other significant benefits to the public which have been cited in the Board's orders include: (1) agreement by the applicant holding company to lower its management fees charged its subsidiary banks,[45] (2) the correction of an unfair competitive situation,[46] and (3) the continuation of a particular financial service being provided in an area.[47]

THE TREATMENT OF PUBLIC BENEFITS BY THE BOARD IN APPLICATIONS THAT WERE DENIED

An important consideration regarding the Board's public benefits test is the circumstances under which an applicant's claimed public benefits would outweigh or be outweighed by adverse effects expected to arise from the transaction. Some insight into this issue may be gained from an examination of the factors that resulted in the denial of bank holding company applications—both in bank and nonbank proposals.

NONBANK ACQUISITIONS. As of February 1974, twenty-five orders of denial under Section 4(c)(8) were published in the *Federal Reserve Bulletin*. In addition, four orders of denial were published in other sources. These cases represent a very small percentage of the total number of nonbank applications. Table III gives the distribution of applications by the type of activity and the Board's record of denials and approvals of holding companies' proposed nonbank acquisitions as of year-end 1973. The table shows that about 90 percent of the applications were approved. Most applicants have recognized that the acquisition of close competitors or of major firms where smaller ones are available would encounter stiff Board opposition. Moreover, the Board's practice of formally determining permissible nonbank activities has precluded many opportunities for denial.[48]

In eleven of these denials, public benefits were not treated in detail—i.e., the benefits the applicants claimed would result from the acquisition were not mentioned or received only brief mention in the order.[49] Apparently in these cases the Board believed the adverse effects from the reduction of existing and potential competition or the undue concentration of resources to be so obvious and overwhelming and/or the benefits to be so weak that no explicit treatment was deemed necessary.

In eighteen cases in which the proposals were denied, the Board treated the public benefits explicitly. In these orders the Board not only discussed the expected adverse effects, but enumerated each of the applicant's arguments as regards public benefits and, in turn, presented its observations on each argument.

Half of the eighteen denials involved the proposed acquisition of a mortgage banking firm. In every one of these cases disapproval was based primarily on the reduction of existing and/or potential competition. One benefit claimed

[41] First National City Corporation (38 FR 31711).

[42] See Continental Bancor, Inc. (71 FRB 676).

[43] See, for example, Depositors Corporation (71 FRB 36) and Northwest Bancorporation (73 FRB 701)—bank and nonbank cases, respectively.

[44] First Banc Group of Ohio (71 FRB 418).

[45] Bank Securities Inc. (72 FRB 280).

[46] Newport Savings and Loan Association (72 FRB 313) and Old Colony Co-Operative Bank (72 FRB 417). As a result of various legal and regulatory restrictions, savings and loan associations in Rhode Island have been at a competitive disadvantage with respect to other thrift institutions in providing checking account services. Mutual savings banks have been able to issue demand deposits through commercial bank subsidiaries acquired prior to 1971. Since 1971, credit unions with shares of more than $1 million have been permitted to accept demand deposits. Noting this competitive disadvantage, the Board has allowed each of the above savings and loan associations to become a bank holding company and acquire a commercial bank in Rhode Island.

[47] American Fletcher Corporation (38 FR 14203).

[48] There have been four proposed nonbank acquisitions that were denied on the grounds that the activities were not closely related to banking. See R.I.H.T. Corporation (72 FRB 595), First Commerce Corporation (72 FRB 674), and Marine Midland Banks, Inc. (72 FRB 676). BankAmerica's proposed formation of BAC Computer Corporation—a nonpayout computer leasing firm —was denied by letter in 1972.

[49] See, for example, U.S. Bancorporation (72 FRB 177) and Crocker National Corporation (72 FRB 419).

by practically all of the nine applicants was that affiliation would result in the mortgage firm's assured access to greater working capital at more competitive rates. The Board responded to this argument with the following:[50]

> While the acquisition of a mortgage company by a bank holding company could have the effect of strengthening the company in certain markets, it appears certain that such increased ability and service, if it came from a bank holding company not now competing or not likely to compete in the market, would have a substantially more desirable impact on the public interest.

In some instances the Board considered such claims to be "essentially conjectural".[51] Governor Bucher explained, in his concurring statement in two cases involving acquisitions by the Mellon National Corporation[52] and the Manufacturers Hanover Corporation,[53] that:

> Serious questions can arise as to whether the public benefits relating to operating efficiency, better services, and lower cost, which are frequently ascribed to proposed affiliations of mortgage banking firms with bank holding companies, exist to a significant degree, especially when larger firms are involved. The advocacy voiced by applicants may not reflect the actual probability of the occurrence of the asserted benefits. Bank holding companies bear the burden of demonstrating that their proposed nonbanking acquisition will have public benefits outweighing any adverse effects, inasmuch as the basic balancing test of Section 4(c)(8) requires a showing of public benefits.

[50] BTNB Corporation (72 FRB 70). See also Marine Bancorporation (72 FRB 504) and Philadelphia National Corporation (73 FRB 913).

[51] See Manufacturers Hanover Corporation (73 FRB 532) and First Tulsa Bancorporation (72 FRB 317). The Board later reconsidered the former case subsequent to an order of denial and approved this acquisition after the applicant submitted pertinent new information. Moreover, the applicant agreed to eliminate a covenant not to compete from various employment agreements. Such covenants, if unreasonably restrictive, have been cited by the Board as anticompetitive—see Manufacturers Hanover Corporation (73 FRB 908). For a further discussion of the Board's view on covenants not to compete, see order denying Citizens and Southern National Bank's acquisition of Ison Financial Corporation (74 FRB 136).

[52] 73 FRB 910.

[53] 73 FRB 908.

Several other cases, denied because of anticompetitive effects, include proposed acquisitions of a sales finance firm,[54] consumer finance companies,[55] and an industrial loan and thrift company.[56]

One denial related to a leasing firm[57] where the principal difficulty involved possible adverse effects for the banking affiliates of the holding company. Chemical New York Corporation sought to acquire CNA Nuclear Leasing, Inc. —a firm which had a high debt-equity ratio and would have required heavy financing to meet its long-term growth objectives. Such an affiliation would have required Chemical to increase its short-term borrowings substantially, possibly sapping the financial strength of the company. In its order of denial, the Board stated that "one of the primary purposes of a holding company is to serve as a source of financial strength for its subsidiary banks". It concluded that this acquisition would reduce Chemical's ability to supply capital to its banks in the future.

Three of the eighteen orders which involved explicit treatment of public benefits were denied on grounds that included undue concentration of resources. These involved BTNB Corporation,[58] First National City Corporation,[59] and The Chase Manhattan Corporation.[60] The latter two orders presented detailed discussions of the applicants' arguments relating to benefits to the public.

First National City Corporation named the following benefits: (1) the affiliation of applicant and Advance Mortgage Corporation (this was a retention application) had made available funds which allowed Advance to increase its volume of originations of construction loans; (2) the applicant allowed Advance to originate and warehouse $30 million of mortgages without investor take-out commitments—this, the applicant contended, had a countercyclical effect on the flow of funds into mortgage lending; and (3) the applicant would expand Advance's geographic operations.

The Board, however, argued as regards (1) that the construction loans of the applicant's bank had increased by a greater margin during this period than did those of Advance. Moreover, the Board noted that originations of one-

[54] First Commercial Banks, Inc. (73 FRB 118).

[55] First National Holding Corporation (73 FRB 203) and Bankers Trust New York Corporation (73 FRB 694).

[56] Tennessee National Bancorporation (73 FRB 700).

[57] Chemical New York Corporation (73 FRB 698).

[58] 72 FRB 71.

[59] 74 FRB 50.

[60] 74 FRB 142.

Table III

BANK HOLDING COMPANY EXPANSION IN NONBANKING ACTIVITIES, 1971-73

Type of activity	Total de novo notifications*	Proposed acquisitions decided by Board of Governors			
		Total	Approved	Denied†	(percent) Approval rate
Finance company (consumer, commercial, general)	148	86	80	6	93.0
Mortgage banking	173	64	55	9	86.0
Insurance (broker or agency, underwriting)	80	55	51	4	92.7
Leasing personal property	123	12	10	2	83.3
Advisory services	92	8	5	3	62.5
Data processing	54	6	6	0	100.0
Trust	13	6	6	0	100.0
Factoring	22	7	7	0	100.0
Community development	13	1	0	1	0.0
Industrial banks	0	7	6	1	85.7
Other	2	7	6	1	85.7
Total	720	259	232	27	89.6

Note: Applications are classified by primary activity only.
* Through June 30, 1973.
† Includes the denial of proposed acquisitions of three *de novo* firms.
Source: Board of Governors of the Federal Reserve System.

to four-family mortgage loans by Advance had increased by a lesser margin than the industry as a whole. As regards (2) the Board noted that both affiliated and independent mortgage banking firms appeared to warehouse an increased volume of mortgages during periods of tight money. With respect to (3) the Board called attention to the applicant's resources which give it the capability to enter new markets *de novo* or through the acquisition of a smaller firm. In addition, the Board was evidently concerned with the possible adverse implications of the acquisition of the third largest mortgage banking firm in the nation by the second largest banking organization. The application was denied on the grounds of reduced existing and potential competition and an undue concentration of resources.

The Chase Manhattan Corporation's proposed acquisition of Dial Financial Corporation[61] was another application recently denied primarily on the grounds of undue concentration of credit-granting resources and the elimination of potential competition. The applicant stated that the proposed affiliation would result in the diversification by Dial into such product lines as small business loans, farm loans, and first and second mortgage loans. The Board noted that many consumer finance companies are diversifying into these areas and that Dial has the ability and resources to do so. The order also declared that Dial is capable of opening new offices and, indeed, appears to have planned to do so in the absence of the affiliation. The Board noted that, while rate reductions on consumer loans constitute a significant public benefit, it considered Chase's proposal in this area similar to one that Dial had already instituted and had the resources to expand.

On the subject of increased availability of capital and credit to Dial, the Board noted that Dial was well able to obtain funds in national markets and that its rate of return on equity significantly exceeded the industry average. The Board summarized its arguments in this case as follows:

> While the proposed acquisition would clearly lead to some public benefits, there is little indication that the above or other claimed benefits are not likely to be obtained in the absence of the acquisition.

[61] 74 FRB 142.

Moreover, the Board's order noted the following as regards the issue of concentration of resources:

> . . . the issue of concentration in credit-granting resources . . . was within the intent of Congress in enacting the 1970 Amendments. While the matter is not free of doubt and is one on which reasonable differences of judgment may occur, the Board has concluded that, at a minimum, this factor weighs against approval of the application.

BANK ACQUISITIONS. In the Board's denials of proposals by bank holding companies to acquire banks, the principal adverse factors have involved a lessening of existing or potential competition, a weakening of the financial and/or managerial condition of the bank, and unsound banking practices. When considering the proposed benefits embodied in these applications, the Board has not been willing to conclude that the gains from prospective new services would offset the adverse factors unless it was satisfied that the community involved had significant unmet needs that would be fulfilled. In this regard, the Board denied at least three cases where competition or financial factors were adverse and it concluded that the community was already being served adequately.[62]

In the case involving Cegrove Corporation, the Board determined that the applicant would be unable to service the debt incurred in financing the acquisition and suggested that the capital position of both the bank to be acquired and the existing subsidiary bank might consequently be impaired. As a benefit, the applicant proposed to offer services that were not being offered by the banks involved. However, the Board determined that the relevant markets were being adequately served and, therefore, concluded that "considerations relating to the convenience and needs of the community to be served are regarded as consistent with, but lend no weight toward, approval".[63]

In the case of First International Bancshares, Inc., the Board determined that the acquisition would eliminate both existing competition and a foothold for another potential entrant to the market and would also increase deposit concentration among the largest organizations in the market. The Board concluded that the needs of the residents of the Dallas area were being adequately served by the existing facilities, and that consummation of the proposed acquisition would have little impact. The Board determined, therefore, that the benefits would not outweigh the adverse competitive effects.

Some cases have been denied when there was no existing competition between the holding company's subsidiary banks and the bank to be acquired. One such case (subsequently approved a year later) involved the proposed acquisition of Citizens National Bank, Englewood, New Jersey by Midlantic Banks Inc., Newark.[64] With five governors voting, the Board concluded that the acquisition would result in: (1) the foreclosure of a substantial amount of potential competition, (2) the elimination of a desirable foothold entry for holding companies located in other banking districts within the state, and (3) the possible development of a trend toward concentration within banking districts. The Board determined that the public benefits from the applicant becoming an additional competitive alternative for large customers in the market were not sufficient to outweigh the adverse effects. The Board further concluded that consummation of the acquisition would have an adverse effect on the convenience and needs of the community since it would preserve home-office protection.[65]

In another denial[66] in which existing competition was not an issue, the Board expressed its concern over the size disparity among the holding companies in Texas and the likelihood that the concentration of deposits among the five largest holding companies might increase as a result of the acquisition. The Board stated that it

> is not required to await the development of undue concentration among bank holding companies in Texas before it intervenes. Indeed, the underlying purpose of the Clayton Act, as incorporated in The Bank Holding Company Act, is to break the force of a trend toward undue concentration before it gathers momentum. . . . It is, therefore, the tendency toward undue concentration the Board must guard against

[62] See, for example, Central Bancorporation, Inc. (73 FRB 461), Cegrove Corporation (73 FRB 676), and First International Bancshares, Inc. (73 FRB 453).

[63] The Board subsequently approved the acquisition after Cegrove offered to raise additional equity capital (39 FR 8387).

[64] 71 FRB 684.

[65] In 1972, as the holding company movement in New Jersey gathered momentum, the applicant reapplied and the Board in a four-to-three decision approved the acquisition after the applicant indicated that it would move the head office of the bank. This move would open its previous home community to branching by other banks.

[66] First International Bancshares, Inc. (74 FRB 43).

> when viewing the probable effect of an acquisition upon future competition in a banking market.

The Board further concluded that the entry into small markets by the state's largest holding companies through the acquisition of large independent banks would increase the levels of concentration in these markets.

In the cases discussed above, as well as others, the Board concluded that the financial and managerial conditions of the bank and the holding company and their future growth prospects were satisfactory. It, therefore, considered these factors as consistent with approval. However, in none of these cases did these factors lend any weight toward approval.[67]

On March 1, 1974, in an order of denial involving another proposed acquisition by First International Bancshares, Inc.,[68] the Board reaffirmed its position of guarding

> against the tendency toward undue concentration not only in a local market but at the Statewide level as well when viewing the probable effect of an acquisition upon potential competition.

The Board concluded that the acquisition would have significantly adverse effects on potential competition in the local banking market and throughout Texas.

In discussing the applicant's proposal to inject equity capital into the bank to be acquired, the Board stated that affiliation with First International Bancshares was not the only means by which the bank's financial resources could be strengthened. The Board indicated that the acquisition of the bank by a smaller holding company could result in similar assistance without the anticompetitive effects attached to the proposal then under consideration. The Board recognized that the applicant's managerial resources and expertise would be available to the bank if the affiliation were approved, resulting in new services being offered to the public, both of which would lend weight toward approval. Nevertheless, it concluded that banking factors and convenience and needs considerations did not outweigh the substantially adverse effects the proposal would have on potential competition.

In at least two cases in which it denied the acquisition of *de novo* banks, the Board found that adverse competitive effects were likely because the applicant was already represented in the market. The Board concluded that further offices would raise barriers to entry by other organizations and increase concentration of banking resources in the market. It held that the proposed benefits (i.e., the addition of new services not readily available in the market) did not lend sufficient weight to offset the adverse effects.[69] In another denial,[70] the Board concluded that a recently established bank would be hurt by the opening of yet another *de novo* bank in the same market and, consequently, that the proposed new bank would have an adverse effect on the development of future competition. In discussing the applicant's claim that the convenience of the community would be enhanced because the new bank would be closer to its potential customers than existing banks, the Board held that this factor lent very little weight toward approval.

PUBLIC BENEFITS IN RETROSPECT

Many public benefits, such as infusions of equity capital, access to lower cost funds, or economies of scale are indirect and yield gains to the public only if the consumer realizes lower prices or better services. Governors Robertson and Brimmer have noted that "it is the public's interest—not Applicant's—that is paramount".[71] In a majority of cases in which the Board has approved applications where the public benefits are indirect, it has done so on the grounds that direct gains to the public would eventually be forthcoming.[72]

In proposals where the anticompetitive effects were either slight or nonexistent, the published orders seldom dwelt on the public benefits of the case. Frequently, the Board has stated that the "banking factors are regarded as consistent with approval" and that "considerations relating to the convenience and needs of the communities to be served are also consistent with approval of the application".[73] Or that ". . . Applicant will give [the company] access to the greater resources of Applicant, and

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[67] See also Dominion Bancshares Corporation (74 FRB 49) and Southeast Banking Corporation (73 FRB 460).

[68] 74 FRB 290.

[69] See Security Financial Services, Inc. (70 FRB 834).

[70] First at Orlando Corporation (73 FRB 302).

[71] See dissenting statement, Chemical New York Corporation (72 FRB 165).

[72] In a speech before the Bank Counsel Seminar of the California Bankers Association on April 26, 1974, Governor Jeffrey M. Bucher emphasized that "the Board requires measurable indications of gains for the public from bank holding company acquisitions, [and] . . . the Board has moved significantly in the direction of making those gains quite specific".

[73] See C.B. Investment Corporation (71 FRB 142), for example.

enable it to compete more effectively".[74]

It is perhaps more significant that the Board's treatment of public benefits suggests only a narrow range within which the types of benefits discussed in this paper would sway the Board when important adverse factors are present in a proposal. Our study indicates many instances where the benefits that might ordinarily be considered significant were viewed as insufficient to outweigh substantially adverse effects. For example, the denial of First Commercial Bank's acquisition of Schenectady Discount Corporation[75] was based primarily on anticompetitive grounds. But a benefit (i.e., that the injection of capital would enhance loan expansion) claimed by the applicant —and recognized in other applications[76]—was discounted by the Board in this case. The Board noted that this benefit "could be achieved by the investment by Applicant of capital funds into its own mobile home sales finance operations".

A similar example may be found in the order denying First National City Corporation's retention of Advance Mortgage Corporation (cited above). As discussed previously, the Board discounted the applicant's argument that the affiliation had made funds available to Advance which, in turn, increased the latter's volume of originations of mortgage and construction loans.

The overall results of our study suggest that public benefits provide the strongest support for an application when the benefits are concrete, when they result in the alleviation of a specific problem, or when they result in lower prices or increased services to the public. Applicants must recognize that such benefits are essential in cases where even a small amount of competition would be eliminated. Yet the value of substantive benefits is increasingly uncertain the more severe are the anticompetitive or other adverse factors perceived by the Board.

[74] Patagonia Corporation-Model Finance Company (72 FRB 170).

[75] 73 FRB 118.

[76] First Virginia Bankshares Corporation (73 FRB 202).