

FEDERAL RESERVE BANK OF NEW YORK



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The Business Situation

The latest business statistics indicate that the economic recovery is continuing at a fairly vigorous pace. During February, retail sales advanced strongly and industrial production moved up at a moderate rate. The increase in economic activity has been reflected in significant gains in employment, and the unemployment rate eased further to 7.5 percent in March. In the last few months, consumer buying has contributed major strength to the recovery. Consumers have stepped up their purchases of big-ticket items, such as automobiles and appliances, putting the economic recovery on a much more solid footing than it was in earlier stages. At the present time, the main weak spot is plant and equipment spending which has failed to show any clear-cut signs of an incipient upturn. Although demand for these investment goods remains weak, the index of leading indicators continues to signal further expansion in the near term.

Inflation has slowed markedly at both the retail and wholesale levels in recent months. Consumer prices rose at a 1.4 percent annual rate in February, the lowest inflation rate in over four years. Wholesale prices were also a source of favorable news, as they increased only slightly in March and remained below December levels. To some extent, however, the recent moderation in inflation has reflected declines in the prices of food and energy items, and it would be overly optimistic to extrapolate the recent experience far into the future. Nevertheless, inflation rates well below the double-digit level appear in prospect.

INDUSTRIAL PRODUCTION AND INVENTORIES

During February, the Federal Reserve Board's index of industrial production registered a 0.5 percent increase, the tenth consecutive monthly advance. The February rise was fairly broadly based across industry and market groupings, an encouraging sign that the economic recovery is now on a solid footing. While industrial production in February stood 9.3 percent above the cyclical trough,

it still has a way to go before the ground that was lost in the recession is fully recovered. Even at recent robust rates of advance, industrial production would not reach its November 1973 peak until early 1977. In fact, only in the nondurable consumer goods sector has the pre-recession peak in output been exceeded.

The automotive sector contributed substantially to the industrial output rise of February, and the available information suggests that a strong gain also occurred in auto output in March. Auto assemblies were up 200,000 units from the improved February level, reaching an 8.3 million unit seasonally adjusted annual rate in March. In recent months the automotive industry has experienced a dramatic improvement in demand from the depressed level earlier in the recovery. Sales of domestic automobiles, which had been essentially flat from late July to November, have picked up considerably since then. Indeed, in February and March, unit sales of domestic automobiles averaged 8.75 million at an annual rate. This represents a 15 percent advance over November and is the highest sales rate since August 1974. While auto manufacturers have stepped up production by a sizable amount, the increase has not been large enough to match the expansion in sales and auto inventories have declined. According to industry sources, an inventory stock equal to about 60 days' supply is regarded as the minimal reserve for the spring selling season. Inventories have been drawn down well below this level, reaching about 50 days' supply at the end of March. It is, therefore, no surprise that the automobile manufacturers reportedly plan to boost their production in the next few months, especially for the larger car models which are in particularly short supply.

In other industries as well, inventory building is likely to be a source of upward thrust in the near future. By the end of last year, it seemed that most businesses had run down their once excessive inventories to the point where further reduction might have resulted in interruptions in the productive process as well as in delays on deliveries of finished goods. Indeed, some analysts asserted that the

declines in November and especially in December were unintended, resulting from unexpectedly strong sales. Recent data suggest that some rebuilding of stocks has begun. The book value of business inventories increased \$1.2 billion in January, as gains were recorded in the wholesale trade, retail trade, and manufacturing sectors. Yet, despite the sizable accumulation, the inventory-sales ratio declined further to a level which is low by historical standards. February data for the manufacturing sector indicate that nondurables manufacturing inventories continued to increase, while the change in durables manufacturing inventories turned positive for the first time in a year. The February accumulation was modest, however, and inventory-sales ratios decreased further in both durables and nondurables manufacturing, as shipments continued to advance rapidly. As a result, substantial further inventory accumulation is likely to be necessary to bring stocks to a comfortable level.

NEW ORDERS AND LEADING INDICATORS

Led by a 28.8 percent surge in orders for automotive equipment, new orders received by durable goods manufacturers spurted 7.4 percent over the three months ended in February. Orders for nondefense capital goods exhibited a modest 1.1 percent advance over the same period, however, and new orders for machinery and primary metals have shown only moderate momentum. The lag of new orders in these industries is important because past movements in new bookings have tended to be fairly reliable advance indicators of changes in economic activity.

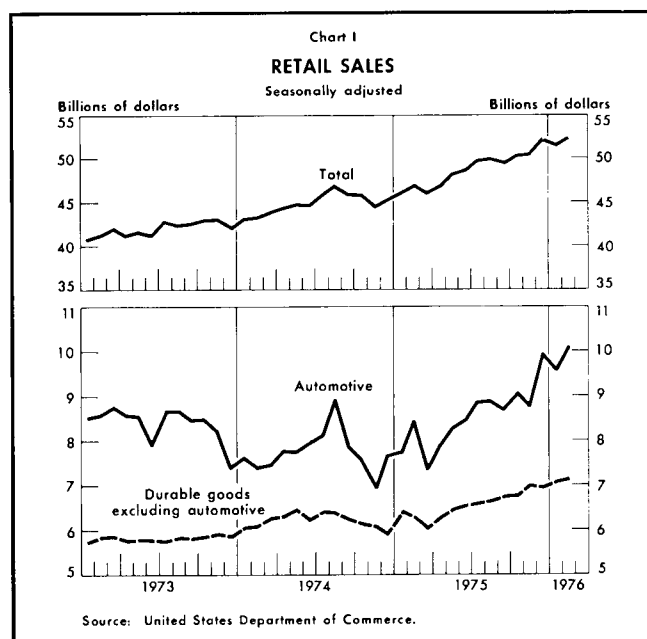
The Commerce Department's composite index of leading indicators has resumed its advance following last fall's sluggish performance, which had caused considerable apprehension. The index has increased 3 percent since November. Eight component series rose, contributing to February's 0.8 percent gain, while three components fell. Though the February increase was well below the revised 1.5 percent January spurt, the recent performance of the leading indicators provides corroborating evidence of a near-term continuation of the recovery.

PERSONAL INCOME AND RETAIL SALES

In February, personal income rose \$12.9 billion, a slightly smaller gain than in the preceding month but one well above that averaged in 1975. A part of the February increase was attributable to a speedup in certain veterans' benefits, as well as to the receipt of a Federal earned income tax credit (for calendar 1975) by some low-income households with dependent children. Wage and salary

disbursements also continued to climb, although the advance was somewhat smaller than in prior months. Over the last three months, wages and salaries have increased at a robust 11 percent annual rate.

The quickening pace of consumption spending that occurred at the end of last year has carried over into the current year. Retail sales had shown comparatively little growth from July to November but have risen strongly since then (see Chart I). In February, total retail sales increased \$0.8 billion and were 4.1 percent above the November level. Though the recent gains have been widespread among the major spending categories—nondurable and durable goods—the rise in spending for durable goods has been most marked. Since November, retail durable sales have advanced 9.3 percent. Looking ahead to coming months, further gains in consumption spending would appear to be in the offing. The unemployment picture has brightened considerably, as has the economic outlook in general. Moreover, the heady advance in the stock market in recent months has substantially restored the wealth positions of many consumers. These favorable developments may facilitate future sizable increases in consumption outlays, particularly for durable goods. Indeed, according to the latest surveys, there has been a sharp rise in consumer confidence, which is usually associated with willingness to spend.



RESIDENTIAL CONSTRUCTION AND CAPITAL SPENDING

Residential construction activity reportedly rose sharply in February, as housing starts spurted ahead 27 percent on a seasonally adjusted basis. The previous three months had shown declines. It has been suggested, however, that the huge February increase may have been overstated due to the application of standard seasonal adjustment procedures. February is typically a cold and wintery month in which residential construction is rather low, so that the reported number of starts is blown up to get seasonally adjusted housing starts, an estimate which eliminates the usual impact of weather in February and permits comparison with other months. This February, however, the weather was unusually mild in the colder regions of the country and construction occurred at an unusually high rate for that time of the year. Hence, for this February, the usual seasonal factor for housing starts resulted in too high a level of seasonally adjusted starts, thus accounting for the appearance of a February spurt. To the extent that construction slated for the spring months began early, housing starts in coming months will tend to be somewhat lower than otherwise. Nevertheless, the outlook for residential construction continues to improve. Permits to build new housing units advanced 13.3 percent during the first two months of this year. The recovery in this sector has been dramatic, with permits up about 60 percent from their low point of a year ago.

Demand will probably improve further, as personal income continues to rise and fears of layoff recede. In the Federal National Mortgage Association April 5 auction, both government-underwritten and conventional mortgage rates declined. Conventional mortgage rates fell from their October peak of 10.02 percent to 9.05 percent in April, while government-underwritten mortgage rates dropped 1.01 percent over the same period. These factors may contribute to housing demand during coming months.

Business fixed investment appears unlikely to contribute much stimulus in the near term. At present, business firms possess substantial excess capacity. Indeed, the current large overhang of excess productive capacity appears to be the principal factor underlying the pessimistic response obtained by the recent Commerce Department survey of planned plant and equipment spending. The latest survey, conducted during January and February, indicates that planned business fixed investment expenditures for 1976 will be 6.5 percent above 1975 levels. Different sectors exhibit a wide divergence in spending plans. The public utilities plan a 15.4 percent increase in plant and equipment spending, while transportation industries

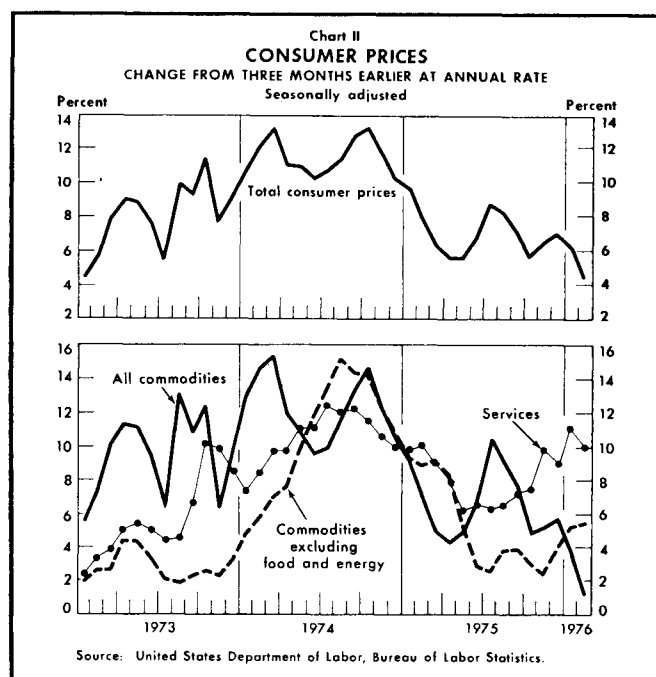
(rail, air, etc.) plan sizable cuts in investment expenditures. The scheduled increase in the manufacturing sector is 8.1 percent—stronger than the total—due to the rapid planned advance of capital spending by the nondurables producers. Overall, however, if this survey is accurate, capital spending in real terms is likely to be up only slightly, if at all.

In interpreting the outlook for business capital spending, several other points are worth noting. First, low capital spending is common in the early part of a recovery. Typically, production strengthens because of increasing demand, and then firms decide to expand capacity. Moreover, many firms tend to underpredict the growth of sales during an upturn and therefore underestimate their capacity requirements. Second, the high backlog of unspent appropriations suggests that there could be a very short lead time to capital spending once businesses decide to go ahead with investment. Third, the costs of financing investment are down. Internally generated funds have exhibited a recent surge and, according to the McGraw-Hill survey, pretax business profits are expected to increase an additional 18 percent in 1976. Equity financing opportunities have been enhanced by the recent rise in stock prices. And last year's worries concerning the possibility that Treasury borrowing would crowd out private investment financing seem to have been largely dispelled. Indeed, the interest rate on long-term debt is now slightly lower than at the recession trough.

PRICES

At both the wholesale and retail levels, inflation has moderated in recent months, in large part because of reduction in food and energy prices. Wholesale prices edged up in March following declines in the previous two months. Prices of farm products and processed foods and feeds were down slightly after four months of sizable drops. With retail food profit margins rather high, some further declines in consumer food prices are likely. Wholesale prices of industrial commodities advanced at a 4.7 percent annual rate which brought the average rate of increase in the first quarter of 1976 to 3.6 percent, a marked improvement from the last half of 1975.

Consumer prices rose a modest 0.1 percent in February, the best monthly performance in over four years. Overall, the performance of the consumer price index during recent months has been quite encouraging (see Chart II). A good part of the recent slowdown in prices, however, is attributable to declines in food prices—a volatile component which is usually not indicative of general price trends—and to declines in energy prices,



resulting in part from recent legislation. Excluding these items, the past three months' experience is somewhat less favorable. For example, consumer commodity prices other than food and energy increased at a rate of 5.5 percent per annum during the three months ended in February, and prices for services advanced at a 10 percent annual pace over this interval. While the favorable behavior of wholesale prices probably augurs well for the consumer price index in the near term, over the longer term inflation may well be more of a problem. One concern is the rate of wage

increase over the coming year. The calendar of scheduled union contract negotiations is quite heavy for 1976, and the terms in the new contracts will have an important impact on overall labor costs.

LABOR MARKET CONDITIONS

Labor market conditions continued to improve in March. Reflecting the trends in production and sales, nonagricultural employment increased by 191,000, its ninth consecutive month of gain, and the rate of unemployment edged down further to 7.5 percent. The March unemployment drop was quite small, as 264,000 new workers entered the labor force looking for work. The extent and duration of joblessness have fallen dramatically. Since last May, employment gains have far outstripped labor force growth, reducing the number of unemployed workers by 1.2 million. Moreover, in recent months, there has been a sharp drop in the number of persons reporting extended unemployment of more than fifteen weeks' duration. Only 2.4 percent of the labor force had been unemployed for fifteen weeks or longer, according to the March survey, compared with 3.3 percent in December.

Improving employment conditions appear to be drawing previously discouraged persons into the work force. In the third quarter of 1975, the Labor Department estimated that 1.2 million such discouraged workers had decided not to search for jobs, despite desiring work, because they believed no jobs were available; in the first quarter this number averaged 0.9 million. With sales continuing to expand, further employment gains appear certain during coming months. If labor force growth picks up in response to improved employment prospects, however, the unemployment rate may tend to recede more slowly in coming months than it has since May.

The Money and Bond Markets in March

Interest rates in the money and bond markets were about unchanged on balance over March. During the first week of the month, a temporary rise in the Federal funds rate led market participants to believe that the Federal Reserve was moving toward a less accommodative policy stance. In response to this, nearly all short-term and other interest rates increased abruptly. These increases were reversed in trading over the remainder of the month, as market participants decided that their apprehensions were unwarranted. The short-term markets were also bolstered by the uncommon absence of net new issues of Treasury bills in the regular weekly auctions, as nearly all new cash raised by the Treasury during March was obtained in longer term issues.

The pattern of long-term interest rate movements was similar to the one followed by short-term rates. The improvement in market sentiment as the month progressed generated good investor demand, and substantial new financing in the Treasury coupon, corporate, and tax-exempt markets was readily accomplished. New issues and trading in the secondary market also appear to have benefited from the report that price increases in February had been modest. In addition, prices of state and local obligations, which had lagged behind during the rally in other sectors, adjusted upward. Reports of progress in resolving the financial problems of certain New York State agencies contributed to the more optimistic outlook.

Preliminary estimates indicate that the narrowly defined money stock (M_1) continued to rise moderately in March. A deceleration in the growth of consumer-type time and savings deposits, however, reduced the rapid expansion of the broadly defined money stock (M_2). Another decline in large negotiable certificates of deposit (CDs) held the bank credit proxy to a small increase.

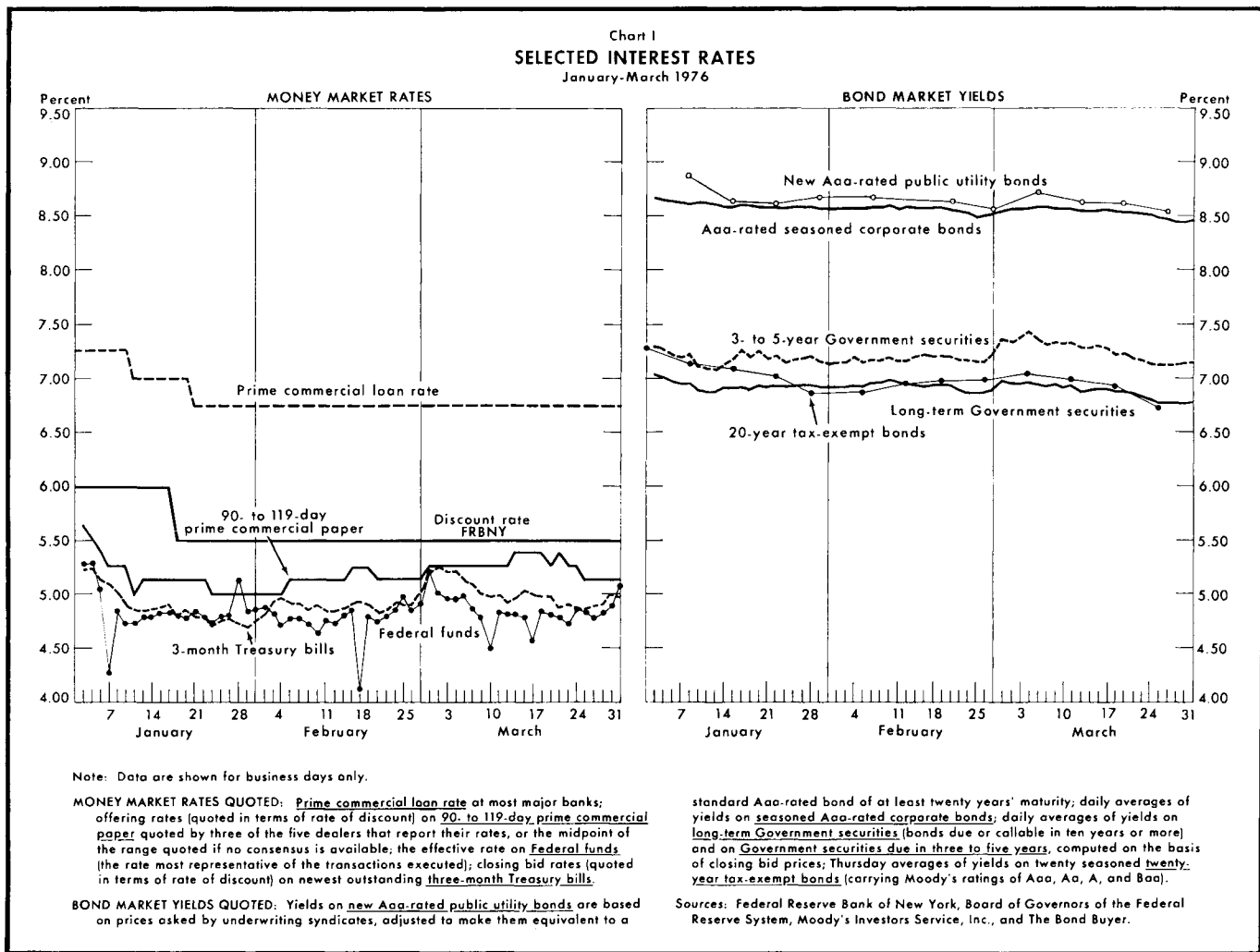
THE MONEY MARKET AND THE MONETARY AGGREGATES

Although the Federal funds rate increased sharply during the first week of March, it soon began to recede to about the levels that have prevailed since shortly after the

start of the year. The effective rate on Federal funds averaged 4.84 percent during the month, compared with a 4.77 percent average for February (see Chart I). After rising at the beginning of the month, rates on most money market instruments declined to levels near those prevailing at the end of the previous month. At the end of March, yields on 90- to 119-day dealer-placed commercial paper were $5\frac{1}{8}$ percent, unchanged from the level at the end of February. Rates on 90-day bankers' acceptances fell by 5 basis points over the month to 5.10 percent. Large negotiable CDs maturing in ninety days traded in the secondary market at 5.23 percent at the end of the period, an increase of 3 basis points over the month. Member bank borrowings from the Federal Reserve fluctuated around frictional levels (see Table I), as the discount rate remained above the rate on Federal funds.

Business demand for bank loans continued to exhibit the weakness which has been characteristic throughout the current recovery. Over the five statement weeks ended March 31, commercial and industrial loans at large commercial banks fell by \$1,676 million. For comparable periods in the preceding two years, these loans showed an average increase of about \$4 billion. The demand for business loans has also been unusually sluggish relative to the early stages of past business upturns. In February, business loans at all commercial banks (seasonally adjusted and including loans sold to affiliates) were about 2 percent below their level in April 1975, about the beginning of the economic recovery. At the same stage of the previous four recoveries, these loans exceeded levels at their respective troughs by a range of $2\frac{1}{2}$ to 5 percent. The unusually long lag in the response of loans to the current economic upswing is accounted for, in part, by more rapid advances in corporate liquidity and slower growth in inventories (which are usually financed by bank loans) than has been experienced in other recoveries.

Preliminary data indicate that the faster growth in M_1 that began in February continued during March. Over the four weeks ended March 24, M_1 —private demand deposits plus currency outside commercial banks—advanced at a seasonally adjusted annual rate of 5.3 percent from its



level over the previous four weeks, bringing growth over the four weeks ended fifty-two weeks earlier to 4.9 percent (see Chart II). As a consequence of sharp decelerations in time and savings deposits in March, however, growth in $M_2 - M_1$ plus these deposits—was somewhat more modest than in recent months. Compared with its average level in the previous four weeks, M_2 in the first four weeks of March grew at an 8.5 percent rate. This brought the growth rate from the four weeks ended fifty-two weeks earlier to 9.3 percent. After a moderate increase in February, the bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—resumed its recent lackluster performance and

rose by only 0.3 percent above its level over the previous four-week period, as large negotiable CDs continued to decline sharply in response to the weak demand for bank loans.

THE GOVERNMENT SECURITIES MARKET

Interest rates on United States Treasury bills during March were little changed from February, although they sustained a sharp increase at the beginning of March before gradually returning to earlier levels. According to market observers, the initial increases represented a sharp reaction to the temporary rise in the Federal funds rate

Table I
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, MARCH 1976

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

Factors	Changes in daily averages—week ended					Net changes
	March 3	March 10	March 17	March 24	March 31	
"Market" factors						
Member bank required reserves..	+ 93	+ 396	— 235	+ 80	— 384	— 50
Operating transactions						
(subtotal)	+466	+3,239	— 165	—3,894	+1,493	+1,139
Federal Reserve float	—816	+ 477	— 144	— 375	— 411	—1,269
Treasury operations*	+995	+2,743	+1,196	—2,929	+1,274	+3,279
Gold and foreign account	— 34	+ 24	+ 26	— 5	+ 21	+ 32
Currency outside banks	+383	— 306	— 880	— 585	+ 600	— 788
Other Federal Reserve liabilities and capital	— 63	+ 301	— 366	+ 2	+ 10	— 116
Total "market" factors	+559	+3,635	— 400	—3,814	+1,109	+1,089
Direct Federal Reserve credit transactions						
Open market operations						
(subtotal)	— 93	—4,051	+ 427	+3,543	—1,002	—1,176
Outright holdings:						
Treasury securities	+334	—2,090	+1,203	+1,093	— 492	+ 48
Bankers' acceptances	— 25	— 36	— 20	— 56	— 14	— 151
Federal agency obligations	+254	+ 42	—	—	—	+ 296
Repurchase agreements:						
Treasury securities	—767	—1,502	— 646	+2,090	— 577	—1,402
Bankers' acceptances	+138	— 379	— 101	+ 191	+ 98	— 53
Federal agency obligations	— 27	— 86	— 9	+ 225	— 17	+ 86
Member bank borrowings	— 64	— 37	— 6	+ 36	— 40	— 111
Seasonal borrowings†	— 2	—	—	—	+ 2	—
Other Federal Reserve assets‡	+122	+ 151	+ 115	+ 154	+ 188	+ 730
Total	— 36	—3,937	+ 537	+3,732	— 855	— 559
Excess reserves§	+523	— 302	+ 137	— 82	+ 254	+ 530

Member bank:	Daily average levels					Monthly averages
	March 3	March 10	March 17	March 24	March 31	
Total reserves, including						
vault cash‡§	34,094	33,396	33,768	33,606	34,244	33,822
Required reserves	33,677	33,281	33,516	33,436	33,820	33,546
Excess reserves§	417	115	252	170	424	276
Total borrowings	84	47	41	77	37	57
Seasonal borrowings†	8	8	8	8	10	8
Nonborrowed reserves	34,010	33,349	33,727	33,529	34,207	33,764
Net carry-over, excess or deficit (—)¶	— 26	175	9	6	67	46

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

* Includes changes in Treasury currency and cash.

† Included in total member bank borrowings.

‡ Includes assets denominated in foreign currencies.

§ Adjusted to include waivers of penalties for reserve deficiencies in accordance with the Regulation D change effective November 19, 1975.

|| Average for five weeks ended March 31, 1976.

¶ Not reflected in data above.

early in the month. As a consequence, 52-week bills were sold in the regular auction on March 3 at an average yield of 6.01 percent, 44 basis points higher than rates obtained at the auction four weeks earlier (see Table II). After upward rate pressures in the money market disappeared, however, the average yield on 52-week bills auctioned at the end of the month fell to 5.78 percent. At the last regular auction in March of three- and six-month bills, average yields were 4.93 percent and 5.33 percent, respectively, up 6 and 12 basis points from average yields on February 23. For the first month in a year and a half, little new cash was raised by the Treasury in these short-term issues. Rates on most bill issues ended March unchanged to 20 basis points below levels at the end of the previous month.

Yields on Treasury coupon issues ended March slightly below those prevailing at the end of February, as the market was bolstered by the announcement of a low inflation rate in February. The Treasury continued efforts during March to meet its cash needs for the first half of 1976 by offering a variety of new coupon issues. On March 5, \$2 billion of new cash was obtained by the auction of four-year notes at a 7.54 percent average rate. On March 18, \$3 billion of two-year notes was sold to raise \$700 million in new cash at an average yield of 6.76 percent. An additional \$2.5 billion of 58½-month notes was sold to raise new cash on March 24 at an average return of 7.38 percent. These securities were well received. Many market observers expect the reliance placed by the Treasury on longer term issues in March to continue throughout 1976, since the average maturity of the debt declined substantially in 1975 and since the Congress has increased the volume of long-term Treasury bonds exempt from a 4¼ percent interest ceiling and has extended the allowable maturity of note issues (which are not subject to a rate ceiling) from seven to ten years.

Rates in the market for Federal agency securities were little changed in generally light trading and remained quite close to those on Treasury issues. Early in the month, the Government National Mortgage Association (GNMA) auctioned two issues to raise \$300 million of new money. The yield on \$200 million of 7¼ percent and \$100 million of 7½ percent thirty-year modified pass-through securities was 8.47 percent. Later in March, GNMA borrowed additional funds by auctioning \$239.3 million of 7¼ percent and 7½ percent modified pass-through securities priced to yield 8.23 percent. The Farm Credit Banks sold \$1,613.6 million of new bonds to replace \$1,196.5 million of bonds maturing April 1 and to raise \$417.1 million of new cash. This financing was composed of \$499.6 million of six-month Banks for Cooperatives bonds yielding 5.80 percent,

\$753.5 million of nine-month Federal Intermediate Credit Banks (FICB) bonds yielding 6.1 percent, and \$360.5 million of ten-year FICB bonds returning 7.95 percent. The Federal National Mortgage Association offered \$400 million of four-year debentures and \$300 million of 9½-year debentures toward the end of the month. These securities were enthusiastically received at yields of 7.375 percent and 7.9 percent, respectively, and immediately traded at premiums in the resale market.

OTHER SECURITIES MARKETS

Yields on corporate bonds ended March about unchanged from the end of February. Early in the month, interest rate expectations and additions to the schedule of new financing precipitated an increase in rates on seasoned corporate issues. The market improved, however, in trading activity during the remainder of the month, as it became evident that a tighter monetary policy had not emerged, as a period of less new issue activity approached,

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

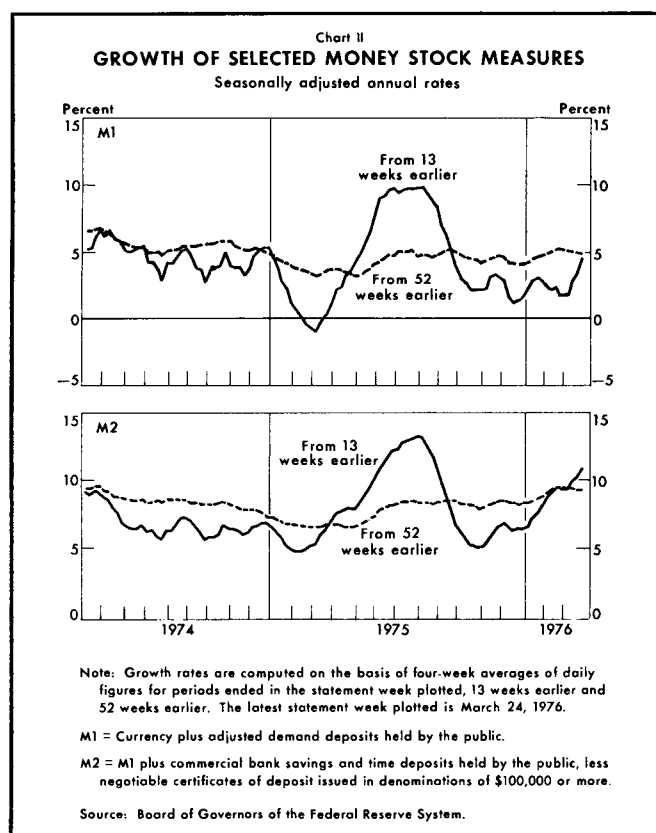
Maturity	Weekly auction dates—March 1976				
	March 1	March 8	March 15	March 22	March 29
Three-month	5.258	5.060	4.981	4.890	4.929
Six-month	5.724	5.487	5.459	5.283	5.327
	Monthly auction dates—January-March 1976				
	January 7	February 4	March 3	March 31	
Fifty-two weeks	5.578	5.572	6.010	5.781	

* 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.

and as inflation in February appeared quite modest despite continued strength in the economic recovery. Yields on tax-exempt bonds declined, on balance, following reports of progress toward resolution of New York State's short-term financing needs.

While new borrowing through corporate debt was very substantial during March, investors appeared willing to acquire longer term issues—albeit at somewhat higher yields than had been required in February. A return of 8.70 percent was available on \$200 million of thirty-year Aa-rated industrial debentures, 25 basis points higher than a similar issue in February. In sales of Aaa-rated debentures, \$300 million of forty-year telephone debt provided an 8.56 percent return and \$300 million of thirty-year industrial obligations yielded 8.57 percent. These yields were about 25 basis points above issues distributed a month earlier.

Though the volume of tax-exempt financing was also heavy in March, yields on most issues trading in the secondary market declined somewhat. In the largest general obligation issue on record, Massachusetts sold \$535 million of 25-year bonds rated A-1 by Moody's and AA by Standard & Poor's. The yield provided by these bonds was 9 percent, and the underwriting was oversubscribed. California offered \$100 million of Aaa-rated serial bonds at yields from 3.4 percent in 1978 to 5.7 percent in 2002. These aggressively priced bonds met with considerable sales resistance. Other sizable offerings included Penn-



sylvania's \$110 million of bonds, with yields ranging from 3.25 percent in 1976 to 7.05 percent in 1995, and Connecticut's \$100 million issue priced to yield 3.8 percent in 1977 to 6.75 percent in 1996. Both issues were also rated A-1/AA and were well received. The tax-exempt market was buoyed during March by reports of progress in New York State's efforts to assemble a \$2.6 billion package to allow four state construction finance agencies to avert

a potential default in March and to finish their ongoing construction projects over the next thirty months. In particular, this development contributed to the strong performance of Municipal Assistance Corporation issues during the month. The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds fell 29 basis points to 6.69 percent. The Blue List of dealers' advertised inventories rose by \$47 million to close the month at \$749 million.

Per Jacobsson Foundation Lecture

The Per Jacobsson Foundation in Washington, D.C., has made available to the Federal Reserve Bank of New York a limited number of copies of the 1975 lecture on international monetary affairs. The Foundation sponsors annual lectures on this topic by recognized authorities in honor of the former Managing Director of the International Monetary Fund, who died in 1963.

The twelfth lecture in this series was given on August 31, 1975 in the International Monetary Fund Building in Washington, D.C. Alfred Hayes, former President of the Federal Reserve Bank of New York, presented a paper entitled "Emerging Arrangements in International Payments—Public and Private". Commentaries on the subject and on his paper were offered by Khodadad Farmanfarmaian, Chairman of the Board of the Bank Sanaye Iran, by Carlos Massad, consultant to the United Nations Economic Commission for Latin America, and by Claudio Segré, President of the Cie. Européenne de Placements, Paris.

This Bank will mail copies of the lecture without charge to readers of the *Monthly Review* who have an interest in international monetary affairs.

Requests should be addressed to the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045.

Banking Structure in New York State: Progress and Prospects

By JUDITH BERRY KUNREUTHER*

The structure of commercial banking in New York State has undergone a quiet revolution in less than a decade. The possibilities for statewide banking through branching and bank holding company acquisitions have brought all the state's banking markets within the range of new competitive influences. These developments, which have contributed to an improved level of financial services to the public, could not have taken place without the substantial liberalization of state restrictions on branching and the granting of authority for bank holding companies to operate in the state. Moreover, the growth of the bank holding company movement has opened new channels of competition through diversification by New York organizations in bank-related activities in New York State, as well as in other states across the nation, and through the entry of out-of-state bank holding companies into financial markets in this state.

New York State has been in the forefront of the swing toward freer competition in local and regional banking markets across the nation. While a strengthening of competition throughout the state could be expected to benefit the public interest, those urging the relaxation of legal barriers to competition in New York State had to contend with the concerns of those who feared the possible domination of banking by the state's largest organizations. Thus far, these fears have not been borne out. It will, of course, take some time to appraise the full impact of statewide branching and the bank holding company movement on banking structure in New York State. Present indications

are that the controlled entry of the state's largest banking organizations into regional and local markets, under regulatory standards designed to promote a healthy competitive environment, has served the public interest by contributing to improvements in the quality and quantity of financial services available to the public.

Multibank holding companies have assumed increased importance in the state's banking structure since the passage of the landmark Federal Bank Holding Company Act Amendments of 1970. They have enabled banking organizations both to expand statewide through acquisition of footholds or *de novo* banks and to engage in nonbanking activities. The liberalization of the state's branch banking law, leading to statewide branching in January 1976, now provides the state's banking organizations with added scope to improve their efficiency and services to the public. A few large organizations have already consolidated their affiliates into statewide branch systems. Banking organizations are likely to be digesting and adjusting to these developments for some time to come. This article reviews the major structural changes that have occurred in the past five years and their significance for the further evolution of banking in New York State.

EXPANSION THROUGH BRANCHING

The provisions of the state's branch banking amendments of 1971 became fully effective on January 1, 1976, following a 4½-year transition period.¹ Beginning this

* The author is an economist in the Banking Studies Department of the Federal Reserve Bank of New York. She wishes to acknowledge the valuable comments provided by her colleagues in the Banking Studies Department.

¹ For a discussion of the history of banking legislation and regulatory developments in New York State prior to 1971, see Karen Kidder, "Bank Expansion in New York State: The 1971 Statewide Branching Law"; *Monthly Review* (Federal Reserve Bank of New York, November 1971), pages 266-74.

year, the new law eliminated the previous nine banking districts, which had served to limit the extent of branch banking within the state except for the authority granted to New York City banks to branch into neighboring Nassau and Westchester counties and for banks in those counties to enter New York City. The effect of this change is to authorize statewide branching.

A second change was a reduction of the degree of home-office protection afforded independent banks in the state's major cities. Prior to 1971, entry by outside banks through branching was precluded in a community that had a population of one million or less and was the headquarters of an independent bank (*i.e.*, a bank not affiliated with a bank holding company). New York City was the only major city in the state not eligible for home-office protection under the population ceiling, although by the end of 1971 a few other major cities could be entered by outside banks since all banks headquartered in those cities were affiliated with bank holding companies. The 1971 amendments reduced the population ceiling for home-office-protected communities to 75,000 in January 1972 and then lowered it again to 50,000 as of January 1976. These changes removed home-office protection from several large cities that

still were the headquarters of independent banks. In addition, a provision that limited to one the number of *de novo* banks a bank holding company could establish in each district expired, as did a provision that allowed a newly chartered bank to open only two branches a year until it had been chartered for five years, except that none could be opened during its first year of operation. At the same time, the prohibition on the acquisition by a bank holding company of a newly chartered bank in a home-office-protected community remains intact.

The 1971 relaxation of the branching law contributed to further heavy branching activity in most of the state's major banking markets, where branch banking had already taken root firmly in response to opportunities within each of the former nine banking districts. During 1971-75, an average of 149 *de novo* branches per year were established by New York State banks, a substantial increase over the average of 93 branches per year established during the previous five years. At the end of 1975, 73 percent of the banks in the state operated branch banking systems, up from 40 percent in 1960, and about 97 percent of the deposits outside New York City were controlled by banks operating branch systems. Table I indicates the growth of branch offices and related changes in New York's banking structure between 1950 and 1975.

Table I
SUMMARY OF BANKING STRUCTURE CHANGES
IN NEW YORK STATE

Category	1950	1960	1970	1975
Number of commercial banks	635	403	296	276
Independent banks	625	384	230	157
Holding company banks	10	19	66	119
Number of branch offices*	755	1,368	2,407	3,253
Number of bank holding companies†	4	8	26	32
Number of multibank holding companies	2	3	8	15
Percentage of state deposits held by multibank holding companies	3	5	24	81
Percentage of state deposits held by one-bank holding companies	‡	‡	62	13
Number of bank mergers§	—	239	130	46
Number of new banks§	—	11	27	26

Note: All data are for the year-end, except 1950 and 1960 deposit data which are for June 30.

* Net figure reflecting *de novo* branches, branch closings, and other changes in bank office status. Excludes foreign branches and military facilities.

† Includes only holding companies with bank subsidiaries operating in New York State.

‡ Less than 1 percent.

§ Refers to number consummated during periods 1951-60, 1961-70, and 1971-75.

Sources: Federal bank-regulatory agencies and *Polk's Bankers Encyclopedia* (September 1950 and 1960).

BANK HOLDING COMPANY EXPANSION

The bank holding company movement in New York State dates back to 1929, when Marine Midland Banks, Inc. began operating as a multibank holding company. Three large New York City organizations (Charter New York Corporation, The Bank of New York Company, Inc., and Bankers Trust New York Corporation) commenced operations as multibank holding companies in the middle or late 1960's as did two smaller upstate organizations (Lincoln First Banks Inc. and Security New York State Corporation). Most of the large organizations in the state, however, did not form holding companies until the late 1960's, and then chose to operate as one-bank holding companies. This enabled them to engage in nonbank activities without being subject to regulation under the Bank Holding Company Act of 1956, which applied only to multibank organizations. At the end of 1970, eighteen of the twenty-six holding companies operating banks in New York State were one-bank companies.

Passage of the 1970 amendments to the Bank Holding Company Act brought one-bank and multibank holding companies under the same Federal regulation, thereby eliminating the advantages of the one-bank company. It

Table II
TWENTY LARGEST BANKING ORGANIZATIONS IN NEW YORK STATE

Banking organization	Consolidated total deposits of organization*	Share of New York State deposits held at domestic offices	Number of domestic bank affiliates
	Millions of dollars	Percent	
Citicorp, New York City	45,163	15.4	7†
The Chase Manhattan Corporation, New York City	33,948	15.2	9
Manufacturers Hanover Corporation, New York City	23,428	12.3	6
Chemical New York Corporation, New York City	19,516	10.1	7
Bankers Trust New York Corporation, New York City	16,956	8.2	9
J. P. Morgan & Co., Inc., New York City	19,954	7.5	1
Marine Midland Banks, Inc., Buffalo	9,658	5.5	10†
Charter New York Corporation, New York City	9,856	5.5	15
The Bank of New York Company, Inc., New York City	3,710	2.4	8†
C.I.T. Financial Corporation, New York City	2,462	1.7	1
Lincoln First Banks Inc., Rochester	2,147	1.7	5
European-American Bank & Trust Company, New York City	2,144	1.4	1
First Commercial Banks Inc., Albany	1,376	1.1	5
United Bank Corporation of New York, Albany	1,305	1.0	3
The Bank of Tokyo, Tokyo, Japan‡	1,286	1.0	1
First Empire State Corporation, Buffalo	1,238	1.0	3†
Republic New York Corporation, New York City	1,215	0.8	1
Security New York State Corporation, Rochester	793	0.6	9
LITCO Corporation of New York, Garden City	504	0.4	1
United States Trust Company, New York City	468	0.4	1

Note: All data are for December 31, 1975.

* Figures include deposits held at both domestic and foreign offices.

† Bank affiliates of these holding companies were merged into one or two subsidiaries in January 1976.

‡ Includes only deposits of Bank of Tokyo Trust Company, New York City.

is not surprising, therefore, that soon afterward the state's four largest banking organizations, which had been one-bank holding companies, sought to expand by acquiring bank subsidiaries across the state. As indicated in Table II, thirteen of the twenty largest banking organizations in the state had established statewide banking operations through holding company affiliates as of the end of 1975. By that time, the number of holding companies operating in New York State had increased to thirty-two, and fifteen of them were multibank organizations. (Two of these holding companies merged their respective bank subsidiaries into one bank in January 1976.) The share of state deposits held by all bank holding companies rose to about 94 percent from 86 percent over the five-year period.

CHANGES IN THE NUMBER AND AFFILIATION OF BANKS IN

THE STATE. The slowing of bank merger activity in New York State between 1970 and 1975 reflected a diminishing number of potential proposals that could satisfy regulatory standards. As a result, the total number of commercial banks in the state declined only slightly to 276 between 1970 and 1975. At the same time, the stimulus to multibank organizations by the Bank Holding Company Act Amendments of 1970 resulted in a jump in the number of banks affiliated with bank holding companies in the state. The number of such affiliates increased from 66 in 1970 to 119 in 1975.

INCREASED COMPETITION

While bank mergers and acquisitions by bank holding companies contributed to a reduction in the number of

nonaffiliated banking institutions serving the state as a whole, the move to statewide banking furthered the entry of new competitors into attractive local and regional markets. The large New York City-based organizations, having very substantial resources at their command, were, of course, in a position to respond to the pull of opportunities in upstate banking markets. As a result, the number of banking institutions operating in many of the state's banking markets increased. Many communities that previously were served only by locally oriented institutions now have access to the services of some of the state's largest and most diversified banking organizations.²

In 1970, as noted above, only Charter New York Corporation, The Bank of New York Company, Inc., and Bankers Trust New York Corporation had upstate affiliates. By 1975, virtually all the major New York City bank holding companies had gained representation in the major upstate markets of Albany, Buffalo, Rochester and Syracuse.³ Yet, the deposits accounted for by the large New York City organizations in upstate banking markets are quite modest. For example, as of December 31, 1975, the seven large New York City holding companies with statewide operations accounted for about 22 percent of the deposits held by New York State banks in offices outside New York City. The four largest New York City holding companies alone accounted for only 4 percent of such deposits, holding as little as 1.4 percent of deposits in the Buffalo market and at most 5.5 percent of deposits in the Albany market.⁴ The deposits of the upstate affiliates of New York City holding companies acquired since 1971 amount, on average, to about \$29 million.

It is indeed no accident that the penetration of upstate banking markets by the large New York City bank holding companies has not gone very far. A significant restraining

influence has been Federal and state regulatory policy, which forecloses any acquisition that would pose a threat to the competitive health of the market involved. Moreover, following the relaxation of the state branching law through the 1971 amendments, the New York State Banking Department established regulatory guidelines to provide for an orderly transition of new entry by the New York City holding companies into upstate markets. The Banking Department's policy centered on two criteria for the upstate acquisitions of New York City holding companies. First, these organizations would be permitted to acquire only *de novo* banks or small footholds. Second, the number of branches established annually by foothold acquisitions would be subject to branch limits similar to those applying to newly chartered banks. Besides these regulatory limits on the establishment of foothold positions in new markets, the natural obstacles to the penetration of new markets, such as the difficulty of changing established banking relationships and overcoming customer inertia, have served to limit the possibilities for these organizations to exert much market leverage.

Table III
MEASURES OF CONCENTRATION IN SELECTED
METROPOLITAN BANKING MARKETS IN
NEW YORK STATE

Relevant area	Number of banks		Three-bank concentration ratio*		Concentration Index†	
			Percent			
	1970	1974	1970	1974	1970	1974
Albany market‡	15	18	56.0	50.0	.140	.129
Buffalo market	10	15	94.3	92.2	.372	.349
Rochester market	17	15	82.0	77.8	.258	.245
Syracuse market	10	14	74.5	71.1	.227	.210
	1972	1974	1972	1974	1972	1974
Metropolitan New York market§.....	113	117	45.1	47.5	.098	.100
New York State	287	280	40.0	43.4		

Note: Data are for June 30 and reflect deposits held in domestic offices.

* Sum of the market shares held by the three largest banks in the market.

† Herfindahl Index. Equals the sum of the squared market shares held by all banks in the market. Value of 1 implies perfect monopoly.

‡ Deposit shares of the Albany banks do not include their holdings of state government deposits.

§ Earlier years not readily available.

|| Not readily available.

Source: Federal Deposit Insurance Corporation.

² Seven New York City organizations are now represented in upstate markets: Citicorp, The Chase Manhattan Corporation, Manufacturers Hanover Corporation, Chemical New York Corporation, Bankers Trust New York Corporation, Charter New York Corporation, and The Bank of New York Company, Inc.

³ A few of the seven large New York City organizations operating in major upstate markets do not have affiliates in every one of these markets. Charter New York Corporation is not represented in the Buffalo market; The Bank of New York Company, Inc. has no affiliate in the Rochester market; and Manufacturers Hanover Corporation and Bankers Trust New York Corporation are not represented in the Syracuse market.

⁴ These four organizations are Citicorp, The Chase Manhattan Corporation, Manufacturers Hanover Corporation, and Chemical New York Corporation. Market deposit shares of these organizations in the Buffalo and Albany markets are as of June 30, 1974.

It should be noted that the possibilities for freer competition in New York State have inspired some new incursions by upstate organizations into the downstate markets. For example, First Commercial Banks Inc., Albany, United Bank Corporation of New York, Albany, and First Empire State Corporation, Buffalo, have acquired bank subsidiaries in the metropolitan New York area and other downstate markets. While such new entry could not be expected to have much immediate effect in the large New York market, it does serve to illustrate that competitive influences seldom operate only in one direction.

The entry into local banking markets by banking institutions not previously represented has tended to reduce the concentration of banking resources in a number of the state's largest banking markets. Both the three-bank concentration ratio and a frequently used index of concentration that is sensitive to changes in the market shares of all market participants (the Herfindahl Index) indicate that there has been a slight reduction in concentration in each of the four upstate metropolitan markets where most new entry has occurred (see Table III). At the same time, concentration has risen slightly over the past few years in the metropolitan New York market. However, with over 100 banking organizations, ranging from very small local institutions to some of the largest banks in the country, competition for retail and wholesale banking business remains quite keen in that market.

PERFORMANCE OF NEW UPSTATE ENTRANTS

Analysis of income and expenses of New York City organizations that have entered upstate markets since 1971 provides significant insight into the nature of the impact that their entry has had to date, the problems that they face in penetrating markets outside New York City, and the efforts they are exerting to enlarge this part of their business. Table IV shows for the years 1974 and 1975 the average operating ratios of eleven member bank affiliates of the major New York City holding companies that entered upstate markets after 1971.⁵ The sample covers affiliates operating in the four major upstate

banking markets—Albany, Buffalo, Rochester and Syracuse. To determine whether the operating experience of the new entrants differed markedly from banks already established in the relevant markets as well as throughout the state, the average operating ratios of these affiliates were compared with those of twenty-five other member banks headquartered in the same four upstate markets and not affiliated with New York City holding companies, and with the average ratios of all member banks in the Second Federal Reserve District having deposits of \$10 million-\$50 million. The latter range included the average size of the New York City affiliates under study. The broad sample of Second District banks included about 130 banks.

One of the striking features of these comparisons is that virtually all of the eleven upstate affiliates of the large New York City organizations under study have not achieved profitable operations since their affiliation.⁶ The losses incurred, on average, by the eleven member bank affiliates in 1974 and 1975 reflect several factors on the expense side of their income statements. Both salary and wage expenses as well as net occupancy expenses of the New York City affiliates were significantly larger, measured as a percentage of total operating income, than those of other banks in the markets in which they operate. These expenses also were significantly larger than those of other banks of comparable size in the Second Federal Reserve District. Net charge-offs on loans also were relatively high. The increase in provisions for loan losses from 1974 to 1975 contributed heavily to a deterioration of the New York City affiliates' ratios of net income to total assets, though this was only one factor in the overall unprofitability of the banks. The New York City affiliates also showed significantly higher interest expenses on time and savings deposits. The relatively high operating expenses appear to be at the root of the New York City affiliates' unprofitability, since their return on loans either exceeded or approximated those of the banks headquartered upstate and the Second District member bank group.

It should be recognized that the operating experience of the New York City affiliates is generally typical of *de novo* banks attempting to penetrate markets of established competitors. Such penetration is not easily achieved. The relatively high occupancy and salary expense probably indicates the opening of many new offices that have not yet produced sufficient business to become profitable as well

⁵ The operating ratios, which are expressed in percentages, are derived from *Reports of Income* and *Reports of Condition* filed regularly by banks with the Federal bank-regulatory agencies. Because of data limitations, the sample excludes a few bank holding company affiliates that are not members of the Federal Reserve System.

⁶ Only one of the eleven affiliates achieved profitable operations in 1974, and none were profitable in 1975.

as the expense of attracting experienced personnel. The high interest paid on time deposits suggests not only higher rates offered on such deposits, but also greater reliance on high-cost deposit sources of funds, in part necessitated by the difficulty of penetrating established deposit markets. Since the growth of the New York City affiliates took place

after 1971, most of their time deposits have been acquired during a period of relatively high interest rates.

The New York City affiliates also show significant differences in the composition of their loan portfolios in comparison with the upstate-headquartered organizations. Roughly 40 percent of the New York affiliates' gross loans

Table IV
ANALYSIS OF SELECTED OPERATING DATA OF FEDERAL RESERVE MEMBER BANKS
LOCATED IN THE ALBANY, BUFFALO, ROCHESTER, AND SYRACUSE BANKING MARKETS

Selected averages	11 upstate affiliates of 4 largest New York City holding companies*		25 banks headquartered upstate†		Second Federal Reserve District member banks with deposits of \$10 million-\$50 million	
	1974	1975	1974	1975	1974 (130 banks)	1975 (126 banks)
	Millions of dollars					
Total deposits per bank	18.8	25.2	330.0‡	322.7‡	25.0‡	24.9
	Percent					
Time and savings deposits to total deposits	55.3	52.4	62.5	63.8§	63.9‡	63.6§
Total capital accounts and reserves to total assets	15.4	10.8	8.8‡	8.9	9.0§	9.0‡
Income ratios:						
Net income to equity capital including all reserves	-10.5	-19.3	6.2§	7.9§	6.0§	2.4§
Net income to total assets	-1.6	-1.7	0.6§	0.7§	0.6§	0.3§
Service charges on deposit accounts to total operating income	1.5	1.9	2.9§	3.1§	3.0§	3.2‡
Return on loans (interest and fees to gross loans)	11.2	10.2	9.5§	8.9‡	9.8§	9.1
Net losses (-) or recoveries (+) on loans to gross loans	-0.8	-1.8	-0.8	-0.4§	-0.5	-0.7
Expense ratios:						
Salaries and wages to total operating income	35.8	41.8	17.7§	18.6§	19.0§	21.2§
Net occupancy expense to total operating income	12.7	15.8	4.4§	5.0§	4.2§	5.2§
Interest on time and savings deposits to total time deposits	7.6	6.1	6.0§	5.4§	5.9§	5.3§
Total operating expenses to total assets	11.9	11.5	6.7§	6.4§	6.8§	6.8§
Total operating expenses to total operating income	147.0	157.4	90.4§	87.6§	91.6§	97.1§
Loan ratios:						
Gross loans to total assets	65.6	64.9	60.1	59.4	58.9‡	57.7‡
Real estate loans to gross loans	21.4	22.3	36.2§	36.9§	37.2§	36.8§
Loans to farmers to gross loans	0.7	0.6	1.4	1.6	2.4	2.5
Commercial and industrial loans to gross loans	38.7	43.7	21.4§	21.4§	20.8§	20.4§
Consumer loans to individuals to gross loans	17.2	20.4	31.2§	31.9§	27.0§	27.4

Note: Significance of the observed differences between banks is measured here by a statistic reflecting the difference in means for the two groups divided by a measure of the variability within the groups.

* Affiliates of Citicorp, The Chase Manhattan Corporation, Chemical New York Corporation, and Manufacturers Hanover Corporation.

† Includes independent banks and affiliates of holding companies headquartered upstate; excludes banks in first group as well as affiliates of The Bank of New York Company, Inc., Bankers Trust New York Corporation, and Charter New York Corporation.

‡ Difference from 11 affiliates significant at 95 percent level.

§ Difference from 11 affiliates significant at 99 percent level.

were commercial and industrial loans, compared with about 20 percent for the upstate-headquartered banks. In contrast, the percentage of the affiliates' loan portfolios in real estate loans and consumer loans was significantly lower than for the upstate banks. The relatively heavier concentration of the New York affiliates in commercial as opposed to retail lending in part reflects the relatively greater expertise of the New York banking organizations in commercial lending, but probably also reflects the difficulty of new banks in penetrating retail banking markets already served by substantial local banking organizations. Comparison of the New York affiliates with the broader sample of member banks shows very similar results.

Thus far, the operating experience of the affiliates of New York City organizations entering upstate markets after 1971 shows that their entry has been limited in scope and achieved at considerable expense. Although additional expansion can be expected in response to opportunities for growth in New York State, there clearly is a need for these banks to strengthen their existing financial positions at these relatively new points of entry. Several organizations have in fact announced plans to close branches that have not proved profitable.

STATEWIDE BANKING— VIA AFFILIATES OR BRANCHES?

The recent liberalization of New York's branching law is not expected to lead to a surge in branch activity or many additional statewide banks, since most organizations that seek statewide representation probably have already done so through a holding company system. The ability of banks to branch without geographical restrictions does, however, have a number of implications for New York's banking structure. Independent banks operating on the fringes of the previous banking district boundaries may serve their customers throughout economically integrated areas through branching. Further, bank holding companies now operating statewide through subsidiaries can evaluate the advantages of consolidating their operations into a single banking institution.

One consideration influencing a holding company to continue operating a number of separate banking affiliates centers on the belief that bank customers prefer to patronize an institution with a local identity, which is manifested in part through a local board of directors. Further, increased reserve requirements that usually result from the merging of several affiliates places a cost on consolidation.

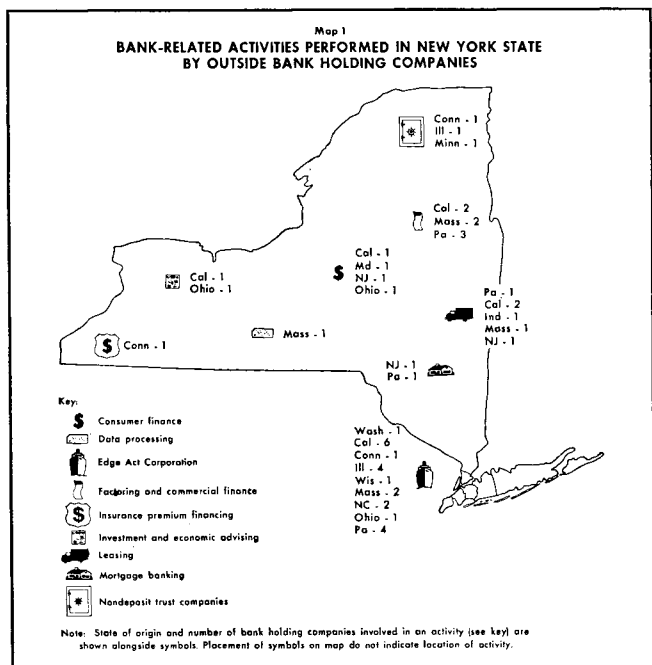
On the other hand, consolidation could enable an organization to implement more uniform policies throughout

all of its offices. Significant economies could be achieved by some organizations in such areas as portfolio and liquidity management, compliance with reporting requirements, data services, and check clearing. Also, a smoother and more efficient movement of funds by a holding company system could be facilitated by merging its affiliates. Such movements of funds can be impeded by the limits imposed by Section 23A of the Federal Reserve Act. This section restricts the movement of funds (interest-bearing deposits, loans, and Federal funds) from one member bank or insured affiliate to another affiliate to 10 percent of the former's capital (including reserves), and to all affiliates to a total of 20 percent of that bank's capital. Moreover, such loans must be secured by acceptable collateral, which ranges from 100 percent to 120 percent of the value of the loan depending on the nature of the collateral. While these constraints were designed to protect banks from undue extensions of credit to ailing affiliates, they can under some circumstances impede intra-holding company flows of funds that serve legitimate economic needs, such as those involved in large seasonal shifts in loan demand within a holding company system. Bank holding companies that are constrained by these or other factors may decide to avail themselves of the advantages of a consolidated statewide branch system.

Marine Midland Banks, Inc. and The Bank of New York Company, Inc. merged all of their respective affiliates in January 1976, and The Chase Manhattan Corporation has initiated a program to consolidate all of its affiliates into a single bank through a series of mergers. First Empire State Corporation also has announced plans to merge its two bank affiliates into one bank. Citicorp, on the other hand, has restructured its operations by forming an upstate and a downstate affiliate. Additional consolidations are to be expected, but the course chosen by the state's holding companies undoubtedly will vary, depending on the perception by management of their best opportunities for achieving efficient operations.

COMPETITION IN BANK-RELATED ACTIVITIES

The growth of the bank holding company movement in New York State has added a new dimension to the provision of financial services in the state and in the nation. The state's large bank holding companies all have subsidiaries that engage in a range of permissible bank-related activities, such as mortgage banking, consumer finance, personal and real property leasing, factoring, and commercial financing to name a few of the more important nonbank activities engaged in by bank holding companies. Entry into these activities has been permitted in



accordance with the provisions of the Bank Holding Company Act of 1956, as amended, which requires that the performance of the activity be in the public interest.⁷

Although most of the New York organizations have substantial operations in New York State, they are not limited by state boundaries, since the Bank Holding Company Act places no geographic restrictions on the performance of approved nonbank activities. Many upstate holding companies also have acquired or formed nonbank subsidiaries that operate in financial markets both in and outside New York State. Moreover, thirty-two out-of-state bank holding companies, representing thirteen states in the nation, own some twenty nonbank subsidiaries and twenty-two Edge Act corporations in New York. Entry into New York State's financial markets by these organizations has added to the flexibility of the state's financial structure and has enhanced its ability to meet the

financial needs of individuals and businesses. Map I provides an indication of outside bank holding company representation in the state.

The diversity and far-flung scope of bank holding company activities in permissible nonbank fields make it difficult to appraise their overall impact on competition. Nonetheless, there are grounds for believing that bank holding company expansion in New York State as well as in the nation has added to the quality and quantity of financial services available to the public and, in some instances, may have contributed to the reduced cost of these services. Most of the out-of-state acquisitions by New York bank holding companies have been in areas where they were not previously represented. As shown in Map II, New York State bank holding companies have entered markets in about forty states in the nation, including New York. Moreover, the size of the subsidiaries in terms of assets seems well below levels that might raise concern over undue concentrations of economic power.

CONCLUDING REMARKS

Banking structure in New York State has adjusted substantially, but smoothly, in response to major changes enacted in Federal and New York State banking laws. These changes have ushered in statewide banking and have given an important forward thrust to the bank holding company movement. As a result, banks have been encouraged to compete more widely and to improve the efficiency of their operations. Such competition, however, seems not to have affected adversely the state's well-managed independent banks. The experience of the New York City affiliates in upstate markets indicates that local banks have remained profitable in the face of entry of the state's largest institutions and should continue serving their local communities on a profitable basis. Banking organizations in New York can expect several additional challenges in the years ahead. Increased competition could come from thrift institutions and from the possible expansion by banks across state lines. Moreover, wider use of electronic funds transfer facilities could bring further changes in banking practices.

Thrift institutions in New York State have actively sought expanded powers, most notably the authority to offer checking accounts, and legislation to permit this activity has been introduced in the state legislature. While the entry of thrift institutions into the area of payments services in principle could be expected to result in improved services to the public, the granting of such powers without ensuring competitive equality in other areas of banking regulation, such as deposit rate ceilings and

⁷ For an analysis of the public interest aspects of bank holding company acquisitions under Section 4(c)(8), see Michael A. Jessee and Steven A. Seelig, "An Analysis of the Public Benefits Test of the Bank Holding Company Act", *Monthly Review* (Federal Reserve Bank of New York, June 1974), pages 151-62.

reserve requirements, could create an undesirable imbalance in the competitive position of institutions doing essentially the same type of business. Over the long run, such imbalances contribute to inefficiencies by causing an allocation of financial resources for regulatory rather than economic reasons.

Competitive opportunities also could be enhanced if banks were allowed to enter large out-of-state metropolitan banking markets. A proposal along these lines was announced last month by New York State Superintendent of Banks Heimann, who suggested that banks from other states be allowed, on a reciprocal basis, to make bank acquisitions in New York metropolitan areas having a population of 1.5 million or more. Enactment of Super-

intendent Heimann's proposal would represent a significant step toward interstate competition in banking via branches or affiliates located across state lines.

The wider introduction of electronic payments systems by the banking industry in transactions with the public promises new flexibility for both small and large banks in meeting the needs of their customers. The investment outlays needed for such facilities are modest, compared with the expense of opening full-service branches, and there may in time be opportunities for banks of all sizes to participate in electronic facilities through pooling arrangements. Such technological improvements could be expected to contribute to greater efficiency in banking and, therefore, to reduced costs of financial services to the public.

