



## Winter 1998

# CENTRAL Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

WINTER ISSUE

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## On the Shoe-Leather Costs of Inflation

Michael R. Pakko

Although most people recognize that inflation is something to be avoided, the popular public perception of inflation's harmful effects can be rather vague. In response to survey questions about inflation, for example, most people express concerns about prices rising (defining inflation itself) or about how inflation somehow erodes standards of living. When economists discuss the costs of inflation, however, they have more specific concerns in mind. One general class of inflationary consequences is sometimes referred to as the "shoe-leather" costs of inflation: To avoid the erosion of their purchasing power due to inflation, people have to spend more time and effort protecting the value of their nominal assets—wearing out their shoes on the way back and forth to the bank.

Of course, this quaint notion represents a much broader and more serious problem than simply the cost of wearing out one's shoes. To protect assets against inflation, societal resources are channeled away from productive activities and toward inflation-hedging activities. These resource misallocations are readily apparent in countries that have experienced hyperinflation, the most famous episode having occurred in Germany in the 1920s. From August 1922 through November 1923, the price level in Germany increased by more than one billion times. During this hyperinflationary episode, price level increases averaged 322 percent per month.

Anecdotes of the distortionary effects of this hyperinflation abound. Workers were paid two to three times per day, rushing out to spend their pay before the money became worthless. At the pub after work, patrons ordered two beers at once in fear of the price rising before they had finished the first one. Shopkeepers posted prices as multiples of a base, changing the multiplication factor hourly after consulting with banks, which had set up phone lines to give the latest exchange rate quotes.

Of course, the effects of hyperinflation are extreme examples of the destructive effect of inflation more generally. It is not unreasonable to suppose, however, that costly distortions emerge on a smaller scale during more moderate periods of inflation.

In a forthcoming article in the Bank's *Review*, I examine previous efforts to quantify these costs and derive some estimates of my own. While methodologies and precise results differ, estimates generally fall into a common range. Inflation of 10 percent, for example, results in a misallocation of resources that amounts to somewhere between 1 and 2 percent of GDP (my own estimates being near the high end of that range). Even lower inflation rates can be costly. My calculations suggest that the costs of an inflation rate of only 3 percent are about a half percent of GDP—approximately \$40 billion.

Some argue that the costs of eliminating inflation are substantial, so we should leave well enough alone. However, these costs are generally considered to be transitory, while the shoe-leather costs of sustained inflation represent a permanent drag on economic activity. Studies have shown that the potential temporary costs of anti-inflationary policies are more than made up for by the gains from achieving low inflation over time. Hence, the case for continued vigilance against inflation need not be based on fears of a surge of high

inflation in the future, but can be justified on the basis that even low inflation environments engender "shoe-leather" costs that we should strive to avoid.



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## **Feditorial: Stability of Banks Cushions Shocks from Afar**

**William Poole**

After a prolonged period of global economic optimism, the Russian default in mid-August suddenly changed the financial landscape. Quality spreads in the securities markets widened dramatically, and new issues of bonds and equities all but dried up. In response, the Federal Open Market Committee (FOMC) cut the federal funds rate target by 25 basis points three separate times over the past three months. The FOMC focused on the likely effects of the credit market disturbance on the economy and not on the state of the financial markets per se.

As for those financial markets, the key issue now is whether their problems are driven by fundamentals, such as corporate earnings prospects, or by irrational fears. If the latter, investors will straighten things out in time as they re-enter the markets to take advantage of bargains. If fundamentals are the problem, then the policy issues for the Fed will be more difficult.

We are fortunate that the banking system is relatively uninvolved in this financial disturbance. Here is a real, live example of the importance of strong bank capital. Some banks have indeed taken hits from loans that have gone bad during this upset, but bank capital has been fully able to absorb the shock. The best information we have is that bank lending policies, especially by small- and medium-sized banks, have changed little since August.

The stability of the banking system in 1998, in contrast to the somewhat shaky situation in the early 1990s, is a great source of stability for the general economy. The banking system is truly a part of the solution rather than a part of today's problem, and that makes the Fed's job much easier.



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## Mortgage Partnership Initiates New Efforts

For the past couple of years, the Community Affairs staffs of six Federal Reserve Banks—St. Louis, Boston, Chicago, Cleveland, New York and San Francisco—have engaged in Mortgage Credit Partnership (MCP) projects in their respective Districts. The goal of these MCP projects was to bring together leaders from financial institutions, real estate agencies, appraisal agencies, insurers and others to eliminate disparate treatment in the home-buying process and help ensure equal access to all financially qualified home seekers.

Several organizations are initiating local programs or policies that address barriers to minority homeownership identified through the MCP projects. Some of the MCP recommendations (listed at right) for eliminating those barriers are deemed to have national implications. During 1998 and into 1999, Community Affairs officers of the participating Federal Reserve Banks are presenting these recommendations to national trade associations and other appropriate groups to request their help with implementing the recommended changes. For more information on MCP efforts, call Glenda Wilson at (314) 444-8317.

### Real Estate

- Address stated preferences for conventional financing: Multiple Listing Service policies should be amended to indicate that properties shall not be marketed in a manner that indicates a preference for conventional financing only.
- Promote consumer awareness and education: A brochure is being designed that highlights web sites consumers can access to educate themselves about home buying.

### Credit Scoring

- Develop a "Best Practices Guide" for users of credit scores: This would further educate mortgage lenders about the role of credit scoring in the underwriting process and in determining the price of a loan. The Fed currently is discussing this idea with representatives of Fair Isaac, Fannie Mae, Freddie Mac and other experienced lenders.

### Insurance

- Review formal and informal underwriting guidelines for homeowners insurance and consider adopting formal criteria.
- Consider implementing an industry-wide practice of providing adverse action notices when coverage is declined, canceled or not renewed, specifying the reason for declination: Providing such a notice would help a homebuyer understand the reason for the denial or cancellation.
- Encourage major insurance companies to develop and implement a plan to assure office and agent accessibility in all communities: The lack of access to insurance agents in inner-city communities creates a barrier to equal access and affordability of homeowner insurance to many minority and low-income residents.

## Appraisal

- Develop an "Urban Appraiser" certification program: Recognizing the challenges and complexity inherent in conducting appraisals in urban neighborhoods, appraisers should have a standardized level of education and experience for qualification as an urban appraiser.



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## CDC Bulletins Available on Internet

Century Date Change (CDC) testing is progressing well in the Eighth District with nearly 300 customers to date having tested with the Fed. To help institutions during testing, the Fed has published several CDC Bulletins. Following are some highlights.

**CDC Bulletin No. 1**—Contains information about any file format changes and "windowing" rules for Fed services.

**CDC Bulletin No. 3**—Contains the 1998 testing schedules for most Fed services and an overview of the testing approach for many major services. A District supplement, which contains scheduling and testing approach information for Check, TT&L and Cash, also is available.

**CDC Bulletin No. 4**—Contains some additional/updated scheduling information and a substantial amount of detail about how to test with several Fed services. This bulletin also provides information about the source of test data for each of the services listed. A District supplement, which provides similar information for Check and TT&L, also is available.

**CDC Bulletin No. 5**—Provides updated scheduling information for several services and focuses on testing with us during the Shared Test Days. A District supplement, which provides similar information for Check, TT&L and Cash, also is available.

**Test Request Form**—This form must be submitted by any institution before testing with the Federal Reserve. The Fed needs this form at least two weeks in advance of the first testing date to make sure the institution is properly set up for testing.





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## Fed Lowers Electronic Payment Fees Again

Prices across all Federal Reserve electronic payment services— particularly Fedwire® and ACH transactions —will decline 17.5 percent in 1999. It marks the fifth straight year that the Fed System has lowered fees for these services. The Fed recently announced these and other 1999 fees and deposit deadlines for the following services: Accounting Information, Cash, Check, Electronic Connections, Electronic Payments and Securities. Banks will reduce the basic fee for a Fedwire funds transfer by almost 30 percent and the fee for a Fedwire securities transfer by almost 25 percent. The Fed will eliminate some ACH fees and reduce others, including the fee for items received, which will decline by more than 12 percent.

The Fed also will implement a volume-based fee structure for the Fedwire funds transfer service and a new fee structure for the Fedwire securities transfer service. These changes will become effective Feb. 1, 1999.

In Check, fees are increasing marginally for select per-item and cash letter services to reflect the costs of providing these services. Electronic check service fees will remain stable.

The Fed recently sent out its 1999 price books. To request additional copies, please contact your Federal Reserve account executive.



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## Treasury Issues Final Rule on EFT 99

In September, the Department of the Treasury and its Financial Management Service (FMS) published its final rule on EFT 99, which is a provision of the Debt Collection Improvement Act of 1996. EFT 99 requires federal agencies to use electronic funds transfer (EFT) for most payments, with the exception of tax refunds, starting Jan. 2, 1999. One element of the final rule concerns a loosening of waivers for individuals who receive federal payments electronically. Waivers can be granted if an individual determines, at his or her sole discretion, that payment by EFT would impose a hardship due to: a physical or mental disability; a geographic, language or literacy barrier; or a resulting financial hardship. Also, those without deposit accounts are entitled to an automatic waiver until an Electronic Transfer Account (ETAsm) is available to them.

Other aspects of the Treasury's final rule include:

**Account requirements:** All federal EFT payments, except for vendor payments, must be deposited at a financial institution in the name of the recipient. Exceptions include cases in which either an authorized payment agent (e.g., a representative payee or fiduciary) has been named to act on behalf of the recipient or the payment is to be deposited into an investment account established through a registered securities broker or investment company.

**Agency requirements:** Using model language from the Treasury, federal agencies must notify all check recipients and newly eligible recipients of their options both before and after an ETA becomes available to these recipients. In some special circumstances, select agencies will not be required to make payments electronically.

**Withholding Payments:** An agency may not withhold or delay a payment to an individual for any reason related to the implementation of EFT 99.

For more information, call Cheryl McCarthy at (314) 444-8459.



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## Little Rock Receives Visit from Fed Governor

Federal Reserve Board Governor Roger W. Ferguson Jr. toured revitalized sections of Little Rock during a visit to the city Sept. 10. The governor's tour aboard the River Market Trolley took him past several areas under development and renovation, including the new South Main District, the River Market area, the convention center expansion, the new public library and the Clinton Presidential Library site, where Skip Rutherford, president of the William J. Clinton Presidential Foundation, discussed the complex with Ferguson.

Accompanying Governor Ferguson on the community tour were directors from the Federal Reserve Bank of St. Louis and the Little Rock Branch. Owners of small businesses joined the group for lunch and the tour to discuss the business climate in Little Rock.



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<https://www.stlouisfed.org/publications/central-banker/winter-1998/regional-roundup>

## Regional Roundup

### FFIEC Guidance: Consumer Compliance in Electronic Banking

On July 15, 1998, the FFIEC issued guidance on the consumer compliance implications of electronic banking services, such as online systems, stored value cards and e-cash. The guidance summarizes emerging issues under various consumer protection laws and regulations and provides suggestions on how to apply existing consumer laws and regulations to new electronic services.

It also emphasizes the importance of compliance officer involvement in the development and implementation of new electronic banking services and web sites. The FFIEC notes that the regulations will be evolving with the new technologies. For more information, visit the FFIEC's web site at [www.ffiec.gov](http://www.ffiec.gov).

### Key Web Sites for Bankers

Essential banking information increasingly is appearing on the Internet these days. Below is a list of important web sites where such data can be found:

[www.fdic.gov](http://www.fdic.gov) (Federal Deposit Insurance Corporation)

[www.ffiec.gov](http://www.ffiec.gov) (Federal Financial Institutions Examination Council)

[www.ffiec.gov/nicpubweb/nicweb/nichome.aspx](http://www.ffiec.gov/nicpubweb/nicweb/nichome.aspx) (National Information Center)

[www.ots.treas.gov](http://www.ots.treas.gov) (Office of Thrift Supervision)

[www.ncua.gov](http://www.ncua.gov) (National Credit Union Administration)

[www.federalreserve.gov](http://www.federalreserve.gov) (Board of Governors of the Federal Reserve System)

[www.federalreserve.gov/FOMC/BeigeBook/2009/](http://www.federalreserve.gov/FOMC/BeigeBook/2009/) (Beige Book)

[www.federalreserve.gov/newsevents/press/all/2009all.htm](http://www.federalreserve.gov/newsevents/press/all/2009all.htm) (statistical releases)



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<https://www.stlouisfed.org/publications/central-banker/winter-1998/fedfacts>

## FedFacts

### National Financial Services Web Site Coming in January

Beginning January 1999, bankers can visit one web site to learn about all Federal Reserve financial services. The site will feature information on all national services and products, as well as updates on Fed initiatives. It will be accessible from any Reserve Bank site, including the St. Louis Fed's site at [www.stlouisfed.org](http://www.stlouisfed.org).

In addition to Fed services like Accounting, ACH and Book-Entry, the national site also will include a link to the Treasury and other useful sites. The centralized maintenance of the site will enable Reserve Banks to concentrate on posting and maintaining local service information on their own sites.

For additional information, call Cheryl McCarthy at (314) 444-8459.

### FCA National Report Now Available

The Federal Reserve's Functional Cost and Profit Analysis (FCA) National Average (NAV) Report for the 1997 data year now is available. This report contains averaged income, expense and product profitability data for all FCA participants, grouped by size. Thousands of institutions purchase the NAV annually to benchmark their costs and to help set prices. This year, for the first time, the NAV is available in both a printed version and a diskette version (in read-only, Adobe Acrobat format). There are separate reports for commercial banks and credit unions, and all reports are \$150 each.

Institutions can receive their own cost accounting data in a tailored report prepared specifically for them, along with free copies of the NAV in print and diskette versions, by participating in the FCA program. To request an order form for the NAV or information on participation in the FCA program, please call Dan Horton at (314) 444-8629.