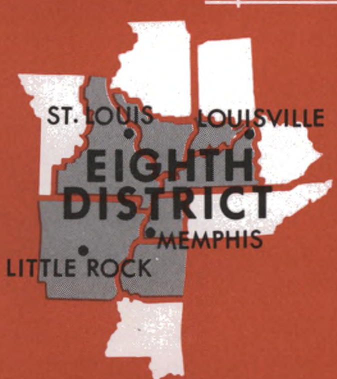
FEDERAL RESERVE BANK
OF ST. LOUIS

JUNE 1972

REVIEW



CONTENTS

Vol. 54, No. 6

Recovery Accelerates

by NORMAN N. BOWSHER

THE TEMPO of economic activity has been quickening. Recovery from the 1969-70 recession began rather slowly, but since late last summer the pace has accelerated. The Census Bureau's composite of leading business indicators rose in April for the tenth consecutive month. Expansionary monetary actions, increased Federal spending, and tax changes have contributed to the greater activity, yet continued progress has been made in reducing the pace of inflation.

Business Developments

Spending – Crucial to any significant economic expansion in our market system is a strong demand for the nation's output, and it appears that such a demand has been developing. Total spending on goods and services rose at an annual rate of 10 percent from the third quarter of 1971 to the first quarter of this year. This compares with rates of 7 percent in the previous year and 4.6 percent in the year before that. Data available for April and May indicate that the growth of spending has continued to rise rapidly in the second quarter of this year.

Not only has demand been vigorous, but recent developments in the housing sector and in the volume of inventories indicate a reserve source of strength to prolong the expansion. Housing starts were at an annual rate of 2.4 million in the first four months of 1972. By comparison, starts were 2.1 million in 1971 and 1.5 million in both 1969 and 1970.

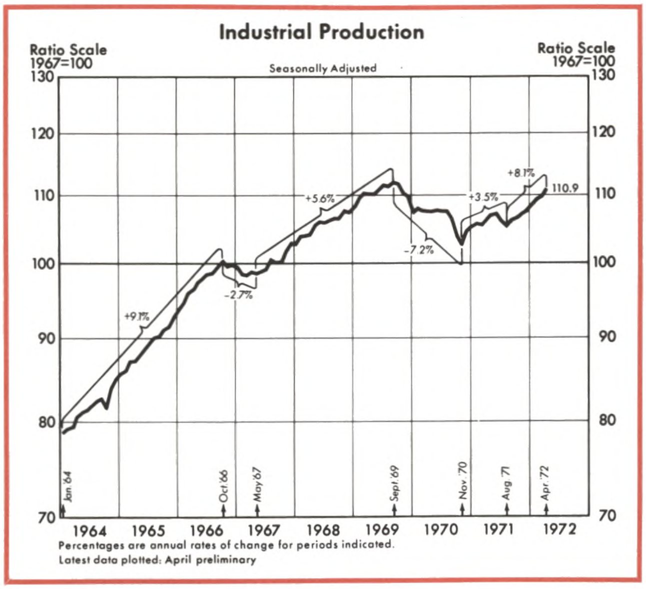
Business sales rose faster than inventories in late 1971 and early 1972 and, as a result, the inventory/sales ratio declined to 1.49 in the first quarter of 1972. By comparison, the ratio averaged 1.55 during 1971 and 1.57 during the four previous years. Unless sales falter, some step-up in inventory accumulation might be expected later this year in view of the relatively low level of stocks currently.

Growth in spending has been accommodated, in part, by a rise in credit outstanding. Real estate loans, consumer credit and business advances have all expanded in recent months. The cost of credit has risen somewhat since February with the increased demand for funds, but remains below average levels of recent years. For example, interest rates on highest grade seasoned corporate bonds averaged 7.3 percent in May and early June, compared with 7.2 percent in January, 7.4 percent in 1971 and 8 percent in 1970.

Production – Reflecting strong demands for goods and services, production has been gaining momentum. Total real output rose at a 5.7 percent annual rate from the third quarter of 1971 to the first quarter of this year. By comparison, real output increased 2.4 percent in the previous year, after declining slightly in the year before that.

Industrial production has been particularly strong with most industry groups sharing in the greater activity. From last August to April, industrial production expanded at an 8.1 percent annual rate. From November 1970, when the economy was at a recession low and hampered by a major automobile strike, to last August production rose at only a 3.5 percent rate.

New construction put in place was at an annual rate of $121.5 billion in the first four months of this year. This was an 18 percent annual rate of increase from the four months ending last September.

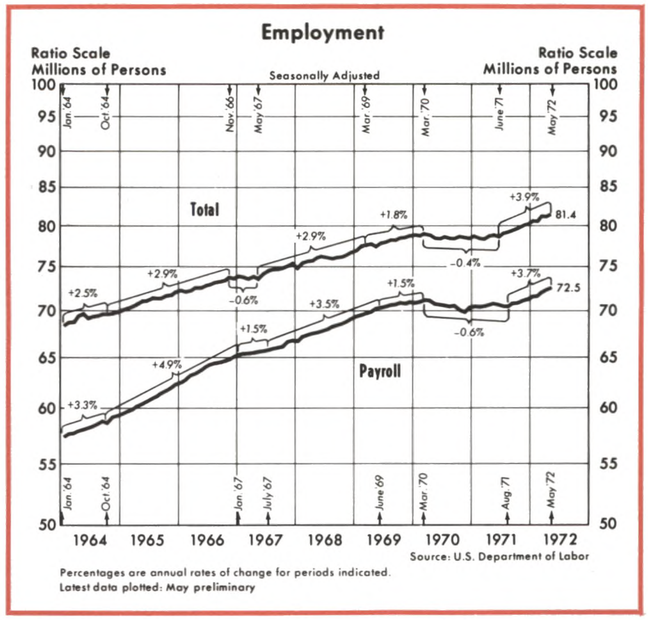


Employment — The greater production has been accomplished by increasing the utilization of the labor force and by a rise in the productivity of labor. Total civilian employment rose at a 3.9 percent annual rate from June 1971 to May after changing little in the previous year and a half. The trend growth in employment was 1.5 percent per year from 1957 to 1971. Average hours worked per week in manufacturing was 40.7 in April and May, up from 39.7 in the three months ending last October.

The widely publicized unemployment rate — which has remained just below 6 percent — has reflected a sharp increase in the labor force as job opportunities have improved. Unemployment among married men declined from 3.2 percent in the third quarter of 1971 to 2.9 percent in the February-May 1972 period. In March, April, and May total employment was an estimated 64.4 percent of the population of working force age (16-64). By comparison, in the third quarter of last year employment amounted to 63.8 percent of this population, and in the relatively prosperous year of 1965 it averaged about 63 percent.

Labor efficiency has also risen. From the second quarter of last year to the first quarter of this year, output per man-hour in the private sector of the economy rose at a 3.1 percent annual rate. By comparison, from early 1966 to the spring of 1971, output per man-hour increased at a 1.9 percent rate.

Income — Together with greater sales, production, and employment, incomes have also been rising. From October of last year to April, total personal income rose at a 9 percent annual rate. Wage and salary disbursements rose at an even faster 12.7 percent rate.



In the previous year total personal income rose 7.1 percent.

Corporate profits, which had been sluggish since the mid-sixties, rose at an 18 percent annual rate from the third quarter of last year to the first quarter of this year. Nevertheless, profits early this year were only 13 percent higher than their 1965 level, a 14 percent decline in real terms. By sharp contrast, from 1965 to early 1972 wage and salary disbursements increased 70 percent, or 29 percent in real terms.

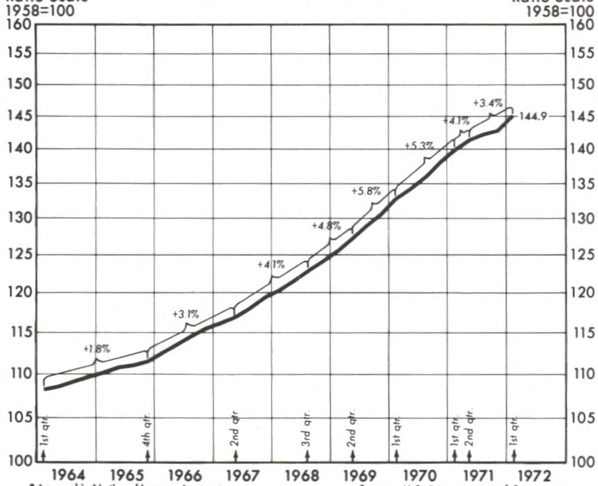
With improved profits, the climate for further risk-taking is encouraged. Concern has developed, however, that profit margin ceilings might discourage expansion or lead to waste and inefficiency. Thus far, there is little evidence that controls have jeopardized the overall recovery or have reduced efficiency materially.

Inflation

The rate of advance in prices has slowed since last summer, but the pattern has been uneven. During the three-month "freeze" from mid-August to mid-November, wholesale quotations changed little and the rise in consumer prices slowed greatly. After the freeze was lifted, price increases accelerated, as had been expected, but since February price increases have been moderate.

On balance, price developments since last August have continued around the trend toward the less inflation that began in early 1970, and primarily reflect the slack in the economy. It is still too early to evaluate the effect of the price-wage control program on

General Price Index*



*As used in National Income Accounts
Source: U.S. Department of Commerce
Percentages are annual rates of change between periods indicated.
Latest data plotted: 1st quarter

inflation, but data to date suggest its overall contribution has been marginal. Producing a marked slowing in inflation by direct controls is a difficult task, since more rigorous restraints on prices and wages would be costly to administer and would likely be accompanied by shortages, black markets, quality deterioration, and reduced incentives.

Inflation was most severe, as measured by rates of increase in overall prices (GNP implicit deflator), from the second quarter of 1969 to the first quarter of 1970. In this period, general prices rose at a 5.8 percent annual rate. From early 1970 to early 1971, quotations increased 5.3 percent. In early 1971 price increases were at about a 4 percent rate, and since the second quarter of last year have been at a 3.4 percent rate.

Consumer prices have followed a similar pattern. From March 1969 to June 1970, average markups were at a 6.1 percent annual rate. In the following year ending June 1971, consumer prices rose 4.5 percent. Since last June they have slowed to a 2.8 percent rate.

The trend rate toward less inflation is also evident in the wholesale sector, but the progress has been more erratic since short-run variations in supply conditions generally have a larger effect on wholesale prices than on other prices. From last August to May, wholesale industrial prices rose at a 2.9 percent annual rate, down from the average 3.9 percent rate from October 1968 to August 1971.

Fiscal Developments

Taxing and expenditure actions by the Federal Government had an expansionary effect on the economy during 1970 and 1971. In early 1972 they became moderately restrictive, but this is expected to be reversed soon.

Federal expenditures, on a national income accounts basis, rose at a 4.5 percent annual rate from mid-1968 to the end of 1969. From then until the end of 1970, Federal spending went up 8.5 percent. Since late 1970 it has risen at a 10 percent rate. In addition, last fall personal tax exemptions were increased, excise taxes on automobiles were lowered, and an investment tax credit was legislated.

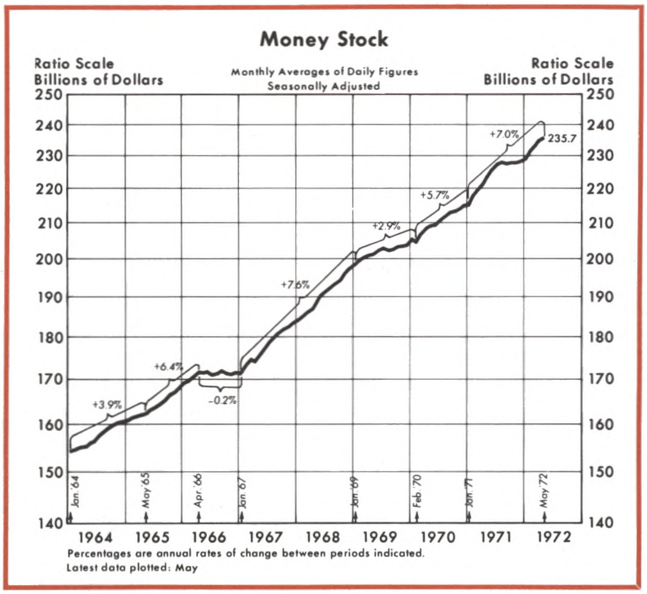
The high-employment budget, which provides an approximate measure of the overall impact of current fiscal actions on economic activity, was $11.4 billion in surplus during 1969. With progressively more stimulative actions, the surplus declined to $6.9 billion in 1970, and further to $1.6 billion in 1971. In the first three months of 1972, however, the surplus rose to roughly an $11 billion annual rate. The marked reversal early this year in the budget was caused, in large part, by over-withholding of individual income tax, an unexpected development which arose with the new withholding tax schedules. This over-withholding is expected to diminish some as the year progresses and will be approximately matched by large refunds in early 1973. Given the projected increases in Government expenditures and the tax payment pattern, the high-employment budget is expected to maintain a small surplus, on average, for the remainder of 1972, then move into a substantial deficit in the first half of 1973.

Monetary Actions

Since 1970 monetary expansion has been more rapid than the earlier trend growth, providing a strong stimulus to economic activity. The money stock of the nation rose at a moderate 2.9 percent annual rate from January 1969 to February 1970. From February 1970 to January 1971, money increased at a 5.7 percent rate, approximately the trend growth since late 1966. From January 1971 to May 1972, it expanded at a faster 7 percent rate.

Underlying the various growth rates of money have been approximately similar expansions in the monetary base. The multiplier relationship between base and money has changed little over this period. Movements in the base, in turn, were largely dominated by changes in Federal Reserve Bank credit.

The trend growth of money, which has its major impact on the trend rate of prices, has accelerated at least twice in the past two decades. From early 1952

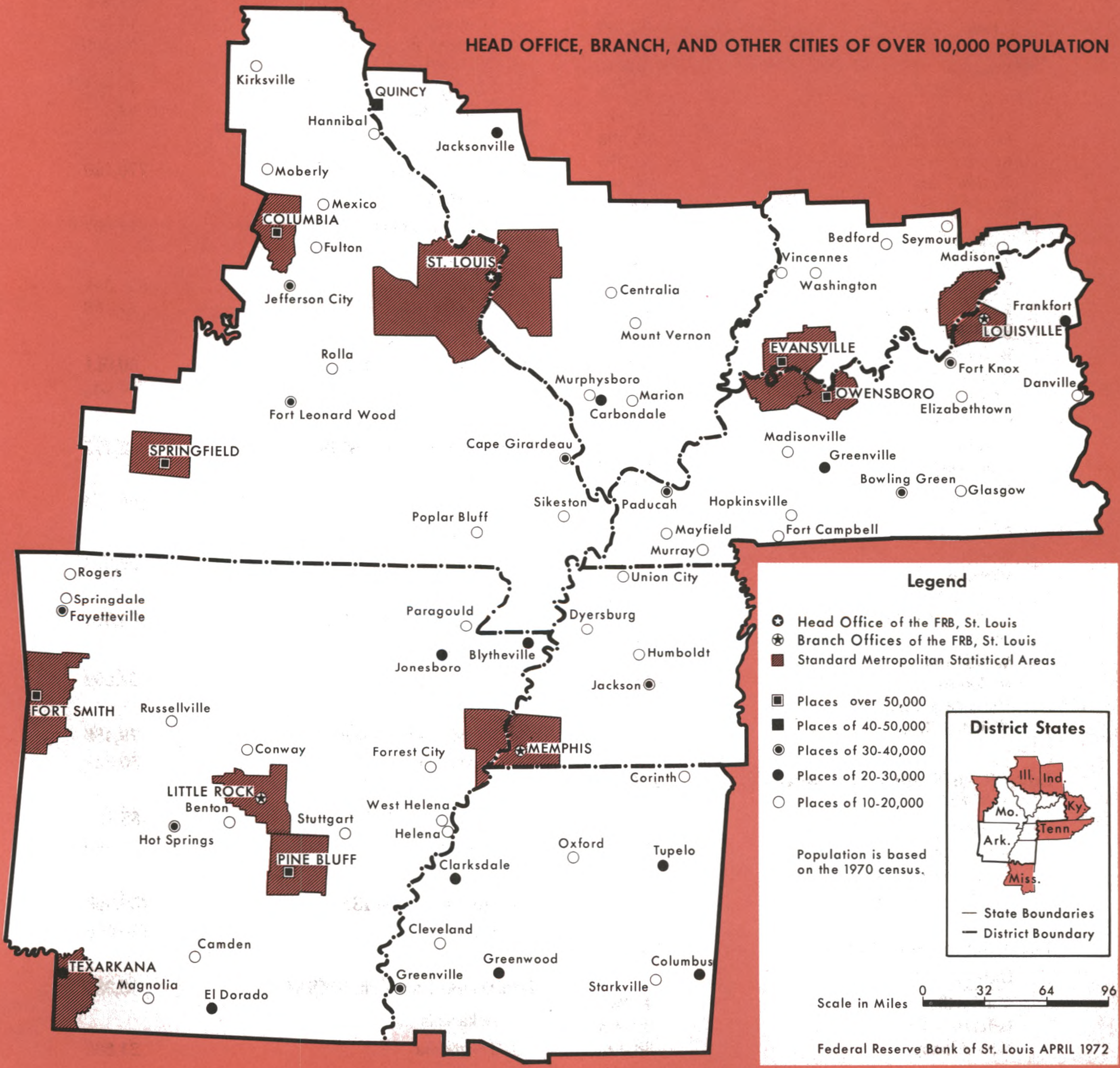


until the fall of 1962, money rose at an average 1.7 percent annual rate, and overall prices (GNP deflator) rose at a 1.8 percent rate. From the fall of 1962 to the end of 1966, money rose at a 3.7 percent rate, and after a lag of about three years, prices began increasing at a 3.9 percent rate. From late 1966 to the end of 1971, money rose at a 5.9 percent rate, and from mid-1969 to mid-1971, prices rose at a 5.4 percent rate.

Summary

Spending, production, employment, and income have all risen at an advanced pace since early last fall. The expansion has been fostered, in large measure, by stimulative monetary actions. Increases in Government spending and tax changes have contributed to the increased activity, but the overpayment of taxes by withholding in early 1972 provided some restraint. Reflecting primarily some excess productive capacity in the economy during the past nine months, the rate of inflation has continued to slow, but this slack is decreasing and will soon disappear as an effective anti-inflationary force.

EIGHTH FEDERAL RESERVE DISTRICT



POPULATION OF STANDARD METROPOLITAN STATISTICAL AREAS AND CITIES OF OVER 10,000 IN THESE AREAS IN THE EIGHTH FEDERAL RESERVE DISTRICT[1]

St. Louis, Mo.-Ill. SMSA	**2,363,017**
Illinois	
Alton	39,700
Belleville	41,699
Cahokia	20,649
Centreville	11,378
Collinsville	17,773
East St. Louis	69,996
Edwardsville	11,070
Granite City	40,440
Wood River	13,186
Missouri	
Affton	24,067
Ballwin	10,656
Bellefontaine Neighbors	13,987
Berkeley	19,743
Brentwood	11,248
Bridgeton	19,992
Clayton	16,222
Crestwood	15,398
Ferguson	28,915
Florissant	65,908
Hazelwood	14,082
Jennings	19,379
Kirkwood	31,890
Ladue	10,491
Maplewood	12,785
Overland	24,949
Richmond Heights	13,802
St. Ann	18,215
St. Charles	31,834
St. Louis	622,236
University City	46,309
Webster Groves	26,995
Little Rock-North Little Rock, Ark. SMSA	**323,296**
Jacksonville	19,832
Little Rock	132,483
North Little Rock	60,040
Southwest Little Rock	13,231
Louisville, Ky.-Ind. SMSA	**826,553**
Indiana	
Clarksville	13,806
Jeffersonville	20,008
New Albany	38,402
Kentucky	
Louisville	361,472
Okolona	17,643
Pleasant Ridge Park	28,566
St. Matthews	13,152
Shively	19,223
Valley Station	24,471
Memphis, Tenn.-Ark. SMSA	**770,120**
Arkansas	
West Memphis	11,007
Tennessee	
Memphis	623,530
Millington	21,106
Columbia, Mo. SMSA	**80,911**
Columbia	58,804
Evansville, Ind.-Ky. SMSA	**232,775**
Indiana	
Evansville	138,764
Kentucky	
Henderson	22,976
Fort Smith, Ark.-Okla. SMSA[2]	**104,914**
Arkansas	
Fort Smith	62,802
Owensboro, Ky. SMSA	**79,486**
Owensboro	50,329
Pine Bluff, Ark. SMSA	**85,329**
Pine Bluff	57,389
Springfield, Mo. SMSA	**152,929**
Springfield	120,096
Texarkana, Tex.-Ark. SMSA[2]	**33,385**
Arkansas	
Texarkana	21,682

[1]Based on 1970 Census. The Eighth District boundaries reflect the transfer of 24 counties in western Missouri to the Kansas City Federal Reserve District on January 24, 1972.

[2]Includes only the Arkansas portion of the SMSA.

The Hunt Commission Report – An Economic View*

**Remarks by CLIFTON B. LUTTRELL, Assistant Vice President,
Federal Reserve Bank of St. Louis,
to the Management Group of this Bank, April 14, 1972**

The views and interpretations stated below are those of the author and do not necessarily reflect the opinions or policies of the Board of Governors of the Federal Reserve System or of the Federal Reserve Bank of St. Louis.

THE HUNT COMMISSION, appointed by President Nixon to study the structure and regulations of the nation's financial institutions, was composed of ten executives of financial agencies, six executives of other firms, two academic economists, one labor union leader, and an attorney-politician. The professional staff which apparently exercised a major influence in formulating both the objectives and final recommendations of the report consisted largely of economists. Chief staff roles were played by the Co-Directors Donald Jacobs of Northwestern University and Almarin Phillips of the University of Pennsylvania.

The President issued the Commission a mandate to "review and study the structure, operation, and regulation of the private financial institutions in the United States, for the purpose of formulating recommendations that would improve the functioning of the private financial system."[1]

The Commission's intermediate objective in carrying out this mandate was "to move as far as possible toward freedom of financial markets and equip all institutions with the powers necessary to compete in such markets."[2]

The Commission recognized that most of the problems of our financial system are the result of legislation enacted in response to financial crises, such as that of the early 1930s. The Commission recognized that the resulting overly-protected financial system is not suited to efficiently meet the nation's current demands for financial services and outlined a series of proposals to make it more competitive and flexible. From an economic view the proposals generally elicit favorable comment.

In consequence, my discussion consists largely of providing theoretical background for some of the recommendations which lacked such a foundation and offering some criticism of minor features of the proposals which appear to be the result of compromises between the occupational interests of some Commission members and the Commission's overall objectives.

Competition in the Private Enterprise System

An economist views a competitive private enterprise system as an elaborate mechanism that unconsciously coordinates the production of goods and services through competitive prices and markets. Each good and service, including the different kinds of human labor, has a price. Although the true price of a commodity is the amount of all other goods and services foregone, it is convenient to express prices in money units. Everyone receives money for what he sells and uses the money to purchase what he desires. If people want more automobiles they will bid up the price and the higher priced automobiles will provide incentive for increased automobile production.

The competitive price mechanism thus brings into equality production and consumption of each good and service. Such a mechanism assures that producers will produce at the lowest possible cost since, if they

*This presentation was given before a group who had some prior knowledge of the contents of *The Report of the President's Commission on Financial Structure & Regulation,* commonly known as the Hunt Commisssion Report. Interested readers may find it helpful to consult the *Report* for more complete information on the points discussed.

[1] *The Report of the President's Commission on Financial Structure & Regulation* (December 1971), p. 1.

[2] *Ibid.,* p. 9.

fail to economize on labor or other resources, competitors can undersell them and attract their customers. Higher profits are awarded to the most efficient producers and reduced profits or losses are incurred by the less efficient. In the absence of external effects of production, such as pollution, the free competitive system works most efficiently with a minimum of legal interference.

Financial institutions, which constitute a major sector of our private enterprise system, are subject to the same competitive forces as other firms. Commercial banks purchase time and savings deposits, attract demand deposits, make loans, sell investment funds and trust services, and perform numerous other services incidental to banking. Other financial firms also purchase and sell financial claims and services.

Those firms that can buy, service, and sell most efficiently will tend to grow the fastest and make the greatest profits. They will tend to innovate more readily, have greater flexibility, and contribute more to community prosperity and growth than the less efficient firms. With these objectives in view, the Hunt Commission proposed that the legal restrictions on financial institutions be loosened somewhat to permit greater competition among firms. It believed that the present excessive legal restraints have both retarded the growth of the more efficient financial firms and slowed general economic development.

During the course of my discussion, I do not take the recommendations one by one, but group them into broad classes having common characteristics relative to the functioning of financial markets.

Proposals for Relaxing Interest Rate Restrictions

First, I shall comment on the Commission's proposals for removing restrictions with respect to interest rates. These recommendations call for phasing out interest rate ceilings on time and savings deposits and dividend restrictions on savings and loan association shares, providing for market rates on FHA and VA loans, and removing statutory rate ceilings on mortgage loans.

Interest rate ceilings were authorized at the Federal level during the early 1930s to prevent so-called "cutthroat" competition. The large number of bank failures at that time were believed by some observers to be the result of "excessively risky loans" which banks were forced to make in order to maintain competitive interest rates on deposits. Thus, a mass of New Deal legislation was enacted to reduce such competition. Banks were prohibited from paying interest on demand deposits, and regulatory authorities were given a responsibility to set ceiling rates on time and savings deposits. A cursory examination of banking since then gives the appearance that the program has been highly successful. Bank failures have indeed declined to a very low rate.

The reduced rate of bank failures, however, cannot be traced to the interest rate ceilings. The rate of failures since the Great Depression of the 1930s has been no greater in those years when market rates were paid on time and savings deposits than when Regulation Q restrictions prevented the payment of market rates. For example, since 1945 there have been seven years when Treasury bill rates were generally above the maximum ceiling rates on savings deposits, thus preventing banks from paying the market rate for savings. During these years an average of 5.29 banks failed per year. Almost the same rate, 5.17, failed per year during the eighteen years when Treasury bills were well below the ceiling rates on time and savings deposits.[3]

The modest proposals of the Commission for reducing such restrictions were certainly in the right direction, but they were made with the apparent fear of treading on quicksand when in fact the foundation was solid. As indicated earlier, during most of the period since the Great Depression the ceilings on time and savings deposit rates have been sufficiently high to be ineffective. Nevertheless, few failures have occurred.

Hazardous situations for bank survival have occurred only in periods following sharp variations in money growth from the trend rate, as in the years since 1965. During this period of rapid money growth, spending and prices rose sharply and inflationary expectations were reflected in higher interest rates. The market rates rose above the ceilings and financial intermediaries were prohibited from paying competitive rates. The inflow of savings declined as savers found other types of investments that yielded higher returns. The restrictions were thus probably more damaging than helpful to the survival of financial intermediaries.

The Commission wisely recommended that the rate restrictions on FHA and VA loans be removed. Prior to limiting the points that could legally be charged borrowers under the FHA and VA programs, the point

[3]For a comprehensive analysis of the impact of interest rate regulation see Albert H. Cox, Jr., *Regulation of Interest Rates on Bank Deposits* (Ann Arbor: University of Michigan, 1966), and George J. Benston, "Interest Payments on Demand Deposits and Bank Investment Behavior," *Journal of Political Economy* (October 1964), pp. 431-449.

spread between the face amount of the mortgage and the amount of funds actually disbursed accounted for the difference between the legal and market rates. Once the points that could be paid by purchasers were limited by law, sellers were forced to make up the difference between legal and market rates by raising their selling price on homes, thus creating an additional problem in real estate sales. The proposal that such mortgages be made at market rates would involve fewer calculations and less effort in shopping for and transacting real estate business.

Although the recommendation that states remove the statutory ceilings on mortgage loan rates is another move toward market determined rates, I see no reason why the recommendation was limited to mortgage loan rates. All loan rate limitations channel funds into less risky loans and deny borrowers who have limited assets the right to pay higher rates to cover such risks. Since lenders make only the less risky loans when rates are actually restricted, the restrictions in effect deny higher risk borrowers access to credit markets. Competition among lenders will assure a market rate to borrowers in the same manner that commodity and other prices are determined in competitive markets.

The Commission pointed out the problems involved in enforcing the prohibition of interest payments on demand deposits. Among the numerous substitutes and subterfuges used to escape the regulation are provisions for "free" services, lower loan rates to those having large deposits, and third party payments by savings and loan associations. A firm or business selects the bank that will provide the package of banking services with the greatest return at the least cost. Thus, if legal restrictions prohibit the payment of the market price for one type of service, the impact of such restrictions will likely be offset by price or service concessions elsewhere.

Despite the use of numerous substitute payments, money is the more efficient means of payment. Other forms of payment lead to poor allocation of resources, since money is the only means whereby all can maximize their returns on deposits at the margin. Nevertheless, the Commission concluded that the undesirable effects of the immediate abolition of the prohibition of interest payments on demand deposits would be greater than the costs imposed by its continuation.

Relaxing Operational Restrictions on Financial Institutions

The proposals that structural and operational restrictions on financial institutions be relaxed should lead to lower cost financial services. The removal of restrictions, such as limitations on branch banking, and the relaxation of loan and investment restrictions on savings and loan associations (S&Ls) and mutual savings banks should increase the ability of these firms to compete in all markets. Permitting S&Ls and mutual savings banks to accept checking accounts and all the depository institutions to sell and manage mutual funds should likewise lead to greater competition in both banking and the mutual fund business.

The proposals would permit S&Ls and mutual savings banks to compete with commercial banks in servicing checking accounts and convert to commercial banks if they so desire. If they want to become commercial banks, I see no reason why their access to the banking field should be prohibited. Furthermore, I see no reason for the continuation of limited entry into banking as long as the participants can provide assurance of reliability.

It has been argued that banking is a special type of industry into which entry should be limited to protect vital public interests. For example, it is argued that medicine, steamfitting, plumbing, law, and the clergy require special licensing by the state or some association to assure the safety of the public. To such arguments I would reply that the restrictions to entry have always been passed with a grandfather clause; that is, those who were then in the occupation could remain.

If public safety were the major factor, the unqualified should be removed at the time entry is restricted. In addition, if public safety were foremost in view, regular examinations would be required to see that those in the occupation remained qualified. New techniques often result in old methods becoming obsolete. Instead of such assurance that current practitioners remain qualified once a license is obtained, license holders generally have a right to a lifetime practice without further qualification. I thus conclude that most licensing and chartering restrictions are used primarily to restrict entry and provide an element of monopoly power to those already in the business and are in fact not in the public interest.

The conversion proposals, along with others which provide for additional chartering powers, tend to loosen the restrictions on entry into banking. With more agencies having power to charter banks or depository institutions which have free conversion privileges among themselves, we may again approach free entry into the finance business. With free entry we can remove most bank holding company and merger restrictions. Such restrictions will then be obsolete since monopoly is almost impossible given the relatively small efficiencies of scale among financial institutions, except for the very small firms.

The Commission recognized the fact that branching can increase competition in many bank markets.[4] Nevertheless, it failed to recommend Federal legislation on this subject. For example, it could have proposed that the National Banking Act be amended to permit statewide branching by national banks. Instead, it recommended that state laws be changed to permit statewide branching. This recommendation provides for little optimism that changes in bank structure will be forthcoming, given the deliberation with which most states move, when they move at all, to improve banking services. One can only conclude that a significant amount of compromising among the Commission members led to such a recommendation.

Public Welfare Goals

Throughout the report there is considerable discussion about housing goals. The Commission, however, logically refused to make recommendations for special financial agency regulations designed to increase credit flows into the housing market.[5] It apparently could not resist completely the pressure for so-called socially desirable credit, however, since it did recommend special tax credits to investors in residential mortgages. However, as pointed out by two dissenters, such credits would mean heavier taxes elsewhere and fewer financial resources in the nonhousing sector of the economy.

Insurance on Bank Deposits and S&L Shares

In view of the proposal that savings and loan associations and mutual savings banks be permitted to function more like commercial banks, the Commission's recommendation that all depository insurance corporations be combined into the Federal Deposit Guarantee Administration is appropriate. Nevertheless, the Commission rejected any change in the current method of assessing premiums at a fixed percent of deposits, despite substantial variations in portfolio risks among banks. In addition, the proposals, if implemented, may further widen the variation of risks among firms. For example, if S&Ls and mutual savings banks are permitted to invest in equities up to 10 percent of their assets, their portfolios will carry greater risks than under current operating practices. Similarly, commercial bank risks will increase if some banks invest in the proposed special purpose equities such as community rehabilitation projects.

The increased competition within the financial system provided in the proposals should warrant the establishment of deposit insurance rates in some relationship to risk. Even under current supervisory regulations, deposit insurance assessments could be used instead of moral suasion to achieve desired objectives, such as capital to asset ratios consistent with risks in individual firms and minimum insurance premiums consistent with a reasonably competitive financial system.

There are significant reasons why the deposit insurance assessments should be made on the basis of risks. First, if all financial firms pay the same rate of assessment on deposits, those with higher risk assets are being subsidized to the extent that such banks are a heavier expense to the insuring agency. Thus, there is some incentive to increase risks given the current inflexible system of assessments. With the increased competition in prospect, the incentive to take greater risks may be increased.

More to the point, however, equity capital in any organization is designed to be the chief risk taker. Since the FDIC has assumed much of the banking risks, it has replaced part of the risk bearing function of equity capital. Banks have thus found it profitable to permit their capital to asset ratios to drift downward since there is little incentive for high ratio maintenance. With a higher assessment on banks with low capital ratios, they will have greater incentive for building up capital and reducing deposit insurance costs.

Reserve Requirements

The Commission's recommendations that all institutions holding demand deposits be required to become members of the Federal Reserve System would place them all under similar competitive rules. Likewise, the proposals for eliminating reserves on time and savings deposits, equal reserve requirements for all banks, and the gradual reduction of reserve requirements over time are moves intended to achieve greater equity among financial firms.

Chartering, Regulations, and Supervisory Recommendations

The recommendations for granting federal charters to stock savings and loan companies, mutual savings banks, and mutual commercial banks will tend to in-

[4] *The Report of the President's Commission on Financial Structure & Regulation,* p. 45.

[5] *Ibid.,* pp. 84-85.

crease competition. As pointed out in the report, when a particular type of financial institution can be chartered by only one administrative agency, the agency tends to become over-zealous in protecting existing firms and forecloses entry by new firms. It is much easier to appease existing firms with a charter denial and confuse the public with the comment that the area is becoming "overbanked" than to serve the public interest by granting charters freely.

As pointed out earlier, I can see no reason why free entry will cause overbanking, overfarming, or an excess of participants in any industry. As long as there is sufficient incentive in an occupation to attract new entrants with their labor and capital, any legislative or administrative action to limit entry reduces efficiency in the production of goods and services.

The proposal that any depository institution has the right to change its charter to that of another type of depository institution should help to assure that overly protective chartering will not occur. If any of the numerous chartering agencies will freely grant charters, there should be relatively free entry into each type of financial activity.

Most of the proposals for restructuring the regulatory and supervisory agencies apparently have little economic content. The new office of Administrator of State Banks would be an independent agency taking over most of the bank supervisory functions of the Federal Reserve System and the FDIC. The Comptroller of the Currency's function would be removed from the Treasury Department and made an independent agency. The Commission felt that these moves would tidy up the administrative functions and leave the Federal Reserve System free to concentrate its attention and resources on economic stabilization policy.[6] I have some reservations, however, in concurring with the view that the additional concentration on stabilization objectives will provide much improvement in stabilization actions. Nevertheless, there may be some specialization gains.

Single Tax Formula

The proposals for enactment of a single tax formula for all financial agencies which hold demand deposits and an eventual uniform tax formula for all depository institutions offering third party payment services are consistent with maximum efficiency. The Commission urged Congress to enact a tax system that would provide for uniform tax treatment for such firms whether organized on a stock or mutual basis. Currently, firms organized on a mutual basis generally receive more favorable tax treatment. There is little justification for different tax rates for firms just because they happen to be organized differently. If one type of financial intermediary pays less tax, it is in effect being subsidized by those paying more. Under such an unequal tax system there is no means of determining whether a firm can operate competitively. If it cannot operate in a competitive market without subsidies, it should not be in existence since it is wasting valuable resources.

Summary

In summation, the Commission's recommendations are generally consistent with the goal of increasing competition in a private enterprise economy. Its proposals for broadening the activities of financial firms and reducing their structural rigidities are all consistent with greater efficiency. The proposals for tax equality and greater uniformity of operating rules, such as reserve requirements and portfolio holdings, tend to provide greater equality of opportunity for profitable operation. The most efficient firms survive and prosper under such conditions and the less efficient tend to drop out and are taken over by the survivors. Relatively free entry and exit are typical of competitive firms. Such a system meets our demands for goods and services at the lowest per unit cost. The Commission's proposals would move our financial system a long step toward greater competition.

My major complaints with the proposals are the timidity shown in certain recommendations, such as the ten-year interval for removing interest rate controls on time and savings deposits, the hesitancy in recommending freedom for banks to purchase demand deposits, the useless recommendation that states permit statewide bank branching, and the lack of analysis with respect to deposit insurance assessments. These failures, however, can probably be attributed to compromises which were necessary to reach the major agreements in the report. Thus, the recommendations were probably the best obtainable given the occupational interests of the Commission members.

[6]*Ibid.*, p. 91.

A Look at Ten Months of Price-Wage Controls

Remarks by
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Before the Eastern Missouri Member Bankers,
St. Louis, Missouri, June 14, 1972

ON AUGUST 15, 1971, the U.S. economy entered into a situation unparalleled in its history. A system of price and wage controls was instituted during a period of considerable economic slack. Previously, such extensive controls had been used during periods when demand for goods and services exceeded the economy's ability to meet the demand. While the price-wage guideposts of the early 1960s also occurred during a time of considerable economic slack, those measures did not represent as vigorous an attempt to control the pace of price and wage advances as the present effort.

The New Economic Plan has also called for stimulative actions to promote an accelerated recovery from the recent recession. Since August the pace of economic expansion has definitely quickened. For example, industrial production has grown at an 8 percent rate since last August, compared with a 3.5 percent rate of increase from the business cycle trough in late 1970 to last August. Employment increased at a 3.7 percent rate from August to May, a marked contrast to virtually no growth in the preceding nine months.

While there is general agreement that the recovery is undergoing a vigorous expansion, considerable concern has been expressed regarding the contribution of the established system of price-wage controls to a reduction in the rate of inflation. My remarks today will be concerned mainly with an evaluation of this question.

Ten months have now passed since the start of the attempt to slow, by a system of price-wage controls, the stubborn inflation of the last seven years. We have had only limited experience with this control system to date, so any evaluation of its contribution thus far will have to be tentative. My reading of the record since last August leads me to conclude that there is little support for the proposition that the rate of inflation has been reduced considerably from what it would have been in the absence of the program.

Before presenting the details of my evaluation, I will provide a brief summary of the general view of the inflationary process which underlies the present control system. This background will then be used to evaluate the record of the fight against inflation since last August. Later in my remarks I will present an alternative view of the basic causes of inflation and will use this view in assessing the possible contribution of controls to promoting price stability.

The General View of Inflation and Controls

A large majority of economists have arrived at a generally accepted view of the forces which underlie the inflationary process. Changes in the price level, it is argued, result basically from a mark-up of unit labor costs. Events underlying changes in the level of wages relative to changes in labor productivity are considered important factors in the determination of changes in unit labor costs and, hence, movements in the price level. In addition, forces which alter the mark-up of costs are viewed as other important causes of inflation.

Wage movements, according to this view, are greatly influenced by the amount of economic slack in existence at any point in time. The greater the slack, frequently measured by a high unemployment rate, the slower wages are expected to rise. On the other hand, a high degree of resource utilization is expected to lead to more rapidly rising wages.

Productivity, or output per manhour, grows overtime at a trend rate determined by advances in technology, accumulation of capital, and increased skill and training of the labor force. Productivity also exhibits short-run movements, rising rapidly as the economy moves upward from the trough of the business cycle and slowly as a cycle peak is approached.

Wages and productivity are constantly changing relative to each other, and these movements, in turn, produce movements in the price level. For example, an increase of wages in excess of productivity gains, according to this widely accepted view, increases unit labor costs, thereby producing a rising level of prices.

This view argues that inflation stems from two primary sources. The first source is a great expansion in demand for goods and services which leads to a high level of resource utilization, or put another way, low unemployment. Growth of aggregate demand leads to an expansion of demand for labor. As a result, wages rise faster than productivity gains, producing a rise in the price level. This is the so-called "demand-pull" inflation.

The second source of inflation is believed to be the exercise of monopoly power by labor unions and large corporations. Labor unions, it is argued, have the power to achieve wage increases in excess of productivity gains. Large business firms are considered to have the power to control the mark-up applied to costs in setting prices for their products. A rise in prices from monopoly power is frequently referred to as "cost-push" inflation. In recent years, this explanation has been used to account for continued inflation, even though considerable slack was present in the economy.

Let us now examine how this generally accepted view regarding the inflationary process has shaped the present price-wage control program. I want to emphasize that the present effort to control inflation is to be accompanied by monetary and fiscal actions designed to rapidly expand the demand for goods and services and thereby lower the unemployment rate. According to the preceding analysis, such a result would be expected, in time, to exert upward demand pressure on prices. In addition, at the time the controls were initiated, it was believed that cost-push forces would remain strong for some time to come. Thus, price-wage controls are an integral part of an overall plan to promote rapid expansion of employment and at the same time reduce inflation.

The control program is, therefore, based on two central ideas – controlling wage increases and limiting the price mark-up of the costs of goods and services. Wage increases are to be based on a set of guidelines. Price increases are to reflect primarily a percent pass-through of increases in costs, with wage costs being reduced by gains in productivity. A limit is set for each business firm's profit margin, thereby limiting its ability to increase its average mark-up of costs in setting prices of its products.

A Look at the Period Since August 15

Let us now examine the record since last summer for an evaluation of the contribution of the present system of controls to reducing inflation. Two questions need to be answered in arriving at an evaluation. First, have wage and price advances actually slowed? Second, if some slowing has occurred, has it been greater than would have occurred in the absence of the program?

Has Inflation Decelerated?

There is no doubt that during Phase I price and wage advances came to a virtual halt and that since the beginning of Phase II, these advances have been substantial in most instances. Since a post-Phase I bulge was expected, I will compare the record over both phases – that is, since last August, with the record just prior to Phase I. In making this comparison, I will examine comparative movements within broad measures of wages, unit labor costs, and prices, rather than make comparisons in terms of adherence to established guidelines or the scaling down of major labor contract settlements. After all, it is the actual performance of key economic data series which is of foremost concern. Selection of time periods are crucial in making an evaluation, and so as not to overstate my case, I have selected periods which give the most favorable interpretation to the program.

The record since last August indicates that some slowing has occurred in the rate of advance in employee compensation, and that this slowing has reduced to some degree the upward pressure on prices from the labor cost side. Employee compensation includes both wages and the cost of fringe benefits. The best over-all measure of employee compensation, private hourly earnings in nonagricultural employment (adjusted for overtime and interindustry shifts), rose at a 6.2 percent annual rate from August to May. By comparison, the rate of increase during the six months prior to the inflation control program was almost 7 percent.

This slowing in the growth of employee compensation, along with a slight increase in productivity growth, has reduced somewhat the rate of increase in unit labor costs, a key link in the widely accepted view of the inflationary process. Unit labor costs increased at a 3 percent rate from the second quarter of last year to the first quarter of 1972, compared with a 4 percent rate of increase in the preceding three quarters.

An examination of over-all price behavior since just before the program shows some slowing in the rate of inflation. Our broadest measure of price movements in the economy, the GNP deflator, rose at a 3.4 percent rate from the second quarter of 1971 to the first quarter of 1972, compared with a rate of about 5 percent in the preceding three quarters. Although some slowing in the rate of advance of wholesale and consumer prices has occurred since February, the time is too short to conclude that their very rapid rates of increase from November to February were merely a temporary bulge following the freeze and that future advances will be less than in the six months prior to last August.

Has Inflation Been Slowed More Than Without Controls?

Now that we have observed some evidence that the over-all rate of inflation has subsided from the rate preceding last August, let us examine the proposition that the slowdown is greater than it would have been in the absence of the controls. There is evidence which suggests that such a development has not occurred.

The rate of inflation was slowing prior to the freeze, reaching a peak sometime in 1970 and then receding slowly. For example, the consumer price index rose 4.4 percent in the year ending last August, down from the 5.6 percent in the preceding twelve months. The GNP deflator had started to rise at a somewhat slower rate after early 1970. For some time prior to last summer, the rate of advance in the wholesale price index was generally stabilized. Of course, all of these series showed temporary upward surges, especially wholesale and consumer prices, in May and June of last year.

The above evidence suggests that there were downward pressures on inflation in existence prior to the adoption of controls. Morever, historical relationships indicate that a further slowing in 1971 and early 1972 could have been expected. Using such relationships, a large number of economic forecasters in early 1971 had projected a further reduction in inflation during the balance of 1971 and into 1972; these projections were not based on any assumption of controls over wage and price movements.

For example, the American Statistical Association reported a survey of about fifty forecasts made shortly before the imposition of price-wage controls. The average rate of inflation, measured by the GNP deflator, projected by this group of forecasters for the second quarter of 1971 to the first quarter of 1972 was 3.5 percent. This indicated an expected decline from the 5 percent increase in the preceding four quarters. Moreover, the average rate projected by this group of forecasters turned out to be the actual rate of increase.

Conclusions from the Record

This examination of the record since last August indicates that some reduction in the rate of inflation has occurred. The record, however, gives little support to the proposition that the rate of inflation has been reduced considerably from what it would have been in the absence of the price-wage program.

An Alternative View of Inflation and Controls

At this time, I will briefly outline another view of the cause of inflation which differs substantially from the one underlying Phase II controls, but which is consistent with the cost and price behavior we have observed. This is necessary, I believe, in order to get a proper evaluation of Phase II.

The Monetary View of Inflation

This view argues that inflation is primarily a monetary phenomenon; that is, the rate of inflation is ultimately determined by the trend growth of the nation's money stock over several years. It is further argued that the cost-push phenomenon is merely a part of the inflationary process, rather than an independent cause. The monopoly power argument is, therefore, rejected as an independent cause of inflation. This view is held by a growing number of economists, including your speaker, but it still remains a minority view.

Let us analyze the inflation record since the early 1950s from this viewpoint. The money stock, defined as demand deposits and currency held by the nonbank public, grew at a 2 percent annual rate from the first quarter of 1952 to the third quarter of 1962. Then, the trend rate of money growth was accelerated to a 4 percent rate to the end of 1966. It was further accelerated to a 6 percent rate, which has continued to the present time.

There was a period of relative price stability from the first quarter of 1952 to the end of 1965. During this period, prices, measured by the GNP deflator, rose at a very moderate 2 percent trend rate. Following the acceleration of the trend growth rate of money, prices rose at a 4 percent rate from the end of 1965 to mid-1969. Next, after another hike in the trend rate of money growth, prices rose faster — at about a 5 percent rate from mid-1969 to the price freeze.

We have been conducting considerable empirical research into the response of the rate of inflation to a change in the rate of monetary expansion. This research indicates that the trend rate of monetary expansion is the dominant factor underlying the inflationary process. It also indicates that the response of inflation to a change in the trend rate of money growth takes from five to seven years to be fully manifested.

Implications of the Monetary View for Controls

This monetary view, to the extent that it is valid, has some important implications for evaluating Phase II. First, this view states that the present program attacks the symptoms of inflation, and not the basic cause — the rapid 6 percent trend rate of growth in money since late 1966. Second, since this rapid trend rate of monetary expansion has persisted for over five years, the economy has about fully adjusted to it, and no lasting reduction in inflation will occur until money grows at a slower pace.

It is our estimate that, at a minimum, a 4 percent basic rate of inflation is implied by the monetary experience since 1966. Some short-lived improvement in this rate of inflation may result as output of goods and services expands rapidly this year. Such an expansion would produce productivity gains, and as a consequence, some improvement in price performance may be noted. However, as the economy approaches a high level of employment, productivity gains will again taper off and inflation will accelerate to about 4 percent.

Consequently, inflation may recede during the balance of 1972, giving the appearance of success to Phase II. If there is a desire, however, to produce continued improvement and there occurs no reduction in the trend rate of monetary expansion, controls will have to become tougher and tougher. This situation would have to continue, according to the monetary view, until the basic cause of inflation is treated instead of just the symptoms.