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CONTENTS

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The Growing Similarity Among Financial Institutions

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DEPOSITORY financial institutions are able to exist because of certain efficiencies which allow them to provide credit to borrowers at lower rates and higher net returns to depositors than would be available without such intermediaries.[1] These efficiencies, combined with nationally mandated priorities concerning the roles of these institutions in society, have produced institutions which are specialized in scope. Despite some efforts to maintain this specialization, financial institutions are forming a new framework within which to operate. By creating and reacting to competitive challenges, financial institutions are breaking away from their specialized roles and successfully altering traditional distinctions.

CHANGES IN ASSET COMPETITION

Response of Thrifts to Rising Interest Rates

Most depository financial institutions are subject to regulatory ceilings on the rates they are allowed to offer to attract funds. In general, these ceilings pose few problems to the institutions as long as the ceiling rates remain competitive with market rates. However, during periods of rising interest rates, short-term money market rates rise above the interest rate ceilings imposed on these institutions.

Because of their more diverse and more stable source of funds, commercial banks are not as seriously affected as "thrifts" by such an imbalance in relative interest rates;[2] being very specialized institutions, thrifts suffer more acutely from deposit outflows, called disintermediation, as market rates rise. When other short-term interest rates become more attractive than those which can be earned at the thrifts, depositors transfer their funds out of savings accounts and into other instruments. Twice during the last eight years, once in the second half of 1969 and again in 1974, disintermediation put severe financial strain on the operations of thrifts.

To complicate matters, thrifts further suffer from problems relating to short-term financing of long-term assets (mortgages). Since only a fraction of thrifts' mortgage portfolios are replaced in any one year, the average return on mortgages (the major earning asset of the institutions) typically does not rise fast enough to match increases in short-term rates. At such times, thrifts are caught in an earnings squeeze.

As these situations arise, thrift institutions increasingly are being pressured to stabilize their deposit sources of funds. Thrifts, taking advantage of the current level of technology, are attempting this stabilization by offering new deposit services (which are discussed in a following section).

At the same time, when high and variable interest rates have forced many institutions to examine the structure of their assets, thrifts are emphasizing shorter-term assets in their portfolios.

Such assets typically have shorter maturities than mortgages, yet still are within regulatory bounds. Investments, such as U.S. Government and agency securities and state and local government securities, are growing in importance. Investment securities at savings and loan associations (S&Ls) rose $23 billion between 1970 and 1976, or at an 18 percent annual rate, compared to an 11 percent rate between 1960 and 1970 (Table I). These securities increased to 9 percent of assets in 1976 from 7 percent in 1970. Investment in corporate and other securities by mutual savings banks (MSBs) increased at a 17 percent rate over the six-year period, compared to a 10 percent rate in the 1960-70 period, and rose from 16 to 25 percent of total assets between 1970 and 1976.

To shorten the average maturity of other assets, some thrifts are emphasizing the development of consumer loans, often forging new regulatory powers. Mutual savings banks and state-chartered S&Ls in Connecticut, Maine, and New York state have been authorized to expand the type of consumer loans they

[1]This article focuses only on commercial banks, savings and loan associations, mutual savings banks, and credit unions.

[2]Thrifts here include saving and loan associations and mutual savings banks.

Table I

DISTRIBUTION OF ASSETS

	1960 ($ millions)	1970 ($ millions)	1976 ($ millions)	Annual Rates of Change 1960 - 1970	1970 - 1976
COMMERCIAL BANKS[1]					
Business Loans	$43,132	$112,215	$177,128	10.0%	7.9%
Mortgages	28,694	73,053	149,276	9.8	12.7
Consumer Loans	26,377	66,006	118,051	9.6	10.2
U.S. Treasury and Agency Securities	60,423	61,617	136,729	0.2	14.2
State & Local Securities	17,337	69,390	104,374	14.9	7.0
Other Assets	80,360	194,070	318,462	9.2	8.6
TOTAL	256,323	576,351	1,004,020	8.4	9.7
SAVINGS & LOAN ASSOCIATIONS					
Mortgages	$60,070	$150,331	$323,130	9.6%	13.6%
Investment Securities[2]	4,595	13,020	35,660	11.0	18.3
Other Assets	6,811	12,832	33,209	6.5	17.2
TOTAL	71,476	176,183	391,999	9.4	14.3
MUTUAL SAVINGS BANKS					
Mortgages	$26,702	$ 57,775	$ 81,630	8.0%	5.9%
U.S. Government Securities	6,243	3,151	5,840	− 6.6	10.8
State & Local Securities	672	197	2,417	−11.6	51.9
Corporate and Other Securities	5,076	12,876	33,793	9.8	17.5
Other Assets	1,878	4,996	11,131	10.3	14.3
TOTAL	40,571	78,995	134,811	6.9	9.3
CREDIT UNIONS					
Loans Outstanding	$ 4,402	$ 14,152	$ 34,293	12.4%	15.9%
Other Assets	1,257	3,798	10,542	11.7	18.6
TOTAL	5,659	17,950	44,835	12.2	16.5

[1]Insured banks.
[2]Includes cash.
Sources: *Banking and Monetary Statistics* 1941-1970; Federal Reserve *Bulletins*.

make, which includes overdraft checking. Credit card services also have been accorded increased importance by thrifts. In 1974, Visa U.S.A. Inc. altered its bylaws to permit membership for MSBs, and in May 1976, membership was extended to S&Ls. As of August 1977, 124 of the nation's 469 savings banks were offering bank credit card services.[3]

One of the most publicized changes in thrifts' asset structure is the variable rate home mortgage (VRM), which is being successfully marketed by some state-chartered S&Ls in California and the Midwest.[4] The interest rate on a variable rate mortgage is tied to a cost of funds index such that the mortgage rate adjusts, within certain bounds, to changes in short-term market rates. With variable rate mortgages, the returns to the thrifts on their mortgage portfolios adjust more rapidly to changes in the level of interest rates than with traditional mortgages.

Increased Competition from Credit Unions

In addition to pressures from high and variable interest rates, thrift institutions will be faced with increased competition for mortgages from credit unions (CUs). In the past, length of loan maturity at credit unions was restricted to not more than 10 years, effectively excluding CUs from the mortgage market. Although state laws often permitted more latitude to credit unions with respect to real estate loans, mortgage holdings of state-chartered CUs typically have been small.

This is likely to change as a result of legislation recently passed by Congress which enables CUs to supply mortgage loans within expanded size and maturity ranges. As a result of legislation which was

[3]*Savings Bank Journal* (August 1977), p. 40.

[4]In 1976, five California S&Ls together made about $6.4 billion in new mortgage loans. Of this amount, $4 billion, or 63 percent, were VRMs. These five associations represent approximately 30 percent of the S&L industry in California. *American Banker,* May 23, 1977.

Table II

A COMPARISON OF SELECTED INTEREST RATES

	NEW AUTO LOANS			OTHER CONSUMER GOODS			PERSONAL LOANS		
	Credit Unions[1]	Commercial Banks	Auto Finance Companies	Federal Credit Unions[1]	Commercial Banks	Consumer Finance Companies	Federal Credit Unions[1]	Commercial Banks	Consumer Finance Companies
1973									
January	9.98%	10.01%	11.89%	11.36%	12.46%	19.04%	11.39%	12.65%	21.00%
February	9.98	10.05	11.86	11.37	12.51		11.40	12.76	
March	9.90	10.04	11.85	11.33	12.48	18.92	11.44	12.71	20.79
April	9.89	10.04	11.88	11.30	12.50		11.43	12.74	
May	9.90	10.05	11.91	11.24	12.48	18.88	11.41	12.78	20.76
June	10.02	10.08	11.94	11.26	12.57		11.44	12.78	
July	10.12	10.10	12.02	11.27	12.51	18.93	11.44	12.75	20.55
August	10.06	10.25	12.13	11.26	12.66		11.51	12.84	
September	9.99	10.44	12.28	11.27	12.67	18.69	11.49	12.96	20.52
October	9.97	10.53	12.34	11.32	12.80		11.48	13.02	
November	10.02	10.49	12.40	11.43	12.75	18.77	11.43	12.94	20.65
December	10.22	10.49	12.42	11.43	12.86		11.36	13.12	
1974									
January	10.20	10.55	12.39	11.41	12.78	18.90	11.37	12.96	20.68
February	10.27	10.53	12.33	11.38	12.82		11.34	13.02	
March	10.06	10.50	12.29	11.23	12.82	18.69	11.16	13.04	20.57
April	10.00	10.51	12.28	11.31	12.81		11.15	13.00	
May	10.17	10.63	12.36	11.31	12.88	18.90	11.23	13.10	20.57
June	10.23	10.81	12.50	11.40	13.01		11.31	13.20	
July	10.31	10.94	12.58	11.39	13.14	19.24	11.28	13.42	20.78
August	10.19	11.15	12.67	11.25	13.11		11.23	13.45	
September	10.39	11.31	12.84	11.26	13.20	19.30	11.29	13.41	20.93
October	10.44	11.53	12.97	11.24	13.28		11.44	13.60	
November	10.45	11.57	13.06	11.39	13.16	19.49	11.60	13.47	21.11
December	10.34	11.62	13.10	11.46	13.27		11.56	13.60	
1975									
January	10.29	11.61	13.08	11.51	13.28	19.80	11.52	13.60	21.09
February	10.45	11.51	13.07	11.55	13.20		11.48	13.44	
March	10.48	11.46	13.07	11.48	13.07	20.00	11.50	13.40	20.86
April	10.66	11.44	13.07	11.60	13.22		11.52	13.55	
May	10.77	11.39	13.09	11.67	13.11	19.63	11.57	13.41	20.72
June	10.86	11.26	13.12	11.63	13.10		11.57	13.40	
July	10.71	11.30	13.09	11.56	13.13	19.87	11.50	13.49	20.97
August	10.59	11.31	13.10	11.52	13.05		11.55	13.37	
September	10.51	11.33	13.18	11.52	13.06	19.69	11.55	13.41	21.14
October	10.62	11.24	13.15	11.64	13.00		11.68	13.38	
November	10.58	11.24	13.17	11.65	12.96	19.66	11.64	13.40	21.09
December	10.61	11.25	13.19	11.71	13.11		11.61	13.46	
1976									
January	10.68	11.21	13.18	11.68	13.14		11.59	13.40	
February	10.81	11.18	13.14	11.65	13.02	19.58	11.59	13.24	21.13
March	10.73	11.13	13.13	11.61	13.02		11.56	13.13	
April	10.61	11.08	13.13	11.59	12.95		11.48	13.16	
May	10.59	11.00	13.15	11.61	12.96	19.37	11.46	13.27	20.93
June	10.65	11.02	13.17	11.59	12.99		11.50	13.32	
July	10.68	11.06	13.16	11.60	13.02		11.55	13.38	
August	10.68	11.07	13.18	11.56	13.02	19.51	11.50	13.31	20.86
September	10.73	11.07	13.21	11.52	13.08		11.42	13.40	
October	10.87	11.04	13.20	11.52	13.03		11.43	13.26	
November	10.87	11.02	13.22	11.55	13.06	19.57	11.44	13.40	21.23
December	10.86	11.02	13.21	11.61	12.97		11.52	13.31	

[1]Credit union rates are centered 3 month moving averages of weighted interest rates.

Sources: Credit union rates are from National Credit Union Administration. Other rates are from Board of Governors of the Federal Reserve System.

formally passed in April 1977, CUs are able to make mortgages with maturities up to 30 years and home improvement or mobile home loans with maturities up to 15 years.

Consumer Loan Market

While credit unions are recent competitive additions to the mortgage market, they are mature and effective competitors with commercial banks in the consumer loan market.[5] Credit unions, with $34 billion in consumer loans in 1976, represent the third largest consumer instalment lender in the country and hold over 16 percent of the 1976 dollar volume of consumer instalment loans outstanding. Over 76 percent of credit union assets is devoted to consumer loans. Commercial banks, with $118 billion devoted to consumer loans, hold 48 percent of the total outstanding consumer instalment debt.

From 1960 to 1970, consumer loans at CUs increased strongly at a 12 percent annual rate. Since 1970, growth has been even more rapid; CU loans have more than doubled between 1970 and 1976, increasing at an average annual rate of 16 percent. The consumer loan business at commercial banks has not grown as fast. Between 1960 and 1970, these loans grew at an annual rate of 9.6 percent, slightly slower, on average, than in the subsequent six years.

The growth of CU loans, and therefore their assets, has been aided by favorable loan rates compared to those of commercial banks and other lending institutions (See Table II). Credit unions are able to profitably offer lower instalment loan rates because they experience lower fixed costs on loans. Several factors contribute to lower fixed costs, including lower costs in assembling information on loan applicants and collecting payments. Regulations governing CUs require a common bond among members before organization of a credit union is permitted. This common bond often provides an established source of information on members and facilitates the payment of the loan through payroll deductions, for example. Moreover, because of the subsidies granted them, credit unions often realize free office space and clerical help, pay no Federal taxes and generally pay little state tax, thus escaping many expenses other institutions face.[6]

During December 1974, for example, direct loans on new cars carried an interest rate of 11.62 percent at commercial banks, while at credit unions such loans carried a rate of 10.34 percent. Personal loans at commercial banks were made at an interest rate of 13.60 percent at that time; at CUs they were made at an 11.56 percent rate.[7] (Table II) Since credit union rates already include such factors as the cost of credit life insurance, the basic rates would be even lower than those indicated here.

Although the difference in rates charged has not been so great since 1974, it is nevertheless noteworthy. During 1976, interest rates for new auto loans at CUs varied between 15 and 53 basis points below those at commercial banks. Personal loans at credit unions fluctuated between 157 and 198 basis points below personal loan rates at commercial banks.

As a result, credit unions are advancing their position in the consumer loan market. Based on instalment credit outstanding, CUs held 13 percent of the total credit outstanding in 1972 (15 percent of automobile credit). In 1976, they held about 17 percent of total credit outstanding (23 percent of automobile credit). Commercial banks, on the other hand, have held a fairly constant share of instalment credit, averaging about 48 percent of the total. The share of automobile credit held by commercial banks declined from 62 percent in 1972 to 58 percent in 1976.

Thus, CUs have found themselves in a favored position relative to commercial banks in the consumer loan market. This advantage, combined with favorable interest rates at a time when the public has become increasingly interest-rate conscious in the face of inflation, has propelled the growth of CUs. As a result, credit unions are providing commercial banks with intensifying competition for consumer loans. Moreover, as S&Ls and MSBs continue to move to shorten the maturity of their asset portfolios, thrifts will become more effective competitors in this market as well.

Future competition in this market is likely to focus on credit card services. Membership rules of Visa U.S.A. Inc. were extended in 1976 to include credit unions. Recently, Visa approved 32 credit unions as card-issuing members, 22 of which participate in a pilot program sponsored by Credit Union National

[5]Commercial banks, finance companies, and credit unions comprise the three largest sources of consumer loans. As mentioned above, S&Ls and MSBs are not yet strong competitors in this market.

[6]Peggy Brockschmidt, "Credit Union Growth in Perspective," Federal Reserve Bank of Kansas City *Monthly Review* (February 1977), pp. 3-13.

[7]Interest rates for credit unions are from the National Credit Union Administration and are centered three-month moving averages of weighted interest rates; those for commercial banks are from the Board of Governors of the Federal Reserve System.

Table III

SELECTED REGULATORY AND INSTITUTIONAL CHANGES

DATE	COMMERCIAL BANKS	OTHER FINANCIAL INSTITUTIONS
September 1970		Savings and loan associations (S&Ls) are permitted to make preauthorized nonnegotiable transfers from savings accounts for household-related expenses.
June 1972		Massachusetts mutual savings banks (MSBs) begin to offer Negotiable Order of Withdrawal (NOW) accounts.
September 1972		New Hampshire MSBs begin to offer NOW accounts.
January 1974	All depository institutions in Massachusetts and New Hampshire (except credit unions) are authorized by Congressional actions to offer NOW accounts. This action limited interest-bearing negotiable deposits to these two states. Thus, interest-bearing negotiable transfer accounts at banks begin on an experimental basis.	
January 1974		Nebraska S&L begins Point-of-Sale (POS) electronic funds transfer system. First Federal S&L of Lincoln, Nebraska places an electronic terminal in a "Hinky Dinky Supermarket." The terminal allows customers of the S&L to pay for groceries, make deposits to, or withdrawals from their savings accounts.
April 1974	State of Washington enacts legislation which allows state-chartered commercial banks, MSBs, S&Ls to establish any number of automated facilities throughout the state, provided that those operating these facilities share the cost and operations of the terminals when asked to do so by the state authorities. Commercial banks are required to share facilities with other commercial banks and have the option of sharing them with thrift institutions. Thrifts are permitted, but not required to share facilities.	
May 1974		Experimental 24-hour electronic facility opens on a shared basis by 15 Washington MSBs and S&Ls.
June 1974		New York state bank regulation permits MSB to offer noninterest bearing NOW accounts (NINOWs).
August 1974		Administrator of the National Credit Union Administration grants 3 Federal credit unions temporary authority to begin offering share drafts. These 3 credit unions were joined by 2 state credit unions in a 6-month pilot program (launched October 1974.)
September 1974		Pennsylvania Attorney General rules MSB may legally offer a form of negotiable order of withdrawal account.
December 1974	Comptroller of the Currency's interpretive ruling permits national banks to operate Customer-Bank Communication Terminals (CBCTs).	Federal Home Loan Bank Board (FHLBB) adopts a regulation which gives depositors traveling more than 50 miles from their homes access to their savings account balances through any other federally-insured S&L by means of a Travelers Convenience Withdrawal (wire or telephone access).
January 1975		California state-chartered S&L offers Variable Rate Mortgages (VRMs). Minnesota MSB introduces Pay-By-Phone service.
April 1975	Commercial banks are authorized to make transfers from a customer's savings account to a demand deposit account upon telephone order from the customer.	FHLBB adopts two regulations: 1). Authorizes Federal S&Ls to offer their customers bill-paying service from interest-bearing savings accounts. 2). Allows Federal S&L service corporations and companies to make consumer loans (limited to states which allow such activity and subject to state restrictions).
May 1975	CBCT operated exclusively by a national bank is subjected to a 50-mile geographical restriction unless CBCT is available to be shared with one or more deposit institutions. A national bank may use a CBCT established and operated by some other institution and may participate in a statewide EFTS system.	
June 1975		Oregon governor signs into law legislation which allows the state's only MSB to offer checking accounts.

SELECTED REGULATORY AND INSTITUTIONAL CHANGES (Continued)

DATE	COMMERCIAL BANKS	OTHER FINANCIAL INSTITUTIONS
June 31, 1975	U.S. District Court Judge Robinson rules CBCTs authorized for national banks by the Comptroller of the Currency are illegal and must be shut down. (About 72 CBCTs, owned by national banks, have been installed in various parts of the country under the interpretive ruling issued by Comptroller December 12, 1974.) Robinson's decision directly attacks the December 12, 1974 interpretation, calling the terminals branches, both as defined by the U.S. Supreme Court in its 1969 Plant City case and as construed by Congress when it passed the McFadden Act in 1928.	
September 1975	Commercial banks are authorized to make preauthorized nonnegotiable transfers from a customer's saving account for any purpose. Previously (since 1962), such transfers were limited to mortgage-related payments.	Massachusetts MSB introduces VRM program.
October 1975		State legislation permits state-chartered thrift institutions in Maine to offer personal checking accounts.
November 1975	Federal Reserve amends definition of savings deposits in Regulations D and Q to permit business savings accounts, up to $150,000, at member banks.	
December 1975		State legislation permits thrift institutions in Connecticut to offer personal checking accounts. While the authority to offer share drafts was still officially temporary, additional credit unions begin to offer share draft accounts following the end of the 6-month pilot program initiated in Fall 1974. As of the year end, 222 credit unions (roughly 1 percent) in 44 states have been approved to offer share drafts to their shareholders.
January 1976		Federal Reserve System adopts a policy for automated check clearing systems (ACHs) to offer their services on a nondiscriminatory basis to all types of financial institutions. Illinois S&Ls begin offering noninterest bearing NOW accounts.
February 1976		Congress authorizes all depository institutions in New England to offer interest-paying NOW accounts (effective March 1, 1976).
May 1976	U.S. Court of Appeals for the District of Columbia upholds earlier ruling by the U.S. District Court for the District of Columbia that national banks' CBCTs are branches under the McFadden Act.	New York governor signs legislation permitting checking accounts, including over-draft privileges, at state-chartered MSBs and S&Ls.
October 4, 1976	U.S. Supreme Court lets stand ruling that CBCTs are bank branches.	
February 14, 1977	Iowa statewide electronic banking system begins operating and represents the nation's first shared statewide network, encompassing a broad range of large and small banks in Iowa. (At last count, the system had 33 participating banks; 92 merchant terminals operate through a switch or central computer).	
April 1977		All but 15 of the nation's 470 MSBs have either NOW accounts, traditional checking accounts, or a combination of the two. Legislation enacted to expand credit union lending authority, including authority to make 30-year mortgage loans.

Association. As CUs are given endorsement to apply for Visa credit, they undoubtedly will improve their competitive position. Federal credit unions are limited by regulation to charging no more than one percent per month on the unpaid balance of a loan. Under present conditions, this regulation would limit interest rates on credit card services to 12 percent per year, while many banks typically are charging 18 percent annually.

CHANGES IN LIABILITY COMPETITION

Deposit liabilities of financial institutions are also undergoing change, primarily surrounding the distinction between demand and savings deposits. Important institutional changes have occurred since 1970 which have allowed more vigorous competition for deposits among institutions (See Table III for a listing of some of these developments). Combined with various maximum rates of interest allowed financial institutions, these changes will likely translate into new positions in the competition for deposits (See Table IV).

Some thrifts were permitted in 1970 to make preauthorized nonnegotiable transfers from savings accounts for household-related expenditures. However, the major impetus for change occurred in 1972 when MSBs in Connecticut and New Hampshire began to offer Negotiable Order of Withdrawal (NOW) accounts. These accounts are essentially interest-bearing savings accounts on which checks can be written. While, at first, introduction of NOW accounts was limited to these two states, authorization for NOW accounts was expanded in 1976 to include MSBs, S&Ls, and commercial banks in all New England states (Table V).[8] Moreover, expanded authority for NOW accounts is currently being proposed to include all states.[9]

At credit unions, similar services are called "share draft accounts." Introduced at five credit unions in 1974, share drafts are now available at more than 940 CUs in 46 states.[10] These accounts, offered through a Credit Union National Association program, permit payable-through drafts which are drawn on the members' interest-bearing share accounts. Share drafts are processed through the credit union's account at a commercial bank.

In addition to NOW accounts, savings and loan associations have also initiated several services which allow them to compete for demand deposit business that has gone, traditionally, to commercial banks. Primarily through the use of electronic services, these thrifts have access to another source of deposits, one which they may be able to more successfully retain than other sources during business cycle fluctuations. At the same time, these services allow thrift depositors to use their savings accounts more like the transaction accounts of demand deposits.

Through electronic terminals, called remote service units (RSUs), depositors of thrift institutions are able to perform within seconds many of the transactions formerly conducted through demand deposit accounts, such as withdrawing cash, making charge account and loan payments, and transferring funds from one account to another.[11] One basic advantage of these units is that they frequently are located in such convenient places as supermarkets, airports, and factories. Moreover, S&Ls as well as MSBs have introduced telephone transfers to third parties and automatic payment services which allow their customers to more easily utilize their savings accounts for transactions purposes.[12]

As far as customers are concerned, the new deposit services at nonbank institutions are little different from demand deposit accounts of commercial banks, except in one important respect: typically, nonbank deposit services explicitly pay interest, whereas those of commercial banks do not.[13] Commercial banks have been prohibited since 1933 from explicitly paying interest on demand deposits. Savings deposit accounts at S&Ls and MSBs, on the other hand, are permitted by law to bear interest which is one-quarter of one percent higher than similar accounts at commercial banks.[14] Thus, not only have thrifts begun to

[8]On January 1, 1974, total NOW account balances in Massachusetts amounted to $138 million. Three years later, in January 1977, NOW balances totalled $1.47 billion. During the same time period, NOWs in New Hampshire increased from $5 million to $186 million.

[9]Some institutions, mainly state-chartered thrifts, have surpassed the initial offering of NOW accounts. Savings banks in New England and five other states are authorized to offer demand deposit accounts.

[10]About 200,000 CU members wrote approximately $800 million in share drafts during 1976.

[11]Between January 1974 and December 1976, 112 applications for remote service units have been approved by the Federal Home Loan Bank Board. Federal Home Loan Bank Board *Journal* (April 1977), p. 39.

[12]Fourteen savings banks in New York, Connecticut, Maine, New Jersey, Pennsylvania, and Washington offer pay-by-phone services (Table VI).

[13]In a few areas, nonbank deposit accounts called Non-Interest Negotiable Order of Withdrawal accounts, (NINOWs) do not bear interest.

[14]Current ceilings on passbook accounts at commercial banks and thrifts are 5 and 5¼ percent, respectively.

Table IV

COMPOSITION OF DEPOSITS

	End of Period			Annual Rates of Change	
	1960 (millions)	1970 (millions)	1976 (millions)	1960-1970	1970-1976
COMMERCIAL BANKS[1]					
Demand	$155,386	$246,168	$332,283	4.7%	5.1%
Time & Saving	73,015	233,006	492,719	12.3	13.3
NOW			$1,265	—	—
TOTAL	228,401	479,174	825,002	7.7	9.5
SAVINGS & LOAN ASSOCIATIONS					
Savings Capital	$ 62,142	$146,404	$336,030	9.0%	14.9%
NOW			180	—	—
MUTUAL SAVINGS BANKS					
Time and Savings	$ 36,086	$ 71,157	$121,961	7.0%	9.4%
NOW			580	—	—
Other	257	423	916	5.1	13.7
Demand			493	—	—
TOTAL	36,343	71,580	122,877	7.0	9.4
CREDIT UNIONS					
Members' Savings	$ 4,981	$ 15,486	$ 38,968	12.0%	16.6%
Share Drafts			803	—	

[1]Insured banks

Sources: *Banking and Monetary Statistics* 1941-1970; Federal Reserve *Bulletins; National Fact Book of Mutual Savings Banking*, 1971, 1975, 1977; *Statistical Abstract of the United States*, 1974.

compete with commercial banks for demand deposits, but by servicing their "demand deposits" from savings accounts, thrifts generally seem to be making the most of their interest rate advantage.

Credit unions are in an even better competitive position. The maximum rate permitted members' savings accounts at CUs is 7 percent. Although not all CUs pay the highest rate, about 50 percent paid between 6 and 7 percent in 1975, significantly higher than the ceiling rates at other institutions. This favorable rate differential for CUs not only appeals to current and potential members, but also allows credit unions to retain funds when other institutions are suffering from disintermediation.

By increasing the convenience of the services which compete with demand deposits, nonbank institutions effectively have decreased the transactions cost to customers of their accounts. Coupled with the higher maximum interest rates allowed these institutions, their deposit growth rates generally have been stronger than those of commercial banks. Since 1970, savings of credit union members have increased at a 17 percent annual rate, and in the last two years, have grown at about a 19 percent rate (Table IV). Total deposits of commercial banks, on the other hand, grew at nearly a 10 percent rate in the period between 1970 and 1976, up from the 8 percent rate which prevailed between 1960 and 1970. Savings capital of S&Ls and deposits of MSBs grew at annual rates of 9 and 7 percent, respectively, between 1960 and 1970. The latter institutions maintained deposit growth rates of 15 and 9 percent, respectively, since 1970.

While many new demand deposit services began in 1974, data on such services tend to be incomplete, making comparisons difficult. However, NOW account data are the most complete, and available across institutions. These data indicate that the dollar volume of NOW accounts at commercial banks increased from $65 million in 1974 to $1.3 billion by the end of 1976. NOWs at S&Ls and MSBs have also shown intense growth, though not as strong as at commercial banks. Between 1974 and 1976, NOWs at thrift institutions increased $146 and $367 million, respectively (Table V). In the same two-year period, share draft balances at CUs grew from $375,000 to $803 million.

In an era of rising prices, people have become more aware of the cost of holding money. More money holders are seeking methods of reducing noninterest-bearing claims in favor of highly liquid earning assets that can either be easily transformed into payments

Table V

NOW Account Activity in New England

Month Ended	Commercial Banks: Number of Banks offering NOWs	Commercial Banks: Outstanding balances ($ thousands)	Mutual Savings Banks: Number of MSBs offering NOWs	Mutual Savings Banks: Outstanding balances ($ thousands)	Savings and Loan Associations: Number of S&Ls offering NOWs	Savings and Loan Associations: Outstanding balances ($ thousands)
September 1972[1]			23	$ 11,094		
December 1972[2]			59	45,272		
December 1973[2]			90	143,254		
December 1974[2]	63	$ 65,249	151	213,661	81	$ 33,666
December 1975[2]	134	358,940	175	386,560	121	93,756
December 1976	242	1,265,262	248	580,596	159	179,622
June 1977	247	1,501,135	250	661,760	158	213,498

[1]Massachusetts only.
[2]Massachusetts and New Hampshire only.
Source: Federal Reserve Bank of Boston.

media or used indirectly for payments. The above figures tend to indicate the extent to which these preferences are influencing relative rates of deposit growth.

IMPACT

In certain areas, new competition has prompted commercial banks to retaliate in order to maintain or regain their competitive position. In some cases, commercial banks have been successful in initiating telephone transfers and automatic payment services similar to those at nonbank institutions.[15] Perhaps the best example of a situation in which commercial banks have been able to equalize competition is the case of NOW accounts in New England. Initiating NOW accounts in 1974, two years after their introduction by MSBs, commercial banks have surpassed savings banks in NOW balances and have about equalled the number of savings banks offering the accounts (Table V).[16]

In other cases, commercial banks have been less successful. For example, although national banks have initiated electronic terminals, called Customer Bank Communication Terminals (CBCTs), placement of them has been limited and certainly more restrictive than that of the similar Remote Service Units of savings and loan associations. The courts have judged that CBCTs are branches as defined in the McFadden

Table VI

Selected Services Offered by Mutual Savings Banks

June 30, 1976

	Number of Mutual Savings Banks	Percent of Total
Automated teller facilities	59	12.4%
Checking accounts[1]	222	46.7
Club accounts	411	86.5
Collateral loans	410	86.3
Credit cards	79	16.6
Educational loans	376	79.2
Home improvement loans	447	94.1
24-hour cash dispensing	48	10.1
Individual Retirement Accounts[1]	379	79.8
Money orders	455	95.8
NOW accounts (interest bearing)[1]	254	53.5
Passbook loans	469	98.7
Pay-by-phone[2]	14	2.9
Payroll deductions	281	59.2
Personal loans[3]	369	77.7
Personal trust services	51	10.7
Point-of-sale services	7	1.5
Safe deposit boxes	378	79.6
Savings Bank Life Insurance	325	68.4
Savings payment plan	94	19.8
School savings	119	25.1
Self-employed retirement savings (Keogh)[1]	259	54.5
Travelers checks	453	95.4
Total number of mutual savings banks	475	

[1]As of December 31, 1976
[2]As of June 1977
[3]Includes overdraft loans.
Source: *1977 National Fact Book of Mutual Savings Banking.*

[15]One area in which commercial banks have been successful in attaining an equal footing with S&Ls is for Individual Retirement Accounts (IRAs) and Keogh plans. S&Ls offer these accounts to savers at a 7.75 percent interest rate, while commercial banks offered comparable accounts at a maximum rate of 7.5 percent. Effective July 6, 1977, commercial banks which are members of the Federal Reserve System can introduce a new category of time deposit accounts which are available for use as IRAs and Keogh plans and pay a maximum rate of 7.75 percent.

[16]See Ralph C. Kimball, "Recent Developments in the NOW Account Experiment in New England" and Donald Basch, "The Diffusion of NOW Accounts in Massachusetts," Federal Reserve Bank of Boston, *New England Economic Review* (November/December 1976), pp. 3-19 and pp. 20-30, respectively.

Act of 1928, a severe competitive blow to commercial banks. This ruling subjects placement of CBCTs to state laws prohibiting or limiting branch banking by commercial banks. S&Ls are not subject to any comparable ruling.

Moreover, as more institutions pay interest on their "checking accounts," more pressure is placed on commercial banks to pay interest on comparable accounts. Legislation has been proposed which would allow all financial institutions in the nation to offer NOWs, with an identical ceiling rate.[17] Legislation of this sort would eliminate the interest rate differential on passbook/NOW accounts among institutions.

With one uniform interest rate, it is a short step to complete elimination of all interest rate differentials. Moreover, if nonbank institutions have formal access to other sources of funds, regulators may argue that the institutions no longer "require" the advantage of the interest rate differential to maintain deposit flows.

Whether or not such proposals pass, the innovations which have occurred already have increased the number of alternative services available to consumers. Consumers are now able to obtain larger mortgages at CUs, a wider range of consumer services at MSBs, and closer substitutes for checking accounts at S&Ls. Moreover, the quantity and variety of services offered at each type of financial institution will probably continue to increase in the future.

Such changes are altering the focus of most financial organizations. Having begun as basically specialized institutions, they are now taking on a more diverse character. The distinction between the asset and liability powers of bank and nonbank institutions is becoming blurred, and with it, the distinction between the institutions themselves.

[17]Credit unions have been included among such legislative packages for share drafts.

CONCLUSION

Commercial banks, savings and loan associations, mutual savings banks, and credit unions perform many similar functions. They accept the savings of economic units and allocate them to borrowers. Since 1970, these institutions have been becoming similar in more specific ways. Nonbank institutions are diversifying and broadening the scope of their assets. S&Ls are including shorter-term assets in their portfolios; MSBs and CUs are devoting more assets to various types of consumer loans. In terms of liabilities, demand deposit accounts are no longer the exclusive domain of commercial banks. All types of thrift institutions are permitted some type of demand deposit services.

Thus, competition is intensifying among the institutions and will likely provide them with incentives to increase efficiency and reduce costs to customers in the future. As a result, consumers have more alternatives for "banking" services from which to choose. In the process, asset and liability powers of the institutions have yielded to equalizing forces. Regulations and incentives for specialization, which maintained the distinction among institutions, are being broken down.

The traditional roles of nonbank financial institutions are changing; their domain, once narrow, is now much more extensive and similar to that of commercial banks. However, there is likely to be some limit to this process of financial institutions becoming more similar. Given current trends, the extent of specialization of the institutions is likely to be determined by competitive forces as well as by public policy to channel credit to specific uses.

The Early 1960s: A Guide to the Late 1970s

NORMAN N. BOWSHER

LESSONS can be learned from a study of the past. Future mistakes can be avoided, using the information gained through analysis of the policy actions that were taken and evaluating the resulting economic performance. Similarly, for these periods when economic performance was successful, an analysis of the contributing forces provides some positive guidance to policymakers. From an economic growth and stabilization viewpoint, the four-year period from 1961 to 1965 was one of the most successful in our history.

Throughout the early 1960s, as in other periods of economic expansion, the desires of the public for rapid gains were strong. Policymakers sought to increase economic welfare by additional stimulus. Taxes were reduced, Government spending was increased, and money growth was accelerated. Yet, the net stimulus from policy actions was more moderate and steadier than in other periods of economic expansion.

Although the economic policy actions which evolved were not necessarily completely intended, in retrospect it appears that they were appropriate. As such, this earlier period can serve as a useful guide to the present by analyzing the economy's responses to the chief causal forces in operation over this period.

Policy Actions and Other Causal Forces Operating on the Economy

The record of the early 1960s demonstrates the strength of the private economy and its movements in the absence of shocks from outside forces. In part, the lack of shocks was the result of fortuitous circumstances. Although there was apprehension caused by the Berlin crisis, resulting in some precautionary buildup of U.S. defenses, no outside force such as a foreign war, an international commodity cartel, or major adverse weather developments caused any material constraints on supply or huge shifts in demand.

However, much of the credit for developments in the early 1960s should probably go to Governmental economic policies followed during that period. These policies were both less restrictive and less stimulative to the economy than those prevailing during most other expansionary periods in our history.

Reliance was placed primarily on competition as a means of regulating economic activity in the late 1950s and early 1960s. There were some Government regulations, price guidelines, and a major confrontation with the steel industry on pricing, but, on balance, it was a period of relative regulatory calm. As pointed out at the time by Beryl W. Sprinkle, "A surprising number of political actions have been consistent with the free market doctrine."[1] This is in sharp contrast to the period of the early 1970s when the Government engaged in a massive regulatory effort in the areas of prices, the environment, safety, and employment.

[1]Discussion of a paper by Neil H. Jacoby, "The Fiscal Policy of the Kennedy-Johnson Administration," *Journal of Finance* (May 1964), p. 391.

Fiscal actions of the Federal Government, when used, were relatively moderate during the early 1960s. Government spending expanded at a 5 percent annual rate from 1961 to 1965 (national income accounts budget). However, from 1955 to 1961 Government expenditures rose at a 7 percent rate, and since 1965 have increased at an average 11 percent rate.

Tax reductions were also implemented, but amounts were relatively small. New depreciation guidelines combined with an investment tax credit enacted in 1962, increased the annual cash flow to corporations by about $2.5 billion and raised the after-tax rate of return on new investment projects. After a prolonged debate, which began in the summer of 1962, taxes were finally lowered in early 1964 by $11 billion on personal incomes and $3 billion on corporate profits to add further stimulus.

The tax decrease and the rise in Government outlays only partially offset a so-called "fiscal drag" emanating from an increase in Government tax receipts as consumer and business incomes grew during the period of pronounced expansion. As a result, the average Federal budget deficit from 1960 through 1965 was just over $1 billion per year. By comparison, in the last three years of the 1950s the average annual deficit was $3 billion. During 1966 through 1970, which included most of the Vietnam buildup, the deficit averaged $5 billion, and since 1970 the deficit has averaged $32 billion.

Monetary actions in the early 1960s were expansionary, but the acceleration of money growth came later than in most other periods of economic recovery and growth. Inflation changed little in that period since most of the increased monetary expansion came after 1963. Nevertheless, these monetary actions contributed to an increase in the rate of inflation in the late 1960s. The money stock grew at an average 2.4 percent rate from 1960 to 1963, and at a 4 percent rate in 1964 and 1965, compared with a 2 percent rate in the 1952-60 period. By contrast, money has been growing at an average 6 percent rate since 1965.

According to a number of studies, the trend growth of money over a period of four years or more primarily determines the rate of inflation.[2] The results of these studies strongly suggest that the moderate money growth from 1952 through 1963 was a major factor in the relative price stability of the early 1960s, and that the more rapid money growth since 1965 has been largely responsible for the much higher inflation rates in recent years.

There were no large prolonged decreases in the growth rate of money in the 1961-65 period, except for a brief period preceding the pause in activity during 1962. Marked and sustained declines in the rate of money growth, such as occurred from early 1969 to early 1970 and from mid-1973 to early 1975, are usually followed within a few months by a decline in the demand for goods and services, resulting in decreased production, employment, and incomes. The absence of any large and sustained slowing in money growth during the 1961-65 period eliminated a force which has preceded most recessions in this country as well as many countries abroad.[3]

Policy Performance Versus Expectations

Despite a robust expansion with little inflation, public desire for aggressive policies to obtain further gains remained strong, as is usually the case during economic expansions. Many analysts in the early 1960s concluded that the pronounced and sustained growth of the economy was not "fast enough." Although unemployment declined from 7 percent of the labor force in early 1961 to 5 percent in 1964 and to 4.5 percent in 1965, these analysts considered such performance inadequate when compared with an "interim target" of 4 percent or less. As late as 1965, the President's Council of Economic Advisers calculated that "a gap of $25-30 billion still remains between the nation's actual output and its potential output . . . 4 percent of our current potential."[4]

Because of the challenge to policymakers to achieve even greater levels of production, employment, and purchasing power, pressures for more expansive fiscal

[2]See W. Philip Gramm, "Inflation: Its Cause and Cure," this *Review* (February 1975), pp. 2-7. Leonall C. Andersen and Denis S. Karnosky, "The Appropriate Time Frame for Controlling Monetary Aggregates: The St. Louis Evidence" (Paper presented at the Federal Reserve Bank of Boston Conference on "Controlling Monetary Aggregate II; The Implementation," Melvin Village, New Hampshire, September 8, 1972); Milton Friedman, *The Optimum Quantity of Money and Other Essays* (Chicago: Aldine Publishing Company 1969); and Irving Fisher, *The Purchasing Power of Money* (New York: Augustus M. Kelley, 1963).

[3]See "Production, Prices, and Money in Four Industrial Countries," this *Review* (September 1972), pp. 11-15; Leonall C. Andersen and Jerry L. Jordan, "Monetary and Fiscal Actions: A Test of Their Relative Importance in Economic Stabilization," this *Review* (November 1968); Milton Friedman and Anna Schwartz, *A Monetary History of the United States 1867-1960"* (Princeton, New Jersey: Princeton University Press, 1963).

[4]*Economic Report of the President* (Washington, D.C.: United States Government Printing Office, 1965), p. 39.

policies increased. With prices relatively stable and an observed "excess" capacity believed plaguing the economy, inflationary potentialities received only nominal attention. However, "The record suggests that the Kennedy-Johnson Administrations were frustrated in their efforts to attain professed goals. It reveals the great power of Congress which, by pulling against the Executive Branch . . ., kept them chained near the middle of the fiscal road."[5] As noted above, Government expenditures were increased and tax rates reduced, but the actual extent of these actions was both moderate and delayed.

Actual monetary developments were not as stimulative as some would have desired for domestic purposes. The monetary authorities accepted, as a prime objective during much of this period, the reduced cost and increased availability of borrowed funds. It was contended that through this goal growth in the nation's liquidity would contribute to continued orderly economic expansion.[6] However, during much of the time the nation also faced a large deficit in the balance of payments and a sizable net outflow of gold. This situation apparently called for maintaining or raising short-term interest rates in order to discourage an outflow of funds seeking more favorable interest rates abroad. These two objectives were partially conflicting, and the dilemma brought compromises.

Efforts were made by the Federal Reserve System to reconcile the conflict by "twisting the yield curve." This was supposed to be accomplished by buying long-term obligations to provide bank reserves and to obtain lower capital market yields for domestic purposes, and by selling some short-term Treasury bills to maintain the higher rates in this sector for international balance-of-payments objectives. During 1961 through 1965 about $8 billion of Government securities with maturities over one year were purchased by the System.[7] On balance, short-term interest rates did rise relative to long-term rates in this period. However, cost and availability of domestic credit changed only marginally, and the shift in the yield curve was similar to that which occurred in other periods of expansion where no massive purchases of longer-term obligations by the System occurred.[8]

There was a sizable growth in total credit extended in the early 1960s. Total new funds raised by individuals, businesses, and state and local governments advanced steadily by a 16 percent annual rate from early 1961 to 1965, compared with an average 9 percent rate since 1965. Large personal and business saving contributed to the growth. Monetary authorities attempted to bolster the availability of credit by maintaining net "free" reserves at member banks(that is, smaller borrowings from Reserve Banks than reserves held in excess of requirements) throughout most of the period. However, the free reserves were a misleading measure of bank credit availability. The small borrowings from Reserve Banks reflected the position of the discount rate, which remained at higher levels than market rates on alternative sources of bank funds.

The Economy's Response to Moderate Policies

The economy's performance in the period 1961-65 was exceptional. There was little inflation, and production grew at a relatively rapid and steady pace for one of the longest spans on record. Over that period industrial production rose at nearly an 8 percent average annual rate, and total real output increased at over a 5 percent rate (see accompanying chart). Employment rose faster than the population of labor force age, and real output per capita expanded at about a 4 percent rate — or double the trend rate since 1965. Corporate profits (after taxes) increased at a 15 percent pace. Notwithstanding, the consumer price index inched up at only a 1.3 percent rate.

The 1961-65 period was characterized by growth. The recession of 1960-61 had been relatively mild, and the upward movement after early 1961 was not a quick rebound, but a period of relatively steady expansion of capacity as well as demand. Investment

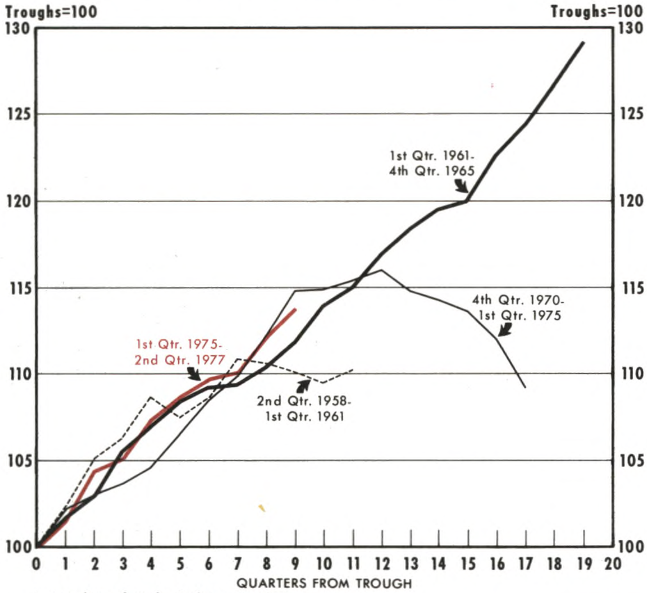
[5]Neil H. Jacoby, "The Fiscal Policy of the Kennedy-Johnson Administration," *Journal of Finance* (May 1964), p. 357.

[6]See *Annual Report of the Board of Governors of the Federal Reserve System,* covering operations for the year 1964, p. 9.

[7]The System received a powerful assist in twisting the yield curve from debt-management policy aimed at heavy concentration of Treasury financing in short-term paper. See John J. Balles, "The Outlook for Fiscal, Monetary and Debt Management Policies," *Journal of Finance* (May 1964), p. 407.

[8]Two studies found little, if any, effect on the term structure of interest rates from a shift in the maturity composition of the debt. Frank De Leeuw, "A Model of Financial Behavior," Chapter 13 in *The Brookings Quarterly Economic Model of the United States Economy,* ed. James S. Duesenberry et al. (Chicago: Rand McNally & Company, 1965); and Franco Modigliani and Richard Sutch, "Debt Management and the Term Structure of Interest Rates: An Empirical Analysis of Recent Experience" (Paper delivered at the Conference of University Professors, The American Bankers Association, September 1966). See also Richard W. Lang and Robert H. Rasche, "Debt-Management Policy and the Own Price Elasticity of Demand for U.S. Government Notes and Bonds," this *Review* (September 1977), pp. 8-22.

Real Gross National Product



Latest data plotted: 2nd quarter 1977

expenditures accelerated in response to an increase in demand for final products, improved rates of profit and cash flow, relatively steady interest rates, reduced taxes, and an improved outlook. From the previous cyclical peak in 1960 to 1965, real output grew at an average 4.7 percent rate, compared with 2.8 percent in the previous cycle and about a 3 percent average in the period since 1965.

During this period there were relatively few large fluctuations in demand or constraints on supply, and the economy expanded in a balanced fashion. Balance was maintained between production and sales at relatively stable prices, thus avoiding both temporary shortages and sizable inventory accumulation. Balance was maintained between the expansion of effective demand and the expansion of productive capacity to satisfy that demand, avoiding the need for cutbacks in capital expenditures. Also, balance was maintained between wages and productivity, and unit labor costs as well as prices changed little. Hence, few destabilizing endogenous forces developed during this extended period.

Recent Period of Recovery and Expansion

The current economic expansion, which began in the spring of 1975, started with an economic situation much worse than the one in the early 1960s. Inflation, as measured by the GNP deflator, had risen at an 11 percent annual rate in the previous six quarters, compared with near price stability in the early 1960s. Also, real production had dropped at a 5 percent annual rate from late 1973 to early 1975 versus a moderate net increase in real output from 1960 to 1961.

The dramatic change in supply and demand conditions for energy resources since 1973 has had a substantial adverse effect on the productive capabilities of the U.S. economy.[9] Hence, even though real production had dropped sharply from 1973 to early 1975, excess economic capacity did not rise proportionately, and was probably about similar to that in 1961. This decrease in capacity, without an offsetting decrease in money growth, also accounted for much of the rise in the rate of increase in the price level,from 5 percent in the early 1970s to 11 percent from late 1973 to early 1975.[10]

After turning up in the early spring of 1975, the economy has progressed in the past two and one-half years at a pace remarkably similar to or even stronger than that of the early sixties. There was a very rapid recovery in the first year following the business trough of early 1975 as activity rebounded from the previous drop, but expansion was fairly rapid in most of 1961 also. Then, there was a hesitation in the rate of the upswing during much of 1976, similar to the pause in 1962, and in both cases the slowdown was attributable to a decline in the rate of inventory accumulation. So far in 1977, economic expansion has been vigorous, similar to that in 1963.

On balance, real production rose at a 5.9 percent annual rate from early 1975 to the second quarter of 1977, somewhat faster than the 5.1 percent rate recorded in the first nine quarters of the expansion in the early 1960s. Other indicators of the strength of the recent expansion have been a 10 percent rate of increase in industrial production and a rise in employment at a rate about 25 percent faster than the population of labor force age since March 1975. Personal income has grown at an 11 percent rate in the same period.

Rasche and Tatom, using a production function which accounts explicitly for capital and energy resources, calculated that because of the new energy regime imposed in 1974, current production is cur-

[9]Robert H. Rasche and John A. Tatom, "The Effects of the New Energy Regime on Economic Capacity, Production, and Prices," this *Review* (May 1977), pp. 2-12.

[10]See Denis S. Karnosky, "Another Recession, But Different," this *Review* (December 1974), pp. 15-18.

rently near potential output.[11] Hence, they concluded that attempts to obtain much greater output now through stimulative policy actions are likely to fail and will add to inflationary pressures. There is little prospect for an extended period of real growth at rates higher than the rate of potential output expansion, which is currently about 3.5 percent a year.

Early in the current recovery some progress had been made at reducing inflation. Overall prices (GNP deflator) rose at an average 5.5 percent rate from the first quarter of 1975 to the fourth quarter of 1976, considerably faster than the 1.6 percent pace observed in the corresponding period in the early 1960s. Experience indicates that eliminating inflation takes time, and the 1975-76 price developments should be judged against the 1970-75 average rate of 7 percent. In the first two quarters of 1977, however, these prices rose at a faster 6.2 percent rate, reflecting both constraints on supply from the severe weather last winter and a faster money growth since early 1976.

On balance, the causal forces bearing on economic activity since early 1975 have moderated from those of the earlier 1970s. Although business has been hampered by numerous Governmental regulations and much higher energy prices, the constraints on production recently have been less than in the immediately preceding period. During the 1972-74 period, the economy received a host of shocks to production which contributed to both the inflationary bulge and the recession. Major shocks include a marked rise in energy prices caused by the cartel of oil producing nations, a hampering of production by Governmental price, environmental, safety, and other regulations, a pronounced realignment of exchange rates among currencies, and a drouth which adversely affected food production.

Fortunately, most of these constraints on production have not intensified. For example, general price controls were abolished in 1974, although selective controls remain in place. The weather generally has been better for crops since early 1975, and energy prices have been much more stable, albeit at a higher level. However, Government continues to regulate business in a myriad of ways, and expectations are that Government regulation will increase in the future. However, the absence of further shocks to production to date, combined with the same underlying strength and resiliency of the private enterprise system as was exhibited in the early 1960s, has been a contributing force to the economic expansion since early 1975.

In addition, Governmental actions bearing on the economy have been more moderate, on balance, than in the immediately preceding period. Since the second quarter of 1975, total Federal outlays have risen at an 8 percent annual rate, or at about a 2 percent rate in real terms. In the early 1960s, nominal expenditures rose at a 5 percent rate, or at about a 3 percent rate in real terms. By contrast, from 1970 to 1975, Government outlays rose at a 12 percent rate (a 5 percent real rate). Although deficits have been enormous (averaging about $62 billion per year since early 1975), they have been financed primarily through saving.

Despite an acceleration of money stock growth recently, money increased at an average 5.8 percent annual rate from early 1975 to mid-1977. This was faster than in the early 1960s, but the rate was moderated from the 7 percent average rate which occurred from early 1971 to mid-1974. The average monetary growth since early 1975 has lowered the trend growth of money slightly, contributing to a slightly lower fundamental rate of inflation. Large and sustained fluctuations in money, such as occurred from mid-1974 to early 1975 when the pace abruptly fell to a 3 percent rate, were avoided. The avoidance of such fluctuations in the pace of money growth has prevented shocks to the economy from this source.

The current situation and many evaluations of it are similar to the situation in early 1963, which was described by the President's Council of Economic Advisers as follows:

> Despite the gains of the past 2 years, the economy has not yet regained full use of its labor and capital resources . . . As 1963 begins, too many workers remain without jobs; too many machines continue idle; too much output goes unrealized as our economy runs below its potential.[12]

Reflecting this evaluation, President Kennedy recommended a "major tax reduction" and an increase in Federal purchases for stepping up the U.S. growth rate. His report also suggested that monetary policy, as well as debt policy, must be coordinated with fiscal policy to secure the objectives of higher employment and growth. But, as mentioned earlier, there were delays in implementing these recommendations, and some were scaled down as a result of changing cir-

[11]Robert H. Rasche and John A. Tatom, "Energy Resources and Potential GNP," this *Review* (June 1977), pp. 10-24.

[12]*Economic Report of the President* (Washington, D.C.: United States Government Printing Office, 1963), p. 9.

cumstances and conflicting objectives. As a result, actions became only moderately more expansive, but the stimulation was comparatively even.

Now, in the fall of 1977, the economic recovery is roughly 2½ years old. To some analysts the volume of unused resources appears sizable. Official reports indicate that unemployment has recently been at about 7 percent of the labor force, and that output has been running at roughly 83 percent of measured capacity.[13] There is considerable discussion in the business community of a marked slowdown in the rate of economic expansion in the near future. A number are calling for increased stimulation to accelerate the progress toward a higher level of resource utilization.

The announced policies of the Government to date have been similar to those followed in the 1961-65 period. The Administration has stated its intention to trim Government expenditures and to attain a balanced budget by fiscal 1981. Monetary policies have been directed to holding money growth at a moderate rate and gradually reducing this rate over time. Since early 1975 the long-range money targets have been lowered. Also, it is the stated policy to reduce the burden of Government on the private enterprise system by eliminating regulations which cannot be justified on a cost-benefit basis.

Nevertheless, recent Government actions have tended to approximate those in other expansionary periods when heavy reliance was placed on increased Government stimulation to bring about more rapid expansion, and when more Government controls were substituted for competition in regulating business activity. Despite a Federal budget deficit of over $40 billion in the first half of 1977, the probabilities are relatively high that there will be some net tax rate reductions and further increases in Government expenditures in the near future. Money growth, which had been at a 4.1 percent annual rate from the second quarter of 1974 to the first quarter of 1976 when the recession was halted and a rapid expansion was launched, has accelerated to an average 6.5 percent rate since the first quarter of 1976 and then about a 9 percent rate since February of this year. Current discussions and actions concerning the energy program indicate more Government involvement in the productive process.

[13]These statistics probably greatly underestimate the degree that potential output is being utilized. See Rasche and Tatom, "Energy Resources and Potential GNP."

Summary and Conclusions

The early 1960s was a period of relative regulatory calm and few disruptions from fiscal and monetary actions. Although no two periods in our history are identical, support for using the early sixties as a guide to the late seventies is strengthened by a large body of economic analysis, based on an examination of policy actions and economic responses over a wide range of circumstances. These studies support the conclusions that the experience of the early 1960s was not unusual, but, upon reflection, was the result expected from the policies pursued.

In the early 1960s the private sector of the economy was not shocked or stimulated greatly by outside forces. There were no large shifts in factors determining either demands or supplies, and the economy responded commendably. The early 1960s was one of the longest periods on record of rapid economic growth with little inflation. All during the period, desires of the public for still better performance were strong; the record indicates that policymakers generally sought to provide more stimulus, but they were partially thwarted in their attempts by conflicting objectives, lack of agreement, and inertia.

The economy has expanded rapidly for about two and one-half years, just as it had in 1963; if anything, the more recent expansion has been even more pronounced than in the corresponding earlier period. When capacity is adjusted for energy developments and other constraints on production, output currently is rapidly approaching potential. In the early 1960s relative price stability was maintained, and during 1975 and 1976 there was a slowing in the rate of inflation. Yet, as in most periods of expansion, the desire for even better short-run economic performance is strong.

Typically, in periods of economic expansion, the attraction of expected short-run benefits to production and employment from ever increasing stimulation has become irresistable. However, these actions have led to boom-bust situations. With more stimulation, upward pressures on prices develop. Removal of the stimulation, once it becomes anticipated, depresses production and employment for a time, but the inflation built up during the period of stimulation remains for several years.

Now, it would seem prudent to adopt intentionally moderate economic policies. This would imply a reduction in the growth rate of Government spending, and a gradual move toward a balanced Federal budget, a policy advocated by the current Administration. Monetary authorities might well follow the course which they have charted since 1975 — that of relatively steady and moderate money growth and a gradual reduction of this rate over time. Regulations on the private sector might be critically assessed, and those that cannot be justified on a rigorous cost-benefit basis removed. Uncertainties caused by potential changes in the energy program and by possible tax law revisions should be clarified soon as they only serve to hamper investment decisions.

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