

NORTHWESTERN Banker Newsletter

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How Inflation Affects Interest Rates

The following report, prepared by Arnold C. Schumacher, consulting economist at Halsey, Stuart & Co., Inc., Chicago, was released September 12:

THE PATTERN of interest rates is one of the most difficult of all economic variables to forecast. Even in terms of a short time interval, interest rates can behave quite differently from expectations, as witness the extremely sharp rise in short-term rates in recent months. Although most analysts anticipated increases in rates, the rapidity and magnitude of the move has been far greater than seemed likely six months ago.

Longer rates are less volatile and not as subject to the extreme pressure for funds which characterize a cycle peak. Most attempts to forecast long-term rates are built around a projection of demand and supply for investment funds. But this technique is not very satisfactory because it involves estimates of economic growth, personal savings rates, monetary policy, capital spending and a host of other series which are all subject to unpredictable and substantial changes over a short time span. But its main deficiency is that it tends to ignore the inflation factor.

Since the mid-1960's the overall rate of inflation has been the most important ingredient influencing the interest rate structure. Investors in high grade fixed-income obligations demand a premium to compensate for the erosion in money value. The pure rate of interest is traditionally placed in the 3.0%-3.5% area. If an investor believes the average inflation rate over the life of a debt instrument will be 5%, then he will demand a return of 8.0%-8.5%.

Because each dollar buys less in terms of real capital equipment, inflation also greatly increases the demand for investment funds.

What about the trend of long-term interest rates over the next three years? Any forecast requires the usual assumptions regarding the rate of economic growth, demand for capital goods, savings rates and, most importantly, the inflation factor. Since 1960 real economic growth (excluding inflation) has averaged 4.3% per year and this seems a reasonable prospect for the future. In order to produce this rate of overall growth, fixed investment in real terms has gone up an average of 6.5% per year. Personal savings in this period averaged 7.2% of disposable personal income. As a broad general framework these trends seem likely to persist. In other words, growth should at least be as high as the average since 1960. However, considering actual and potential shortages in a wide range of products, the period between now and 1976 should be one of heavy capital outlays, provided government regulation and tax policies are favorable to such investment.

By far the most difficult problem is making some kind of an intelligent guess regarding inflation. Since early 1971 unit labor costs have risen at a rate of approximately 2% per year, but this was a period characterized by large gains in productivity. Output per man-hour is likely to be significantly lower in the next three years. We would estimate that recent wage increases (and those to come in 1974 and 1975), combined with lower productivity, will result in a cost-push inflation factor of at least 3.5%-4.0%. This would represent a

rock bottom minimum rate of inflation, assuming no large government deficits and a monetary policy which restricted money growth to around a 4% annual rate. It also assumes the restoration of a balance in supply-demand conditions for major world commodities, including agricultural products. To the extent that temporary market dislocations take place as a result of government price regulations, political disturbances (both foreign and domestic) or sudden surges in demand — these types of developments would intensify the inflation trend.

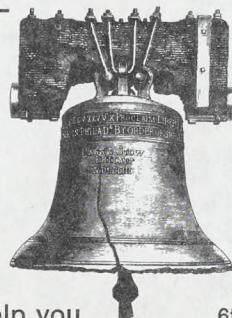
We believe that inflation (in terms of the GNP deflator) between now and 1976 will average 4.0%-4.5% per year. Taking the high side of this range and adding a 3.5% pure rate of interest, we get an average yield of 8.0% as a long-term interest rate applicable, say, to high grade corporate bonds. Obviously, this is only an average and rates under our assumptions would fluctuate perhaps 50 basis points (or more) above or below this level. So, we come out with an estimate of 7.50% to 8.50% yield for the next three years.

The actual numbers are not too important in this kind of an exercise. What is important, if our assumptions are reasonable, is that the cost of borrowing is going to remain high and in a range moderately above the experience of 1971, 1972 and the first half of 1973. It also should be remembered that this scenario is based on a supposition that public policy decisions in the area of fiscal and monetary affairs will be directed toward responsible and non-inflationary programs. To whatever extent this is violated, yield levels will rise. While we believe events over the next two or three years may lead to some serious efforts to

(Continued on back page)

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IOWA NEWS

BETTENDORF: Jay P. Hull has been appointed vice president and trust officer of Security State Trust & Savings Bank. Mr. Hull joined the bank in 1970.

BOONE: Kenneth D. Sundall, cashier, has been elected president of the Boone State Bank and Trust Company, succeeding H. C. Overbeck, who recently observed his 50th year in banking. Mr. Overbeck is chairman of the board. Richard C. Hare has been elected first vice president and cashier. Mr. Hare previously was assistant vice president of the Home State Bank at Jefferson.

DES MOINES: The Iowa Supreme Court has held that interest rates on credit card purchases must not exceed the 9 per cent maximum interest rate set by Iowa law. Major department stores have charged 18 per cent. Further interpretation is being made by bank attorneys concerning rates for bank credit cards.

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Independent Bankers have filed a petition for review in the District of Columbia Court of Appeals on the Fed's approval of Northwest Bancorporation's acquisitions of the Bettendorf Bank & Trust Company and the Security State Bank, Keokuk, on August 2.

DUBUQUE: The Board of Governors of the Federal Reserve has denied acquisition of the First Nat'l. Bank by the Northwest Bancorporation, Minneapolis by a vote of 4 to 0. The board felt that it would have an adverse affect on competition.

WATERLOO: The Waterloo Savings Bank will hold an open house for the public on Sunday, Sept. 30, from 11 a.m. to 5 p.m. in its new three-story building.

WEBSTER CITY: Joe Parrish, Jr., has been named an assistant cashier at the Farmers National Bank. Since 1966 he has been employed by the Federal Reserve Bank of Chicago as a bank examiner.

NEBRASKA NEWS

OMAHA: Frank O. Starr, president and chief executive officer of The Omaha National Bank, will speak September 27 at New York's Hilton Hotel to a banking conference dealing with the strategic growth options for banks. Mr. Starr will talk on the subject of how smaller and medium-size banks can compete in the field of electronic funds transfer systems, now being introduced throughout the financial world.

ILLINOIS NEWS

A one-day marketing seminar for Illinois community banks will be held Wednesday, Oct. 17, at the Holiday Inn, Mt. Vernon.

The program, which is sponsored by the marketing and public relations division of the Illinois Bankers Association in cooperation with the American Bankers Association, is designed for top executives of small and medium size community banks.

Registration will begin at 8:30 a.m. and the program will begin at 9 a.m. Areas to be covered include: the philosophy and process of community bank marketing, research, product strategy, advertising strategy, selling the bank's products, public relations strategy and writing the annual marketing plan.

CAMBRIDGE: A charter has been issued to Peoples Bank of Cambridge, 201 North Prospect Street, as a result of the conversion of The Peoples National Bank of Cambridge to a state bank.

The capital stock of the bank is \$100,000, divided into 5,000 shares issued of a par value of \$20 each. The surplus is \$500,000.

The officers of the bank are: Lyle P. Campbell, chairman of the board; Erman A. King, president; Victor E. Meyer, executive vice president; Frank H. Wilson, senior vice president; and Carl Wexell, cashier. Directors include: Mr. King, Mr. Meyer, Leonard W. Telleen, Roy E. Reppert and Mr. Wexell, all of Cambridge, and Mr. Campbell of Downers Grove.

CHICAGO: An application by the Community Bank & Trust Company of Edgewater for Federal deposit insurance has been approved. Total capital accounts of the bank are \$2 million.

CHICAGO: An application for a permit to organize the Eagle State Bank at 3919 West 26th Street has been filed. Total capitalization of the new bank would be \$1 million, consisting of: \$400,000 in capital stock, \$400,000 in surplus and \$200,000 in reserve. Applicants include: Eusebio Arce of Bridgeview; Larry Villarreal, Buenaventura Albor, Rosa Thelma Lopez, Arthur Velazquez, Juan F. Ruvalcaba, Noe Trevino, all of Chicago.

HINSDALE: Edward I. McEldowney was elected president and a director of the Bank of Hinsdale. He succeeds Donald H. Fischer, who will continue as vice chairman.

MINNESOTA NEWS

The 24th annual Minnesota Bankers



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Association Bank Officer and Staff Conference will be held October 16-17 at the Radisson South Hotel in Bloomington.

Topics to be covered include: bank laws and regulations, Hunt Commission recommendations, education, personnel development, developments in the payments system and their effect on Minnesota Banks and economics.

CANBY: The National Citizens Bank of Canby has changed its name to the National Bank of Canby. The change is effective October 1.

PINE ISLAND: The directors of the Security State Bank have announced that control of the bank has been purchased by a group of Omaha, Nebr., investors.

F. W. Sanborn, former vice president and cashier, was appointed president to succeed retiring president James E. Hervey, who previously owned the controlling interest. No other changes are expected.

SAINT PAUL: The Northwestern National Bank has received notification that a decision handed down October 2, 1972, by Judge Edward J. Devitt has been reversed by the Eighth Circuit Court of Appeals.

The suit involves the television teller facilities operated by Northwestern under authority received from the Comptroller of the Currency of the United States. These facilities are located at the west entrance from Wabasha to the bank building. Opponents in the case, the Independent Bankers Association and Commercial State Bank, have contended that the units provide the bank more than one detached facility from which it can serve its customers.

In 1971, a bill passed by the Minnesota Legislature authorized banks to establish a paying and receiving facility not physically attached to the main office of the bank. Northwestern opened operation of a facility

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in November of 1971 at 125 Endicott Arcade.

Reversal by the Appellate Court directs the Comptroller of the Currency to review the charter granted this facility. Pending the outcome, the bank will continue to operate the television units.

SOUTH DAKOTA NEWS

CLEAR LAKE: Wes Skunberg has joined the staff of the Deuel County National Bank as installment loan officer. He was with the First National Bank and Trust Company of Fargo, N. D.

RAPID CITY: Rey Klay, executive vice president of the western division of the National Bank of South Dakota, has announced the election of Dennis L. Reinhart as assistant cashier in Rapid City. Mr. Reinhart joined the Rapid City office of the bank in September of 1967 as a computer operator.

NORTH DAKOTA NEWS

GRAND FORKS: First National Bank has established a new marketing division and made several staff changes. B. P. McDermott, vice president, will direct the new division. John A. Dunagan, assistant vice president, will replace Mr. McDermott as head of the installment loan division. Charles S. Youlden, assistant vice president, now heads of the real estate mortgage area.

COLORADO NEWS

Officials of Affiliated Bankshares of Colorado, Inc., and First Colorado Bankshares, Inc., recently noted that the Justice Department apparently will not resist the proposed merger of the two bank holding companies, slated to become official September 28.

The two firms said in a statement that the 30-day waiting period in which the Justice Department could file suit against anti-trust violations in the merger had passed without any action being taken.

The proposed merger, previously criticized by the Justice Department, would bring together 18 Colorado banks with total assets of \$729 million. The new entity, to be known as Affiliated Bankshares of Colorado, Inc., will be the state's third largest bank holding company.

SALIDA: Application has been made to establish the Chaffee County Bank at 146 G Street. Listed as organizers of the new bank were Leo J. Leonardi, F. Wallace Koster.

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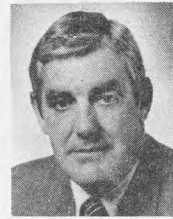


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INTEREST RATES.....
(Continued from Page 1)

restore economic discipline, this is not going to take place rapidly. There is a strong inflation bias built into the system and this is going to keep the cost of money high by historic standards.

Financial Markets

The money supply since mid-June has risen at an annual rate of only 3.1%. This is in marked contrast to the period from March to June when the rate was close to 10%. It seems reasonable to expect the continuation of this tightening policy for at least another two to three months. Its major impact in slowing the economy will probably not be evident until late in the fourth quarter of the year.

In the past two or three weeks there have been instances of strength in long-term bond prices, but in our opinion these do not represent any major shift in the market. The trend of rates is still up and we do not expect the peak to be reached before late this year or early 1974. Short rates should peak by October or November. The thrust of demand forces for both consumer and capital goods remains strong and, with the possible exception of housing, there is little to suggest any slowing in activity. We are

still moving upward in a cyclical expansion which will be confirmed by third quarter data when it is reported.

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