Federal Reserve Bank of San Francisco

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Business & Financial Letter

Firmer Monetary Policy

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The world of February 1973 is considerably different from that of August 1971. Policymakers during the days of the unfolding New Economic Policy found themselves dealing with conflicting goals—stimulating a sluggish economy on the one hand, and curbing price increases on the other. But today, with the inflationary pressures of a second devaluation added to those generated by a booming domestic economy, their policy role becomes quite evident. The perennial task of "leaning against the wind" is no longer complicated by any uncertainty about the direction from which the wind is blowing.

The firmer Federal Reserve policy stance can be discerned from the recently released minutes of the December meeting of the Federal Open Market Committee, the key policymaking body. The committee agreed in December that the economic situation called for a slowdown in the growth of the monetary aggregates, in contrast to the 8½-percent annual growth of the money stock recorded in the latter part of 1972.

Then last weekend, the Federal Reserve System began to move to a 5½-percent discount rate—the second increase this year—in contrast to the 4½-percent rate that was maintained between December 1971 and January 1973. In view of the strong credit demands—and rising money-market rates—generated by the business boom, a hike in the discount rate "was called for in furtherance of the objectives of economic stabilization." Meanwhile, the System has had to contend with the turmoil in the money markets that accompanied the recent international crisis.

Devaluation impact
The devaluation crisis had the short-run effect of widening the gap between the Federal-funds rate and the discount rate. (The former is the rate at which member commercial banks borrow unused reserves from each other, and the latter of course is the rate at which they borrow from the Federal Reserve.) As the German and other foreign central banks absorbed large amounts of dollars, they utilized those dollars for substantial purchases of U.S. Government securities, both marketable and nonmarketable. Their purchases of Treasury bills were so large as to cause the three-month bill rate (daily average basis) to decline by 23 basis points in the week ending February 14 alone.

Foreign central banks' payments for **nonmarketable** Treasury issues caused member-bank reserves at the Federal Reserve to decline by about $3 billion. This substantial withdrawal of reserves forced the Fed into direct open-market

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purchases as well as repurchase agreements with dealers. (The latter represents purchases from dealers who agree to buy the securities back at some later date.) The Treasury meanwhile attempted to offset the reserve contraction, reflected in a trading rate of over 7 percent for the Fed-funds rate, by moving cash balances at the Fed into Treasury tax-and-loan accounts at commercial banks.

In addition, foreign central banks' purchases of **marketable** Treasury securities accentuated the difficulty of conducting open-market operations, because these purchases dried up the collateral which dealers use for repurchase agreements and which banks use to collateralize tax-and-loan accounts. Because of their inability to take on certain types of repurchase agreements, member banks increased their borrowings heavily at the Federal Reserve discount window; in the week ending February 14, borrowings averaged $2.0 billion (several times the level of mid-December) and average net borrowed reserves jumped to $1.8 billion.

Prime rate quandary
With the prime rate at 6 percent until recently, some short-term borrowers turned away from the commercial-paper market, where rates on 90-119 day dealer paper were hovering around 6¼ percent, and began to borrow instead from the commercial banks. Thus, commercial and industrial loans began to grow at a rapid pace; during the first week of February, for example, such loans increased by more than $1 billion, as against a $37-million gain in the comparable week of 1972.

The need to satisfy new loan demands has caused banks to expand their search for funds, with special reliance upon negotiable certificates of deposit. The primary market rate on 90-day certificates has risen 60 basis points since the beginning of the year. A liquidity problem could have resulted had commercial banks paid 6¼ percent for 90-day CD money and then lent those funds out at 6 percent to prime borrowers. However, the recent discount-rate hike to 5½ percent and the accompanying prime-rate increase to 6¼ percent diminishes the possibility of a squeeze of this type.

Bankers now have three guidelines to follow in dealing with the prime rate, according to Arthur F. Burns, in his second capacity as chairman of the Committee on Interest and Dividends. These guidelines help explain the delayed and relatively modest increase in the prime rate this past week.

"First, if increases in the prime rate occur, they should be decidedly less than for related open-market interest rates because institutions operate with certain relatively stable costs that can be spread over a rising volume of business. Second, such adjustments should be delayed until it becomes clear that the increase in open-market rates is not a temporary phenomenon. Third, if any rise in the prime rate occurs, special moderation should be observed in any adjustments of interest rates on small business and agricultural loans as well as on home mortgage and consumer loans."

Policy stance today

The December FOMC directive called for "bank reserve and money market conditions that will support slower growth in monetary aggregates over the months ahead than appears indicated for the second half of this year." The second half of 1972 saw the narrowly defined money stock, M_1—demand deposits plus currency in the hands of the public—grow at an 8½-percent annual rate.

A firmer policy stance has been strongly evident since the December meeting. M_1 remained unchanged during January, and has grown only moderately in February. Also, the discount rate has now risen twice, each time by one-half percentage point, to the present 5½ percent. But although the discount rate affects total borrowed reserves, its impact on M_1's growth rate is less evident. Member-bank borrowing is only a small portion of the total "monetary base," which is composed not only of borrowed reserves but also of nonborrowed reserves and currency held by the nonbank public.

The greatest impact of Fed open-market operations falls upon the non-borrowed reserve portion of the monetary base. While unanticipated member-bank borrowing may make open-market operations more difficult for the Fed, the major movements in the monetary base are caused by open-market purchases and sales of Treasury securities. Raising the discount rate to 5½ percent may moderate the growth of borrowed reserves, but open-market policy still will determine the growth of total reserves and the monetary base.

Today, unlike August 1971, the economy is expanding vigorously, and continued growth seems all but certain in the months ahead. Like August 1971, however, fears of accelerating inflation appear to be spreading—and with much stronger reason, because of the quickening tempo of business activity and the recent upsurge in food prices. In these circumstances, monetary and fiscal policies must play their basic role in keeping the expansion within bounds. This means not only a firmer hand on the Federal budget, but also a firmer monetary policy stance.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/14/73	Change from 2/7/73	Change from year ago Dollar	Change from year ago Percent
Loans adjusted and investments*	69,455	+ 157	+8,375	+ 13.71
Loans adjusted—total*	51,458	+ 176	+8,434	+ 19.60
Commercial and industrial	18,424	+ 417	+2,517	+ 15.82
Real estate	15,268	+ 60	+2,487	+ 19.46
Consumer instalment	7,897	+ 19	+1,394	+ 21.44
U.S. Government securities	6,770	— 42	+ 58	+ 0.86
Other securities	11,227	+ 23	— 117	— 1.03
Deposits (less cash items)—total*	67,723	+1,103	+7,675	+ 12.78
Demand deposits adjusted	20,617	+ 339	+1,834	+ 9.76
U.S. Government deposits	1,852	+ 927	+1,165	+169.58
Time deposits—total*	44,160	— 25	+4,558	+ 11.51
Savings	18,032	— 40	+ 160	+ 0.90
Other time I.P.C.	17,498	+ 41	+3,059	+ 21.19
State and political subdivisions	6,279	— 33	+ 811	+ 14.83
(Large negotiable CD's)	7,079	+ 36	+2,048	+ 40.71

	Weekly Averages of Daily Figures: Week ended 2/14/73	Week ended 2/7/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	4	67r	5
Borrowings	20	101	0
Net free (+) / Net borrowed (—)	—16	+ 34r	+ 5
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (—)	—34	+507	—638
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (—)	+71	+315	+128

*Includes items not shown separately.

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