

# Federal Reserve Bank of San Francisco

July 6, 1973

## Tightening

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The monetary authorities announced several actions last week that had the intent of tightening policy several more notches. By raising the discount rate and imposing higher reserve requirements on demand deposits, the Federal Reserve acted to restrain the "continuing excessive expansion in money and credit" amidst the worldwide concern over the inflationary expansion of the American economy.

Most analysts expect that the anti-inflation fight will get some help from a slowdown in the GNP growth rate, since second-quarter statistics should show the annual rate of increase falling somewhat below the 8.0-percent annual rate recorded in each of the past two quarters. However, with the economy now close to effective full employment, it would be difficult to match the pace of last winter and spring. Usable industrial capacity and experienced manpower are both being worked to the limit, so that the opportunities for further accelerated growth are somewhat limited.

Constraints on that other necessary economic resource—money—may soon become equally evident as the policy-tightening measures take hold. To date, however, abundant availability has been the rule, judging from the evidence provided by the Commerce Department's index of sensitive financial flows, a leading indicator of cyclical activity. (The index consists of changes in the money supply and changes in

business, mortgage and consumer loans.) The level of this index was no higher in 1970 than it was in 1967, but it increased 9 percent between early 1971 and early 1972, and then jumped 17 percent between first-quarter 1972 and first-quarter 1973. According to early indications, this indicator moderated in April but then surged upward again in May.

### Money problems

In this atmosphere of headlong credit expansion, the monetary authorities have shown growing concern over the recent rapid growth of the various monetary aggregates, such as the narrowly-defined money supply (demand deposits plus currency). From a rapid 8½ percent annual rate during the fourth quarter of 1972, the money supply grew at less than a 2-percent rate over the first quarter of this year, but then grew at more than a 9-percent rate over the statistical quarter just ended.

A statistical fluke related to the early-1973 international monetary crisis was partly responsible for this recent shift. Treasury bank deposits, which are not counted in this measure, were built up during the first quarter but were then shifted into private demand deposits during the second quarter, expanding the money supply. In April and May alone, Treasury tax-and-loan accounts dropped from \$7.4 billion to \$3.9 billion. Yet even after allowing for this factor, the monetary aggregates have still shown an over-rapid rate of growth, necessi-

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# Business & Financial Letter

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tating further attempts to cut the monetary cloth to the dimensions of the real economy.

In its initial attempts to counter the inflationary boom, the Federal Reserve tightened open-market policy early last winter. The flavor of these actions is found in the published minutes of the December through March meetings of the Federal Open Market Committee. These actions were supplemented in mid-May, when the System turned its attention to the increasing commercial-bank reliance on money-market sources of funds—in particular, large negotiable CD's. At that time, the Board of Governors imposed a supplemental 3-percent reserve requirement on large CD's and related instruments in excess of those held in the mid-May base period.

### **Cutting the base**

Last week's action was a logical next step, as the Board moved to impose an across-the-board increase in reserve requirements on member-bank demand deposits, effective July 19. Reserve requirements were raised from 17½ to 18-percent for the largest banks—those with deposits of more than \$400 million—and the requirements applicable to smaller banks were similarly raised

½-percent point. (The increase was applied to all but the first \$2 million of net demand deposits.)

The same weapon was used for credit-tightening purposes in early 1968 and again in the spring of 1969, as requirements were raised ½-percent point on each occasion to counter the Vietnam inflation. Thereafter, requirements affecting large (reserve city) banks were left unchanged, although a structural change was made last fall (Regulation D), which generally reduced requirements for small and medium-sized banks.

These changes in reserve requirements represent the use of the heavy artillery in the System's arsenal of policy weapons. According to the Board's statement, last week's action will remove about \$800 million from the reserves that support the banks' loan and deposit structure. It should be added, however, that if the System follows its usual practice of replacing reserves through open-market operations, only the banks' profits would be immediately affected.

### **Raising the rate**

The discount-rate hike draws attention to another increasingly used policy weapon. The rate had remained at 4½ percent for more than a year until last January, but has since been raised six times—twice during June alone—and now stands at 7 percent. At that point, it matches the record reached during the 1920-21 tight-money period and

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compares with the 6-percent high reached during the difficult 1969-70 period. More importantly, the increase restores the discount rate's traditional relationship with the 90-day Treasury bill rate and other money-market rates.

The recent action permits the discount rate to support and strengthen the effectiveness of System open-market policy. In an inflationary period like today, the Federal Reserve uses open-market operations to hold down the supply of reserves in relation to swelling credit demands, and thus acts to push market interest rates upward. In this situation, when member banks find their reserve positions under increasing pressure, they have an incentive to expand their borrowings from the Reserve banks. (Borrowings this past spring have been about three times the level of last fall and considerably above the 1969 peak.) The System thus can reinforce open-market policy by raising the discount rate, in order to discourage the creation of additional reserves through borrowing—and instead, to encourage the adoption of more cautious lending policies and the reduction of available credit.

#### **Other approaches**

Today's inflation problem is so intractable that it dictates the adoption of several other approaches besides the monetary approaches described above. Federal Reserve Chairman Burns referred to some of these possibilities in Congressional

testimony last week.

He referred in particular to new fiscal measures designed to cool the economy by soaking up private purchasing power. One proposal, which could have ecological as well as economic benefits, would be a tax on autos based on horsepower. Another would be the lowering of the 7-percent investment tax credit as a means of curbing the business-spending boom. In addition, he proposed a compulsory saving plan, that would force corporations in inflationary times to turn over a certain proportion of their profits to a Federal Reserve escrow account, and that would then provide for a return flow of funds in less buoyant times.

All these measures, designed as they are to smooth out the extremes of the business cycle, would provide welcome reinforcement to the anti-inflation battle right now. In their absence, continued stress must be placed upon the weapons of monetary policy, and upon such "jawbone" approaches as Chairman Burns' May letter asking banks to resist "excessive" credit demands and to exercise "prudence" in acquiring CD's and other loanable funds.

**William Burke**

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/20/73	Change from 6/13/73	Change from year ago	
			Dollar	Percent
Loans adjusted and investments*	72,915	- 833	+ 9,536	+ 15.05
Loans adjusted—total*	55,867	- 717	+ 10,071	+ 21.99
Commercial and industrial	20,113	+ 150	+ 3,345	+ 19.95
Real estate	16,372	+ 102	+ 2,742	+ 20.12
Consumer instalment	8,311	+ 33	+ 1,351	+ 19.41
U.S. Treasury securities	5,651	- 67	- 725	- 11.37
Other securities	11,397	- 49	+ 190	+ 1.70
Deposits (less cash items)—total*	70,717	- 275	+ 8,641	+ 13.92
Demand deposits adjusted	21,019	- 445	+ 1,950	+ 10.23
U.S. Government deposits	986	+ 566	+ 58	+ 6.25
Time deposits—total*	47,651	- 262	+ 6,670	+ 16.28
Savings	17,965	- 29	- 141	- 0.78
Other time I.P.C.	20,145	- 110	+ 4,835	+ 31.58
State and political subdivisions	6,882	- 105	+ 1,152	+ 20.10
(Large negotiable CD's)	9,565	- 138	+ 4,390	+ 84.83
<b>Weekly Averages of Daily Figures</b>	<b>Week ended 6/20/73</b>	<b>Week ended 6/13/73</b>	<b>Comparable year-ago period</b>	
<b>Member Bank Reserve Position</b>				
Excess reserves	- 23	- 18		9
Borrowings	235	229		0
Net free (+) / Net borrowed (-)	- 258	- 247		+ 9
<b>Federal Funds—Seven Large Banks</b>				
Interbank Federal funds transactions				
Net purchases (+) / Net sales (-)	+ 509	+ 626		- 645
Transactions: U.S. securities dealers				
Net loans (+) / Net borrowings (-)	+ 608	+ 575		- 8

\* Includes items not shown separately.

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