CONDUCT OF MONETARY POLICY

(Pursuant to the Full Employment and Balanced Growth Act of 1978, P.L. 95-523)

HEARING

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

SECOND SESSION

JULY 23, 1980

Serial No. 96-63

Printed for the use of the
Committee on Banking, Finance and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1980

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WEDNESDAY, JULY 23, 1980

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building; Hon. Henry S. Reuss (chairman) presiding.

Present: Representatives Reuss, Moorhead, Gonzalez, Minish, Annunzio, Hanley, Mitchell, Neal, Blanchard, AuCoin, Evans of Indiana, D'Amours, Cavanaugh, Vento, Barnard, Watkins, Stanton, Wylie, Hansen, Leach, Evans of Delaware, Green, Paul, Bethune, Shumway, and Porter.

The CHAIRMAN. Good morning.

The House Committee on Banking, Finance and Urban Affairs will be in order for its semiannual inquiry into the conduct of monetary policy.

Chairman Volcker, we meet today under grim economic conditions. Since January we have entered a steep slump. In the second quarter the economy declined more rapidly than at any time since the Second World War. Housing, steel, autos, and other basic industries are in crisis. Unemployment, already too high, is going higher. Inflation has declined somewhat, but it has settled at its underlying rate, which is determined by the pace of wage settlements and productivity gains, and it shows no signs of coming down any further.

Under these conditions, the Federal Reserve has a lot of explaining to do. After our last review of monetary policy, this committee called on the Federal Reserve, in 1980, "to pursue measured restraint without precipitating recession." It was our nearly unanimous view that a recession would engender irresistible pressure for fiscal stimulus, and so jeopardize all efforts to contain inflation. We entertained the modest hope, which the Federal Reserve and the administration did not discourage, that a steady winding down of inflation could be accomplished without recession. We understood that the Federal Reserve's October shift of emphasis from interest rate to reserve targeting was undertaken so as to achieve this goal.

It is now clear that our hopes were illusions. Monetary control was achieved in October, as the committee acknowledged in April. Yet, far from doing what we had hoped, the achievement of monetary control precipitated a severe recession and all that that en-

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tails: huge deficits, crises in industry, calls for protectionism, capital outflows and a falling dollar, and domestic social upheaval. And we face every prospect of a renewed inflationary spiral as soon as the recovery is underway.

In my view, the Federal Reserve, the administration, and we in Congress should acknowledge our errors frankly. And we must recognize that our present policies are not working, that they cannot work, and that we can and must take steps that will work—steps that will put people back to work, raise productivity, increase real incomes, and so make it less necessary for wage earners to exact their pound of flesh in money-wage terms. In short, we need a monetary policy that will fight both inflation and recession.

Such a comprehensive monetary policy must have a macroeconomic, an international, and a microeconomic aspect.

First, at the broadest macroeconomic level, there is nothing wrong under most conditions with the rule that the Federal Reserve should set, and try to meet, a target for the growth of money. Such a rule quite properly causes the Federal Reserve to "lean against the wind": to restrain booms and to soften slumps. The provision of numerical monetary growth targets to the Congress also provides a valuable indication of Federal Reserve intentions, and with this in mind I strongly object to the omission of such targets for 1981 from the present report. But monetary growth targets by themselves cannot cope with the forces of instability that buffet our economy in the present world. To rely on them alone is reckless.

Second, our national monetary policy must be coordinated with our allies. If the United States alone pursues monetary expansion in the midst of recession, our interest rates will fall sharply by comparison with those abroad. If relative interest rates fall, short-term capital will flow away from this country, and the dollar will fall. The immediate consequence will be a new surge in the prices of manufactured imports and raw materials; the ultimate consequence will be a new rise in the price of oil. We can afford neither.

There is no way we can pursue a monetary strategy for recovery in a vacuum. We must coordinate our recovery from recession with the Central Banks of our allies. To this end, the Federal Reserve and the Treasury should begin immediate discussions with Germany and Britain, in particular, to persuade them to lower their interest rates as we lower ours. If all of our major allies act in a coordinated way, interest rates can come down without destablizing short term capital flows. This will help economic expansion in all countries without threatening anyone's currency. If our friends need to avert inflationary pressures, that can be accomplished with tighter fiscal policies, which will not have the same adverse international ramifications.

Third, most important, we must recognize that the indefinite future our national reserves of credit will be scarce. We therefore need urgently to address the microeconomic question: To whom should our scarce credit resources go? Everyone wants credit. Only the largest and most profitable corporations can finance their expansion plans without it. Small businesses rely on credit. So do farmers. So do home buyers, and so do millions of consumers. A national policy on who should have priority access to this credit is

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an indispensable concomitant of a necessary national policy that makes credit relatively scarce.

Last October, the Federal Reserve and the administration took a first, halting step toward a policy on the uses of credit. The Fed announced a series of objectives, and it wrote to the banking system asking for cooperation in their attainment. The objectives were laudable: That banks should concentrate their lending on small businesses, consumers, home buyers, farmers and productive capital investment, while avoiding loans for commodity, gold and foreign exchange speculation and for purely financial activities such as stock buy-backs and corporate takeovers. But despite these good intentions, the Federal Reserve and the administration have utterly failed to monitor and secure voluntary compliance with their request.

Faced with declining loan demand at high interest rates after October 1979, the banking system simply disregarded the Federal Reserve's admonitions.

How else can one account for the incredible fact that a handful of large banks channeled some $800 million—nearly 10 percent of all bank lending in the country in February and March—to Bunker Hunt and his associates alone? How else can one interpret the fact that the Federal Reserve did no know of any bank lendng against silver until March 26, and that it has allowed Bunker Hunt's daughter to buy a silver mine despite a guarantee, made in the Fed's own report to Congress, that the Fed-approved loan to the Hunts and Placid Oil would bar the Hunts and "any related entity" from all speculative activity for the lifetime of the loan?

How else can one account for such loans as the $40 million credit from 5 large banks to Nortek, Inc., approved in late October, which had its unvarnished purpose—"to acquire the equity securities of a * * * 'target' corporation"—written right into the loan application?

How else can one account for the duplicitous behavior of the large New York banks in the first quarter, who raised their official prime rates, to which small business and housing loans were tied, thereby squeezing small borrowers right out of the market, while the banks made over two-thirds of their total loans—to big borrowers—at rates below the official prime?

How else, indeed can one account for the record profits turned in by the big New York banks in the second quarter?

In mid-March, the Federal Reserve took steps that ostensibly stiffened surveillance and control over speculative lending. This was the special credit restraint program. Did it work? We will never know, because, incredibly, the Federal Reserve did not ask the banks to report on how much speculative lending they had been doing prior to the imposition of restraints. So we cannot find out whether the reporting requirements had their desired effect. And in any case the issue is now academic, since only a few weeks ago the Fed withdrew its antispeculative admonitions and abolished its reporting requirements, allowing the blindfold to slip totally over its eyes.

Unfettered speculation has the effect of raising credit costs and limiting credit availability to legitimate borrowers, such as small business, home buyers and builders, consumers and farmers. It also

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increases the general demand for bank loans—the Hunt brothers alone drove up loan demand in February and March by nearly 10 percent—and so gives false signals to the monetary authorities causing them to tighten more harshly than conditions warrant. And of course it is not the big-time speculator, but the legitimate small borrower who is caught in the squeeze.

This discrimination against the borrower that we ought to be helping is made worse by the recent big bank practice of posting phony prime interest rates—the rates which the big banks are supposed to charge their best customers. In fact, when the prime rate was 20 percent a couple of months ago, and the average borrower was paying 20 percent plus, the big banks were giving under-the-table discounts to their large corporate customers of as much as 5-percentage points. Bank loans at below prime rates—mainly large loans of short maturities, rose from 8.8 percent in 1977 to 16.1 percent in 1978, to 32.6 percent in 1979 and to an astounding 58.8 percent of all new loans made in May 1980 at 48 large banks surveyed by the Federal Reserve. The main effect is to squeeze borrowers who are not eligible for these secret-rebate prime loans.

I have previously, on May 23, called the attention of the Federal Reserve to the problem of the phony prime loans. The Fed's reply says that "the data * * * do not themselves appear to justify sweeping charges of discrimination against particular groups of borrowers." But the Federal Reserve concedes that the unrealistically high prime rates of this spring may have worked "to the disadvantage of customers that do not have access to the open market for large short-term business credit." This was precisely what I had feared. And the Fed's study, far from invalidating my claim of sweeping discrimination against worthy borrowers, shows that in fact they were given the short end of the lender's stick. For example, the study shows that the average size of loans below prime by 48 large banks in May was $1.2 million, while the average size of loans above prime at the same banks was $208,000.

There is only one way to control credit, and that is to control it. If the Federal Reserve is asleep at the switch, and if small business, agriculture, productive capital investment and the construction industry have been derailed, then affirmative steps should be taken to guarantee access to credit for these vital uses. We must use the Nation's credit resources to fight both inflation and recession by encouraging lending to productivity-enhancing capital investment, small business, housing, consumers and farmers, and discouraging lending for commodity speculation and corporate takeovers.

To implement this policy, no new economic inventions are required. The Federal Reserve already has the necessary tools, through its reserve, discount and regulatory powers, to achieve an inflation-recession breakthrough. In your July 21 responses to my detailed questions on bank lending for silver speculation and for corporate takeovers, you make clear that the Federal Reserve has come a long way in its willingness to scrutinize and criticize lending practices that are not in the national interest—and I commend you for it.

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Now, it is our task as those who under the powers of the Constitution have the powers to control money and regulate the power thereof, and you, to whom we have delegated this constitutional authority, to adopt a monetary policy that goes beyond control over the monetary aggregates sufficient to gladden the heart of the monetarists, which is an admitted part of what needs to be done, and which gets on with the job of bringing an international aspect to monetary policy, and most important of all, a microeconomic aspect to monetary policy which sees that housing, capital investments, farming, consumers, and other necessary users are not sacrificed on the altar of commodity speculation and corporate takeovers.

Thank you very much.

Mr. Stanton.

Mr. STANTON. Thank you very much, Mr. Chairman.

Mr. Volcker, I welcome you to the committee once again under the rules and regulations of fulfilling our requirements of the Humphrey-Hawkins bill.

Mr. Chairman, may I first compliment you on your opening statement? It is thorough, concise. It was obvious that you did not get up to Detroit, Mich., last week on the shores of the upper Great Lakes in preparing that excellent statement.

The CHAIRMAN. I was in the Great Lakes area, but a bit away from Detroit.

Mr. STANTON. I don't have any opening statement, Mr. Chairman. I would like to comment on a specific point you made and what I understand was referred to yesterday by members of the other body; that is, Mr. Chairman, the lack of projected target ranges for 1981. I join in that criticism because over the years a lot of political blood was spilled in trying to temper these hearings to adequately reflect the independence of the Federal Reserve System.

Over the years we have come to this conclusion. We started out with specific interest rate targets. We disagreed with that and threw that out.

Two provisions were put into this legislation, Mr. Chairman, to protect you in regard to the target ranges. One was the provision that instead of single points, which was talked about at one time, we used the ranges.

Second, there is a statement in there that basically is to the effect that nothing requires the Fed to actually keep the targets if they think it is unwise to do so.

I would hope under those two restraints, Mr. Chairman, that you would reconsider this question.

It is, indeed, of importance, I believe, in keeping the letter of the law as far as the Humphrey-Hawkins Act is concerned.

I would only make that opening comment, Mr. Chairman, that I do join you in that regard.

I think the request would be almost universal in that regard.

The CHAIRMAN. I am sure it would be, Mr. Stanton. I thank you.

There is a pro forma vote going on. Would the committee appreciate it if I declared a 7-minute recess to make that?

I hereby do that. Mr. Volcker, if you will just relax, we will be back shortly.

[Recess taken.]

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The CHAIRMAN. The committee will be in session again.

Thank you for your patience, Mr. Volcker.

We have the midyear monetary policy report before us and also in timely fashion your prepared statement for today. Both under the rule, without objection, will be included in the record.

[Mr. Volcker's prepared statement and the midyear monetary policy report referred to may be found on p. 16.]

Would you now proceed in your own way to summarize——

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, as you know, I testified before the Senate yesterday. My statement this morning parallels my testimony there.

I wrote that statement in considerable part in response to a letter from the chairman July 1 that puts the issue before us.

He reviews some of the problems of the economy, not only changes in the economy, but changes in financial conditions of great rapidity recently, and concludes, "I am not suggesting a change in the monetary strategy"—a conclusion with which, of course, we agree—"but the experience of recent months demonstrates that monetary and fiscal policies alone cannot by themselves offset the present instability of our domestic and international economic affairs. We need urgently to develop comprehensive stabilization policies * * * ."

My statement is partly directed toward that kind of comment. With your permission, I will proceed.

The CHAIRMAN. You may do that.

Mr. VOLCKER. I am, of course, delighted to be with you in this semiannual occupation. My purpose today is to add some personal perspective to the more formal report that you have.

As the chairman has emphasized, the direction of economic activity has changed swiftly in recent months. We have acute problems of recession and inflation. There have been unprecedented changes in interest rates and the imposition and removal of extraordinary measures of credit restraint. The fiscal position of the Federal Government is changing rapidly.

In these circumstances, confusion and uncertainty can arise about goals and policies, not just those of the Federal Reserve, but of economic policy generally.

That is why I particularly welcome the opportunity to be here to emphasize the underlying continuity in our approach at the Federal Reserve and its relationship to other economic policies, matters that are critical to public understanding and expectations. The Federal Reserve has been, and will continue to be, guided by the need to maintain financial discipline—a discipline concretely reflected in reduced growth over time of the monetary and credit aggregates—as part of the process of restoring price stability. As I see it, this continuing effort reflects not simply a concern about the need for greater monetary and price stability for its own sake—critical as that is.

The experience of the seventies strongly suggests that the inflationary process undercuts efforts to achieve and maintain other

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goals, expressed in the Humphrey-Hawkins Act, of growth and employment.

As you know, our operating techniques since last October have placed more emphasis on maintaining reserve growth consistent with targeted ranges for the various M's, with the implication interest rates might move over a wider range. Those targets were reduced this year as one step toward achieving monetary growth consistent with greater price stability. For several months after the new techniques were introduced in October, the various aggregates were remarkably close to the targeted ranges.

At that time, and for months earlier, you will recall widespread anticipations of recession. Nevertheless, reflecting a variety of developments at home and abroad—including an enormous new increase in oil prices, Middle Eastern political volatility, and interpretations of adverse budgetary developments—there was a marked surge in the most widely disseminated price indices and in inflationary expectations in the early part of this year.

Those expectations in the short run probably helped to support business activity for a time; in particular, consumer spending relative to income remained very high, with the consequence of historically—and fundamentally unhealthy—low savings rates and high debt ratios. Speculation was rife in commodity markets.

Spending and speculative activities of that kind are ultimately unsustainable. But they carried the clear threat of feeding upon themselves for a time, contributing among other things to a further acceleration of wage rates and prices. In that way, inflation threatened to escalate still further in a kind of self-fulfilling prophecy, posing the clear risk that the subsequent economic adjustment would be still more difficult.

Credit markets reflected these developments and attitudes. Bond prices fell precipitously. Long-term money—including mortgages—became difficult to raise. Partly as a consequence, short-term demands for credit ballooned in the face of sharply rising interest rates, at the expense in some instances of further weakening business balance sheets. That heavy borrowing also was reflected in acceleration in the money and credit aggregates during the winter.

An attempt to stabilize interest rates by the provision of large amounts of bank reserves through open market operations to support even more rapid growth in money—at that time money was running high or above our target ranges—would probably have been doomed to futility even in the short run, for it could only have fed the expectations of more inflation. It would certainly have been counterproductive in terms of the overriding long-term need to combat inflation and inflationary anticipations. Instead, consistent with our basic policy approaches and techniques, the Federal Reserve resisted accommodating the excessive money and credit growth.

During this period of rising inflation and interest rates, the administration and the Congress also appropriately and intensively reviewed their own budget planning. Coordinated with the announcement of the results of that broad governmental effort and the decision of the President to invoke the Credit Control Act of 1969, the Federal Reserve announced on March 14 a series of exceptional, temporary measures to restrain credit growth, rein-

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forcing and supplementing our more traditional and basic instruments of policy.

The demand for money and credit dropped abruptly in subsequent weeks, reflecting the combined cumulative effects of the tightening of market conditions, the announcement of the new actions, and the rather sudden weakening of economic activity.

In response, interest rates within a few weeks fell about as fast—in some instances faster and further—than they had risen in earlier months. Growth in the aggregates slowed, and for some weeks M_{1A} and M_{1B} turned sharply negative.

There is no doubt in my mind that these lower levels of interest rates can play a constructive role in the process of restoring a better economic equilibrium and fostering recovery. Indeed, there is already evidence—if still tentative—that homebuilding and other sectors of the economy sensitive to credit costs and availability are benefiting. Meanwhile, progress is being made toward reducing consumer indebtedness relative to income and toward restructuring corporate balance sheets as bond financing has resumed at a very high level. The sharp improvement in credit market conditions has been accompanied by slower rates of increase in consumer and producer prices, helping to quiet earlier fears of many of an explosive increase in inflation.

The suddenness of the change in market conditions has, however, raised questions in some minds as to whether the interest rate declines were in some manner "contrived" or "forced" by the Federal Reserve—whether, to put it bluntly, the performance of the markets—together with the phased removal of the special credit restraints—reflects some weakening of our basic commitment to disciplined monetary policy and the priority of the fight on inflation. These perceptions are not irrelevant, for they could affect both expectations and behavior, most immediately in the financial and foreign exchange markets, but also among businessmen and consumers.

The facts seem to me quite otherwise.

Growth in money and credit since March has certainly not exceeded our targets; the M_1 measures have in fact been running below our target ranges. Bank credit has declined in recent months; while the decline in commercial loans of banks can be explained in part by exceptionally heavy bond and commercial paper issuance by corporations, there is simply no evidence of excessive rates of credit expansion currently. In these circumstances, it is apparent that interest rates have responded—and have been permitted to respond—not to any profligate and potentially inflationary increase in the supply of money, but to changes in credit demands, and—so far as long-term interest rates are concerned—to reduced inflationary expectations.

It is in that context—with credit demands reduced and growth of credit running well within our expectations and targets—that the special credit restraint programs simply served no further purpose. Those measures were invoked to achieve greater assurance that credit growth would in fact slow, and that appropriate caution would be observed in credit usage. The special restraints are inevitably cumbersome and arbitrary in specific application. They involve the kind of intrusion into private decisionmaking and com-

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petitive markets that should not be part of the continuing armory of monetary policy; their use was justified only by highly exceptional circumstances—circumstances that no longer exist. Our normal and traditional tools of control—which in fact have been solidified by the Monetary Control Act passed earlier this year—are intact and fully adequate to deal with foreseeable needs.

Neither the decline in interest rates nor the removal of the special restraints should be interpreted as an invitation to consumers or businessmen to undertake incautious or imprudent borrowing commitments, or as lack of concern should excessive growth in money or credit reappear. That is not happening now. But markets—and the public at large—remain understandably extremely sensitive to developments that might aggravate inflationary forces. As we saw only a few months ago, consumers and businessmen will react quickly in their lending and borrowing behavior to that threat.

While the recent easing of financial pressures helps provide an environment conducive to growth, we should not be misled. A resurgence of inflationary pressures, or policies that would seem to lead to that result would not be consistent with maintenance of present—much less lower—interest rates, receptive bond markets, and improving mortgage availability. We in the Federal Reserve believe the kind of commitment we have made to reduce monetary growth over time is a key element in providing assurance that the inflationary process will be wound down.

I noted earlier the money stock actually dropped sharply during the early spring. In a technical sense, working on the supply side, we provided substantial reserves through open market operations during that period, but commercial banks, finding demands for credit and interest rates dropping rapidly, repaid discount window borrowings as their reserve needs diminished. In general terms, it seems clear that, at least for a time, the demand for money subsided—much more than can be explained on the basis of established relationships to business activity and interest rates—apparently because consumers and others hastened debt repayment at the expense of cash balances and because the earlier interest rate peaks had induced individuals to draw on cash to place the funds in investment outlets available in the market.

As the report illustrates, M_1 growth has clearly resumed, and the broader aggregate M_2 is now at or above the midpoint of its range. In the judgment of the Federal Open Market Committee, forcing reserves onto the market in recent weeks simply to achieve the fastest possible return to, say, the midpoint of the M_1 ranges may well have required early reversal of that approach, have been inconsistent with the close-to-target performance of the broader aggregates, and therefore led to unwarranted interpretations and confusion about our continuing objectives. Depending on the performance of the broader aggregates and our continuing analysis of general economic developments, the FOMC is in fact prepared to contemplate that M_1 measures may fall significantly short of the midpoint of their specified ranges for the year. That is this year, 1980.

I have emphasized the committee's intention to work toward the lower levels of monetary expansion over time. In reviewing the

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situation this month, the committee felt that, on balance, it would be unwise to translate that intention into specific numerical targets for 1981 for the various M's at this time. That view was strongly reinforced by certain important technical uncertainties related to the introduction of NOW accounts nationwide next January, as well as by the need to assess whether the apparent shift in demand for cash in the spring persists.

If I might elaborate on that, Mr. Chairman, you have referred to the failure to provide a specific numerical range next year, and so did Mr. Stanton. I want to explain just what the committee had in mind there.

It seems to have led to some questioning and uncertainty as to what our intentions are. I think my statement makes clear that the general philosophy and intent of reducing the targets remains intact. We attempted some very careful wording in that report to express that intention.

Then we ran into a problem. We are not living in quite the world that we would like to live in in some respects.

One of the things we face is the certainty of technological change next year, growing out of the Monetary Control Act. Particularly, I am thinking of the fact that NOW accounts go nationwide.

We have run into a situation this year where it appears that M_{1A} is somewhat depressed relative to M_{1B}, just as to the technical relationships between them, because we are getting more movement out of demand deposits into NOW accounts than we expected at the moment.

We expected about half a percent depression of M_{1A}. It is more like 1.5 percent in the first 6 months. The staff thinks it will be a little less for the year as a whole.

Technically, we might have changed the relationship between M_{1A} and M_{1B} to allow for that, but it didn't look big enough to be worthwhile.

Next year we go nationwide. We have some estimates from our deliberations as to what the impact might be on the relationship between M_{1A} and M_{1B}. M_{1A} might be depressed anywhere from 1 to 5 percentage points by shifting out of demand deposits to NOW accounts, while M_{1B} might be raised substantially by shifting from regular savings accounts into NOW accounts.

That poses a very difficult problem for us, and uncertainty as to what target we could present that does not mislead more than it is helpful.

There is also a question, which the committee deliberated at great length, as to the persistence of this short fall in M_1 that developed in the first half, which is off the schedule, so to speak, of past equations. And I think you can understand that the committee thought that before putting its name on the line, so to speak, with a specific number, we would like to have a little more time to see how that shortfall works out.

There is a much less important but nonetheless a real question about the treatment of money market funds, which we now include in M-2, but that has some of the characteristics of a transaction balance. In any event, they are growing very rapidly.

We thought it would be less misleading, in fact, to express the general intention of achieving a reduction of size unspecified.

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Rather than to attempt in this very difficult situation to specify a specific range for numbers that would be moving in different directions because of the technological impact.

The sense of what we were doing was to indicate that the basic policy of gradual reduction would be unchanged as we now see 1981.

We did not see this as a legal question or a legal argument. In fact, I asked the question whether this kind of expression was consistent with the law, and the advice I got was there was no real question; it was consistent with the law. I understand there is some argument about that now.

I just want to make the point that we thought this was the best practical way to proceed. We weren't making any philosophical, legal statement. We understand the desirability of stating the general tenor and direction we think these things should move in next year.

We reached a practical conclusion in that area. I am not sure there is any philosophical difference between the comments of the members and our own, but we did have some very practical problems.

Mr. STANTON. Mr. Chairman, if the gentleman would yield, I hate to interrupt the statement, but you diverted from it a moment ago. I am willing to let the subject drop, but on February 19, at your previous meeting before this committee—and I quote—you made the following statement:

> Enactment of nationwide NOW account legislation would be expected to raise the growth of this money stock measure this year and the present range would have to be reconsidered in that light.

That was basically the same statement you made now. At that time you went ahead——

Mr. VOLCKER. That is right. These targets are operational on a current year basis. We need a target for our reserve path and all the rest. Obviously we don't need one for operational purposes right now.

Last year, as I recall, in February—and I am going from memory now—the figure that we put down was one we thought would be appropriate if the law to trigger nationwide NOW accounts was not enacted this year; we didn't know what the law was going to say at that point.

As it turned out, the law included nationwide NOW accounts, but effective December 31. In those circumstances, we felt we didn't have to change the target which was predicated on no nationwide NOW accounts.

As I indicated, the estimate appears to have been slightly wrong in the area of——

Mr. STANTON. I am glad you are trying to clarify this. What you have done inadvertently, Mr. Chairman, is add to the element of confusion about those who want a tax break and those who don't want a tax break.

You will be quoted on it.

Mr. VOLCKER. I have some sense that some element of confusion has arisen; in trying to avoid confusion, we may have inadvertently created some.

Mr. STANTON. Certainly have.

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Mr. VOLCKER. The other side of the coin is that we set down, ranges. We said these are highly tentative in view of all these circumstances; we may have to come back and change them fairly soon. We were afraid that would be confusing. I think the substance of this, in a sense, is an indication that the committee does want to work toward somewhat lower ranges, if one visualized those ranges abstracting from technological change.

The reason I am not so sweeping about that is very simple. If we got a big shift into NOW accounts, partly out of demand deposits and partly out of savings accounts, that would affect the M_{1B} just as a technical matter. It has no policy significance; it is a technical matter. It affects the growth trend of M_{1B} in a way which we have to allow for when we have to make these targets operational.

To move beyond the question of targets at the moment, for the purpose of completing the statement, I think this whole targeting procedure is the critical question. As we approach these targets, the general nature of the potential problems and dilemmas for 1981 and beyond is clear enough; these are important questions, not just for monetary policy but for the full armory of public policy.

The targets for the monetary aggregates are designed to be consistent with, and to encourage, progress toward price stability without stifling sustainable growth. But in the short run, the demand for money—at any given level of interest rates—tends to be related not to prices or real output alone, but to the combined effects of both—the nominal GNP. If recovery and expansion are accompanied by inflation at current rates or higher, pressures on interest rates could develop to the point that consistency of strong economic expansion with reduced monetary growth would be questionable.

Obviously, a satisfactory answer cannot lie in the direction of indefinitely continued high levels of unemployment and poor economic performance. On the other hand, ratifying strong price pressures by increases in the money supply offers no solution; that approach could only prolong and intensify the inflationary process—and in the end undermine the expansion. The insidious pattern of rising rates of inflation and unemployment in succeeding cycles needs to be broken; with today's markets so much more sensitized to the dangers of inflation, economic performance would likely be still less satisfactory if that pattern emerges again. The only satisfactory approach must lie in a different direction—a credible effort to reduce inflation further in the period ahead, and policies that hold out the clear prospect of further gains over time, even as recovery takes hold.

We are now in the process of seeing the inflation rate, as recorded in the consumer and producer price indices, drop to or even below what can be thought of as the underlying or core rate of inflation of 9 to 10 percent. That core rate is roughly determined by trends in wages and productivity. We can take some satisfaction in the observed drop of inflation, and the damping of inflationary expectations. But the hardest part of this job lies ahead, for we now need to make progress in improving productivity or reducing underlying cost and wage trends—as a practical matter both—to sustain the progress.

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The larger the productivity gain, the smoother will be the road to price stability—partly because that is the only way of achieving and sustaining growth in real incomes needed to satisfy the aspirations of workers. Put in that light, the importance of a concerted set of policies to reconcile our goals—not simply relying on monetary policy alone—is apparent. While those other policies clearly extend beyond the purview of the Federal Reserve, they obviously will bear upon the performance of financial markets and the economy as the Federal Reserve moves toward reducing over time the rate of growth in money and credit.

In that connection I recognize the strong conceptual case that can be made for action to reduce taxes. Federal taxes already account for an historically large proportion of income. With inflation steadily pushing income tax payers into higher brackets and with another large payroll tax increase to finance social security scheduled for 1981, the ratio will go higher still.

The thesis that this overall tax burden—and the way our tax structure impinges on savings and investment, costs and incentives—damages growth and productivity seems to me valid. Moreover, depending on levels of spending and the business outlook next year, the point can be made that the implicit and explicit tax increases in store for next year will drain too much purchasing power from the economy, unduly affecting prospects for recovery.

But I must also emphasize there are potentially adverse consequences that cannot be escaped—to ignore them would be to jeopardize any benefits from tax reduction, and risk further damage to the economy.

Whatever the favorable effects of tax reduction on incentives for production and productivity over time, the more immediate consequences for the size of the Federal deficit, and potentially for interest rates and for sectors of the economy sensitively dependent on credit markets, need to be considered.

Many of the most beneficial effects of a tax reduction depend upon a conviction that it will have some permanence, which in turn raises questions of an adequate commitment to complementary spending policies and appropriate timing. We are not dealing with a notion of a "quick fix" over the next few months for a recession of uncertain duration, but of tax action for 1981 and beyond at a time when Federal spending levels, even for fiscal 1981, appear to be a matter of considerable uncertainty, with the direction of movement higher.

Experience is replete with examples of stimulation, undertaken with the best motives in the world, that has turned out in retrospect to have been ill-timed and excessive. Given the demonstrable frailty of our economic forecasting, it takes a brave man indeed to project with confidence the precise nature of the budgetary and economic situation that will face the Nation around the end of this year. Moreover, an intelligent decision on the revenue side of the budget implies knowledge of the spending priorities of an administration and a Congress, a matter that by the nature of things can only be fully clarified after the election.

For all the developing consensus on the need for "supply side" tax reduction—and I share in that consensus—some time seems to me necessary to explore the implications of the competing propos-

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als and to reduce them to an explicit detailed program for action. I have emphasized the need to achieve not only productivity improvement but also a lower trend of costs and wages; despite its importance, I have seen relatively little discussion in the current context of how tax reduction plans might be brought to bear more directly on the question of wage and price increases.

The continuing sensitivity of financial markets, domestic and international, to inflationary fears is a fact of life. It adds point and force to these observations and questions. Tax and budgetary programs leading to the anticipation of excessive deficits and more inflation can be virtually as damaging as the reality in driving interest rates higher at home and the dollar lower abroad.

I believe it is obvious from these remarks that a convincing case for tax reduction can be made only when crucial questions are resolved—questions that are not resolved today. The appropriate time for decision seems to me late this year or early 1981. Fiscal 1982 as well as fiscal 1981 spending plans can be clarified. We will know if recovery of business is firmly underway. There will have been time to develop and debate the most effective way of maximizing the cost-cutting and incentive effects of tax reduction, and to see whether a tax program can contribute to a consensus—a consensus that has been elusive in the past—on wage and pricing policies consistent with progress toward price stability. To go ahead prematurely would surely risk dissipating the potential benefits of tax reduction amid the fears and actuality of releasing fresh inflationary forces.

I have spoken before with this committee and others about the need for changes in other areas of economic policy to support our economic goals. Paramount is the need to reduce our dependence on foreign oil—a matter not unrelated to tax policy.

We need to attack those elements in the burgeoning regulatory structure that impede competition or add unnecessarily to costs. And I believe it would be a serious mistake to seek relief from our present problems by retreat to protectionism, at the plain risk of weakening the forces of competition, the pressures on American industry to innovate, and undermining the attack on inflation.

We are now at the critical point in our efforts to reduce inflation while putting the economy back on the path to sustainable growth in the eighties.

I sense the essential objectives are widely understood and agreed—the need to wind down inflation even as recovery proceeds; the importance of restoring productivity and increasing incentives for production and investment; the maintenance of open, competitive markets; a substantial reduction in our dependence on foreign energy.

You know as well as I how much remains to be done to convert glittering generalities into practical action, to achieve and maintain the necessary fiscal discipline, to make responsible tax reduction and reform a reality, to conserve energy and increase domestic sources, to tackle the regulatory maze. But I also know there is no escape from facing up to the many difficulties. Our policies must be coherently directed toward the longer range needs. In that connection I believe that economic policies, public and private, should recognize that the need for discipline and moderation in the

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growth of money and credit provides the framework for decision-making in the Federal Reserve.

Thank you.

[Mr. Volcker's prepared statement and the "Midyear Monetary Policy Report" of the Board of Governors of the Federal Reserve System follow:]

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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I am pleased to be here today to review the conduct of monetary policy and to report on the Federal Reserve's economic objectives for the year as a whole, as well as its tentative thinking on policy goals for 1981. Our so-called "Humphrey-Hawkins Report" has already been distributed to you. I would like simply to add some personal perspective this morning on the course of monetary policy, in the context of the economic prospects and choices facing us with respect to other policy instruments.

Seldom has the direction of economic activity changed so swiftly as in recent months. Today the country is faced simultaneously with acute problems of recession and inflation. There have been unprecedented changes in interest rates and the imposition and removal of extraordinary measures of credit restraint. The fiscal position of the Federal Government is changing rapidly.

In these circumstances, confusion and uncertainty can arise about our goals and policies, not just those of the Federal Reserve, but of economic policy generally. Therefore, I particularly welcome this opportunity to emphasize the underlying continuity in our approach in the Federal Reserve and its relationship to other economic policies, matters that are critical to public understanding and expectations.

The Federal Reserve has been, and will continue to be, guided by the need to maintain financial discipline -- a discipline concretely reflected in reduced growth over time of the monetary and credit aggregates -- as part of the process of restoring price

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stability. As I see it, this continuing effort reflects not simply a concern about the need for greater monetary and price stability for its own sake -- critical as that is. The experience of the 1970's strongly suggests that the inflationary process undercuts efforts to achieve and maintain other goals, expressed in the Humphrey-Hawkins Act, of growth and employment.

As you know, our operating techniques since last October have placed more emphasis on maintaining reserve growth consistent with targeted ranges for the various Ms, with the implication interest rates might move over a wider range. Those targets were reduced this year as one step toward achieving monetary growth consistent with greater price stability. For several months after the new techniques were introduced in October, the various aggregates were remarkably close to the targeted ranges.

At that time, and for months earlier, you will recall widespread anticipations of recession. Nevertheless, reflecting a variety of developments at home and abroad -- including an enormous new increase in oil prices, Middle-Eastern political volatility, and interpretations of adverse budgetary developments -- there was a marked surge in the most widely disseminated price indices and in inflationary expectations in the early part of this year. Those expectations in the short run probably helped to support business activity for a time; in particular, consumer spending relative to income remained very high, with the consequence of

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historically (and fundamentally unhealthy) low savings rates and high debt ratios. Speculation was rife in commodity markets.

Spending and speculative activities of that kind are ultimately unsustainable. But they carried the clear threat of feeding upon themselves for a time, contributing among other things to a further acceleration of wage rates and prices. In that way, inflation threatened to escalate still further in a kind of self-fulfilling prophecy, posing the clear risk that the subsequent economic adjustment would be still more difficult.

Credit markets reflected these developments and attitudes. Bond prices fell precipitously. Long-term money -- including mortgages -- became difficult to raise. Partly as a consequence, short-term demands for credit ballooned in the face of sharply rising interest rates, at the expense in some instances of further weakening business balance sheets. That heavy borrowing also was reflected in acceleration in the money and credit aggregates during the winter.

An attempt to stabilize interest rates by the provision of large amounts of bank reserves through open market operations to support even more rapid growth in money would probably have been doomed to futility even in the short-run, for it could only have fed the expectations of more inflation. It would certainly have been counter-productive in terms of the overriding long-term need to combat inflation and inflationary anticipations. Instead, consistent with our basic policy approaches and techniques, the

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Federal Reserve resisted accommodating the excessive money and credit growth.

During this period of rising inflation and interest rates, the Administration and the Congress also appropriately and intensively reviewed their own budget planning. Coordinated with the announcement of the results of that broad governmental effort and the decision of the President to invoke the Credit Control Act of 1969, the Federal Reserve announced on March 14 a series of exceptional, temporary measures to restrain credit growth, reinforcing and supplementing our more traditional and basic instruments of policy.

The demand for money and credit dropped abruptly in subsequent weeks, reflecting the combined cumulative effects of the tightening of market conditions, the announcement of the new actions, and the rather sudden weakening of economic activity. In response, interest rates within a few weeks fell about as fast -- in some instances faster and further -- than they had risen in earlier months. Growth in the aggregates slowed, and for some weeks M-1A and M-1B turned sharply negative.

There is no doubt in my mind that these lower levels of interest rates can play a constructive role in the process of restoring a better economic equilibrium and fostering recovery. Indeed, there is already evidence -- if still tentative -- that homebuilding and other sectors of the economy sensitive to credit costs and availability are benefitting. Meanwhile, progress is being made toward reducing consumer indebtedness relative to

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income and toward restructuring corporate balance sheets as bond financing has resumed at a very high level. The sharp improvement in credit market conditions has been accompanied by slower rates of increase in consumer and producer prices, helping to quiet earlier fears of many of an explosive increase in inflation.

The suddenness of the change in market conditions has, however, raised questions in some minds as to whether the interest rate declines were in some manner "contrived" or "forced" by the Federal Reserve -- whether, to put it bluntly, the performance of the markets (together with the phased removal of the special credit restraints) reflects some weakening of our basic commitment to disciplined monetary policy and the priority of the fight on inflation. These perceptions are not irrelevant, for they could affect both expectations and behavior, most immediately in the financial and foreign exchange markets, but also among businessmen and consumers.

The facts seem to me quite otherwise.

Growth in money and credit since March has certainly not exceeded our targets; the M-1 measures have in fact been running below our target ranges. Bank credit has declined in recent months; while the decline in commercial loans of banks can be explained in part by exceptionally heavy bond and commercial paper issuance by corporations, there is simply no evidence of excessive rates of credit expansion currently. In these circumstances, it is apparent that interest rates have responded -- and have been

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permitted to respond -- not to any profligate and potentially inflationary increase in the supply of money, but to changes in credit demands, and (so far as long-term interest rates are concerned) to reduced inflationary expectations.

It is in that context -- with credit demands reduced and growth of credit running well within our expectations and targets -- that the special credit restraint programs simply served no further purpose. Those measures were invoked to achieve greater assurance that credit growth would in fact slow, and that appropriate caution would be observed in credit usage. The special restraints are inevitably cumbersome and arbitrary in specific application. They involve the kind of intrustion into private decision-making and competitive markets that should not be part of the continuing armory of monetary policy; their use was justified only by highly exceptional circumstances -- circumstances that no longer exist. Our normal and traditional tools of control (which in fact have been solidified by the Monetary Control Act passed earlier this year) are intact and fully adequate to deal with foreseeable needs.

Neither the decline in interest rates nor the removal of the special restraints should be interpreted as an invitation to consumers or businessmen to undertake incautious or imprudent borrowing commitments, or as lack of concern should excessive growth in money or credit reappear. That is not happening now.

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But markets (and the public at large) remain understandably extremely sensitive to developments that might aggravate inflationary forces. As we saw only a few months ago, consumers and businessmen will react quickly in their lending and borrowing behavior to that threat.

While the recent easing of financial pressures helps provide an environment conducive to growth, we should not be misled. A resurgence of inflationary pressures, or policies that would seem to lead to that result, would not be consistent with maintenance of present -- much less lower -- interest rates, receptive bond markets, and improving mortgage availability. We in the Federal Reserve believe the kind of commitment we have made to reduce monetary growth over time is a key element in providing assurance that the inflationary process will be wound down.

I noted earlier the money stock actually dropped sharply during the early spring. In a technical sense, working on the supply side, we provided substantial reserves through open market operations during that period, but commercial banks, finding demands for credit and interest rates dropping rapidly, repaid discount window borrowings as their reserve needs diminished. In general terms, it seems clear that, at least for a time, the demand for money subsided (much more than can be explained on the basis of established relationships to business activity and interest rates) apparently because consumers and others hastened debt repayment at the expense of cash balances and because the earlier interest rate peaks had induced individuals to draw on

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cash to place the funds in investment outlets available in the market.

As the Report illustrates, M-1 growth has clearly resumed, and the broader aggregate M-2 is now at or above the mid-point of its range. In the judgment of the Federal Open Market Committee, forcing reserves on to the market in recent weeks simply to achieve the fastest possible return to, say, the mid-point of the M-1 ranges may well have required early reversal of that approach, have been inconsistent with the close-to-target performance of the broader aggregates, and therefore led to unwarranted interpretations and confusion about our continuing objectives. Depending on the performance of the broader aggregates and our continuing analysis of general economic developments, the FOMC is in fact prepared to contemplate that M-1 measures may fall significantly short of the mid-point of their specified ranges for the year.

I have emphasized the Committee's intention to work toward the lower levels of monetary expansion over time. In reviewing the situation this month, the Committee felt that, on balance, it would be unwise to translate that intention into specific numerical targets for 1981 for the various Ms at this time. That view was strongly reinforced by certain important technical uncertainties related to the introduction of NOW accounts nationwide next January, as well as by the need to assess whether the apparent shift in demand for cash in the spring persists.

At the same time, the general nature of the potential problems and dilemmas for 1981 and beyond is clear enough; these are important questions, not just for monetary policy but for the full armory of public policy.

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The targets for the monetary aggregates are designed to be consistent with, and to encourage, progress toward price stability without stifling sustainable growth. But in the short-run, the demand for money (at any given level of interest rates) tends to be related not to prices or real output alone, but to the combined effects of both -- the nominal GNP. If recovery and expansion are accompanied by inflation at current rates or higher, pressures on interest rates could develop to the point that consistency of strong economic expansion with reduced monetary growth would be questionable.

Obviously, a satisfactory answer cannot lie in the direction of indefinitely continued high levels of unemployment and poor economic performance. But ratifying strong price pressures by increases in the money supply offer no solution; that approach could only prolong and intensify the inflationary process -- and in the end undermine the expansion. The insidious pattern of rising rates of inflation and unemployment in succeeding cycles needs to be broken; with today's markets so much more sensitized to the dangers of inflation, economic performance would likely be still less satisfactory if that pattern emerges again. The only satisfactory approach must lie in a different direction -- a credible effort to reduce inflation further in the period ahead, and policies that hold out the clear prospect of further gains over time, even as recovery takes hold.

We are now in the process of seeing the inflation rate, as recorded in the consumer and producer price indices, drop to or

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even below what can be thought of as the underlying or core rate of inflation of 9 to 10 percent. That core rate is roughly determined by trends in wages and productivity. We can take some satisfaction in the observed drop of inflation, and the damping of inflationary expectations. But the hardest part of this job lies ahead, for we now need to make progress in improving productivity or reducing underlying cost and wage trends -- as a practical matter both -- to sustain the progress.

The larger the productivity gain, the smoother will be the road to price stability -- partly because that is the only way of achieving and sustaining growth in real incomes needed to satisfy the aspirations of workers. Put in that light, the importance of a concerted set of policies to reconcile our goals -- not simply relying on monetary policy alone -- is apparent. While those other policies clearly extend beyond the purview of the Federal Reserve, they obviously will bear upon the performance of financial markets and the economy as the Federal Reserve moves toward reducing over time the rate of growth in money and credit.

In that connection, I recognize the strong conceptual case that can be made for action to reduce taxes. Federal taxes already account for an historically large proportion of income. With inflation steadily pushing income tax payers into higher brackets and with another large payroll tax increase to finance social security scheduled for 1981, the ratio will go higher still. The thesis that this overall tax burden -- and the way our tax structure impinges on savings and investment,

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costs and incentives -- damages growth and productivity seems to me valid. Moreover, depending on levels of spending and the business outlook next year, the point can be made that the implicit and explicit tax increases in store for next year will drain too much purchasing power from the economy, unduly affecting prospects for recovery.

But I must also emphasize there are potentially adverse consequences that cannot be escaped -- to ignore them would be to jeopardize any benefits from tax reduction, and risk further damage to the economy.

Whatever the favorable effects of tax reduction on incentives for production and productivity over time, the more immediate consequences for the size of the Federal deficit, and potentially for interest rates and for sectors of the economy sensitively dependent on credit markets, need to be considered.

Many of the most beneficial effects of a tax reduction depend upon a conviction that it will have some permanence, which in turn raises questions of an adequate commitment to complementary spending policies and appropriate timing. We are not dealing with a notion of a "quick fix" over the next few months for a recession of uncertain duration, but of tax action for 1981 and beyond at a time when Federal spending levels, even for fiscal 1981, appear to be a matter of considerable uncertainty, with the direction of movement higher.

Experience is replete with examples of stimulation, undertaken with the best motives in the world, that has turned out in retrospect to have been ill-timed and excessive. Given

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the demonstrable frailty of our economic forecasting, it takes a brave man indeed to project with confidence the precise nature of the budgetary and economic situation that will face the nation around the end of this year. Moreover, an intelligent decision on the revenue side of the budget implies knowledge of the spending priorities of an Administration and a Congress, a matter that by the nature of things can only be fully clarified after the election.

For all the developing consensus on the need for "supply side" tax reduction -- and I share in that consensus -- some time seems to me necessary to explore the implications of the competing proposals and to reduce them to an explicit detailed program for action. I have emphasized the need to achieve not only productivity improvement but also a lower trend of costs and wages; despite its importance, I have seen relatively little discussion in the current context of how tax reduction plans might be brought to bear more directly on the question of wage and price increases.

The continuing sensitivity of financial markets, domestic and international, to inflationary fears is a fact of life. It adds point and force to these observations and questions. Tax and budgetary programs leading to the anticipation of excessive deficits and more inflation can be virtually as damaging as the reality in driving interest rates higher at home and the dollar lower abroad.

I believe it is obvious from these remarks that a convincing case for tax reduction can be made only when crucial

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questions are resolved -- questions that are not resolved today. The appropriate time for decision seems to me late this year or early 1981. Fiscal 1982 as well as fiscal 1981 spending plans can be clarified. We will know if recovery of business is firmly underway. There will have been time to develop and debate the most effective way of maximizing the cost-cutting and incentive efforts of tax reduction, and to see whether a tax program can contribute to a consensus -- a consensus that has been elusive in the past -- on wage and pricing policies consistent with progress toward price stability. To go ahead prematurely would surely risk dissipating the potential benefits of tax reduction amid the fears and actuality of releasing fresh inflationary forces.

I have spoken before with this Committee and others about the need for changes in other areas of economic policy to support our economic goals. Paramount is the need to reduce our dependence on foreign oil -- a matter not unrelated to tax policy. We need to attack those elements in the burgeoning regulatory structure that impede competition or add unnecessarily to costs. And I believe it would be a serious mistake to seek relief from our present problems by retreat to protectionism, at the plain risk of weakening the forces of competition, the pressures on American industry to innovate, and undermining the attack on inflation.

We are now at the critical point in our efforts to reduce inflation while putting the economy back on the path to sustainable growth in the 1980's.

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I sense the essential objectives are widely understood and agreed -- the need to wind down inflation even as recovery proceeds; the importance of restoring productivity and increasing incentives for production and investment; the maintenance of open, competitive markets; a substantial reduction in our dependence on foreign energy.

You know as well as I how much remains to be done to convert glittering generalities into practical action: to achieve and maintain the necessary fiscal discipline, to make responsible tax reduction and reform a reality, to conserve energy and increase domestic sources, to tackle the regulatory maze. But I also know there is no escape from facing up to the many difficulties. Our policies must be coherently directed toward the longer-range needs. In that connection, I believe that economic policies, public and private, should recognize that the need for discipline and moderation in the growth of money and credit provides the framework for decision-making in the Federal Reserve.

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Board of Governors of the Federal Reserve System

Midyear Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

July 22, 1980

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 22, 1980

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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CHAPTER 1

THE OUTLOOK FOR THE ECONOMY AND MONETARY POLICY OBJECTIVES

SECTION 1. THE OUTLOOK FOR THE ECONOMY

The economy moved into recession in the first half of this year. A cyclical downturn had been widely anticipated for some time, but the decline in spending, output, and employment, once under way, has been steeper than most analysts had foreseen. The second quarter decrease in real gross national product, at an annual rate of about 9 percent according to the Commerce Department's preliminary estimate, was considerably sharper than in the initial quarters of other postwar recessions.

The slump in activity has been most pronounced in the housing and auto industries--the latter sector being adversely affected by structural problems as well as by general cyclical pressures. But the decline has not been limited to these sectors. Retail sales excluding autos have dropped considerably since January, and business outlays for equipment and new construction also have fallen.

The very sharp curtailment of spending on houses and consumer goods and services in the current downturn probably is attributable in large part to the cumulative effect of inflation on consumers' financial well-being. Real disposable personal income was virtually flat in 1979 and has declined appreciably this year. Earlier, consumers had reduced their rate of saving in the face of shortfalls in real income in an effort to maintain consumption standards and in anticipation of inflation. This was accomplished by further rapid growth in installment and mortgage credit in the late stages of the recent expansion, but with the result that debt service burdens--which already were at high levels historically--continued to climb. Sharply higher interest rates and generally more stringent credit terms in late 1979 and early 1980 acted as additional deterrents to spending, encouraging households in their efforts to reduce debt and to rebuild savings.

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The falloff in final sales has caused businessmen to spend more cautiously. This tendency has been reinforced by financial factors as well. The liquidity position of businesses had deteriorated appreciably during the expansion, particularly in the latter stages when there was a surge in short-term borrowing; many firms now are making strong efforts to restructure balance sheets.

The unexpected rapidity of the current downturn thus far has led analysts to reassess their view of the prospects for economic activity in the period ahead. Significant disagreement has arisen with regard to whether recovery will be prompt and strong, with the recent relaxation of credit market conditions encouraging a resumption of normal spending patterns, or whether the cyclical adjustment will be prolonged and the subsequent upturn possibly sluggish. The experience of the past year or so has demonstrated the hazards of forecasting, and the uncertainties at the present time clearly are substantial. Much will depend, for example, on the perceptions of businessmen about the longer-range prospects for demand and the attractiveness of investment, the response of consumers to the 1981 model-year automobiles, and the strength of the rebound in housing that may develop in the wake of the recent easing in mortgage market conditions.

There are signs that the contraction in some sectors may be nearing an end, but these are far from conclusive. Retail sales in June turned up slightly after four months of sharp decline; in the first ten days of July auto sales were at the strongest pace in three months. Housing starts and sales of new homes strengthened in the most recent months for which data are available.

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In reflection of the prevailing uncertainties, there is a considerable range of views among the members of the Federal Open Market Committee regarding the movement of major economic variables over the remainder of the year. Most of the members believe that the recession probably will persist into the fourth quarter, with a cumulative net drop in real GNP less than that in the downslide of 1973-75. Although the decline should slow in the months ahead, employment may be cut back further, and the unemployment rate could rise beyond 8-1/2 percent by year-end. The increasing slack in labor markets and in industrial capacity utilization should at the same time help to moderate inflationary pressures.

The table below presents ranges for key economic variables that generally encompass the judgments of the individual FOMC members about the probable performance of the economy this year and in 1981.

	Actual	Projected	
	1979	1980	1981
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	9.9	5 to 7-1/2	8-1/2 to 11-1/2
Real GNP	1.0	-5 to -2-1/2	1/2 to 3
Implicit GNP deflator	8.9	9 to 10	7-3/4 to 9-1/2
Average level in fourth quarter			
Unemployment Rate (percent)	5.9	8-1/2 to 9-1/4	8 to 9-1/4

The outlook for 1981 is especially uncertain at the current time. Economic and financial developments over the next six months should lay the groundwork for the recovery anticipated in 1981. But, in addition, any

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actions taken in the fiscal arena would have an impact on the path of recovery. The projections presented in the table, which do not assume a tax cut in the next year, indicate a turnaround in economic activity--although there is a considerable range of views concerning the potential strength of the recovery. On balance, the forecast is for a moderate rebound in real GNP, accompanied by some further slackening in the pace of inflation. Unemployment, however, is likely to remain high throughout the year.

Should there be a tax cut in 1981, the impact on economic performance will, of course, depend on its timing and composition. There is the distinct--and very troubling--possibility that a poorly designed tax reduction, or one not coupled with adequate restraint on the expenditure side, might give rise to added inflationary and financial pressures that would in time dissipate the beneficial short-term effects of the fiscal stimulus. Any indication that the Congress and the Administration were moving away from a commitment to rigorous fiscal discipline would run the risk of reinvigorating the inflationary expectations that have played such a major role in the economy's difficulties. The Committee thus feels it important that the question of a tax cut be approached cautiously; if a tax cut ultimately is enacted, it should be carefully structured to enhance the productive potential of our economy and to yield the greatest relief from cost and price pressures over the longer run.

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SECTION 2. MONETARY POLICY OBJECTIVES

The task for monetary policy—and for stabilization policy generally—in the current circumstances obviously is a difficult one. Recession naturally summons forth calls for stimulus to aggregate demand. The prevailing high level of unemployment, and the exceptional weakness apparent in particular industries and sectors of our economy, certainly must be given careful consideration in the formulation of public policy. But caution must be exercised in the application of any broad countercyclical stimulus, especially in the present environment of persistent inflationary pressures. Indeed, there is no clearer lesson from the experience of the past decade and a half than that excessive stimulus is detrimental to the objective of achieving and sustaining noninflationary, balanced growth.

A primary and continuing goal of monetary policy must be to curb the accelerating inflationary cycle. It now appears that some progress is, beginning to be made in that direction. Price increases have slowed considerably from the pace of early in the year, in part reflecting some relief in the food and energy sectors, but also as a result of the drop in demand pressures. In addition, recent attitudinal surveys point to a reduction in inflationary expectations. The continuation of this trend in expectations will result in a greatly improved economic and financial environment, one more conducive to long-term growth. We already have witnessed one benefit of an easing of inflationary fears: a substantial decline in long-term interest rates from their highs earlier this year and a revitalization of the bond markets. The Federal Reserve's pursuit of a policy of monetary restraint—evidenced this year by a moderation of money growth—has been an important factor in this

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turn in expectations; a sustained commitment to the attainment of noninflationary rates of money and credit growth is essential if this progress is to be extended.

Despite the improvement that has occurred, however, inflationary forces are far from subdued. The past years have left a legacy of adverse cost trends that will not be reversed quickly. Moreover, more extreme inflationary expectations easily could be reignited. In establishing its plans for growth in the monetary aggregates, the Federal Reserve will continue to place high priority on reducing inflation, believing that this is essential to fostering a sound and sustained recovery. Over the long term, a reduction in the underlying rate of inflation is essential for a strong U.S. economy, for encouraging the saving we will need to finance adequate capital investment, and for maintaining the position of the dollar in international markets.

But it is clear also that if inflation is to be restrained without undue disruption of economic activity we cannot rely solely on monetary policies. For example, fiscal discipline is essential to ensure that excessive pressure is not placed on the financial and real resources of the economy. The structure of our tax system should be examined with an eye to the incentives it provides for productivity-expanding research and capital formation. And the full range of governmental policies should be reviewed to ensure that they do not add needlessly to costs and do not stunt innovation and competition.

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SECTION 3. MONEY AND CREDIT GROWTH IN 1980 AND 1981

In February the Federal Reserve reported to the Congress ranges of growth for the monetary aggregates in 1980 that it believed to be consistent with the continuing objective of reducing inflationary pressures over time while providing for sustainable growth in the nation's production of goods and services. These ranges anticipated a substantial deceleration in monetary growth in 1980 from the pace of the preceding year. Measured from the fourth quarter of 1979 to the fourth quarter of 1980, the ranges adopted were: for M-1A, 3-1/2 to 6 percent; for M-1B, 4 to 6-1/2 percent; for M-2, 6 to 9 percent; and for M-3, 6-1/2 to 9-1/2 percent. The associated range for bank credit expansion was 6 to 9 percent.

During the first half of 1980, growth of the monetary aggregates slowed considerably from the 1979 pace. The deceleration was particularly marked for the narrower aggregates, M-1A and M-1B, which grew at rates below the lower limits of their longer-run ranges--at annual rates of about 1/2 and and 1-3/4 percent, respectively, from the fourth quarter of 1979 to the second quarter of 1980. (M-1A is currency and demand deposits held by the public, while M-1B includes checkable interest-bearing deposits as well.) At the same time, the broader aggregates, M-2 and M-3, grew at annual rates of 6-1/2 and 6-3/4 percent, respectively, which is somewhat above the lower limits of their ranges. In fact, by June, as the accompanying charts show, M-2--which includes money market fund shares and all deposits except large CDs at banks and thrift institutions--was around the midpoint of its longer-run range, and M-3 slightly below, while the narrower aggregates were moving back toward their ranges, following an unusually sharp drop in early spring.

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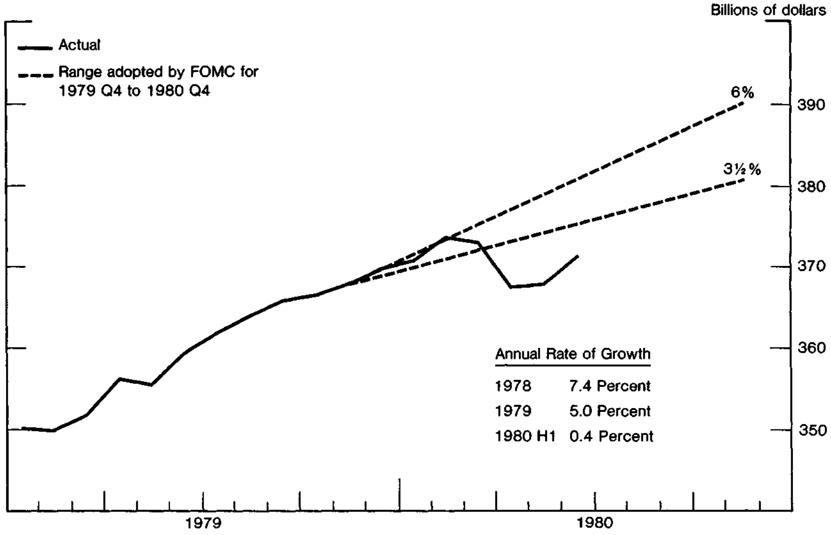
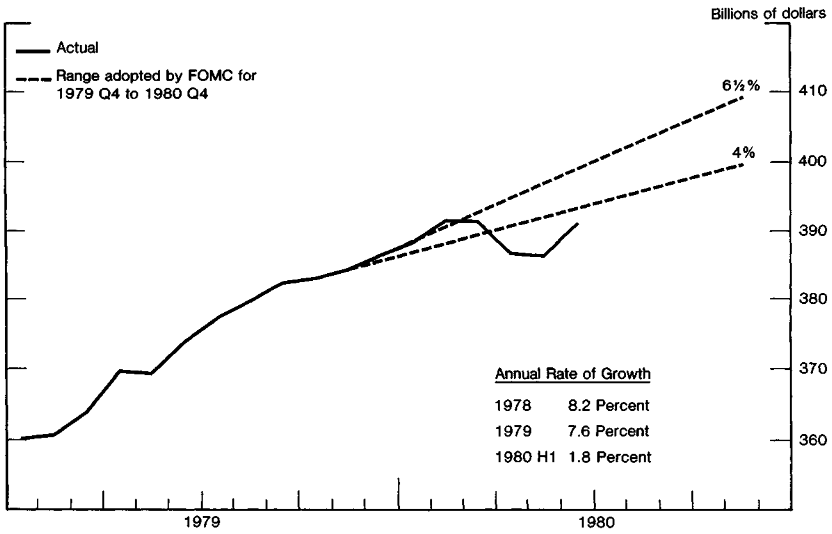
Growth Ranges and Actual Monetary Growth

M-1A



M-1B



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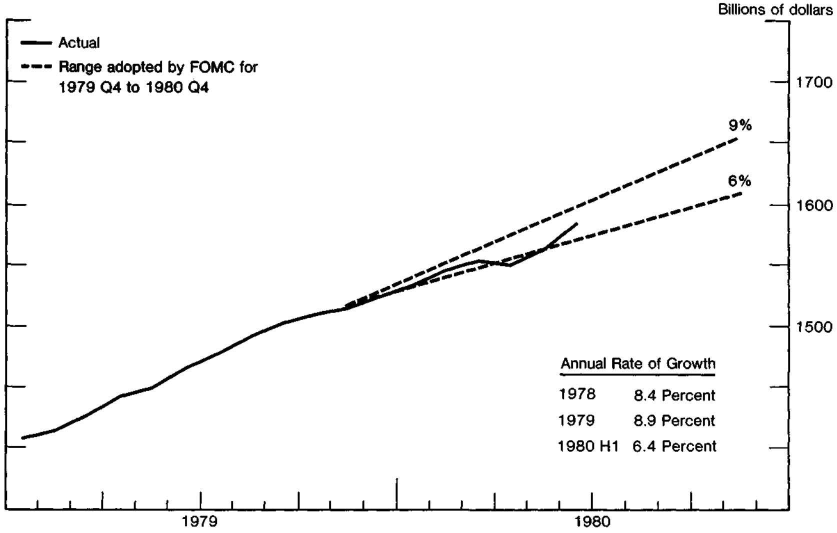
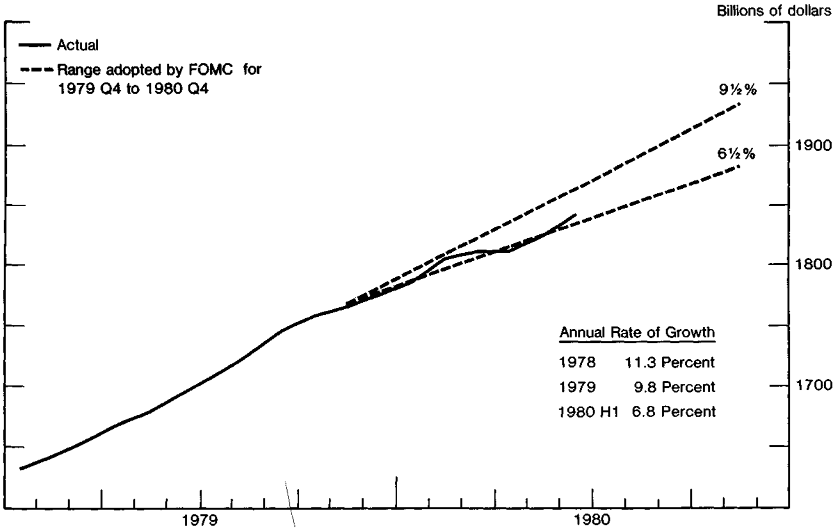
Growth Ranges and Actual Monetary Growth

M-2



M-3



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The contraction in the narrower aggregates during the second quarter was much greater than would be expected on the basis of the historical relationships among money, income, and interest rates. This unusual weakness may have reflected exceptional efforts by the public to pare cash balances, such as have characterized some other periods following a sharp upward adjustment in market interest rates to new record levels. There may also have been an impact from the surge in debt repayments, especially at banks, after the imposition of the credit control program in mid-March, with some of the funds apparently coming out of cash balances. In light of these special circumstances affecting the public's demand for transactions balances, and given the relative strength of the broader aggregates and the usual lags between changes in credit conditions and growth in the narrow aggregates, the FOMC believed it appropriate to foster a more gradual return of M-1 growth to the ranges established earlier.

In connection with reserve targeting procedures, System open market operations supplied a large volume of nonborrowed reserves over the course of the second quarter. Given the weak demand for money and bank credit, most of the added nonborrowed reserves were used by banks to repay borrowings from the Federal Reserve discount window. Borrowings fell from a high of $2.8 billion on average in March to minimal levels recently, and the easing of bank reserve positions was reflected in a sharp decline in the federal funds rate. From their peaks of late March or early April, short-term interest rates have declined 7 to 9 percentage points and long-term rates by roughly 2 to 3 percentage points.

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Expansion in the broader aggregates over the first half of the year reflected the very rapid growth for much of the time in money market mutual fund shares, 6 month money market certificates, and 2-1/2 year small saver certificates, instruments that pay market rates of interest. Late in the period, as short-term market interest rates declined sharply, the contraction in savings deposits at banks and other depository institutions halted, and the outstanding amount of those deposits began to rise. For part of the period, growth in M-3 was sustained also by continued issuance of large time deposits by commercial banks and thrift institutions, which are included in M-3 but not in M-2; however, large time deposits began to contract in late spring as credit demands weakened substantially.

Bank credit growth greatly exceeded the FOMC's range in the first quarter of the year. The second quarter, however, saw a sharp contraction in this measure, and credit growth was well below the FOMC-specified range as of midyear. Demands for bank loans by households and businesses dropped abruptly in the second quarter, while the banks--concerned about the possible erosion of profit margins by high cost funds obtained earlier and seeking to conform to the guidelines of the March 14 special credit restraint program--pursued relatively tight lending policies. Businesses, meanwhile, have met a substantial portion of their credit needs through issuance of commercial paper (which serves as a close substitute for bank credit for many large firms), by borrowing in bond markets, and by reducing holdings of liquid assets. Over the half year, the total of credit advanced by banks and in the private short-term money markets rose at an annual rate of around 7-1/2 percent.

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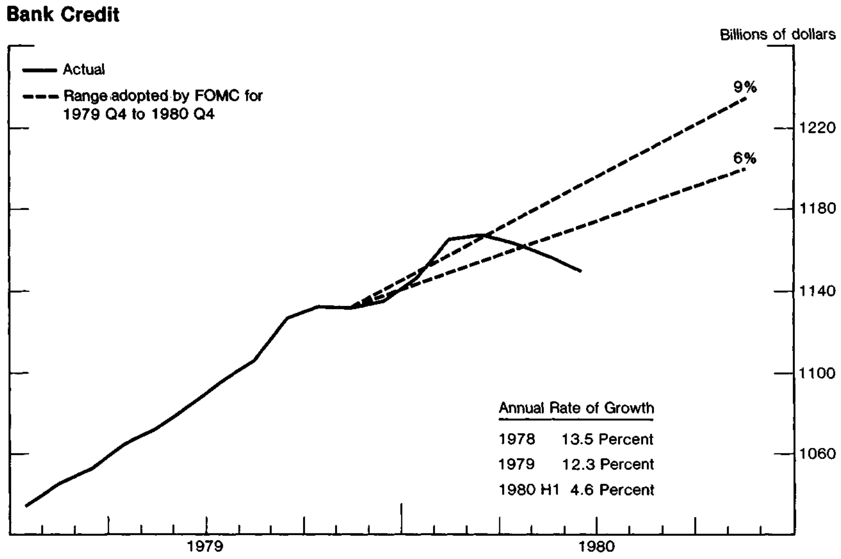
Growth Ranges and Actual Bank Credit Growth



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At its meeting in July, the Federal Open Market Committee reassessed the ranges it had adopted for monetary growth in 1980 and formulated preliminary goals for 1981. The Committee elected to retain the previously established ranges for the aggregates over the remainder of 1980. This decision by the Committee took into consideration the recent behavior of the money stock measures as well as emerging economic conditions. In this regard it was recognized that, if the public continues to economize on cash balances to an unusual degree in the second half of the year, growth in the narrower aggregates would likely fall toward the lower end of the established ranges.

With respect to the broader aggregates, growth in the second half is likely to place them nearer the midpoints of their respective ranges, and in the case of M-2 quite possibly in the upper half of its range. Recent trends suggest that a continued substantial expansion in the interest-bearing nontransactions component of M-2 is likely. In the current cyclical environment, consumers have begun to reevaluate their financial positions and have reduced their borrowing and adjusted upward their rate of saving. Thus, if the recent lower level of interest rates persists, the outlook is for an augmented flow of funds to depository institutions along with continued, though slower, growth in money market mutual funds.

The Committee also noted that the recent sharp contraction in bank credit makes it quite likely that this measure will fall below the 6 to 9 percent growth range specified in February. A resumption of bank credit expansion during the second half is anticipated, but the strength of that move will depend to a considerable extent on patterns of corporate finance. The desire for balance sheet restructuring may well continue to mute business

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loan demands, although weaker corporate cash flows and a narrowing of the spread of the prime rate over commercial paper rates likely will prompt some borrowing at banks. Mortgage loan demands also should begin to recover as the year progresses, and the runoff in consumer loans is expected to abate.

One factor that contributed to the recent weakness in bank lending was the Board's special credit restraint program. As announced earlier, the program is being phased out this month because there is now no evident need for extraordinary measures to hold bank lending within reasonable bounds. In removing the special controls, the Board has emphasized its intention to continue to maintain aggregate growth in money and credit at rates consistent with a reduction in inflationary pressures.

With regard to monetary policy over the longer run, the FOMC reiterates its intent to seek reduced rates of monetary expansion over coming years, consistent with a return to price stability. While there is broad agreement in the Committee that it is appropriate to plan for some further progress in 1981 toward reduction of the targeted ranges, most members believe it would be premature at this time to set forth precise ranges for each monetary aggregate for next year, given the uncertainty of the economic outlook and institutional changes affecting the relationships among the aggregates. The extent and timing of adjustments in the targets will depend upon an appraisal of the outlook at the end of the year. The appropriate money growth in 1981 relative to 1980 of course will depend to some extent on the outcome in this year--that is, on exactly where in the present ranges the various aggregates fall at year-end.

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In addition, the various measures of money will be affected in 1981 by shifts in the demand for different types of financial assets. The introduction of NOW accounts on a nationwide basis in January will accelerate the shift from regular demand deposits into interest-earning transactions balances, thereby depressing M-1A growth next year. On the other hand, M-1B probably will be boosted somewhat next year by shifts from savings deposits and other interest-bearing assets into NOW accounts. The range for M-1B thus may have to accommodate a period of abnormal growth as the public adjusts to the availability of a new instrument. The experience of the past year and a half with ATS accounts has indicated the difficulty of estimating in advance the public's demand for such balances. Although growth in M-2 and M-3 will not be affected by NOW account movements, these broader aggregates include other relatively new financial instruments, the demand for which is still subject to uncertainty. The behavior of these instruments in coming months will aid the FOMC in determining appropriate growth ranges for the broader aggregates in the 1981 period.

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SECTION 4. THE ADMINISTRATION'S SHORT-TERM ECONOMIC GOALS AND THE RELATIONSHIP OF FEDERAL RESERVE OBJECTIVES TO THESE GOALS

The Administration, in association with its midyear budget review has updated its forecast of the behavior of major economic variables for 1980 and 1981. The revised figures are shown below.

The Administration's Forecast

	1980	1981
Change from fourth quarter to fourth quarter, percent		
Nominal GNP	6-3/4	12-1/2
Real GNP	-3	2-1/2
Implicit price deflator	10	9-3/4
Average level in fourth quarter		
Unemployment rate (percent)	8-1/2	8-1/2

These estimates, which the Administration has indicated should be viewed as forecasts rather than as goals, show a considerably greater decline in real activity in 1980 than had been anticipated in the January Economic Report of the President. The outlook for nominal GNP growth through year-end has been lowered by a smaller amount, owing to a somewhat higher anticipated rate of inflation for the four quarters of 1980. The Administration's projections for this year fall within the ranges expected by the members of the FOMC.

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The Administration has projected a resumption of output growth next year that places real GNP near the upper end of the range encompassed by the forecasts of the members of the FOMC. At the same time, the Administration's estimates place the rate of inflation somewhat above the range of the FOMC members' expectations. (Like the FOMC members' projections, the Administration's forecast does not include a tax cut provision for 1981.)

As indicated in the preceding section, the Federal Reserve intends to set monetary growth ranges for 1981 that will help to restrain inflationary pressures in the recovery period. As experience this year illustrates, considerable uncertainty attaches to any analysis of the relationships over relatively short periods among money, interest rates, and nominal GNP. However, a substantial expansion in demands for goods and services, accompanied by a lack of progress on the inflation front--or worse, an actual increase in inflation or inflationary expectations--would raise the possibility of a considerable firming of conditions in financial markets. Large and prolonged federal deficits would increase that risk. This highlights the urgency of concerted effort by the public and private sectors to reduce the rate of advance in costs and prices and the need to focus any discussions of fiscal action on approaches that would serve to alleviate cost pressures and bolster productivity.

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CHAPTER 2

A REVIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS

SECTION 1. ECONOMIC ACTIVITY DURING THE FIRST HALF OF 1980

Economic activity turned down early this year following almost five years of expansion. Between January and June, industrial production fell 7-1/2 percent, employment declined by about 1-1/4 million, and the unemployment rate jumped 1-1/2 percentage points. Real gross national product is estimated to have fallen at an annual rate of 9.1 percent in the second quarter, with the decline in activity widespread among major sectors of the economy. Retail sales have decreased substantially since January, housing starts have dropped to near-record postwar lows, and business outlays for equipment and new construction have declined. Although businesses were cautious in building inventories during the expansion, the severity of the recent decline in final sales has led to some involuntary stock accumulation; as in past cycles, the resulting efforts to curb inventory growth have played a significant role in the weakening of orders and production.

Recent reductions in aggregate demand, coupled with a slower rise of energy prices, meanwhile have brought some moderation in the overall pace of inflation. The producer and consumer price indexes have risen at much less rapid rates in the past few months than they did earlier in the year. Moreover, there are indications from consumer surveys that inflationary expectations have been lowered. Nevertheless, inflation still possesses a strong momentum, with unit labor costs continuing on a steep upward trend.

Personal Consumption Expenditures

Personal consumption expenditures fell sharply in real terms during the first half. A number of adverse trends had characterized household finances for some time prior to the beginning of 1980. Real disposable income had stagnated after 1978, household liquidity positions had weakened as liabilities

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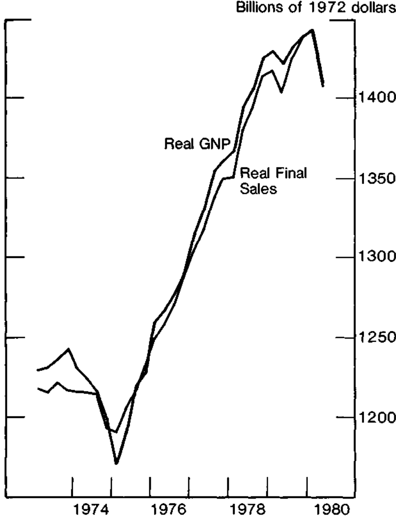
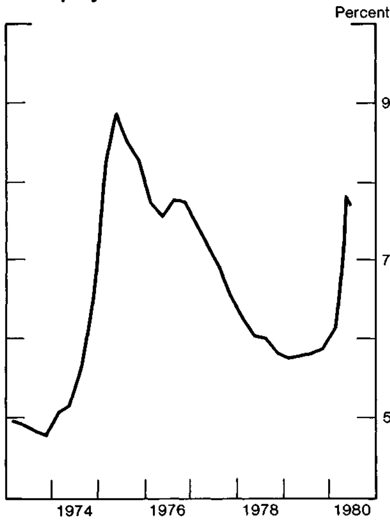
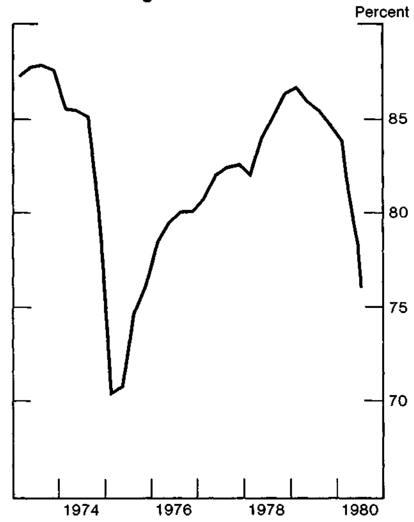
Current Indicators of Economic Activity







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increased faster than financial assets after late 1976, and a near-record proportion of disposable income had been committed to the servicing of debt. Moreover, consumer confidence, as measured by opinion surveys, had deteriorated to levels last seen in the 1973-75 recession. In the light of these trends, a downward adjustment of consumer outlays might have been expected last year; the fact that it did not occur appears attributable in part to growing expectations of inflation that fostered a buy-in-advance psychology.

Between January and May, retail sales fell 6-1/2 percent in nominal terms and more than 9-1/2 percent in real terms--the sharpest four-month drop in the postwar period. Preliminary estimates for June, however, indicate that sales moved up somewhat. As in past recessions, large decreases in sales this year have occurred for the relatively discretionary items of consumer expenditure. Automobile sales in June averaged only 7.6 million units at an annual rate, close to the May pace, which was the slowest since late 1974. Furniture and appliance sales also are down sharply this year, in part because of the fall in housing sales. But weakness in consumer outlays has not been confined to the durable goods sector. Purchases of nondurables in real terms also have been falling since late last year, with sizable declines recorded for clothing and general merchandise.

Since January, real disposable income has decreased substantially as employment and hours worked have fallen and prices have continued upward at a rapid pace; nonetheless, the retrenchment by consumers has lifted the saving rate somewhat above the extraordinarily low level of the fourth quarter of last year. It still remains low by historical standards, however, and uncertainty

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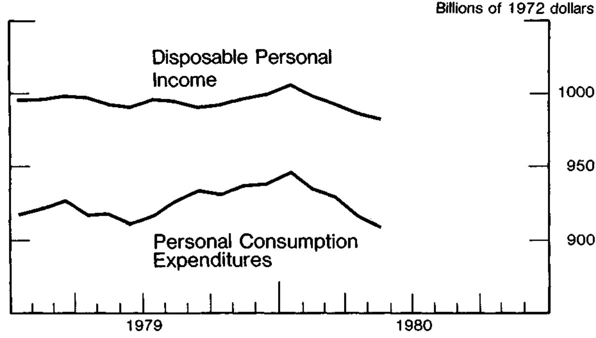
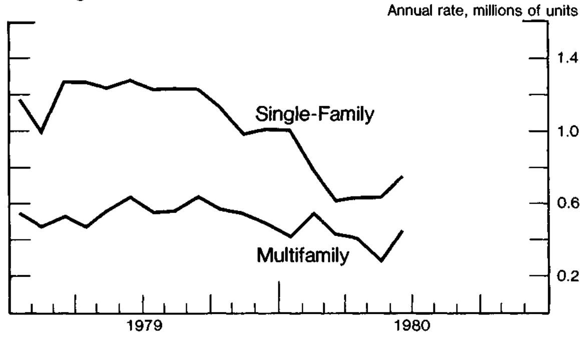
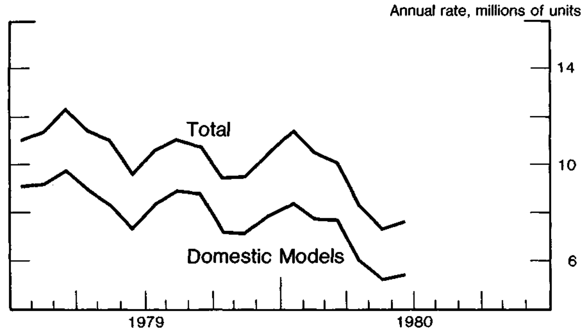
Real Personal Consumption Expenditures and Real Disposable Personal Income



Housing Starts



Auto Sales



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about job and income prospects may well prompt households to enlarge precautionary savings, thereby contributing further to the weakness in personal consumption expenditures.

Residential Construction

Homebuilding activity has experienced a severe decline. Housing starts, which averaged nearly 1-3/4 million units at an annual rate during the first nine months of 1979, began to fall sharply last autumn. By December, starts were at a 1-1/2 million unit pace, and by May they had declined almost to a 900,000 rate. June saw a pickup in starts to a 1-1/4 million annual rate.

In the single-family sector, starts dropped 45 percent between the third quarter of 1979 and the second quarter of this year. Although demographic factors remained quite favorable during this period, the demand for such dwellings was curtailed by the increased cost of homeownership associated with higher house prices and the rapid rise in mortgage interest rates. The monthly cost of interest and principal on an average-priced new home financed with a conventional mortgage rose to $700 in May--a third higher than six months earlier and 50 percent above the same month of 1979. Households probably were increasingly reluctant to undertake such heavy financial obligations, especially as income and employment conditions weakened this year.

Home sales have dropped almost 40 percent from the pace of last summer. Although production adjustments have reduced the number of unsold new single-family dwellings on the market, these unsold units bulk larger relative to the recent slower rate of sales. At the May sales pace, which was up sharply from April, there was almost a nine-month supply of unsold new single-family units on the market. The pickup in sales in May is perhaps a sign of

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some increased interest on the part of homebuyers, prompted by the recent easing in financial markets; however, the still large overhang of unsold homes is likely to discourage a quick resumption of building in many localities.

Multifamily housing starts began declining sharply late last year and in the second quarter were off about 35 percent from the already-reduced pace of the third quarter of 1979. The decline in this sector has been less severe than in the 1973-75 period, as low vacancy rates in many areas and an acceleration in rent increases beginning in late 1979 have given builders an incentive to sustain a significant level of apartment construction in the face of high construction costs and tight financial conditions. In addition, demands for condominiums--a lower-cost alternative to single-family homeownership--have provided support to multiunit activity.

Business Spending

Business spending on plant and equipment has slowed in recent months as firms have sought to avoid expanding capacity at the onset of a recession. Spending on nonresidential structures, which accounted for much of the gain in investment during 1979, peaked in January and declined substantially in the following months. Business purchases of trucks and automobiles also have been falling since early this year, as have outlays for other capital equipment.

Weakness in capital spending in the first half of the year--as well as in forward-looking indicators of investment activity such as surveys, construction contracts, and equipment orders--probably reflected businessmen's anticipations that sales may remain sluggish for a while. In addition, corporate cash flows are diminishing, and with liquidity positions already

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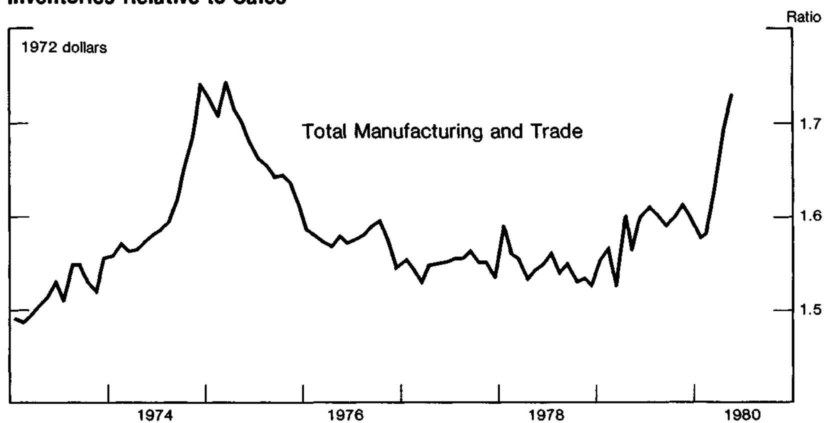
Contracts and Orders for Plant and Equipment

Inventories Relative to Sales



*Annual changes are from Q4 to Q4; semi-annual change is from Q4 to the April-May average.

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strained in many instances, there may be a reluctance to undertake additional projects requiring external financing. Although interest rates have fallen dramatically from the high levels reached earlier this year, growing excess plant capacity suggests the likelihood of further decreases in real outlays, while firms take advantage of lower long-term rates to restructure their balance sheets.

Despite sizable cutbacks in production, some involuntary inventory accumulation appears to have occurred this spring as a consequence of the steep fall in sales. The stock-sales ratio for all manufacturing and trade in real terms rose only moderately during the first quarter, but climbed appreciably in April and May to near the level of late 1974. Since the start of the year, substantial increases in the ratio have been registered in most major industries with especially large rises for primary metals manufacturers, furniture and appliance retailers, and the motor vehicle industry. Auto sales incentive programs and production adjustments in the first quarter of 1980 largely eliminated excessive stocks that had resulted from last summer's gasoline shortages. However, beginning in mid-April, automobile sales plummeted and, despite further curtailments of production, some overhang of stocks at dealers reappeared.

Government

Spending at all levels of government has been restrained in recent months. Total federal expenditures, which grew rapidly in the early months of the year, moderated in the second quarter largely as a result of the March budget cuts. Growth in receipts fell off much more, however, as weakness in

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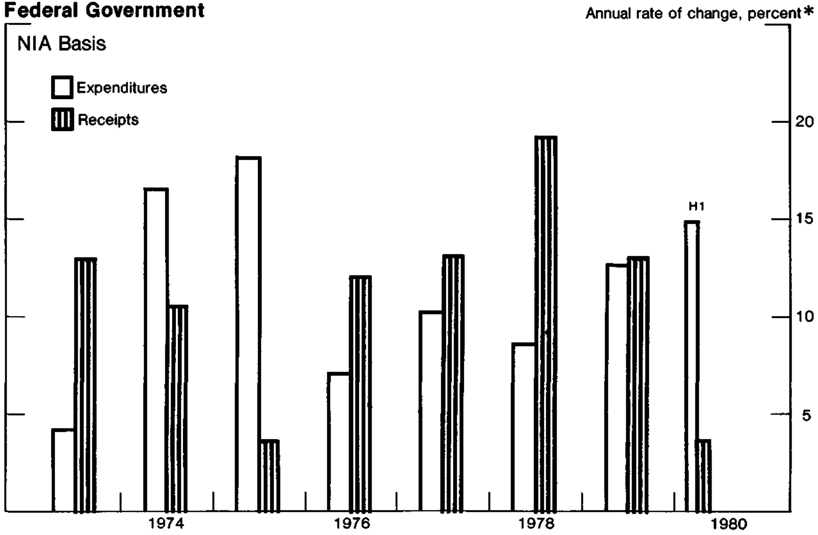
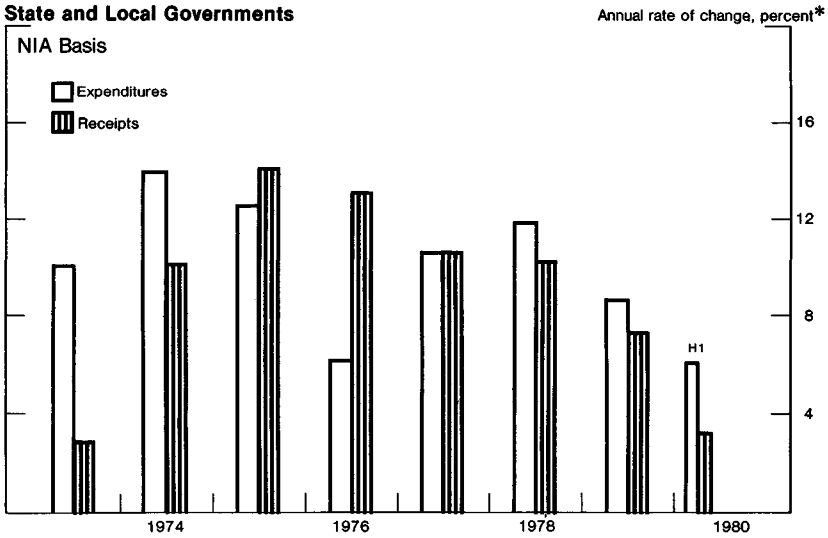
Public Sector Expenditures and Receipts





*Annual changes are from Q4 to Q4; semi-annual changes are from Q4 to Q2.

Data for 1980 H1 are partially estimated by the Federal Reserve.

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personal income and profits offset the impact of additional revenue from the windfall profits tax on oil producers. As a result, the federal deficit on a national income accounts basis probably deepened by about $30 billion, at an annual rate, between the fourth quarter of 1979 and the second quarter of 1980. However, the high-employment budget, a better indicator of the thrust of discretionary fiscal policy, showed a movement toward restraint during this period.

State and local government spending fell in real terms during the first half of 1980, as governmental units curtailed outlays in response to the slower growth of revenues caused by tax cuts enacted in 1979, the weakening economy, and the March reductions of federal grants-in-aid. The reduced pace of spending was most pronounced for construction activity because federal funding was cut back and municipal bond issuance was constrained in the first quarter by high interest rates. Despite the downward adjustments of outlays, the aggregate operating deficit of the state and local government sector apparently widened considerably in the spring.

International Trade and Payments

Real exports of goods and services continued to grow rapidly in the first quarter of 1980, but the rise appears to have slowed somewhat in the second quarter. The deceleration largely reflected the slowing of economic expansion abroad and the fading of the impact of the 1977-78 real depreciation of the dollar. All of the growth in the first half was concentrated in nonagricultural exports; agricultural shipments were reduced, partly because of the

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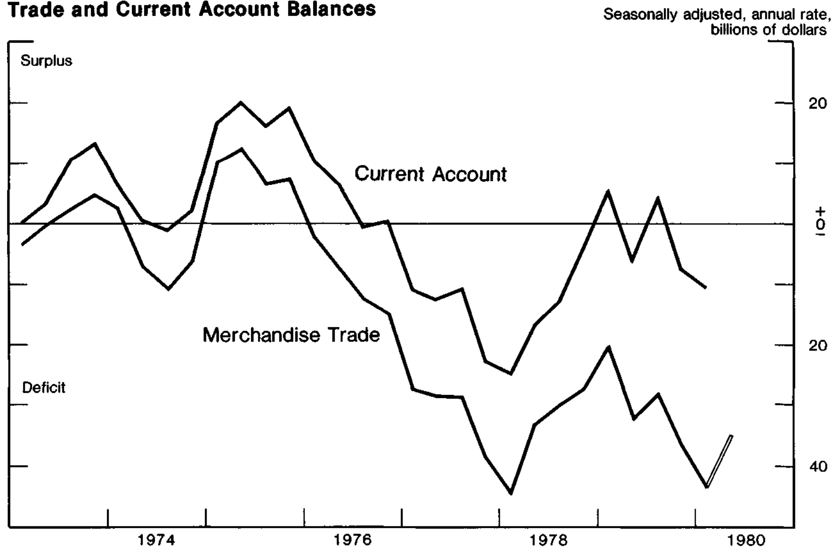
Exports and Imports of Goods and Services

Trade and Current Account Balances



Data for 1980 Q2 Merchandise Trade Balance are partially estimated.

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embargo on additional grain sales to the Soviet Union imposed by the President in January.

The volume of imports, meanwhile, began to fall off as U.S. economic activity slackened and as higher prices and greater fuel efficiency acted to restrain oil imports. The volume of non-oil imports rose slightly on balance in the first half of 1980, but all of the increase was in the first quarter. The quantity of oil imports fell, apparently reaching its lowest rate in four years in the second quarter. Despite a declining volume of oil imports in the first quarter, higher OPEC prices resulted in a continuation of the rapid growth in the dollar value of oil imports. The oil import bill nearly doubled between the fourth quarter of 1978 and the first quarter of 1980; in the second quarter the value of oil imports changed little as lower volume offset a further rise in import prices.

The U.S. merchandise trade deficit increased about $6-1/2 billion, at an annual rate, in the first quarter of this year from the rate in the last quarter of 1979. The current account moved from a deficit of about $7 billion at an annual rate in the fourth quarter, and near balance for the year 1979, to a deficit of about $10 billion in the first quarter of 1980. Higher foreign earnings of U.S. oil companies offset part of the rise in the merchandise trade deficit. Partial data indicate that the trade and current-account deficits narrowed in the second quarter.

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SECTION 2. LABOR MARKETS AND CAPACITY UTILIZATION

Labor demand was relatively well-maintained early in the year, but it fell off steeply in the spring as firms responded to the sharp declines in sales by cutting their work forces and shortening workweeks. Between January and June, the number of workers on the payrolls of nonfarm establishments fell almost 950,000; total employment, as measured by the household survey, fell more than 1-1/4 million. With layoffs rising, the nation's jobless rate jumped from 6-1/4 percent in January to 7-3/4 percent in May and June.

Much of the cutback in employment occurred in the construction sector and in durable goods manufacturing, especially motor vehicle and related industries. By June, the number of auto workers on indefinite layoff was nearly 250,000 (about 30 percent of total hourly workers in the industry), and substantial layoffs had occurred in the steel and tire industries as well. Construction employment began to drop early in the year, and subsequently suppliers of building materials also reduced their payrolls. During the spring, however, weakness in labor demand began to spread throughout the economy; employment at trade establishments dropped 190,000 over the second quarter, and in June payrolls in the service-producing sector registered the first monthly decline since 1975.

In addition to trimming payrolls, employers have curtailed work schedules in light of the weakening of sales. Since January, the average workweek at manufacturing establishments has been shortened almost 1-1/4 hours. More generally, the number of workers on part-time schedules for

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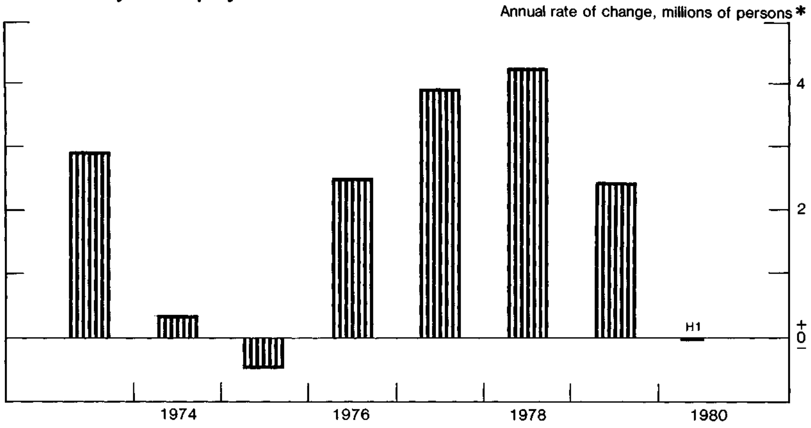
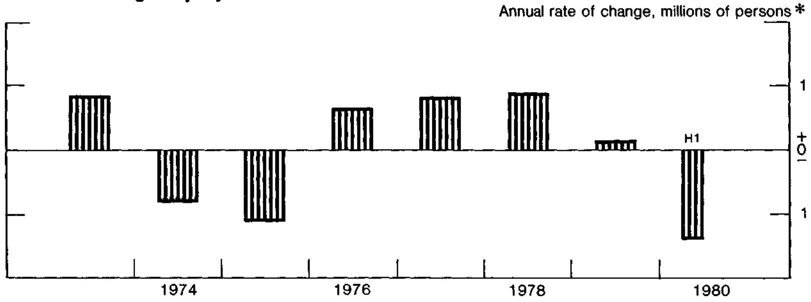
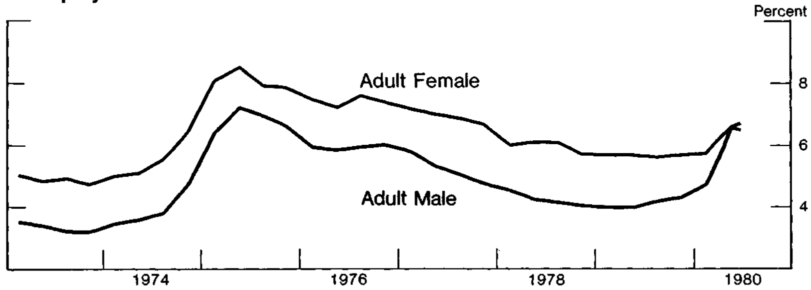
Nonfarm Payroll Employment



Manufacturing Employment



Unemployment Rates



*Annual changes are from Q4 to Q4; semi-annual changes are from Q4 to Q2.

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economic reasons rose sharply in the second quarter, with former full-time jobholders accounting for most of the increase.

The rise in joblessness has been widespread among demographic and occupational groups, with especially large increases reported among adult males. Since December, the jobless rate among men has climbed almost 2-1/2 percentage points, compared with an increase of 3/4 percentage point for adult women, and June marked the first time in two decades that the rate for men was higher than that for women. Unemployment among blue-collar workers rose sharply to an 11-1/2 percent rate in June, the highest since September 1975. In contrast, unemployment rates among white-collar workers have increased only marginally since the end of 1979.

The adjustments in output by firms, especially in the second quarter, were reflected in a sharp decline in the index of industrial production. Between January and June, industrial production fell nearly 7-1/2 percent. Production declines in auto-related industries and in industries supplying construction materials began early in the year, but by late spring cutbacks were occurring in most other industries as well. Among manufacturing firms, capacity utilization in June dropped to 76 percent, almost 11 percentage points below its 1979 peak.

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SECTION 3. PRICES, WAGES AND PRODUCTIVITY

After exploding upward in the early months of the year, rates of price increase moderated significantly in the second quarter. The improvement resulted primarily from a stabilizing of energy prices and from declines in the prices of nonferrous metals, after a flurry of speculative activity earlier in the year. Increases in the prices of construction materials and components also slowed noticeably in the second quarter with the decline in activity in the housing sector.

In the energy area, retail prices surged in January and February, in large part the result of the hike in OPEC prices that occurred in late 1979, but the pace of increase then slowed noticeably in the spring, as inventories reached near-record levels and demand continued to drop. The increase in energy prices also moderated at the producer level. Nonetheless, indirect effects of earlier increases in the prices of fuels and petroleum feedstocks were still evident through the end of June in items such as plastics and rubber products, industrial chemicals, and household supplies. Moreover, a number of factors--including the latest increases in OPEC prices, the curtailment of gasoline production, and the progressive decontrol of crude oil prices--suggest that further relief in the energy area is not to be expected.

Food prices generally have exerted a moderating influence on aggregate price measures since the beginning of the year. At the producer level, finished food prices fell at about a 4-1/2 percent annual rate between December and June. Steep drops in wholesale prices through May--particularly for livestock--alleviated cost pressures at the retail level, contributing to relatively

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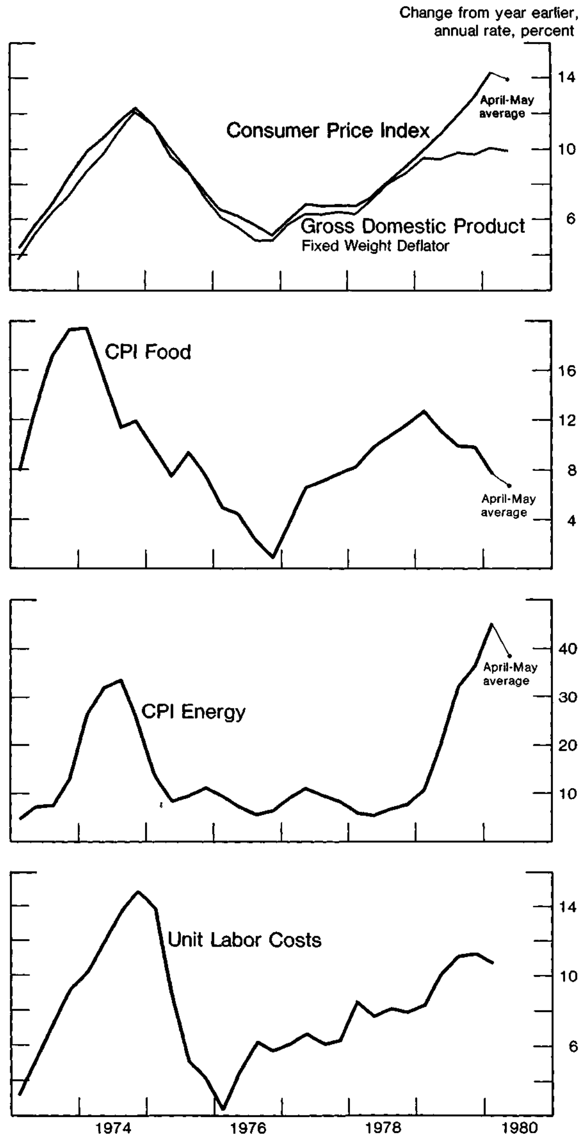
Prices and Labor Costs



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stable retail food prices since the end of last year. However, recent developments in the markets for livestock and fresh produce indicate that food prices also are likely to rise more rapidly in the second half of the year.

Inflationary pressures have persisted in sectors outside food and energy since the beginning of the year. In the consumer price index, increases in the homeownership component have been particularly large, as the measures of mortgage rates and home purchase prices both advanced rapidly in the first half of this year; the recent easing of mortgage rates will likely hold down increases in the CPI during the next few months. In the producer price index, prices of capital equipment accelerated in the first half of 1980 from the already rapid pace of 1979.

Labor cost pressures remained intense in the first half of 1980, as compensation increases were substantial while productivity declined further. Output per hour in the private nonfarm business sector dropped at about a 1-1/2 percent annual rate in the first quarter, after falling 2 percent over the preceding year. At the same time, hourly compensation accelerated to a 10-1/4 percent annual rate, so that the unit labor costs of nonfarm businesses rose at about an 11-3/4 percent rate in the first quarter. Preliminary data for the second quarter suggest that unit labor costs continued to rise rapidly, as productivity contracted further. Although cyclical reductions in overtime and the changing employment mix may restrain the growth in total compensation somewhat in coming months, wage demands are likely to remain strong, especially in light of past increases in consumer prices. Thus, upward pressures on unit labor costs will probably remain substantial over the near term.

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SECTION 4. FINANCIAL DEVELOPMENTS DURING THE FIRST HALF OF 1980

Interest Rates

Market rates of interest moved sharply higher in the early months of 1980, exceeding previous record levels and peaking around the end of the first quarter. These increases were largely reversed in the second quarter amid a substantial downslide in economic activity and contracting demands for money and credit. The upward pressure on yields at the turn of the year resulted from a combination of factors, including a deterioration in inflationary expectations as actual price increases accelerated in January and February, the failure of incoming data to confirm the long-anticipated downturn in activity, and international political developments that raised the likelihood of an increase in federal deficit spending. In February, moreover, growth in money and credit surged, creating demands for bank reserves well in excess of the provision of nonborrowed reserves consistent with the Federal Reserve's target ranges for growth in the monetary aggregates. In the Treasury bill market, in particular, the resulting rise in short-term interest rates was reinforced by large sales of securities by foreign institutions to finance intervention in foreign exchange markets.

On March 14, the Board of Governors took actions of a temporary nature designed to reinforce the effectiveness of the measures announced in October 1979 and thus to provide greater assurance that the monetary goals reported to the Congress in February would be met. These actions, some of which were taken under the authority of the Credit Control Act as part of a broad government effort aimed at reducing inflationary pressures, included:

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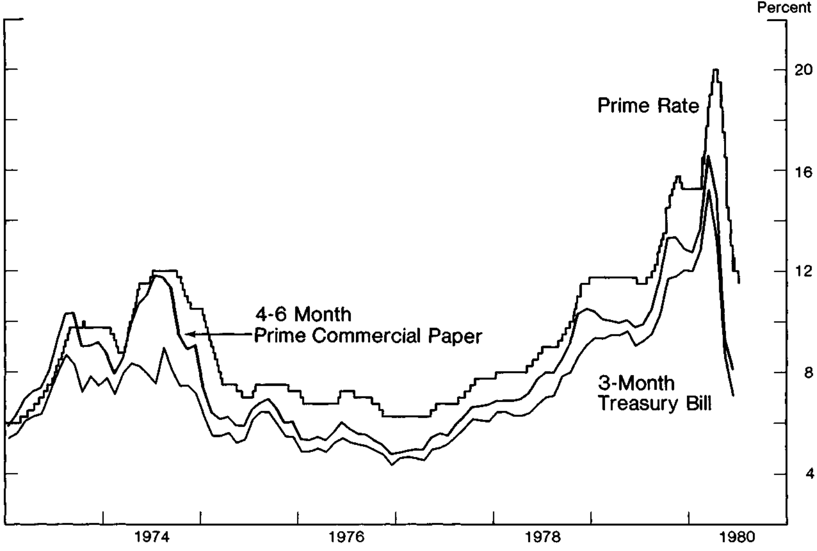
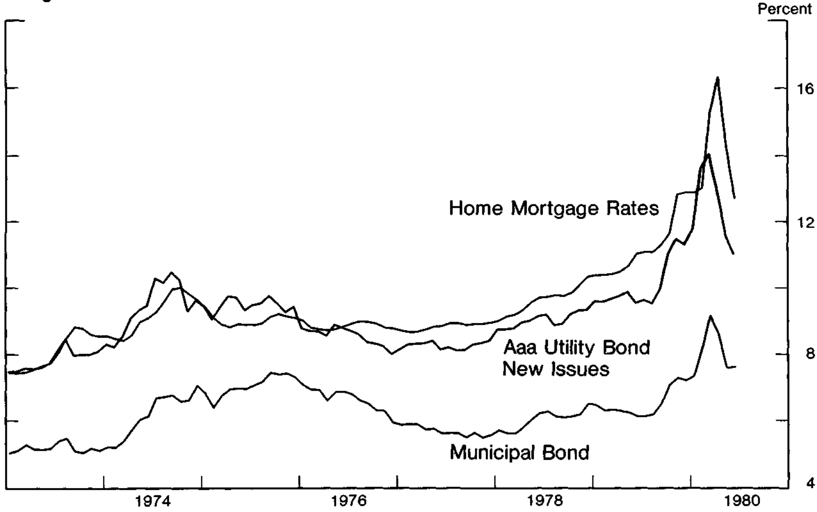
Interest Rates





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(1) a special credit restraint program directed toward limiting the growth in loans to U.S. customers by commercial banks and finance companies to ranges consistent with the monetary and credit objectives of the Federal Reserve; (2) a special deposit requirement for all types of lenders on increases in certain categories of consumer credit; (3) an increase in the marginal reserve requirement on managed liabilities of large member banks and U.S. branches and agencies of large foreign banks; (4) a special deposit requirement on increases in managed liabilities of large nonmember banks; (5) a special deposit requirement on increases in total assets of money market mutual funds; (6) a surcharge of 3 percentage points on frequent borrowing by large member banks from Federal Reserve Banks.

These measures hastened the movement toward reduced credit availability already in train at many lenders, and apparently increased the resolve of consumers to curtail their use of credit. In subsequent weeks, incoming data revealed a substantial slackening in money and credit growth to well within the Federal Reserve's objectives. In light of these developments, the Board amended the special credit program: on May 6 the 3 percentage point surcharge on discount borrowing by large banks was eliminated, and on May 22 special deposit requirements were reduced by half and the special credit restraint guidelines were modified. On July 3 the final phase-out of the program was announced.

The rise in most interest rates came to a halt in late March and early April, and yields began to move down as demands for money and credit dropped abruptly in response to developing slack in the economy. Most private short-term rates fell 7 to 9 percentage points, to their lowest levels since

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the spring of 1978. In long-term securities markets, bond yields retraced most or all of the increases recorded earlier in the year, as market participants appear to have lowered their expectations of inflation. The restraining posture of monetary and fiscal policy, as well as moderating rates of price increase in the cyclical downturn, has contributed to this improved outlook for price changes.

Foreign Exchange Markets and the Dollar

Movements in U.S. interest rates greatly influenced fluctuations in the foreign exchange value of the dollar over the first half of 1980. The dollar was in strong demand early in the year when U.S. interest rates rose sharply. The growing perception by market participants of accelerating inflation and worsening payments deficits abroad gave added impetus to the dollar's rise over this period, as did the announcement of credit control measures on March 14. Authorities in a number of foreign countries also moved to tighten monetary conditions, but the resulting increase in foreign interest rates lagged well behind that of U.S. rates. The strengthening in the foreign exchange value of the dollar in February and March was moderated somewhat by substantial intervention activities by U.S. and foreign monetary authorities.

The peaking and subsequent steep decline in U.S. interest rates in early April triggered heavy selling pressure on the dollar in international markets, and its foreign exchange value fell in the April to June period. Foreign and U.S. monetary authorities intervened to moderate this decline by making net purchases of dollars. Even so, by the end of June earlier gains were entirely erased, and the weighted-average exchange value of the dollar at mid-year was little changed from its value at the beginning of the year.

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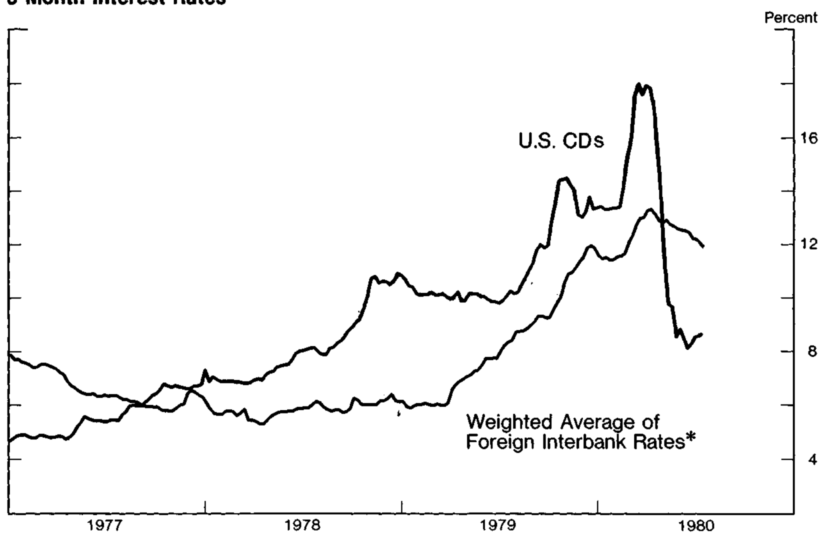
Weighted Average Exchange Value of U.S. Dollar*

3-Month Interest Rates



* Weighted average against or of G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

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Domestic Credit Flows

Net funds raised in credit markets by domestic nonfinancial sectors of the U.S. economy totaled a sizable $391 billion at an annual rate in the first quarter of 1980, but contracted sharply to an estimated $193 billion in the second period. This exceptionally large decline in borrowing reflected in large part the recent sudden weakening in production and sales activity; in addition, monetary restraint, supplemented by the special policy actions of mid-March, contributed to tauter credit terms and reduced availability of funds at many lenders.

In the private sector, the volume of funds raised in the first quarter was greatly enlarged by a surge in borrowing on the part of nonfinancial business firms. Some of this increased borrowing reflected needs to finance growth in inventories and fixed capital outlays, as the gap between such expenditures and internally generated funds of nonfinancial corporations widened. But fears that unchecked inflation would lead to the imposition of credit controls and a consequent reduction in credit availability apparently led to a burst of anticipatory borrowing by firms as well. As a result, corporations added substantially to their holdings of liquid assets in the first quarter and appear to have drawn down these holdings in subsequent months.

As interest rates moved up rapidly early in the year, businesses concentrated their credit demands in short- and intermediate-term markets, with borrowing at banks and in the commercial paper markets especially heavy. Corporate bond financing remained relatively low as businesses, especially industrial firms, were reluctant to issue long-term debt at historically high

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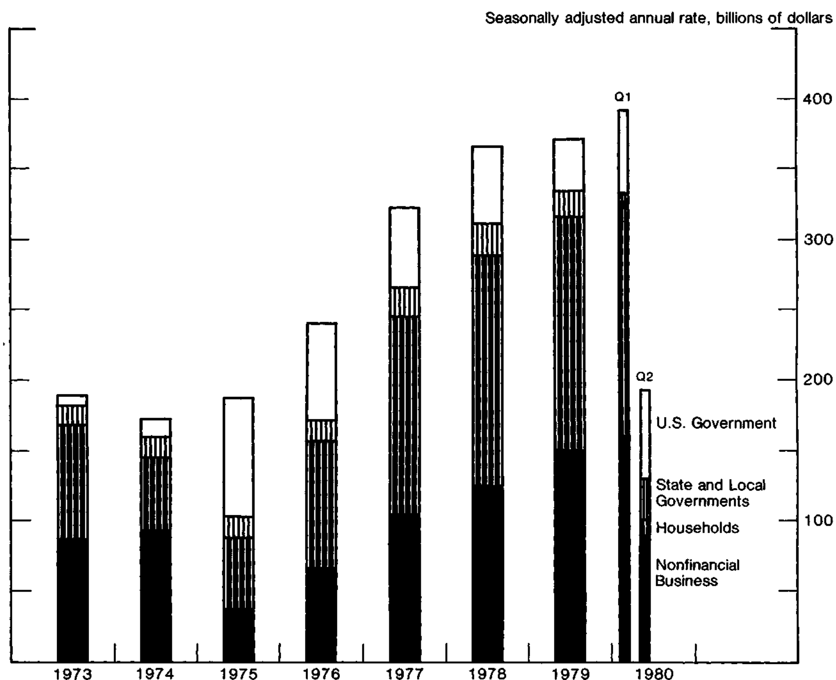
Net Funds Raised in Credit Markets
By Domestic Nonfinancial Sectors



Source: Federal Reserve Board *Flow of Funds Accounts*. Data for 1980 Q2 are partially estimated.

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yields. This pattern of corporate financing shifted dramatically, however, when interest rates dropped rapidly in the spring. Public offerings of longer-term corporate bonds accelerated to unprecedented levels, with the proceeds from many of these issues being used to pay down bank debt.

After March, commercial banks--concerned both about pressures on their earnings margins as interest rates dropped and about meeting the loan growth guidelines of the voluntary special credit restraint program--tended to discourage business borrowers. In particular, adjustments in the bank prime lending rate lagged substantially behind downward movements in other market rates, greatly increasing the relative cost of this source of financing. As a result of the relatively high cost of bank credit, coupled with a desire of businesses to adjust their balance sheets following the heavy reliance on short-term debt in previous months, business loans at banks contracted markedly in the second quarter. Although commercial paper issuance by firms remained very large, total short- and intermediate-term business credit demands in the second quarter moderated appreciably from the first-quarter pace. Late in the second quarter, the prime rate began to move down, narrowing the gap with market rates somewhat; survey data, furthermore, suggest that banks in May were making a large share of short-term business loans at below-prime interest rates.

In the household sector, consumers greatly reduced their use of installment credit during the first half. The large growth of consumer installment and mortgage debt in 1979--both in absolute terms and in relation to disposable income--had produced a marked deterioration in household liquidity. The combination of resulting heavy debt burdens, high interest rates, and, in some states, restrictive usury ceilings acted to slow growth of installment

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credit in late 1979 and the first quarter of 1980. The volume of outstanding installment credit contracted in the second quarter as consumers curtailed expenditures and repaid debt against a backdrop of rapidly declining real incomes and rising unemployment. Credit-tightening measures by lenders after the announcement of the credit-control package on March 14 and uncertainty on the part of consumers about the effects of those controls contributed further to the reduction in credit use.

Household borrowing in mortgage markets also slowed considerably in the first half. Reduced deposit flows and pressures on earnings margins from rising costs of funds constrained the lending activity of thrift institutions and pushed mortgage rates to record levels in March. Many would-be homebuyers were deterred by the high cost of mortgage credit. More recently, lower market interest rates have helped to reduce cost pressures for thrift institutions and have contributed to a pickup in deposit flows. Sharp drops in mortgage rates since early April and reports of some easing in nonrate terms suggest that lending institutions have become more active in seeking mortgage loans since early June. But mortgage rates remain high by historical standards, while demands for housing and housing credit continue to be damped by a weak economy and by the liquidity concerns of households; consequently, mortgage commitment activity apparently has remained relatively sluggish.

The Treasury borrowed heavily in credit markets in the first half to finance the combined deficits of the federal government and off-budget agencies. Normal seasonal patterns in federal cash flows associated with the timing of tax receipts led to a concentration of the Treasury's borrowing in the first three months of the year. Although the first-quarter deficit was

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further deepened this year by unusually large tax refunds associated with over-withholding in 1979, the Treasury was able to even out its borrowing pattern somewhat by permitting its cash balance to drop over the first quarter and then rebuilding it in the second.

In contrast to the federal sector, net borrowing by state and local governments dropped off in the first quarter but accelerated appreciably in the second. Many municipal governments postponed or canceled scheduled bond issues early in the year because of high interest rates; for some governmental units, these actions were necessitated by the rise of interest rates above statutory limitations. But the volume of tax-exempt financing picked up considerably in the second quarter when interest rates fell and many previously postponed bond issues were brought to market. The financing needs of state and local units generally increased over the first half in response to slower growth of revenues and a consequent widening of their operating deficits. In addition, the volume of tax-exempt securities issued continued to be boosted by offerings of mortgage revenue bonds, designed to finance single-family housing.

The CHAIRMAN. Thank you very much, Mr. Volcker.

We will now proceed under the 5-minute rule.

As I have indicated to you in my letter of July 1, 1980 and in my remarks this morning, I am persuaded that we need a comprehensive monetary policy, including active supervision of the uses of credit. This point is driven home, I believe, by the experience of the Great Silver Bubble of early 1980. Your letter to me of July 21, responding to my inquiries of June 12, sheds important new light on the bank role in supporting rampant speculation in silver. I would like to review the main points with you and ask a few additional questions.

First, it is clear now that banks were financing silver speculation from the beginning, even while the market was rising and while the Hunts were still acquiring silver. Direct bank loans to the Hunts on the upside of the market totaled at least $150 million, loans through brokers at least $50 million.

Second, none of the banks consulted with the Federal Reserve between October and March, to see whether such loans contravened the Federal Reserve's anti-speculative lending directives of October. Only three banks reported making such loans under the special credit restraint program instituted in March.

Third, both the Hunts and their brokers had long-standing business relationships with the banks involved. These relationships may have permitted the Hunts to obscure the massive scope of their February-March raid on the credit markets, and they may have seduced the banks into witting or unwitting collaboration. With respect to the Hunts, you state: "It is not at all clear that the banks individually knew the extent to which the Hunts' wealth was tied up with silver." With respect to the brokers, you state: "It

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does appear that some of the banks were not as diligent as they might have been concerning the precise utilization of the funds."

You argue that the banks played only a minor role in the development of this fiasco. Nevertheless, the facts show that the Hunt involvement was a major factor of credit restraint. The banks apparently give three excuses for this noncompliance: First, that they made the loans under previous commitments, second, that they were unware of the uses to which the money was being put, and third, that the loans were needed for "damage control". The first excuse is clearly a legalistic nonsense: In light of the Federal Reserve's expressed concern, the banks could and should have renegotiated their commitments. The second merely shows the credulity of the bankers in their negotiations with the Hunts. The third illustrates a fundamental fallacy: If, in fact, the Hunts had known that massive loans would not be available on the downside, then very likely the original speculation would never have occurred.

My specific questions follow:

First, how many banks were involved, in total, in lending directly or indirectly to the Hunts? Of these, how many now profess to have been unaware of what they were doing? Who were they? Would you provide for the record of these hearings, the statements of the three large banks who attempted to justify their Hunt loans under the special credit restraint program? As a matter of artistic draftsmanship these will surely be of interest.

Second, do you believe that the terms of the bail-out loan from the banks to the Hunts via Placid Oil adequately protect the public from further speculation by the Hunts? If so, how do you square the recent purchase of a silver mine by Bunker Hunt's daughter with the assurance given in your interim report that there would be no further silver acquisitions by the Hunts or "any related entity"?

Third, you note that the October admonitions to the banks were without the "force of regulation, law, or even formal reporting requirements." In retrospect, isn't it clear that the banks fell down on the job, and that the Nation would have been better served had there been formal reporting requirements?

Could we hear from you on those points, and to the extent that you don't have time fully to respond now, we would appreciate it for the record.

Mr. VOLCKER. Let me make one general comment on this situation that I think is essential to the understanding of bank's involvement.

Let me say, first of all, that nobody is less happy about this whole situation than the person before you, both because of its real impacts, the questions that it raises in terms of public policy, and the amount of time that is involved on my part.

The point I wanted to make to start with is that, I think it is not correct to say that bank lending supported this speculative activity during the period of the rising market. There was relatively little bank financing during that time. There may have been only one bank who was lending to the Hunts against silver at that time. The amount was a tiny fraction of the Hunt ownership of silver during the rising market. The big credit expansions, extensions, took place during the declining phase of the market, in effect when specula-

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tive venture was coming to an end, not when it was in the damaging stage at the beginning.

Nonetheless——

The CHAIRMAN. If I can interrupt, but even this little $200 million direct-plus-indirect bank loan to the Hunts is not peanuts. There is many a bedraggled home builder, consumer, small businessman, who would have loved to have had that credit channeled to him rather than to Bunker Hunt.

Mr. VOLCKER. I have forgotten the exact amount; it may have reached a peak of $200 million during that stage; I think it was only one bank. I don't want to defend the episode, but $200 million is, as you know, a tiny amount relative to the total amount of bank loans outstanding. I just want to put it in perspective. These big loans arose on the downside.

So far as supplying the exact number of banks, I haven't got that figure right in my head at this stage. I think that is all in the interim report we presented.

The CHAIRMAN. Would you provide that for the record?

Mr. VOLCKER. Yes.

[Chairman Volcker subsequently submitted the following for inclusion in the record of the hearing:]

At this point, we have identified 24 banks that extended credit to the Hunts, either directly or indirectly, prior to restructuring of the Placid Oil loan. Another 4 banks initially extended credit to the Hunts when the $1.1 billion Placid Oil restructured loan was funded for a total of 28 banks.

The above figure does not represent all the bank credit the Hunts may have received through brokers (indirect loans). We are aware that a number of other brokers extended credit to the Hunts; however, we have not identified any specific bank credit used to fund such loans. This is an area of continuing review.

Mr. VOLCKER. I feel reluctant to provide the exact statements made by the banks to which you referred. I think there are three banks that volunteered to report; it is unfair to the banks that didn't volunteer to report.

The CHAIRMAN. Let's do this, then. Leave their names out of it, but I am fascinated by the literary pyrotechnics. They did all this but left out the name of Bunker Hunt. Let me see their prose, but leave out the names.

Mr. VOLCKER. I might say that in reading these explanations I had some of the same questions you raised. Let us say this: Simply knowing the loan was secured by silver did not tell them it was a Hunt long position; that referred basically to loans to brokers. The banks in some instances—maybe in all instances—certainly knew the loan was against silver; some apparently thought it was a hedge silver position as part of the normal mechanism of the market. Whether they should have known more or less is another question.

The CHAIRMAN. Furnish us with their alibis. I think that the trout in the milk does persist in the minds of many of us. We may be doing an injustice to these bankers. If that is so, we will be the first to apologize.

Mr. VOLCKER. All I am saying is that knowing the loan was secured by silver doesn't answer that question.

Are we adequately protected? All I can say is we are a lot better protected than we were before. The banks negotiated a loan agreement. They negotiated the loan agreement at their initiative. At

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my insistence, but without their resistance, provisions were put in to protect against renewed speculation to the best of their ability. I am convinced that those provisions are as tight as lawyers can reasonably make them.

You asked me whether that loan agreement with the Hunts covers everything in the world; it doesn't.

The CHAIRMAN. How about his daughter, though?

Mr. VOLCKER. The term "related entities" in that loan agreement technically means people and entities that were related, that somehow had participated with the Hunts in this particular episode, whether they are companies or people.

Apparently, the daughter did not participate with them in the loan agreement. It does not cover every member of the extensive Hunt family; it would cover those who had been participating in that silver episode.

The CHAIRMAN. Are you aware of the fact that the lady was into soybean speculation heavily over a period of years?

Mr. VOLCKER. I am not aware of all the activities of every member of the Hunt family over a period of years. I know that this purchase of stock—it is a relatively small amount of stock, as I understand it, by Hunt standards, a small piece of the company—to the best of my knowledge—and I did look into it—certainly did not involve any of the bank lenders who were involved in this loan agreement.

As near as I can see, it didn't involve any bank credit at all. It was a purchase of stock apparently by the Hunt daughter, a small piece of a silver mining company. It didn't involve any bank credit, to the best of my knowledge.

Your third question was, should there have been reporting earlier? Well, I don't know. One can always go back and try to replay the tape. I don't feel strongly on that issue. I think there is an implication—maybe a direct statement in what you read earlier—that the banks paid no attention to what we had said either about speculation or takeovers.

I don't think that is a fair comment at all. That does not say that you cannot find instances that one would question, and I might question, as to whether it was the most full-faith following of the request as might have been hoped for. I don't think there is any doubt that there was a good faith effort by a great number of banks, and I——

The CHAIRMAN. Let me be clear on that. My indignation on this matter is principally because the many good bankers are made the fall guys for the corner-cutters who are greedy for profits.

Mr. VOLCKER. That kind of problem arises in these programs. I must say that when you get into particular instances the issue is seldom black or white. When it is really black, I think the banks cooperate. We have had, for instance, during this period—as one kind of example of the problems that arise—a number of inquiries from Congress and elsewhere as to whether banks should not be permitted or even encouraged to finance a takeover in specific instances. A couple arose when a foreign company was threatening to take over an American company and the American company, understandably, said, "How can we get our so-called white knight if nobody can finance him?"

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A number of people had sympathy with that argument. I only bring that up to illustrate that it is very hard to say one type of lending is bad, another type of lending is good. There are all sorts of shades of gray. I don't think you can say, obviously, that all activity in commodity markets is bad. Commodity markets serve a very real economic purpose, and it requires a certain amount of lending and borrowing to make those function, just in the normal course of events.

The CHAIRMAN. Well, my 5 minutes approaches its end, but I would say, with all of the force I can muster, that just as we look to the judiciary to make microdistinctions, just as we listen to Mr. Justice Potter Stewart say of pornography that he can't exactly define it but he sure knows it when he sees it, just as we ask the administration to exercise its fiscal power, not just to deal with boxcar macroeconomic balanced budgets, deficits, or surpluses, but to be concerned with their content and composition, we believe that the Federal Reserve must, according to its lights, observe a similar microeconomic emphasis.

The reason I have devoted my 5 minutes to silver is that this is one of merely scores of examples where our current miseries, I believe, are due to the flowing of credit to the wrong things instead of to the right things.

Mr. VOLCKER. I have no reason to believe there are scores of situations that in any way parallel this silver lending in terms of magnitude or impact. I think our general philosophy and approach at the Federal Reserve—not just as a matter of Federal Reserve decision but as general philosophy in this area—has been that we basically want those markets to operate in a competitive environment, on their own.

It is not our job to say this loan is a good loan or that loan is a bad loan. That philosophy has guided us basically through history. Of course, it is a philosophy that isn't confined simply to bank lending.

The CHAIRMAN. Do you eschew the accolade I gave you before, which I sincerely meant, relative to last October when you said that commodity speculation and corporate raiding are not desirable uses of the Nation's scarce credit, but that capital investment, enhancing productivity, small business, farmers, consumers, and housing are. Do you slough off the compliment I was paying you?

Mr. VOLCKER. Not if it is confined to that particular situation. We did it and meant it. I am referring to what is a basic continuing policy. I don't think it has been our posture in the past, it is not our posture now, and I, frankly, hope it is not our posture in the future, to put ourselves in a position of deciding that one loan is a good loan, another loan is a bad loan.

As I wrote to you recently, I think we can try—and we are trying, although it is not an easy process—through changes in either our examination or statistical procedures or both, to get a better handle promptly on any unusual episodes of this sort that might arise again and to, in effect, discourage banks or caution banks about the problems of certain types of speculative lending.

The CHAIRMAN. A moment ago you said—and I agreed with you—that many banks have been patriotic and public spirited in their adherence to your list of goods and bads. To make that

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statement, you must have been capable of some intellectual judgment as to what they were doing.

I leave you, then, with the thought that you do have a continuing obligation, not to fool around with individual loans, but to establish standards to which banks of goodwill can repair. Otherwise we are not going to escape, in my judgment, from the inflation/recession bind that we are in.

My time is up.

Mr. VOLCKER. If I may just add one very brief comment. The kinds of problems that arose in the commodity market, I think, can and should be attacked through a different avenue. What are the proper rules and regulations, including margin requirements, borrowing requirements, all that sort of thing, on commodity markets? We are working very hard in that area.

The CHAIRMAN. Well, if you slough off the Federal Reserve's duty in these premises, I hope you will be as specific in telling us who should carry out those duties as you are in telling us what tax policy should be.

Mr. VOLCKER. We are aiming—in cooperation with other agencies—toward making very specific recommendations in this area, which may include some Federal Reserve authority.

Mr. MINISH. Mr. Chairman, aren't we under the 5-minute rule?

The CHAIRMAN. Yes, we are. I am guilty of——

Mr. MINISH. We are going on to 20 minutes right now.

The CHAIRMAN. Right.

Mr. Stanton?

Mr. STANTON. I certainly agree with the Member from New Jersey that we should move along.

Mr. Chairman, two points: First, I was very pleased to see your reference on page 6 to what I would assume were references to the Credit Control Act of 1969. In that statement you said that credit controls involve the kind of arbitrary intrusion into decisionmaking that should not be a part of monetary policy.

I have restrained from talking to you about this subject or corresponding with you on it because while it was in the process of being implemented, on the actual books it, of course, was part of the President's program on inflation.

Now that it is off the books, in the light of the broadness of that legislation that took place December 17, 1969, I wonder what your personal views would be on a sunset provision to the Credit Control Act, perhaps 1 year from now?

Mr. ANNUNZIO. Will the gentleman from Ohio yield?

You made a statement that the Credit Control Act is off the books.

Mr. STANTON. No. Its actual implementation.

Mr. ANNUNZIO. That is right. It is off the books. They are just not using it now.

Mr. STANTON. It has been on the books since December 17, 1969.

My question is, Would you consider because of its hardness, especially its rough treatment of consumers in our country, the poor people, consider some kind of sunset legislation perhaps for 1 year from now which would force Congress to take a look at it, perhaps curtail some of those controls, if not take them off? What is your feeling on that?

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Mr. VOLCKER. My personal feeling about that act is that it is, indeed, a very sweeping piece of legislation with rather broad criteria for its use, to put it kindly.

It is not really appropriate to have that sweeping grant of power, in this case to the President and the Federal Reserve combined. You have a protection in a sense that both sides have to act.

When I look at the language of that legislation on its face, I share the feeling that it is extremely sweeping; it would permit, in the last analysis, control of almost all transactions in the economy; it makes me uneasy.

Mr. STANTON. The second question, Mr. Chairman. You made yourself very clear on the subject of tax cuts next year, presumably along the lines of a 10-percent, 15-percent, 20-percent individual tax cut. I wonder, could you comment quickly: Would your objection also lend itself to such language that over 300 of us have cosponsored called the Capital Cost Recovery Act, which would limit itself strictly to a change in the method of accounting of the actual depreciation schedules that we refer to as 10-5-3, known as the Jones-Conable or Conable-Jones bill?

This type of legislation it seems to me is necessary to give industry a leadtime. I am vitally interested. There is a plant in my district, a steel plant. This means a good deal to it. It takes months and years of planning ahead. Would your objection to specific tax cuts also lend itself to something like that?

Mr. VOLCKER. I think it is clear in my statement—I hope it is—that when one begins talking about tax reduction and rates, which I think is a very good topic of discussion, that the effort ought to be to maximize, among other things, the impact on the investment saving process, and on enhanced productivity.

One of the leading contenders, obviously, in that area is some kind of depreciation reform. There are other ways of going but I have myself believed that the depreciation area is the best way to do it; for the maximum kick for minimum revenue loss, particularly in the short run, it has a lot of appeal.

Whether the 10-5-3 proposal specifically—and I do not want to pose as more of an expert than I am——

Mr. STANTON. I am limiting the question specifically to that, not to broaden it out as maybe the administration has.

Mr. VOLCKER. I am not familiar with the particular bill you are referring to. I do not think I can make a sweeping comment in opposition to measured response to the problems we know exist, on the productivity-investment side, and with known revenue costs that are tolerable, in light of everything we know now.

My comments refer to a total tax package. I think there is some merit in putting things together in a package.

That is not my judgment to make in the end. I think all of these things have to be gaged toward the general problems that I tried to lay out here.

Mr. STANTON. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Chairman.

Mr. Volcker, I am going to follow up a little on Mr. Stanton's comments about the Credit Control Act.

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I think that having had experience with it, with the imposition, with the removal of it, we ought to be thinking about the future. It seems to me that the imposition had the very good effect of converting a blazing fire into some smoldering embers and that the removal of the controls did not cause the fire to blaze up again, so that it has some merit.

I do agree with you that some of the language is rather staggeringly broad. Would not, in your opinion, the better approach be—based on your experience in administering the act—to have the Federal Reserve—since it is the primary accounting agency—propose amendments to the act based on your experience rather than, in effect, a repeal outright or a delayed repeal?

Mr. VOLCKER. We could do that. I think my own basic feeling is that our ordinary control powers, except in very exceptional circumstances, are going to be adequate. We do have some emergency provisions in the act that you passed this year, dealing only with the reserve requirement question.

Now the real debate, it seems to me, ought to be as to whether there is some reason, on a very exceptional basis, to have a little more clearly defined emergency power than granted by either the Credit Control Act—because it is too sweeping—or by the Monetary Control Act because it is limited to one particular use of reserve requirements.

I am sure you understand that when the Credit Control Act was invoked, we used an instrument that was very parallel to our ordinary instruments of monetary policy. We did that quite deliberately. We used——

Mr. MOORHEAD. Mr. Volcker, why did you not use the existing one rather than the Credit Control Act if you could have accomplished——

Mr. VOLCKER. I do not think we could have accomplished precisely that purpose in the same way. I think we could look at that and see whether the addition of some language to existing law would make it just a bit more flexible. Maybe that would take care of the problem.

Let me say that I do not feel bereft without this kind of legislation, that sat there for 10 years without being used—or rather it was used for one brief, exceptional period—but I think it is a reasonable question as to whether, with some modification of existing law, so to speak, the standby purpose might be served.

Mr. MOORHEAD. Thank you, Mr. Volcker.

Let me turn now to the questions of tax cuts. What if there are proposals for an immediate across-the-board 10-percent tax cut? I would like to ask you, first, what would happen, in your judgment, to the now projected—$30 billion deficit for 1981? As I see it, we have two ways of financing it. Either by printing money, which is inflationary, or by borrowing, which removes money from the capital markets.

The implication for those who support a tax cut is that of stimulating income that will immediately rise and that the deficit would not increase. Do you share that opinion, sir?

Mr. VOLCKER. No, not in the short run. You can make that argument over a period of time, but certainly not in fiscal 1981.

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Mr. MOORHEAD. If we come to considering a tax cut—and you mentioned here an increase in the payroll taxes in 1981, and I think you have also suggested a tax policy that would increase or make more attractive investment possibilities—if we were to consider a tax cut, do you believe it should be directed to a combination of reducing or holding fast on the payroll taxes, which I think are both inflationary and deflationary, and on stimulating investment which, frankly, would not have that immediate effect, but would—in the long run—hopefully increase productivity?

Mr. VOLCKER. I think all the tax actions you take should be taken toward the long-range need to deal with productivity and costs and incentives. There are purchasing power implications, too, but you should not just look at a purchasing-power tax reduction. You should use this opportunity, if indeed it arises at all, to get the maximum impact in terms of these long-term requirements.

On the particular question of the payroll tax, there are competing considerations. I would love to see the payroll tax not go into effect or offset because it has a direct impact on costs and inflation.

Mr. MOORHEAD. It also takes money out of the worker's pocket.

Mr. VOLCKER. It has the purchasing-power implication.

On the other hand, social security, I think for good reason, in this country is financed with a tax related to benefits. That link is an important piece of philosophy that I hate to see broken. How you can do both at the same time, relieve the impact of the payroll tax and maintain the link with benefits at a time when the fund is potentially running out of money, is obviously the dilemma.

I think it is worth a little thinking as to whether some way cannot be found through that; I would love to see it done. On the other hand, I hate to see the link broken.

Mr. MOORHEAD. I would not break it as far as retirement is concerned. Maybe some other benefits.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Gonzalez.

Mr. GONZALEZ. Mr. Chairman, on page 4 of your statement, your short statement, you say:

> There is no doubt in my mind that these lower levels of interest rates can play a constructive role in the process of restoring a better equilibrium and foster recovery.

It has been argued that the delicate position of the international dollar makes it difficult to lower interest rates in our country, at least as quickly as we might otherwise like to, as you infer.

Suppose we could get our major allies, Germany, Britain, to lower their interest rates as we lower ours, while fighting inflation with tighter fiscal policies, if necessary. Could we not then lower our interest rates a little faster without having short-term capital flow overseas and setting off an inflationary pressure on the dollar?

Mr. VOLCKER. I have a couple of comments. Our general posture, as you know, is not to, in a sense, manipulate the interest rates, but to try to guide our operations with somewhat longer range vision—if that is the right word to use—about the aggregates. The interest rates fall out of that process.

With the economy slumping, interest rates have gone down. In that context, I think they play this constructive role.

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Now, these interest-rate movements can affect, let us say, the dollar internationally, both because they may be misinterpreted as a basic change in policy and the expectation about inflation and all the rest, and also directly, because of the interest rate relationships to which you refer. So that inherently there is another side of the coin: What is going on abroad.

I have rather continuously evaluated this situation. We have discussions about it internationally. You say, "Would it not be nice for other countries to tighten up their fiscal policy and ease their monetary policy?" Yes, it would be nice, from the standpoint of this immediate situation we face. Whether that is feasible and desirable from their standpoint, given all the problems they have in manipulating fiscal policy, their own evaluation of the economic outlook, and all the rest, I don't know. It is not a flexible tool, let me put it that way.

These countries come back to us and say why don't you do the opposite?

I do not think we can expect to live in a world where everybody is readily changing basic fiscal policy in response to all those relatively short-term problems. But differing postures of the different countries are an important thing, a relevant consideration; they are under more or less continuous observation and recurrent discussion.

Mr. GONZALEZ. Well, but has there been any effort to exert American leadership at any point? You have the emergence of EMF and EMS without a whimper from us. It is obviously intended as part of the forced policy that even U.N. conferences have accepted. They have done it to us. They have insisted on——

Mr. VOLCKER. But the question you are referring to, Mr. Gonzalez, is a question that has arisen in literally the past 3 months. In the previous 3 or 4 months, the shoe was very much on the other foot. They, in fact, said why can't you do more on fiscal policy and less on monetary policy, because the dollar is going up too much and our currencies are going down. Our answer is that it is not all that easy to change fiscal policy overnight. That is their question at the moment.

I think we have been setting a basic structure for several years. It is another thing to cope with what is a very short-term problem. Indeed, I believe the major factor that will affect the dollar over any reasonable period of time is the degree of conviction that is generated about the prospects for the American economy generally, for inflation in particular, and for the balance of payments. The balance-of-payments side is rather favorable at the moment, relative to the unfavorable situation that most other industrialized countries have.

The key element is whether there is, in fact, progress and an appreciation of progress on the inflation front. In that circumstance, I do not think you have to worry so much about these short-range wiggles—or more than wiggles—in the short-term interest rate.

I do not think you can expect that we can handle every one of these basically cyclical problems through a basic change in fiscal policy. It is just too hard to do in that time frame.

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Mr. GONZALEZ. Well, when the pressure was on, though, it has been done.

Mr. VOLCKER. I think it is reasonable to talk about it as a basis for general strategy. But you cannot put it in the context of a problem for the next 2 months, or 3 months; it has to be fit into a longer term perspective.

Mr. GONZALEZ. I notice my time is up. I wanted to get into what I call M_3. That is groceries. And one of my predecessor Congressmen from my district, Maury Maverick, Sr., during the height of the Depression when they were talking about constitutional crises preventing remedial help for the people suffering, he said, well, he was interested in preserving the Constitution, but also groceries. I think that is the issue today in America.

I do not have time. We will get to that later.

The CHAIRMAN. Mr. Wylie.

Mr. WYLIE. Thank you very much, Mr. Chairman.

Mr. Volcker, I would like to followup on what Mr. Gonzalez was into there. You have expressed some reluctance to allow interest rates to fall any further at this time; and may I assume that this is at least partly responsible for the money growth being below your targets?

Mr. VOLCKER. I put it the other way around, I think. We felt we should not push very hard to get reserves in and make up that April drop just as fast as we possibly could for a variety of reasons.

Now that might have—probably would have in the short run—— driven the short-term rates down. What it would have done to the long-term rates is not at all clear to me. I am sure it would have led to a lot of confusion about whether we were headed off on another bout of inflation. You might have actually gotten a perverse effect on long-term rates. If we just shot the money supply up again, that is a policy that would have lasted for a month or two; we would have been back on target. But then you would say we have to go back the other way again. That would have whipsawed the market.

Mr. WYLIE. I understand what you are saying, but from my standpoint, why would it not have been better to allow interest rates to come down further vis-a-vis our own economy? Is it the fear, as Mr. Gonzalez suggested, that the dollar might fall on foreign exchanges and might that not be good for our economy? Would that not be good for American exports such as automobiles? Would that not be good for American imports or for foreign imports such as automobiles?

Mr. VOLCKER. We basically have stayed on a course of providing reserves, and the interest rates are going to fall out of that.

You know, I am not happy—I would not be at all casual about— the prospects of a real foreign exchange disturbance. We have not had that. I do not think, on balance, it would be helpful at all. I think it would be quite destructive of the kind of progress we want to make over a period of time, because it generates inflationary expectations; it is a problem in its own right for us and for other countries. I am sure it would be temporary anyway in terms of our competitive position. So on balance, I would not look at all casually on that kind of foreign exchange situation, to take just that aspect of the problem. Among other things, when you get that kind of

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foreign exchange situation, it is not going to be a good climate for domestic bargaining.

Mr. WYLIE. Mr. Stanton talked about the Capital Cost Recovery Act a little while ago. You commented on that. I cosponsored that bill, too. It brings up another question. That is a possible increase in, and making permanent, an investment tax credit which Mr. Miller suggested as preferable when he was here. Would you comment on the permanent investment tax credit? Are you more in favor of that?

Mr. VOLCKER. I would just offer perhaps a helpful comment. There are alternative ways of dealing with this investment problem. I support the idea that this is the key problem, that we have to look at it.

Which technique is the best in getting the maximum favorable impact with the minimum cost is an appropriate matter for debate. I do not have a judgment for you in the last analysis as to whether you should push an investment tax credit as compared to the depreciation reform.

That answer obviously should be resolved not simply on the merits—where the merits are very close between the two—but on where the consensus lies, where it is easiest to move forward if, indeed, the impacts are very similar.

Those two cases, I think, come pretty close to having a rather similar impact, depending upon the specific design.

Mr. WYLIE. The capital cost recovery might go more to wages or more to operating expenses rather than directing it to, it seems to me, capital investment.

Mr. VOLCKER. If that is true; I am not familiar enough with it.

Mr. WYLIE. As you say, there are a lot of questions here which are subject to legitimate debate which makes it all the more difficult for us in the final analysis.

As we know—I want to followup on your reluctance here to talk about money targets for next year; 1980 is, of course, a Presidential election year. This year's candidates, so far, differ rather sharply on the question of whether or not there should be a tax cut for fiscal 1981, although I noticed in the New York Times today—I guess on Monday—that the President is talking about having some sort of leadership conference to shape a tax reduction bill, which is almost certain to pass Congress this year.

Does the iffyness of your projections relate to the iffyness of the outcome of the election?

Mr. VOLCKER. It does not relate to the outcome of the election at all.

Mr. WYLIE. That does not enter into the uncertainty of money projections for next year or the difficulty in projecting money targets?

Mr. VOLCKER. No. I think I can honestly say I do not remember the word election or anything connoting that episode arising in our discussions.

Mr. WYLIE. Would there be much difference in the projected monetary and credit aggregates under an assumption of a 10-percent tax cut or whether there was no tax cut? That is really what I am getting at.

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Mr. VOLCKER. As a first approximation, I would say our long-term goal and objective is to get these monetary targets reduced. The principal difference of whether or not you have a tax reduction will be in the impact on the credit markets.

One of the concerns that we have is that you get what I guess I called yesterday a collision between the provision of money and credit at a reduced rate—which this committee supported; the committee in the Senate supported; and which has been general policy—and other policies, if they are all inflationary; then you have a problem. If deficits arise, wages rise, cost trends are exacerbated in other ways, and we are working, plugging away, at trying to get the money supply reduced, you have a collision.

Mr. WYLIE. Let me say your reluctance to give money targets adds to our confusion, of course. I think that it can be projected.

Mr. VOLCKER. I am beginning to get the message that it adds to confusion. My message was that it should not.

Mr. WYLIE. If you cannot guess what it is going to be like, how can we?

Mr. VOLCKER. I indicated that the FOMC was very concerned that the kind of figures that we would give would add to the confusion rather than relieve the confusion. If we give figures, I think they would have to be, in a sense, on the assumption that we did not have institutional change; that this is what the targets would be if we did not have to take account of NOW accounts, money market funds, and so forth.

That may be the clearest way of expressing our objective.

Mr. WYLIE. Thank you very much.

The CHAIRMAN. Mr. Minish?

Mr. MINISH. Nice to have you before the committee.

I am not going to get involved in this technical language involving M_1, because M_2, M_3; before we are finished, we will be up to M_{16}. People will confuse it with guns and butter.

I want to ask a simple question. What is the outlook for the economy?

Mr. VOLCKER. I have to preface that with my usual comment, about which I feel rather strongly: We make a mistake in economic policy to put too much money on any particular forecast. We have been fooled too often in the past. You get yourself in more trouble by saying, "I know what the economic outlook is; I am going to put all policies in that basket for the short run."

I think we ought to realize and recognize there is uncertainty here. We ought to stay on a path.

That has real implications for monetary policy. As you can see, that is happening: the economy went into a slump, interest rates went down. That, in itself, is a contribution to economic recovery. Interest rates went down faster in my judgment than if we had been operating on the old technique and had to manipulate them down.

It was in the chairman's statement; you have an automatic countercyclical force at work.

My own feeling, and the estimates of the FOMC, were summarized in our report. The range was fairly wide. They reflected a general consensus that the recovery ought to begin in the latter part of this year, during the fourth quarter sometime; that was the

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central trend of the discussion, with a rather restrained recovery next year based upon what we know now.

The most recent information—even since we had that discussion—strikes me as being somewhat more favorable. I don't want to put too much weight on that, but we have had a bigger increase in homebuilding than many people expected. There is some indication that the car industry will come back to some degree from a very depressed level.

The last consumer buying figures suggested that normal patterns may be returning, but those are, at this point, straws in the wind.

I wouldn't put a lot of weight on them, but they tended to be in that direction.

Mr. MINISH. Mr. Chairman, we have received reports that some financial institutions, are charging social security recipients $1.50 when their check is mailed for direct deposit to the institution. How widespread is that?

Do you have an idea?

Mr. VOLCKER. I do not know. I will look into it.

Mr. MINISH. Frankly, it is outrageous as far as I am concerned. I will appreciate if you can get us more detailed information.

Thank you, Mr. Chairman.

[Chairman Volcker subsequently submitted the following for inclusion in the record of the hearing:]

This is the first instance that has come to our attention in which a financial institution is imposing a service charge for direct deposits. Other institutions that have communicated with our staff from time to time have all indicated that they do not impose a charge. I should add, however, that many institutions believe the Electronic Fund Transfer Act and the resulting regulation impose an undue burden on institutions that are subject to Regulation E only because of their participation in the federal recurring payments programs.

The situation you describe is illustrative of a general problem that, unfortunately and all too frequently, arises in the implementation of statutes designed to benefit consumers. While the regulations do protect the majority of individuals and groups, they can also cause unintended hardships on others—despite conscientious efforts to impose only those requirements necessary under the statutes.

In the case that you brought to our attention, the action taken by the New Jersey bank was the result of its efforts to conform to Regulation E. The regulation requires, among other things, that financial institutions offering EFT services provide customers with documentation of electronic fund transfers, including preauthorized credits. Financial institutions that receive direct deposits of social security benefits, for example, have the choice of sending a notice of receipt or of giving customers a telephone number that they can call to verify whether a deposit of funds has been received by the institution. For some institutions, sending a notice each time (though costly) is more feasible than responding to telephone calls from customers.

Although there is no prohibition against charging for EFT transfers, so long as disclosures are given, we are surprised that a charge would be imposed for direct deposits made via the automated clearing house network. Direct deposits, like the electronic handling of many other transactions, are cheaper in the long run than making transfers by paper check. We understand, however, that this particular bank has relatively few direct deposit customers, and it may be unable to realize economies of scale sufficient to offset the added costs imposed by the Act and regulation.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. Mr. Volcker, I just have one compliment. You would make a very good Congressman. You do answer the mail. My mail is also answered.

You would make a very excellent prisoner of war because you wouldn't tell the enemy a thing.

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Mr. Chairman, there is a feeling in the savings and loan industry and the building industry that there is a move on in the Federal Reserve Board and that fake deregulation committee that I didn't vote for to kill the savings and loan business, and in fact it has been suggested that you are the triggerman.

Quite frankly, from the recent actions of the Fed and the DIDC, it would appear that these feelings are well founded. As we know, despite a small increase in housing starts last month, housing starts are at a 10-year low and may well reach the lowest level since the 1930's.

What I would like to know is, what you, as the chief monetary officials of this country, plan to do to make certain that the housing industry does not disappear, just like our TV industry, our shoe industry, the disaster that hit the auto industry? I could go on and recite the litany of what is happening.

I also would like your views on the savings differential which—it is no secret to you—I favor that very much because it hasn't cost the taxpayers one cent—between the savings and loans and the banks.

What is wrong with allowing S. & L.'s to pay more so that we can have a sound industry in the housing field? In that regard, does the DIDC plan to abolish the differential prior to the 6-year cutoff date mandated by the Congress?

Under the reserve setting authority granted by H.R. 4986, your agency was granted broad new powers with setting reserves for all financial institutions. In that regard do you or does the Board have any plans to expand these powers to further regulate savings and loan, credit unions, or to try to examine these institutions?

Mr. VOLCKER. You have suggested a direct answer, and I will try to give you a direct answer.

Mr. ANNUNZIO. I am a very direct guy. I would appreciate a direct answer.

Mr. VOLCKER. I am delighted you raised the question.

Mr. ANNUNZIO. If you are against the differential, just say so.

Mr. VOLCKER. Let me go through this in order, if I can remember all the parts of the question. I really appreciate the chance to put a little different perspective on some of these questions.

I think the first question was whether I am masterminding the demise of the savings and loans?

The answer to that question is——

Mr. ANNUNZIO. And the housing industry?

Mr. VOLCKER. The answer to that question is that it is a ridiculous thought. Nothing could be further from the truth. Could I be more explicit than that?

Mr. ANNUNZIO. Go ahead. I am listening.

Mr. VOLCKER. So far as the decisions of the DIDC are concerned with respect to the differential, obviously the general answer is, we are going to follow the law. The law, I think, requires that a differential on any instrument in existence before some date in 1967, as I remember it, be maintained for this period.

The committee will follow the law and maintain the differential on all those instruments that were in existence and are covered by the act.

Let me, if I may—the final question was what?

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Mr. ANNUNZIO. The final question was if you are planning to expand——

Mr. VOLCKER. The answer to that question is no. If I can return to the middle question and explain the nature of the decision that was made by the DIDC, I would appreciate it, because I think it was a constructive decision in the interests of this country.

We had several purposes in mind in making the decisions that were made in May I know it looks complicated, because the structure that had been built up was inherently complicated. We changed some aspects of a complicated structure and inevitably that looks complicated.

I think the general purposes that we had in mind should be clear enough. One of those purposes—in a sense the basic purpose, the most significant purpose of those changes—was to put all the depository institutions, including the savings and loans, in a more favorable competitive position vis-a-vis the rest of the market.

The money market funds——

Mr. ANNUNZIO. You know there is no competition when the banks have had 150 years to build up their business and their checking accounts.

You have given people checking accounts that they don't want, so that statement is——

Mr. VOLCKER. I know there is enormous competition between all these institutions and money market funds, which happened to be by far the most rapidly growing institution and which don't put any money into mortgages——

Mr. ANNUNZIO. You are going to see more smalltown banks, neighborhood banks, small thrift institutions out of business before you get through.

Tell me what you have in mind for the housing industry. How do you plan for us to come back so that the young people of this country can buy a home at a reasonable interest rate?

That is what the people want to know.

Mr. VOLCKER. If I may finish describing what we had in mind with this decision, one consideration, one important consideration, was to put all these institutions, all of which provide money—not only to housing, but so far as some of them are concerned to agriculture, to automobile dealers, and to others that also urgently need credit—in a better position to do that job.

Mr. ANNUNZIO. You put them in a difficult position.

Mr. VOLCKER. Their inflows of funds——

Mr. ANNUNZIO. Companies with 75 years of business went out of business.

Mr. VOLCKER. Their inflows would unquestionably be lower today if we had not made the decisions that we made in May.

Second, we made a very modest step toward deregulation, which is the name of the committee, and said that consistent with our first objective, if market interest rates go low enough, these institutions can all compete more freely for money so that they can channel it to housing and other vitally needed areas of credit demand.

Finally, on the differential, if I may address myself to that: the differential was not touched on the form of deposit which seems

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most suitable and most desirable and most stimulative of housing, that is, the 2½-year certificate.

On the money market certificate, the differential was kept in the operative range with an exception for people who held already deposits in commercial banks which they had obtained during a time when there was no differential; there was a rollover privilege provided.

We were, without question, concerned about the impact of sizable drains of funds from small banks around the country that were very heavily pressed in providing agricultural credit, in providing credit to local small businesses, automobile dealers, and others.

I continue to believe it was a highly constructive decision made by that committee, consistent with the intent of the Congress, consistent with the interests of the homebuilding industry, and consistent with the interests of the country as a whole.

Mr. ANNUNZIO. My 5 minutes are up. I want to end by saying that the best favor you can do for this country—that all of us that were involved in the creation of this committee—swallow our ego, and come out and make some suggestions to get rid of the committee.

Your statements are good, Mr. Volcker. You make beautiful statements, but they don't add up to action on what is going on.

Mr. VOLCKER I am willing to let that action stand. It can be debated, and if someone else can tell me how to do it in the better interests of the country, I will be glad to listen.

Mr. ANNUNZIO. Come up with a proposal to get rid of that committee we created.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. Mr. Chairman, as you know, one of the pieces of legislation now before this committee involves the creation of export trading companies.

Mr. VOLCKER. Yes.

Mr. LEACH. The most contentious issue within that is whether banks should be allowed to take involvements in these trading companies.

Do you have a position on that issue?

Mr. VOLCKER. Yes. I have had some conversations and correspondence with Senator Stevenson who has been the chief sponsor in the Senate, as you know. I was about to have some further conversation with him today.

The remaining issue, as I understand it, is the question of bank control. We approach that issue, generally, as saying that this country has had a philosophy and a tradition of distinguishing between banking and other businesses. That line has been maintained pretty much through thick and thin, so we have been reluctant and opposed to opening a large hole in that traditional approach and letting banks go into an export trading company that could conduct a great variety of commercial activities.

The export trading company idea may be a very constructive idea from the standpoint of the country. Our question is, Does it require bank ownership? The bill permits—and we are not troubled by this—bank participation in the ownership; the only issue is control.

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The Board has felt rather strongly on maintaining this traditional distinction. Senator Stevenson has raised with me the issue of a very limited purpose export trading company, perhaps put together for one project or for a series of discrete projects, or a trading corporation that is handling some specialized area of trading, not the kind of thing that is likely to attract widespread ownership interest.

I am prepared to indicate to him, if that is the concern—speaking personally now—that we may retain the presumption against control, but perhaps make an exception where there is a showing that in a particular case a limited purpose export trading corporation really cannot operate without a sponsor and it must be a bank.

But let's keep the banks out of the big multipurpose trading corporation idea. I don't think we want to duplicate the Japanese experience in that particular respect. It is contrary to the general way we have organized our banking system. I would hope something can be worked out in that area.

The rest of the bill, as I understand, looks fine from our standpoint. I think it could be constructive.

Mr. LEACH. I would basically agree with you on that and just want to pursue one other thing touched upon earlier. That is this issue of growth in liquidity outside the banking system.

Domestically, a most notable example is the money market fund phenomenon. Obviously there is an inequity here in tax policy because reserve requirements are not applied in the same way as they are on deposits in banks and other financial institutions. It seems from a tax equity point of view one should either establish reserve requirements in one area or take off certain reserve requirements in other areas.

Is the Fed prepared to utilize its authority or make a legislative recommendation that will have an effect upon equalizing competition?

Mr. VOLCKER. Yes. It is an annoying issue that has substantive repercussions over a period of time. It is partly the reason, I think, the Eurodollar market has expanded so rapidly in recent years.

We have approached it from both directions. We have had extensive discussions with foreign countries and foreign central banks about how competitive conditions might be equalized, approaching it through the Eurodollar market. There were differing opinions among foreign countries on that. By the nature of the problem, you have to have widespread agreement where everybody moves to the least common denominator.

Mr. LEACH. How about within our own country?

Mr. VOLCKER. Domestically you can approach it from the perspective of reducing reserve requirements.

There have been proposals made for domestic international banking facilities, I guess that is the term. Board consideration of that was deferred more than 1 year ago in light of the international discussions and in light of the Monetary Reform Act.

The Monetary Reform Act clarifies our legal ability to do that, so I would expect it to come before the Board of Governors within the next 2 months for a decision.

Mr. LEACH. Thank you. My time has expired. I would appreciate your presenting something more specific in writing about the issue

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of money market funds and how to insure equitable competition as well as the impact of money funds on small rural banks in particular.

Mr. VOLCKER. That is another matter; it is an issue. I haven't got a magic answer. I will be glad to elaborate on it further.

Mr. LEACH. Thank you.

[In regard to the colloquy above, information submitted for the record may be found in the appendix.]

The CHAIRMAN. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Chairman, on page 3 of the Board's report, the Blue Book, dated July 22, 1980, you offer a table which presents ranges for key economic variables, probable performance of the economy this year and in 1981.

For the fourth quarter of 1980 to the fourth quarter of 1981, percent changes projected are as follows:

For normal GNP, 8.5 to 11.5 percent; implicit GNP deflator, 7¾ to 9.5 percent; real GNP, minus 5 to minus 2.5 percent in 1980 to .5 to 3 percent in 1981.

Mr. Chairman, you offer these projections. Yet you will offer us no projections for money growth over the same period.

It seems simply inconceivable to me that you could begin to consider these projections of economic activity without considering money growth. It seems to me that you have done much to restore some confidence in the fact that this country is serious about fighting inflation. I am very concerned that if you will not focus, especially on M_{1B}, which I think would solve some of the problems that you discussed earlier on this subject, and give us and those that watch these figures, and this economy carefully, a clear projection of the intention of the Federal Reserve, most especially on M_{1B}, which is what people can spend, then I think you will undo much of the good that you have done.

Mr. VOLCKER. Let me just state the other side. I now understand that impression exists. We discussed this for hours, partly in connection with these projections. The clear consensus that emerged from the committee was that in a conceptual sense—if I can put it that way—we want to continue to make progress in 1981 toward some reduction.

I will just illustrate the problem by reference to M_{1B}. The transfer from demand deposits in M_{1A} to M_{1B} does not affect the M_{1B} total; it affects the M_{1A} total, and from that standpoint the M_{1B} total looks good. The transfer of savings deposits to M_{1B} artificially inflates M_{1B}. That will undoubtedly happen next year; we will have an artificially inflated M_{1B} figure. So if we had taken the view that you expressed here we might have said,

> Look, we really have to make some assumption on whether the rate of growth of M_{1B} is affected by savings deposits. It certainly will be. So let us assume—just for technical reasons, nothing to do with policy—that whatever our projection would otherwise be on M_{1B}, we should add 2 percent to it, or 3 percent, or 4 percent.

Our fear of doing that was that that would yield a confusing figure. You would think we were going wild.

That is the kind of problem we had in putting this in perspective. You understand that at the same time we would be saying. "But look, M_{1A} is going down; and M_{1B} is going down from its earlier

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target. It is a confusing business. I sense the confusion that is being created. I am a little afraid of the prospect of creating still more because of this technical, purely technical, problem. This is a transfer of existing money. It has nothing to do with policy or what the growth rate should be over a period of time.

Mr. NEAL. Mr. Chairman, I understand that. I think though, if you would set your targets and explain it as you have this morning, and on several other occasions, that it is the clear intent of the Fed to follow a policy of gradual reduction over time, make it clear that is a consistent policy you intend to stick with, and are dedicated to sticking with, and annotate it any way necessary to clarify these technical concerns—that it would——

Mr. VOLCKER. That is precisely what we tried to do. We apparently tried to do it in too brief a compass to make it fully comprehensible.

The wording was rather carefully chosen to, I think, reflect the sense of what you are saying, which I understand. We have maybe, unwittingly, raised some questions that we did not anticipate, frankly because we thought we were putting it in the way that we thought would be clearest.

Mr. NEAL. Would you attempt to help us with this? Make it clear? Especially with the focus on M_{1B}?

Mr. VOLCKER. I am worried about the focus on M_{1B}; we have to have a bigger context than that somehow.

Mr. NEAL. On another subject, there has been some discussion of these money market funds. There was a period when it appeared that a lot of money was flowing out of the small savings institutions, small banks, savings and loans into the big money market funds.

I guess as interest rates come closer together, that trend would be reduced somewhat. But even though it might not make sense to require reserve requirements on all money market funds—because they all do not behave like banks—would it not make sense to require reserves on those money market funds that do behave like banks: Those that offer checking privileges, for instance, so that we might create a more level playing field, as I believe has been your intent?

Mr. VOLCKER. There is that possible approach. It has its problems, like everything does. Again, we could kind of go the opposite way. If anything is done at all, we could say they shouldn't act like banks, they shouldn't have checkwriting privileges, make a clear line of distinction between the banking business—the transactions balance business in particular—and the liquid investment business that is the basic business of money market funds.

One of the problems you run into, of course, is that money market funds, while substantively providing virtually the same service, are organized differently. They are mutual funds operating under the investment laws, and that creates problems of its own. There are varying degrees of urgency with which people approach this problem, but this is an area in which I share the feelings that that competitive position should be examined to see whether it really is fair and sustainable over a long period of time.

Mr. NEAL. Doesn't it have some impact on your ability to control the monetary aggregates also?

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Mr. VOLCKER. Yes. Not only to control, but in reading M_2. We are always trying to find out what these aggregates are trying to tell us when they move, and what the significance of a change is. Those money market funds, I think, are quite properly in M_2, but they are growing so rapidly—partly at the expense not of other things in M_2, but of things outside of M_2, that you have to at least have in mind the question as to what extent, when they are growing so rapidly, that biases the M_2 figure.

If the world stood still and we didn't have these kinds of changes, it would be easier. When the world changes in these respects, you have to have some room for judgment as to the meaning of the change.

Mr. NEAL. Are you sugesting a policy change of any kind?

Mr. VOLCKER. Regarding money market funds?

Mr. NEAL. Yes.

Mr. VOLCKER. I don't want to suggest a policy change at this moment. I want to suggest that I think it is an area that ought to be looked at, but I haven't got a conclusion so far.

Mr. NEAL. My time has expired.

The CHAIRMAN. Mr. D'Amours.

Mr. D'AMOURS. Thank you, Mr. Chairman.

Mr. Volcker, thank you for presenting your testimony. I have a couple of observations and then a few quick questions.

In your dialog with Mr. Stanton, I got the very clear impression that you are very concerned about the Credit Control Act, authority that you and the administration have. You are uneasy about it, I think you said.

Mr. VOLCKER. Uneasy.

Mr. D'AMOURS. It seems this act has been on the books for 10 years and hasn't done anybody any harm. It did us, I think, a considerable amount of good. If it ain't broke, why do you want to fix it?

Mr. VOLCKER. I think the word is uneasy rather than gravely disturbed.

When I look at that, it is just an extremely sweeping authority and, in that sense, I suppose it doesn't conform with my basic instinct about legislation, which is that it should be a little better defined if it is going to be there at all.

Mr. D'AMOURS. Are you anticipating making any suggestions, issuing any reports, doing anything to eliminate, change——

Mr. VOLCKER. We have issued a first report. We will issue another report on our credit restraint program part of which was made possible by use of that act. I haven't contemplated any particular action with respect to the Credit Control Act itself.

Mr. D'AMOURS. Another observation. I want to be sure I have this straight. In response to your colloquy with Mr. Wylie earlier, do I understand you were saying that the Kemp-Roth proposal is inflationary and as such it would cut against our attempts to lower interest rates?

Mr. VOLCKER. I said what I said in my statement rather carefully. I don't want to get drawn into anything that could resemble a partisan comment here. I think the thrust of what I am trying to say——

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Mr. D'AMOURS. If you prefer, I won't refer to it by name, if that changes anything.

Mr. VOLCKER. The thrust of what I am saying is that a tax program of that type, or any type, has to be looked at in the context of these other criteria that I tried to spell out or allude to.

Is it the most effective, practical package we can put together in terms of the savings investment-incentive cost problem we have? Is it really the most effective package you can make? Is the timing right? Can we afford at this time the impact on the deficit?

We can't answer that question without asking what the expenditure trend is going to be. If you are talking about a 3-year tax program, what is the expenditure trend going to be over 3 years? Is the implication of that kind of approach that we are really going to cut spending persistently and vigorously over a long period of time? Or are we going to spend more?

I don't think you can answer the question that you raise without going into those other questions, because the danger is if they are not answered and if they are not answered affirmatively. You might have the problem to which you alluded: That you don't get any advantage out of the tax reduction, but rather what you may have done is increased the Federal deficit, had an impact on the credit markets, have done more damage in that direction than the constructive intent of the bill. So the criteria have to be in place.

Mr. D'AMOURS. I just thought I heard you tell Mr. Wylie that you didn't think that was the direction we ought to take.

Mr. VOLCKER. I don't think it is the direction we ought to take now. I don't think those criteria are in place.

Mr. D'AMOURS. Under existing criteria, the answer to my question is yes.

Mr. VOLCKER. We should not go ahead? The answer is "Yes."

Mr. D'AMOURS. That it was inflationary?

Mr. VOLCKER. Yes. As the situation exists now, yes.

Mr. D'AMOURS. The answer is yes?

Thank you.

Does the Federal Reserve, Mr. Chairman, have any way of knowing pretty accurately at any given time how much speculative lending is being engaged in by banks?

Mr. VOLCKER. No.

Mr. D'AMOURS. Wouldn't that be desirable to develop?

Mr. VOLCKER. Yes. In the abstract it is desirable. I have had some correspondence with your chairman about this.

You run into the problem that one man's speculative loan is another man's perfectly good investment.

But we are looking at and have action underway as part of the regular examination process. Are there criteria, procedures that the examiners can use to identify or discourage really excessive speculative activity that might go to the safety and the soundness of the bank?

We are also looking at the routine, statistical collection to see whether there are some different subdivisions we can make that, in effect, would give us a better clue to highly unusual speculative activity. We are not going to pick up normal, continuing activity which goes on all the time in support of the commodity markets.

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Mr. D'AMOURS. While the Credit Control Act was being enforced, weren't you requiring some sort of reporting?

Mr. VOLCKER. Yes.

Mr. D'AMOURS. Couldn't that be continued? Simply continue what you were already doing?

Mr. VOLCKER. Theoretically, yes. We decided not to do that; we had some cautionary words; we decided these other approaches might be more promising. We have a real problem of definition: A loan ordinarily doesn't jump out at you and say, "I am speculative."

Mr. D'AMOURS. I have one quick question remaining in my time. All of the charges that have been built into the credit card industry to offset the cost effects of the Credit Control Act, is there anything being done to monitor whether these charges are being removed now that the Credit Control Act is no longer being applied?

Is anything being done to look into what could be done about getting them removed?

Mr. VOLCKER. We followed that to some degree—and I am sure we will follow more closely during this period than in the past—and have had a flow of information about charges for credit and charges for cards and all the rest.

I don't think you should relate that increase in costs in a substantive way to the Credit Control Act. The amount of extra cost imposed by that provision that we introduced after the Credit Control Act was triggered was minor. I think it did have a psychological impact, without any question. I am sure many lenders, in effect, said:

> If the Government is indicating official concern to this degree about the extension of consumer credit, we have a favorable psychological climate for going ahead and introducing cost increases we want to make anyway.

But I think the basic rates and charges for cards were charges they wanted to make anyway, whether or not the Credit Control Act was on. I think they took it as some kind of official imprimatur on their ability to do so with minimum adverse repercussions on the part of customers.

It wasn't a calculation that, "The Credit Control Act in itself cost us *x* dollars which we have to recoup." It was that they were under heavy cost pressure anyway. It is a little hard, many of them found, to be making consumer loans at 12 percent or 18 percent under the usury statutes when they have to pay 18 percent for money.

Mr. D'AMOURS. Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

Mr. Volcker, you remember last October there was the unfortunate incident when the financial markets were perturbed by incorrect monetary data from one of the major New York banks. When we were looking into that at that time, I raised the question as to whether there was an investigation as to trading in interest rate sensitive securities by anyone involved with this data. In response to my question, special counsel was appointed to investigate the matter. I do not know whether it was the Federal Reserve System or the New York bank that appointed special counsel. The staff

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advises me we have never had a report on the outcome of that investigation.

Mr. VOLCKER. I have not yet had the final report of the special counsel. I inquired myself recently and was told that it would be with us very shortly. The general counsel just told me the final draft is being reviewed. I have had an interim report which was not disturbing in that connection.

Mr. GREEN. I hope we can have that.

Mr. VOLCKER. When we have the final report, we will send it up here.

Mr. GREEN. Regarding the midyear monetary policy report, I was struck by the first chart on page 26 which showed a remarkable phenomenon in terms of the Federal Government spending, that the rate of increase from 1978 to the first half of 1980 of the annual rate of change was quite markedly up, whereas the rate of increase in Federal Government receipts was quite markedly downward over that period.

Does not this one picture really tell us as much as thousands of words as to why we have our economic problem today?

Mr. VOLCKER. It is certainly part of the problem. I would not point entirely at 1 year. The deficits, the high expenditures—it is precisely that trend which suggests to me that one of the criteria about a tax reduction has not been resolved, not to my satisfaction, anyway.

Mr. GREEN. If I can turn to page 31 of the report, you note a sharper rate of adult male than adult female unemployment.

In the past there was an assumption that adult male unemployment is more painful in a sense because at that time it was assumed that female employment was essentially secondary wage-earner unemployment. I would not assume that in this day and age, but I wondered if you care to comment?

Mr. VOLCKER. I have not examined that particular relationship closely. It is an interesting contrast.

I assume it reflects what is going on in the chart immediately above. It is manufacturing employment that has been hard hit; that is predominantly male.

Mr. GREEN. I see.

Let me return to a question that Mr. Wylie raised. Do you feel that the level of the dollar in the foreign exchange markets compared with other major foreign currencies is an appropriate one, one that we should be comfortable with as a country?

Mr. VOLCKER. Oh, I am always happier to see the dollar rising than falling, if you want an honest answer.

It is on a level which I think is certainly consistent with our competitive position. I think we are in a reasonably good competitive position. One could raise the question whether it is not too low, but it is within the range in which it has traded for roughly 2 years now.

Mr. GREEN. So you would not advocate a policy of trying to reduce the value of the dollar?

Mr. VOLCKER. I certainly would not.

Mr. GREEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

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Let me say, Chairman Volcker, in connection with the matter that Mr. Green referred to, the statistical problem which gave rise to your appointment of a special counsel, I have not seen the report from the special counsel, but I commend you for doing what seems to me exactly the right thing. There was a question, a cloud in people's minds. The appointment of an outside counsel with a let-the-chips-fall-where-they-may mandate was the course I would have thought best calculated to quiet things down. It certainly quieted me down.

Mr. VOLCKER. I, of course, agree with that. It has taken a long time, which is what inspired my comment the other day. I hope I can associate the length of time with the thoroughness of the report.

The CHAIRMAN. Fine.

Mr. Blanchard.

Mr. BLANCHARD. Thank you, Mr. Chairman.

I am curious. Your report indicates a possible unemployment rate of up to 9¼ percent. It appears that the Fed's policies are to continue present policies, holding the monetary growth to relatively slow rates.

I am wondering what it is you would recommend to help fight unemployment; and if you are not so sure we ought to move in that direction, what it is you would recommend we do to fight unemployment to counteract what may be a helter-skelter politically panicked tax package on the Hill?

Mr. VOLCKER. This is the key question. In a sense, our own policies are fighting unemployment now and they are consistent with much easier money market conditions—not with an easier monetary policy in terms of growth of the aggregates, but rather consistent with conditions in the financial market that I think themselves are now conducive to recovery. The real challenge is how you get a program together that can move us ahead on the recovery side and help support that and at the same time recognize these inflationary problems.

That is why I think there is such a strong fundamental case for moving on taxes. I say there is a strong fundamental case, but that we better get these other conditions in place to make it a responsible and not a counterproductive policy.

I think over a period of time, that can be very helpful. I think there has got to be some recognition, generally, that there is kind of a tradeoff; there is a real tradeoff.

If we want to move toward getting rid of inflation—which I think we must, in the interests of unemployment over time, if nothing else—if it is essential as part of that program to achieve at least a gradual reduction in the money supply, then we are going to have to look at other policies that are consistent in that respect. The more that prices go up, the more that cost trends go up—whether social security taxes, wage bargaining—the more constrained you are on the employment side. There is kind of a direct choice: The higher wages are, the lower employment will be.

I am not sure that is fully understood. Of course, the wage bargain is worked out as an individual bargain with a lot of other considerations in every particular instance. But from the national interest it is clear, and from the worker's interest it is clear that,

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with a given rate of decline in inflation and in the money supply, the lower the wage settlement, the more employment there will be the more real income there will be, and the better off everybody will be.

That is fine in concept, and I think it is an important concept. The question is how to get from here to there.

To put a small practical tinge on it, it makes a lot of sense under these conditions that if you are going to have wage guidelines at all, you do not raise them, because that works in the other direction.

Mr. BLANCHARD. Let me approach the issue a little differently. It would appear that unemployment is and will be greater than was anticipated by the administration; not necessarily you, although I suspect by you as well.

Mr. VOLCKER. Yes, greater than they anticipated a few months ago.

Mr. BLANCHARD. All evidence suggests that this country and its political leadership does not have the stomach or the heart, I might add, to watch this happen without trying to do something.

Even if you and the Secretary of the Treasury and the President and his advisers resist the support of a tax cut, it may well be forced upon you by the Congress. In that case, you are going to have to have some alternative policy or we may well end up with what we have had in recent years, a demand-side stimulus which may encourage double-digit inflation into the future, exactly what you began fighting.

I hope you have in your hip pocket somewhere a carefully developed alternate set of tax policies, because otherwise we are going to have that again.

Mr. VOLCKER. In that connection, let me say that I do not resist the tax cut at all; I would welcome a tax cut. All that I urge is that you pay the necessary attention, in my judgment, to having the other policies in place that will make that constructive and not destructive. I think it is the No. 1 item on our agenda, getting that act together as an agency. I am on the side of the Federal Reserve now.

For the tax cut to go ahead without the conditions being in place is not going to be productive. It is going to be counterproductive.

Mr. BLANCHARD. I tend to share your feeling. It is just that we are awfully close to an election. It would appear that the President is in the position of having to oppose a tax cut of any kind. For purely symbolic reasons, he does not want to look like he is trying to buy votes.

I hope there is something carefully worked out that can be arranged with our Ways and Means Committee. God knows what they will do.

Mr. VOLCKER. I understand your concern.

Mr. BLANCHARD. We are worrying about jobs in Michigan right now. It is twice the national average.

Mr. VOLCKER. It just would be extremely unfortunate to go for some quick fix that is not going to be constructive.

The CHAIRMAN. Mr. Cavanaugh.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

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Mr. Chairman, I am also concerned about the failure—your failure to include in this report your monetary aggregate ranges, numerical range for 1981; and I have listened to your explanation several times and read your explanation several times. It would lead me to conclude that in your report to us next February, you also would find yourself not in a position to provide numerical target ranges because the conditions which you cite will be the same as they are today.

Mr. VOLCKER. Some of them.

Mr. CAVANAUGH. Then are you informing the Congress that we will not again have numerical ranges?

Mr. VOLCKER. That was not part of our intention. I recognize that some of the important problems to which I referred are still going to be with us at that time. At that time—if we are using anything like our present procedures, and we intend to be—we will need the targets for operational purposes. We also thought at that time we would have a better sense of how this might develop. Even then, we recognize that these technical problems may contribute a good deal of uncertainty. But other things will be a little more clarified. We will, at that time, I think, be able to make a better judgment as to the lasting significance of this short-lived April dip in money supply in terms of the future trend. We will have further evidence on the moneymarket fund-trend, whether that is continuing at the same rapid rate of growth.

But you are quite right; we will be left with some of these problems. The intention was to face up to them then, and give the explanation that was appropriate.

Mr. CAVANAUGH. So the February report will contain numerical figures?

Mr. VOLCKER. Yes. Without any question.

Mr. CAVANAUGH. Let me ask you: Do you feel it is a requirement of the law that the February report contain numerical targets?

Mr. VOLCKER. I do not want to pronounce a legal judgment. We had not considered that in that context. We consider it necessary from an operating point of view.

I think the law points very strongly in that direction, but I do not want to pronounce a legal opinion.

Mr. CAVANAUGH. You do not feel, I take it, that it was in the spirit of the law that the July report contain numerical targets?

Mr. VOLCKER. I read the law carefully at the time; I have read some of the committee reports and other material more fully since then. But as I indicated, I did inquire at the time. I read the law. Speaking for myself, without profound consideration, it seemed that there was not any real question about that; it was not a real issue; we did not have a legal debate.

Mr. CAVANAUGH. The distinction between the requirements for the February report and the July report, the distinction that you made was, I take it, that the February report requires numerical targets?

Mr. VOLCKER. I cannot honestly say that I was reading the law to see whether there were any distinctions. I took it for granted. I think all the members of the committee took it for granted that we

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would certainly have a numerical target. We did not discuss it; it was just assumed; it was not an issue.

The committee was not dealing with the issue as to whether we should have a target; that is taken for granted. The issue was whether at this point it was confusing or undesirable to try to make an explicit numerical target for 1981 amid all the uncertainties that I referred to. Nobody sat down and had a debate about whether we should have targets or not.

Mr. CAVANAUGH. Mr. Chairman, I did not ask whether there was a debate on whether or not there should be targets. It seems wholly obvious that you must have targets in order to have goals and in order to have objectives and in order to fulfill the functions of the Fed. The Congress would be appropriately concerned with the fact you are not supplying targets in spite of the fact that the language of the requirements for the February report and the July report are the same. The circumstances and justifications which you cite for not supplying numerical targets in this July report can be anticipated to be substantially similar in February; and so we could be appropriately concerned that we would perhaps never again have numerical targets or that the law does not adequately require numerical targets.

Mr. VOLCKER. I think it is clear that inadvertently we raised a question in some people's mind that was not in our mind, and we did not realize we were raising it.

Mr. CAVANAUGH. In my mind, Mr. Chairman, you violated the law. More serious than that, in my mind—and I have been an optimistic and enthusiastic supporter and heralder of your leadership at the Fed—I think your February report to this committee was among the most outstanding reports I have seen as a member of this committee.

This report is nonsensical to me. I think it does great damage to your personal reputation and to the confidence that you have enjoyed with this committee, with the Congress, and with the American people.

This Congress or anyone interested in monetary policy can not hope to evaluate the goals and objectives of the Fed over the next several months without numerical targets, even redefined and explained—and frankly, the distinctions and difficulties that you make with the anticipated transitions from M_{1A} to M_{1B} I do not find that obscuring and beyond the comprehension of this committee or interested members of the American public. I think that your coyness in that regard unnecessarily diminishes the reputation for candor and for leadership that you have developed over the initial months of your leadership of the Federal Reserve System.

I would hope that you can go back and supply this committee and the Congress with the numerical targets as the law clearly requires and rehabilitate what otherwise will be a serious and lasting gap in the continuum of the ability of those of us in the Congress and the country to evaluate the flow of monetary policy in the country.

Mr. VOLCKER. To make an observation as a matter of judgment, I do not think the committee came to a different conclusion than you did. This may amaze you, but I think the committee actually thought that they were being more helpful and explicit than they

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were being 1 year ago when they said vaguely we are going to have targets next year of such and such. We thought we were providing a little more content than that. We are very conscious of the problem. Many members of the committee were extremely reluctant to change a target once they had set it down because of the kind of problem that you are raising in a different context here; maybe it was a misjudgment on our part of what was the clearest way to get the message across. I do not think the message was meant to be obscure. We can try to do it better.

Mr. CAVANAUGH. Do I still have time?

In our discussion the last time that you appeared in February, you made a statement regarding the dangers, the serious inflationary dangers that would be attendant upon a significant increase in the defense expenditures above the President's budget which at that time: when submitted to the Congress, was for 1981, $161.8 billion. I am looking for your quotation. You said at that time:

> Let me say, for example, it must be recognized that any substantial increase in defense spending beyond what is already contemplated in the administration budget could significantly alter the economic outlook. The lag between authorization and actual Federal outlays may be quite long in the case of military hardware, but its exceptional impacts on employment, production, and private spending can emerge fairly quickly.

Subsequent to that, of course, in the budget resolution currently adopted, that increase has been significant to the authorizations for 1981. It has risen to $171 billion. Do the consequences which you describe for the committee in February attend to the reality that we have experienced?

Mr. VOLCKER. I have to state the context clearly. We are now in a recession. I think that question is still relevant in terms of looking at the tax cut prospect again; that is an important consideration.

How much is defense spending going up? I do not myself have at this point a confident feel as to what the answer to that question is. It is one of the relevant considerations in gauging the extent of Government expenditures and, therefore, how much room you have for a tax cut.

It is perhaps the principal uncertainty on the budgetary side. The budget is being affected, I might say, by purely cyclical developments; I discount those a lot in making this judgment. There are other things going on in the budget, specifically in defense spending, that color the appropriateness of the tax reduction.

Mr. CAVANAUGH. Do you think what the Congress has done this year in defense spending mitigates against helpful tax policy? Anti-inflationary tax policy?

Mr. VOLCKER. I simply do not at this point have a close enough analysis of what the Congress has done and what its implications are to give you a useful judgment this morning.

Mr. CAVANAUGH. Could you supply one for the record?

Mr. VOLCKER. I can attempt to supply something for the record, yes.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

[Chairman Volcker subsequently submitted the following information for the record:]

> I don't feel that I can comment on what would be an appropriate level of the defense outlays. But one thing is clear—the outlook is for more defense spending.

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Both the Congress and the administration have been specifying increases in the defense budget in recent months. In the First Concurrent Budget resolution Congress targeted over $170 billion for budget authority in national defense for fiscal year 1981, considerably more than had been requested by the administration in January and in the March budget update. By July, in the mid-session budget review, the administration estimate exceeded the congressional figure, partly on the basis of incoming cost data. These developments suggest a trend of successive upward revisions, that also is apparent in outlay estimates. The administration had projected fiscal year 1981 defense outlays to amount to $146 billion in the January budget, but this estimate was increased to almost $158 billion in the midsession budget review. My point is that the defense sector is growing rapidly and its pace of expansion is subject to further large revisions. A dollar spent on defense is not necessarily much more inflationary than a dollar spent on many other types of government programs. But the rising trend of defense spending must be taken into account in formulating policies for nondefense outlays and in considering the possibility of tax reductions.

The CHAIRMAN. Mr. Paul?

Mr. PAUL. Mr. Volcker, welcome to the committee. I was delighted to hear your comments about the credit controls and that you remain uneasy about them. You know I have been uneasy about the Credit Control Act for a long time.

I, too, have been concerned about the power that is granted under this act being too broad and too sweeping; so hopefully someday we can settle this, possibly with some sunset legislation. I hope we can get your support on that.

A few months ago, we had an economist in who stated that he thought that the primary cause of inflation was related to the many hundreds of billions of dollars of guaranteed loans that Government has granted. They total now over $400 billion. These are guaranteed or subsidized loans, low-interest loans to special groups. He did not indict business loans, even if they were construed as speculative, as the primary cause. In this group of guaranteed loans, we also have the Export-Import Bank where now, I believe, they have lending authority up to $40 billion; and this is usually below market, at 8 percent.

The borrowers have benefits where they do not have to pay back quickly and may not have any payments for 5 years.

Since I do not believe anything is for free or anything is below the market value unless somebody else pays, I am inclined to believe that the average American taxpayer must subsidize these loans; and if this is the case, I have several questions to follow up. I have three questions.

One, do you believe it is fair to the American citizen who is forced to subsidize this loan, this low-interest loan, in particular those loans that may go to a foreign interest—and it may be beneficial to a domestic industrial interest, but it is of necessity beneficial to some foreign interest as well—is it fair to this American taxpayer who has to subsidize it against his will to then go out and borrow in the marketplace, if he can find the money, and pay 12 to 14 percent for his house mortgage?

The second question I have is do you agree that the Government-subsidized loan is a significant factor in our inflationary forces, or do you maintain that there is a great deal of danger in private loans of an individual going out in the marketplace and—even if it is construed as speculative—is he the principal cause of inflation?

Under this circumstance, I agree that the banker who is granting this speculative loan has to be discreet in his ability to stay in

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business and to grant the loan with his own interest in mind as well.

Third, would you agree that commodity speculation is more the result of an uneasy economic climate, a result of inflation rather than the cause?

Mr. VOLCKER. On your first question, as to fairness, I do not think I would put it in those terms. I think it is a matter of whether it is good public policy or bad public policy. That depends upon the examination of the particular case. Is there some legitimate national interest being served in your case by export credit? I am a supporter of the Export-Import Bank in general; I do not like to see the subsidies in their loans. I think export credits in general—not just in the United States; more elsewhere than in the United States—have tended to get into a kind of a competitive race that does nobody any good. On the other hand, given that situation, it is hard for the United States, and may be counterproductive in terms of our national interest, to stay out. I think, particularly, the subsidy element has to be watched very carefully.

I would not just make a sweeping judgment that it is fair or unfair. It is a useful instrument of public policy or it is not; it has to be looked at on its merits.

I think it is hard to make a distinction whether a subsidized loan is more inflationary than a private loan. In a sense, they both are; in a sense, neither of them are. It all depends upon what else is going on.

I think it is a futile chase to say that a particular loan is inflationary, or another loan is not inflationary. The question is what the total is, what else is going on in the economy. And I think you have to recognize as one of the problems that the more subsidized loans you make, the less money there is for your home buyer; it is making things harder for him, and that should be put in the equation.

There has often been an attitude in the past—going back many decades—about Government loan programs. They are off-budget; we can forget about them; the credit markets will supply everything that is needed. I think in recent years we have found out there are choices in the credit markets, too; the more that goes in that direction, the less that will go someplace else. I think there are those problems.

Finally, I would agree with your comment that speculative episodes in commodity markets—commodity markets very broadly defined—are I think, a part of the whole of mania we have for creating new futures contracts, for increased speculative activity in many directions. These are a symptom of inflation, rather than the cause. Now particular speculative incidents like this silver market episode can be very troublesome in themselves; but, in general, the likelihood of that kind of thing arising or of a more general speculative atmosphere arising is a symptom of inflation and not the cause. I agree with that.

Mr. CAVANAUGH [presiding]. Mr. Vento?

Mr. VENTO. Given the different lag we have in terms of unemployment and so forth, shouldn't the Federal Reserve Board immediately try to return to the midpoint of its target ranges much faster and with much faster monetary growth in 1980?

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Mr. VOLCKER. When you say return to the midpoint in targets, let me say that we are already above the midpoint in one of those targets.

Mr. VENTO. I think since you were below the targets earlier, I am suggesting maybe we should return to putting as many dollars in circulation as had been initially intended.

Mr. VOLCKER. We are below and have been significantly below on the M_1 measure. The M_2 measure, to which I attach some importance as well, is above the midpoint. By pushing up M_1, you also push up M_2.

Mr. VENTO. Given the dynamic——

Mr. VOLCKER. Let me answer the question. We made the explicit choice I reviewed in my statement, that it would be more constructive over a period of time not to push as hard as we possibly could to get back on that target in the shortest possible period of time. That judgment was made that on balance, over a period of time, it would not be the most constructive approach.

In fact, M_1 and M_2 have been coming up fairly rapidly in the past couple of months. The inclination is in the direction you suggest, but we did not push as hard as we could have pushed.

Mr. VENTO. I thank you especially for your comments about the fact you are trying to induce that. Let me just go a point further.

There has been great discussion today about missed targets and the lack of targets in the Humphrey-Hawkins review that is before us. In other words, one of the concerns is that you can't be held accountable for what you don't say.

Mr. VOLCKER. Right.

Mr. VENTO. You can't be held accountable for what you don't say.

Mr. VOLCKER. No, I understand that. I think that is part of the whole philosophy of this targeting.

On the other hand, there is another side to that coin. We don't want to be held accountable for a target that is distorted for technological or other reasons. These are very difficult to estimate. I think it is a trap for you as well as for us.

Mr. VENTO. Let me just carry this particular thought. The fact of the matter is that we have a very dynamic economy; one for which we do look to the Federal Reserve Board to provide some stability. It is a question of us working with the fiscal side but needing a responsible monetary policy in order to coordinate our planning.

In other words, what we want from you is a commitment. What you want from us is some commitment so we can go forward.

My concern and I think the concern that is being expressed by others, is that you seem to be hedging based on the fact you don't know what Congress is going to do and you don't know what the world economy is going to do.

Mr. VOLCKER. There is obviously confusion here. There is a sense we were trying to hedge; I don't think we were trying to hedge. The problem goes back to the point, I suspect, that there is no definition of money that is perfect. We approximate it in our statistics. You can talk theoretically about a concept of money and what money is, but when you go out and look for it in the real world, it is a marginal decision whether *x* is money or whether it

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isn't money. Some things clearly are; some things clearly aren't. There are a certain number of things on the borderline.

Now with that inevitable haziness at the borderline—and that area of haziness is distorted when we have a lot of technological change—we have a little problem of communication in what we really mean.

Looking at it from different sides of the table, apparently, without any attempt to mislead, I understand what your concerns are. I understand what our concerns are. We ended up confusing you. We didn't mean to confuse you; we meant just the opposite.

Mr. VENTO. Let me go a step further for the purpose of what my concerns are with the Federal Reserve Board. I am disappointed and I hope the message is getting through.

Mr. VOLCKER. I believe the message there is considerable confusion.

Mr. VENTO. I think the Congress has been quick to respond in terms of giving the Federal Reserve Board powers that are necessary to deal with the monetary policy. In fact, we are very concerned about, for instance, the nature of the large loans that Chairman Reuss outlined, and the sad episode of silver speculation you were involved in, if not engineering. We are also concerned about the Fed's missed targets, their curious actions under the Credit Control Act in which consumer needs were pushed aside, the inability of the Federal Reserve Board to enforce prices, and the highest profits in the bank history occurred recently. I expect you will be writing back an answer to me on that.

We have tried to respond in terms of giving you the tools to deal with this, new definitions of credit and so forth, but the Federal Reserve Board is obviously not able to use these new and old tools to come to grips with providing the strong leadership we would expect from them.

We all know about the pressure in the financial community, but we don't expect the Federal Reserve Board to leave the monetary ship of policy at sea without a rudder and perhaps without a captain.

Your actions show more than your rhetoric, yours and the FRB's willingness the public responsibility and authority slip to other private economic circles and foreign currency decisions. I am disappointed. I think this leaves our monetary policy unguarded and unguided, subject to the battering, the ups and downs of the privately controlled foreign monetary forces the rhetorical question is why the timidity? I just don't understand it.

I am disappointed that at a time when we need stability in this area to protect the public interest, indeed it is a very substantial thrust that you appear to have deserted or are afraid to exercise forthrightness. I am concerned about it. I know there are a lot of characterizations that have probably been made of your leadership, but I didn't think timidity would be one of them, Mr. Volcker.

Mr. VOLCKER. I have a little difficulty in responding because I must confess I don't recognize any accusation. Perhaps we could have some discussion later.

Mr. CAVANAUGH. Not now.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. CAVANAUGH. Mr. Watkins?

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Mr. WATKINS. Mr. Volcker, I am glad to have you with us today.

Mr. Chairman, I think you are in a very enviable position to do something in this country about the economy. When President Carter came off his mountain from Camp David, he made a speech that a lot of people snickered at. I was not one of those. He talked about a crisis of confidence.

I do think we have a crisis of confidence in this country today. Mainly because the families of this country have overextended themselves with credit. One of the areas of jurisdiction you have as Chairman of the Fed is over credit. For about 3 years, I was a lone voice on this committee, talking about credit controls or credit restraints as part of a solution for trying to get hold of inflation.

I am glad to see on pages 5 and 6 of your report that you discuss credit controls as helping to get interest rates down, and to get hold of this country's inflationary spiral.

On February 19 when you appeared before the committee, I asked you if you had considered consumer credit. Your answer was no, that you had not considered it.

Mr. VOLCKER. That was an accurate answer at the time.

Mr. WATKINS. I understand it was. You and I have had discussions on this subject since. On March 14, it became part of the national policy. I was quite concerned whether this was just shooting from the hip or what, but I really think, Mr. Chairman, we cannot dismiss credit as part of the monetary policy.

My constituents tell me, when I head back to Washington, "Quit printing that money up there." Well, credit, consumer credit is printing money. Sears, J.C. Penney's, banks, businesses that issue credit cards, that is printing money. An increasing amount of the families in America have as high as 25 percent of their disposable income paying on consumer credit. That is when credit plays a very significant part of our monetary system.

As a result, it also creates a confidence factor, I think, with families. Ministers will tell us, when they counsel with married people, the biggest problem causing family problems happens to be financial difficulties. This is what I consider a crisis of confidence.

What I am saying is, I hope we don't take credit too lightly. In the first quarter there was $391 billion worth of credit. It dropped sharply to $193 billion the second quarter.

As a former homebuilder who has been out there on the whipping block, I know what it is like to face rising interest rates. When interest rates went from 14 percent all the way to 20 percent, we put on the credit restraints, to try to slow consumer credit and to get hold of inflation. I have been advocating credit restraints for 2 years because I believed it was a way to get hold of inflation.

I have gone to the point of researching this issue of credit restraints and I have determined that perhaps a trigger point is needed which would start consumer credit controls. That is a must if interest rates go so high again. They went over the roof with 20-percent figures before we decided to do something and go with another mechanism such as consumer credit controls.

I am asking this committee and my colleagues to start looking at a trigger. I would like to ask your opinion on this factor. Second, I

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think we have to put a limitation on what interest rate levels can be charged on credit cards.

If I am a manufacturer and I am borrowing money for a lot less, I will build my inventories. I will make a push to sell that inventory. If I can sell it on credit and charge 18 percent, 20, 24 percent, they can make more money. Credit card issuers are putting the families of America in a crisis because the more they can get them to buy on credit, the more they can borrow.

If businesses can borrow more money at a lower rate, they will build their inventory stock in order to then try to sell it on credit at a higher rate. I think we need to suggest to them that they can't charge more than 2 percent above prime for their consumer credit rates. That will save them from operating on a lot of credit in order to get the families to buy on credit.

What I am saying is, I think, we have placed the American families into a dilemma by pushing them to purchase more under credit which puts them under more of a strain. It puts more of a question on the confidence factor in this country which creates a much more negative attitude.

Maybe I am looking at a whole big problem. I really, truly believe that. There are two things I am saying are needed: A triggering formula to trigger consumer credit controls and second, putting a limit on what interest rates businesses can charge on consumer credit cards because they can well afford to go borrow that money.

What do you think of those two ideas, Mr. Chairman?

Mr. VOLCKER. It turned out I had to consider it within a relatively few weeks after I was here in February. You are now asking a longer range problem. My sense is that it is not moving in the right direction. I think we are operating an economy where we, to the extent possible, want to leave those choices on credit use to American business, to home buyers, to homebuilders, and to the consumer. It is not unreasonable that companies, banks, develop credit packages to help with their sales or to make money. That is the way the system works.

Now, imbalances can develop over a particular time. I think we had an imbalance in the consumer area in the past year or two. Consumer indebtedness became historically very heavy relative to income, and a good part of this trauma we are going through at the moment reflects a readjustment of that.

Apparently, people have decided they are not going to be so deeply in debt at the moment. They have been trying to repay. In fact, the amounts have gone down quite sharply. While these figures move sluggishly, you can already see improvement in income/debt ratios, but it is very hard to say that the Government has the wisdom or the Federal Reserve has the wisdom to say that a certain level of credit usage is appropriate, a certain level is not appropriate, and then to get involved in what would inevitably become, I think, a rather elaborate control mechanism.

My own feeling, and I think it is consistent with our traditional approach, is that that kind of thing really ought to be sorted out in the market to the maximum extent.

Now the Government can make a major policy decision and say we want to discourage the use of consumer credit. I think you are

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also saying you want to discourage consumer spending, because presumably you want to stimulate investment and other things in the economy. But that is a major philosophical as well as a narrow economic policy decision. My own thinking is not along those lines.

Mr. WATKINS. My time has expired. Please just try to bring people back to the conditions where they can live within their means, not just live within their credit.

You asked me when we met with the Speaker, the majority leader, and the Secretary of the Treasury, what the interest rate would have to go down to for homebuilders to get back to building their inventory?

I said, somewhere between 12, 13, 14 percent. I think that has proven correct. You look at June. It had the largest jump in homebuilding for many months. Who got interest rates down? Builders started moving from their equity financing at the high interest end to operating financing which definitely turned out great. I commend you for that.

Mr. VOLCKER. One month, anyway.

Mr. WATKINS. At least 1 month.

Thank you, Mr. Chairman.

Mr. CAVANAUGH. Mr. Bethune?

Mr. BETHUNE. Thank you, Mr. Chairman.

I was very intrigued by your comments, Mr. Volcker, on the comments about the tax cut. What it boils down to is you say we need it, but go slow, let us wait, let us study it a little bit more.

In 1976, the tax collections by this Government were $300 billion. In 1981, if our budget holds up with respect to revenue, it is going to be somewhere in the neighborhood of, perhaps in excess of $613 billion. It is more than doubled just since the 1976 budget.

You express concern about let's don't cut taxes, let us wait, study it, because we need to know about spending, budgetary controls, all of that.

So, what is all this caution about a very small tax cut? It is really a very small tax cut when you measure it against the increase that has taken place since 1976 and the increase that is going on right now as a result of bracket creep.

I wonder where was all this caution back on March 14 when you and the administration, I think, dangerously invoked the Credit Control Act and you got a reaction that you didn't expect? Did you approach that decision with all of the caution and care that you are now suggesting that we invoke in the enactment of a very small return of the tax bill that is more than doubled since 1976?

Mr. VOLCKER. I approached that decision with a great deal of caution.

Mr. BETHUNE. Did you have at your command all of these facts? Couldn't the same thing be said—I mean, in your statement here today when you talk about the tax cut, there is sort of an offhand slap, in my judgment, at those of us who were advocating the tax cut when you say it takes a brave man to project with confidence the precise nature of the economic situation we will face at the end of this year. Relatively little discussion about how the tax plans are brought to bear upon the question of wage and price increases.

Mr. VOLCKER. I think you misinterpret my position. I would like a tax cut. I want the tax cut in an environment that will promise

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to bring about results that could be very constructive. My concern is not slowing down on the tax cut for its own sake, but whether that is in place. The quicker you can put that environment in place, the quicker we can have the tax cut.

Mr. BETHUNE. Isn't it so that the tax cut that is being discussed by those of us on the Republican side is much less likely to cause an exaggerated response in the economy as did your action back on March 14?

Mr. VOLCKER. The direction, the thrust, the philosophy of that tax program as I understand it is in the direction that I think is supported by common consensus, an emphasis on production, productivity. I still have a question in my mind about whether the conditions are in place.

On March 14 we had a clear and present danger.

Mr. BETHUNE. What was the clear and present danger?

Mr. VOLCKER. The clear and present danger was exploding inflation and inflationary expectations, exploding credit and, in a more moderate degree, money. I think that had to be coped with at that time. The problems toward which this tax cut are correctly directed, in my judgment, are continuing, long term, central problems of the economy. It can have constructive effects. I want to get the conditions right so the short-term implications do not vitiate the highly constructive effects it could have in the long run.

Mr. BETHUNE. But the setting that you had back on March 14, you decided to do something about the high inflation rate by involving yourself into the credit market; isn't that the case?

Mr. VOLCKER. But I knew I could disinvolve myself in 3 months.

Mr. BETHUNE. But you did involve yourself in the credit market?

Mr. VOLCKER. That is correct.

Mr. BETHUNE. I think that was very risky. I don't think you, the Treasury Secretary, and least of all President Carter has any notion of what the credit market is all about. I say that not out of any comment that you and those of you are experts and have a great deal of education in this field. I say it because of what Mr. Paul said a moment ago.

With respect to Federal credit assistance programs, $1 out of every $6 now in the credit market is being sopped up by some sort of subsidized program, lending program, insured program, guaranteed program, and the CBO has said that they don't know the nature and extent of those programs, that is, they cannot, therefore, give an opinion about how it is impacting the credit market.

If they don't know that, then I don't think you do, and I don't think anybody can predict with any certainty what is going on in the world of credit. I think it was an extremely risky thing to do. I think you have to admit you don't know what is going on out there in the world of credit.

Mr. VOLCKER. I am not a great believer in credit controls. I thought I made that clear this morning. Their use was justified by the particular circumstances existing at that time. I don't want to stay in that business.

Mr. BETHUNE. My time has expired. I could go on.

Mr. CAVANAUGH. Mr. Porter?

Mr. PORTER. Thank you, Mr. Chairman.

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Mr. Volcker, you have been battered about by the committee a great deal in the hearings this morning. In fact, Mr. Cavanaugh even suggested that the Fed may have violated the law.

Mr. CAVANAUGH. I got promoted for that.

Mr. PORTER. I think myself that whether or not you have the target ranges, you are going to be judged as to what the state of the economy is and not whether you met some ranges or not. I want to at least commend you for the discipline that you have explicitly stated in your statement and have implicitly stated in your comments today, that you will hold the line and provide a steady growth for our economy with low inflation and a minimum of unemployment.

I think if you can do that, you are going to be possibly thought of as Presidential timber by either one of the parties, and at the very least, except for the comments made earlier, I would suspect that Representative Annunzio might be willing to give you a gold medal.

Nevertheless, I think there are a couple of questions that I would like to address.

One is the timing of a tax cut. In your statement you indicate that there are tax increases that are coming along both through bracket creep and through increases in social security taxes.

Let us call those nominal tax cuts. Why can't the Congress make a present commitment, make a statement to the American people right now that we are not going to allow taxes to increase next year and put off, if it seems necessary to do so—as you indicated—a commitment to real tax cuts at a later time.

Wouldn't that provide a good deal of confidence at a good point in time?

Right now, for the American people to look ahead and say at least we are not going to have our disposable incomes further reduced by Government action as it appears we will now if the Congress doesn't act at all?

Mr. VOLCKER. I suppose, in terms of my comments, you would have to add a couple of other statements. If you could say we are going to commit ourselves to that course of action—not just for 1981, but beyond—and we are also committed to a complementary spending program that assures that the budget will come into an appropriate relationship, you are a long ways toward making the statement ring true in my ears. But without that kind of recognition, you can't talk about a tax cut in a complete vacuum. It does depend upon what is happening to the other side of the budget.

If you could make a credible statement, "We have a tax cut that will absolutely maximize the cost, production, incentive side"—and I am not saying you can say that—then I can assure you that with the complementary budget program you are a long ways toward home.

I still have the reservation that was in my statement. I understand that explicit tax reduction offsets tax increases already on the books. But is there some way we can use this process to get the message through that this isn't a license for other inflationary, cost-increasing kinds of actions, but instead part of the bargain to wind down other sources of inflation to make this tax cut even safer.

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Put that all together, that is what I tried to say. I am not opposed to a tax cut if you can do it as part of that process. I think it will help the American economy.

Mr. PORTER. What you are saying is the Congress ought to make room in the budget for the tax cut?

Mr. VOLCKER. Yes, precisely.

Mr. PORTER. And not add to the deficit?

Mr. VOLCKER. It is going to scare people, understandably. I can't say the scares are wrong, if all you say is that you are going to have tax reduction, but you are making no commitment on the budget, and I don't care what else goes on. I think you are going to get a bad reaction in the markets directly.

You know, that is not a question of my policy preferences. I am now stating a forecast.

Mr. PORTER. Can I ask kind of a basic question? Do you believe we can control inflation through monetary policy alone regardless of the level of deficits that the Congress funds in a long-term sense? Can we do that?

Mr. VOLCKER. I think in a theoretical sense, yes, but it is not a theory you would like to see implemented in practice because it involves so much strain and maladjustment and pressure on some sectors of the economy or the market. It is not the best way to go. What we need is help from other policy tools, particularly the budget.

Mr. PORTER. Isn't it true that there are other countries that have experienced the same kinds of oil price impact that we have experienced, for example, that have run substantial deficits, and still held inflation to an acceptable level?

Mr. VOLCKER. I don't want to put the whole emphasis on the deficit. That is one factor in the credit markets and how the economy works.

But some of the countries that have the best record—let me take Japan and Germany—happen to have substantial budgetary deficits at the moment, more substantial than ours in relation to the GNP, but they also have an institutional setting that in other respects I think has served them very well. It is a remarkable fact that Japan—which went through an inflationary episode of some size after the first oil price increase—achieved a consensus among labor this year to have a rate-of-wage increase that is very little above the rate of productivity increase. It is very substantial in Japan, the rate-of-productivity increase. That was a rate-of-wage increase well below what one might have thought of as a possible inflation rate. They did this in the wake of the oil crisis. Their price and cost trends are reflecting that.

We don't have a mechanism for arriving at that kind of consensus in the same way. The same process, to some degree, seems to be at work in Germany, partly because they have such severe memories of past inflation. They have succeeded in getting a message across that everybody has something to gain from a noninflationary policy; if you conduct your own affairs that way, it will help the process.

In the United States, we have different patterns, different traditions and that is one of our great strengths, but it means we are winding down the cost/price cycle.

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Mr. PORTER. Thank you very much, Mr. Chairman.

Mr. CAVANAUGH. Thank you, Mr. Chairman. It appears my good friend from Oklahoma would like to enter round 2. I would indulge that with the consent of Mr. Volcker. I think he has been most generous to the committee.

Mr. VOLCKER. I am perfectly happy to answer.

Mr. CAVANAUGH. I would express some hope it would be brief.

Mr. WATKINS. Be very brief.

I commend Mr. Volcker on his restraint.

I wish a couple of colleagues that were moving on you had dealt with you like I have. I know you have held back. I thank you for looking at the tax cut deal.

I would like to adhere. A couple of my colleagues questioned you about the dollars reaching into the available credit. Again the consumer credit, when it reached $400 billion roughly, we were talking about a lot of money that was not being directed by the Government, because we were talking about the paper money being written by a lot of companies with the credit cards and other things that were out there.

I would like to just encourage the Fed, in general, to take time to set up time to look at it. I think we have to have a balance. That is why I said we had to look at the triggers. When the interest rates went to 20 percent, we got out of balance.

In 1973, 1968, when I was in the homebuilding business, interest rates, top money, I crawled on my stomach to survive. When we went to 20 percent on the investment capital, it really just—in the automobile business, the President came out with an automobile policy on the guaranteed loan. Really it was uncalled for if we hadn't gone so far out of kilter or out of balance.

I would just like to say, encourage, ask, plead with the Fed to look at trying to find a balance with the credit situation, the interest rates so it will not put this investment category of homebuilding, automobiles, other areas on their knee as quickly as we have done this past time.

I do think we cannot divorce credit, consumer credit, again, from the monetary policy. I don't think there is any way we can do it.

I would like to encourage you to do that. That is why I wanted to wait for these last few minutes to just encourge that and make that comment to you.

Mr. VOLCKER. I don't question your basic premise about what is going on in this credit area. It is of significance for monetary policy and money. It is just a question of whether this leads one to the idea of a direct control; I think that is the only difference we have.

Mr. WATKINS. I agree with you. Thank you.

Mr. CAVANAUGH. Mr. Volcker, on behalf of the committee I want to express our great appreciation for your tremendous indulgence and the great generosity of your time with us today.

With that, we will conclude this hearing and we are adjourned.

Mr. VOLCKER. Thank you.

[Whereupon, at 1:43 p.m., the committee was adjourned.]

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APPENDIX

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 29, 1980

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Chairman Reuss:

It is apparent to me from the questions and discussions at the recent monetary policy oversight hearing before your Committee that confusion has unfortunately arisen over the intent of the Federal Open Market Committee in characterizing monetary target ranges for 1981 only in general terms. I was, for instance, disturbed that some members of the Committee apparently seriously considered that the FOMC was somehow signaling a reluctance to provide specific numerical targets for 1981 at an appropriate time -- a thought, I can confidently say, has never entered FOMC discussion.

Our concern was quite different. We wanted to reiterate, as clearly as possible, the intent of the FOMC "to seek reduced rates of monetary expansion over coming years, consistent with a return to price stability" and the "broad agreement in the Committee that it is appropriate to plan for some further progress in 1981 toward reduction of targeted ranges." We believed then, and believe now, that those general statements are the clearest and most useful indication of intentions that we can make (and are responsive to the requirements of P.L. 95-523, the Humphrey-Hawkins Act) and we have been concerned that an attempt to set forth precise numerical ranges for each target could well prove to be ultimately a source of confusion rather than clarity. A major part of the reason is that certain institutional changes are in train or in prospect -- in particular the introduction of NOW accounts on a nationwide basis but also the possible continued development of money market funds -- that will upset "normal" relationships among the various aggregates and their relationship to economic activity. While we know these institutional changes are under way, the magnitude of their impact is (and for a time inevitably will remain) in substantial doubt. Moreover, the FOMC wished to appraise for a period of time the lasting significance, if any, of the recent short-fall in M-1 relative to economic activity.

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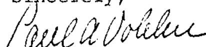
Unfortunately, our attempt to cut through the institutional uncertainty to describe the broad substance of our intent with respect to monetary growth ranges seems to be subject to misinterpretation. To attempt to clear up any misunderstanding, let me indicate that, abstracting from the institutional influences and questions cited above, the general intent of the FOMC at this time can be summarized as looking toward a reduction in ranges for M-1A, M-1B, and M-2 for 1981 on the order of 1/2 percentage point. Converting that approach into specific numerical ranges for next year requires making a number of technical judgments that involve considerable uncertainty and necessarily, at this point, a degree of arbitrariness. Specific ranges for each aggregate, and assumptions behind their derivation, are shown in the attachment to this letter.

In accordance with usual procedures, all of the ranges will have to be reassessed in or before next February. The extent of downward adjustments in the ranges not only will be influenced by the various technical factors described in the attachment, but also will be conditioned by the speed with which inflationary biases in labor and product markets can be reduced, and by the likelihood that the economy can make an orderly adaptation to curtailed money growth. The need for public policies, other than monetary policy, to move in a complementary way to speed those adjustments was, of course, the essence of my testimony before the Committee.

The appropriate performance of money growth in 1981, within the ranges adopted, relative to actual results in 1980 will also depend to some extent on the outcome this year -- on for instance, whether this year sees a very slow growth in narrow money because the public has, for one reason or another, economized sharply on cash balances.

The FOMC approaches the targeting process with a great deal of care, and is frankly concerned that changes in numerical targets, particularly once specified in detail as in the attachment to this letter, will give rise to confusion even when (perhaps particularly when!) such changes are purely in response to a technical, institutional change that has no real significance for monetary policy. But I trust this additional information will, despite those concerns, help further the greater public understanding of monetary policy that we both wish to foster.

Sincerely,



Attachment

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ATTACHMENT

DERIVATION OF SPECIFIC MONETARY
RANGES FOR 1981 ON THE BASIS OF CERTAIN ASSUMPTIONS

A number of technical judgments need to be made in deriving specific numerical monetary growth ranges for the aggregates in 1981 consistent with the intention to reduce ranges for M-1A, M-1B, and M-2 on the order of 1/2 percentage point. These include: (a) the extent to which the public will shift from demand deposits to NOW accounts next year; (b) the extent to which there will be shifts from savings accounts or other interest-bearing assets to NOW accounts; (c) the degree to which money market funds will continue their phenomenal growth (in the process drawing funds that would otherwise have flowed both through institutions whose liabilities are in M-2 and the open market); and (d) the extent to which the public will or will not tend to return to longer-run relationships between cash holdings, interest rates, and the nominal GNP -- in other words, assessment of factors affecting shifts in the public's desire over the longer run to hold money balances in relation to income.

The degree of shifting into NOW and ATS accounts will depend on the aggressiveness with which banks and other depository institutions promote the new accounts, as well as on public response. Partly on the basis of experience in various New England States it may be estimated that in 1981 shifts from demand deposits to NOW accounts could lower M-1A growth by amounts ranging from 1 to 5 percentage points. Similarly, such shifts from savings accounts could raise M-1B growth 1/2 to 2-1/2 percentage points.

If the mid-points of those ranges are taken as the best (but obviously crude) estimate available at the present time, target ranges for M-1A and M-1B would be implied of 0 to 2-1/2 percent and 5 to 7-1/2 percent, respectively. In essence, those changes represent a 1/2 point reduction in the ranges adopted for 1980 -- which are 3-1/2 to 6 percent for M-1A and 4 to 6-1/2 percent for M-1B -- but with the downward adjustment noted above for M-1A to allow for the effect of shifts into newly introduced NOW accounts from demand deposits and the upward adjustment for M-1B to allow for shifts from other assets. The target growth range for M-1A would have to be raised if shifts out of demand deposits were less than assumed, and lowered if shifts were greater. Similar reasoning would apply to the range for M-1B with regard to shifts out of savings deposits and other interest-bearing assets. The ranges for M-1A and M-1B also imply continued efforts in general by the public to economize on transactions-type cash balances.

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Consistent with a reduction in ranges on the order of '2 percentage point, the growth range for M-2 for 1981 would be -1/2 to 8-1/2 percent unless money market funds, included in M-2, re judged to be drawing substantial new amounts of funds that in he past would have been lodged in open market instruments (which re not in M-2). Consistent with the indicated M-1 and M-2 tar-ets, M-3 and bank credit ranges of growth for 1981 of 6-1/2 to -1/2 percent and 6 to 9 percent, respectively, could be the same s for 1980. Maintenance of these ranges relative to M-1 and M-2 is related to the growth in housing, business, and other credit that would be a normal accompaniment of the expected recovery in economic activity.

It should be emphasized that the relationship among the specific numerical ranges for the M-1s and M-2 are dependent at this state on necessarily rough, and somewhat arbitrary, judgments of the impact of institutional change and must be considered illustrative. These complications should not obscure the basic intent of achieving a modest further reduction in monetary growth rates next year, as the FOMC indicated earlier. That the range for M-1B next year will, in all likelihood, be higher than this year needs to be understood as no more than a technical adjustment to accommodate one-time shifts out of savings accounts in response to the introduction of NOW accounts on a nationwide basis. The reduction in M-1A is exaggerated downward for comparable reasons. The basic point is that these ranges, abstracting from such shifts, are expected to be lower than in the preceding year, and thus reflect a further curtailment of money growth.

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225-4247

July 1, 1980

The Honorable Paul A. Volcker
Chairman
Board of Governors
Federal Reserve System
Washington, D. C.

Dear Mr. Chairman:

I have no doubt that the recent turn of the economy is as disturbing to you as it is to the American public. Since January, we have entered a steep slump. Housing, autos, steel, and other basic industries are in crisis. Unemployment, already too high, is going higher. Bank lending is down sharply, signalling perhaps a retrenchment that will ensure a long recession and a slow recovery.

At the same time, inflation remains intolerably high. Inflation has dropped sharply, but past experience and the current political environment suggest that the recession has milked about as much out of the so-called "Phillips curve" as it is going to do. Significant further reductions in inflation cannot be obtained through prolonged recession. The outlook on both fronts is therefore very grim.

I do not wish to point the finger of blame at the Federal Reserve or anywhere else. Nevertheless, I have been struck by the dissonance between the notions on which recent policy has apparently been based, on one hand, and the actual course of events on the other.

For years now, the Federal Reserve, the Administration and we in Congress have labored under the belief that, properly done, monetary and fiscal policies could steer a narrow course between excessive inflation and excessive unemployment. In recent times, a particular variant of this view has predominated: that monetary policy, through careful control of the growth of the monetary aggregates, would bring down the rate of inflation slowly, while avoiding a sharp short-run contraction of output.

This Committee has led in urging that such a policy be adopted. In each of our three reports on monetary policy under the Humphrey-Hawkins law we have written, with nearly unanimous support, that the Federal Reserve should "pursue monetary restraint without precipitating recession". We have made clear that we believed control of the aggregates was the appropriate policy tool. We assumed, in short, that there did exist a feasible stable path, and that monetary policy could get us on that path if properly conducted.

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Last October 6th, the Federal Reserve made a decisive move to stable monetary control: it abandoned its federal funds target and shifted the emphasis of open market policy to control of aggregate bank reserves. The stated purpose of this change was "to support the objective of containing growth in the monetary aggregates." Monetarists applauded the move. Since then, the Federal Reserve has -- no one can seriously question -- made every effort to implement the new policy. This Committee's report of April 15, 1980 took note of this fact:

> "Control of the money aggregates was finally attained after the Federal Reserve, on October 6, started conducting daily operations by targeting reserves instead of interest rates, a change we applaud."

One cannot look at the results without dismay. Against the pressure of rapid growth in bank loans and strong inflationary pressure in the period from November through February, the Federal Reserve drove interest rates to historic levels, to the point, indeed, of financial crisis for mutual savings banks, savings and loan associations, and some large commercial banks. Monetary expansion accelerated nevertheless. Still more severe measures were applied in March. Monetary expansion halted as the economy collapsed underneath. Then, as the economy tumbled, inflation tumbled rapidly toward, but not below, the high levels of last year.

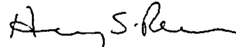
The failure of monetary policy to control expansion of the aggregates from November to February contradicted our expectation that a policy of steady deceleration could be implemented in the face of a strong surge of inflationary credit demand. The sharp slump of March to May contradicted our expectation that a policy of steady deceleration could avert recession.

I am not suggesting a change in monetary strategy at this time. The appropriate policy in a slump is to provide liquidity to the economy, letting interest rates fall where they may. This objective is well-served by a policy of attempting to stabilize money growth.

But the experience of recent months demonstrates that monetary and fiscal policies alone cannot by themselves offset the present instability of our domestic and international economic affairs. We need urgently to develop comprehensive stabilization policies, including an industries policy to revive our industrial base and re-establish competitiveness in world markets, and an incomes policy to get our underlying rate of inflation under control. Restrained monetary expansion is a necessary but wholly insufficient tool.

I would appreciate your thoughts on this at our hearing July 23.

Sincerely,



Henry S. Reuss
Chairman

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PAUL A. VOLCKER
CHAIRMAN

July 21, 1980

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairman Reuss:

I have read your letter about the silver situation and related transactions very carefully and share many of the concerns that are reflected in it. Even several months after the event, I am not certain that all of the facts of the situation are known. It is clear that the Hunts and related interests had accumulated massive positions in silver and that as a result of this and other circumstances, a series of difficulties and problems emerged, as broadly reviewed in your letter. But while the general outline of the train of events can be identified, the complexity of the relationships among the many participants, and those who financed them--whether brokers, banks or other interests--makes it extremely difficult, if not impossible, to identify all of the elements, contributing forces, and motivation of the participants.

Before commenting on the specific questions that you have raised, there are several aspects of the silver situation that I would like to clarify.

In your letter you referred to reports that an earlier loan to the Placid Oil Company may have been related to the silver situation. It is true that Placid did negotiate a bank credit line for $450 million in the fall, but we have looked into this and I am satisfied that the proceeds were used for normal business operations. Our best estimate of the extent of Placid financing of the silver activity of the Hunts prior to the initial restructuring of the Hunt indebtedness is still $115 million.

One area of concern has been the extent to which bank financing was used on the upside of the silver market in the fall of 1979 and early 1980.

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In our "Interim Report" we indicated that "bank credit was not a major factor in connection with the acquisition or maintenance of silver positions by Hunt and Hunt-related interests during this period." Considering the size of the Hunt positions, that remains a fair assessment. However, on the basis of our continuing investigations, we now know that the timing of credits in the amount of $150 million to Hunt interests occurred in the fall of 1979 rather than in early 1980 as we had previously thought. The loans in question were committed prior to October 6. We are also now aware of approximately $50 million in credits to the Hunts from brokers on the upside of the market that were financed by bank borrowings. Furthermore, it also appears that others on the short side during this interval may have been forced to rely on bank lines to meet variation margin calls. We are still looking into this.

There is a reference in your letter to the Commodity Futures Trading Commission report that we were alerted to the presence of potentially troublesome speculative concentrations in September 1979. Because of press reports and market rumors of irregularities in the silver market, and because of the potential damaging impact on inflationary expectations and on inflation of a renewed outburst of speculatively driven price increases in precious metals, I initiated inquiries with the CFTC about developments in the precious metals markets in September and again in December, in the latter instance with emphasis on the silver situation. In the course of those discussions no information other than that generally available was provided. I later learned that other inquiries of a very general nature were made by the CFTC staff about our interest in silver market developments but these were not brought to my attention. At no time prior to March 26 did the CFTC inform the Federal Reserve as to the extent of the emerging problem.

As to the first of your specific questions, none of the banks involved in lending to the Hunts or their brokers consulted with us during the fall of 1979 or early 1980 about the loans that they made. The vast majority of the loans were, of course, made

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prior to March 14. Thus, the operative Federal Reserve guideline was my October 6, 1979, request that banks avoid making "speculative" loans. That request was in the form of "moral suasion" and did not have the force of regulation, law or even formal reporting requirements. Basically, the subsequent explanations given by the banks operating in the United States fell into three (sometimes overlapping) categories. First, in some instances the banks pointed out that the loans were made under lines of credit that were committed prior to October 6, 1979. Second, in other instances the lending banks have indicated that they were unaware of the fact that the loan proceeds were being used to finance unhedged positions in silver by the Hunt interests. Finally, other lenders clearly viewed the credits as "damage control" loans which were not of a speculative nature, in part because the proceeds were not being used to acquire additional silver.

Your second question concerned bank reporting under the Special Credit Restraint Program of extensions of credit to Hunt interests. In the March reports received in mid-April, three of the largest lenders did acknowledge the loans in question, describing them in detail (without, of course, identifying the loans by customer name) citing earlier commitments or refinancing. None of the other banks acknowledged their lending activity in this area. In retrospect and after further discussion with the banks, their failure to report may, at least in part, be related to the inherent ambiguities in defining speculative activity. In addition, I should mention that the detailed reporting under the Special Credit Restraint Program focused on commercial and industrial lending. Consequently, some banks, rightly classifying loans to the Hunts in other categories, may knowingly or unknowingly have omitted reporting on the technical grounds they were not "commercial" loans. In that sense, the nature of the detailed reporting forms contributed to the error. Given all of the publicity about the silver situation and the Special Credit Restraint Program, one might nonetheless have expected the institutions to err on the side of reporting rather than non-reporting.

In this connection, your third question related to the steps we were taking to insure that we have better and more timely information at our disposal in regard to the behavior of banks in financing speculative activity. The question is both relevant and difficult--difficult because speculative lending permits no easy definition. We are working along a number of lines. We are exploring modifications in our regular reports on bank lending with a view toward singling out categories of loans more apt to be associated with "speculative" activity--i.e., those on commodities. I must emphasize that this is not an easy task since there is no simple category that can be described to blanket "speculative" lending, much less identifying the kind of speculation that is of specific concern. I have also asked

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the bank examinations staff to look into what further changes in bank examination procedures could be made to assist in identifying and discouraging damaging speculative activity. I expect that effort will, in the near future, result in the submission to the Federal Financial Institutions Examination Council of new guidelines, procedures and instructions that will focus more attention on this area in the examination process.

Potentially much more important, we are looking into the larger issues involved by way of various studies--in cooperation with the Treasury, the SEC and the CFTC--on "financial futures" and related markets. In our work so far, it is clear that in attempting to guard against a repetition of the recent silver situation, bank surveillance and restraint alone, however diligent, are not sufficient. Apart from the definitional problems, it appears that the amount of bank credit supporting the Hunts on the upside of the market was relatively small. The procedures and rules of the organized exchanges may well have to be modified to reduce the risks of individuals or groups obtaining significant speculative positions capable of disrupting the orderly functioning of those markets.

In your fourth and fifth questions, you asked about the relationships between the banks and the Hunts. In the case of the largest lenders, there were long standing relationships with the Hunts and/or Hunt-related companies for financing in a wide variety of business areas. Past lending typically was well secured. There is no evidence that the banks involved had assumed, from their point of view, more than normal banking risks. We have also noted that at the time most of the silver loans were made, there were sizeable margins of excess collateral, and as is illustrated by the ability of the Hunts to restructure their loans, they had and have assets of their own, and of related companies and family-owned trusts, of considerable size. It is not at all clear that the banks individually knew the extent to which the Hunts' wealth was tied up with silver and it is possible that this might have influenced their lending judgment.

In your last two questions you expressed concern about the relationship of the banks with the brokers. Our study of broker financing arrangements is still incomplete; however, we do know that the vast majority of the bank loans to brokers, the proceeds of which were in turn made available to the Hunts, were made under long-standing credit lines and banking relationships. Indeed, under usual conditions, brokers utilize standing bank credit lines and the distribution of broker extended credit to customers would not be of concern to the bank on a day-by-day basis. However, in retrospect it does appear that some of the banks were not as diligent as they might have been concerning the

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precise utilization of the funds. I would emphasize, however, that the matter of broker financing in the silver market is one of the more complex areas of this whole episode and is still under study.

While I share your concern in general about the role that bank credit may have played in the silver episode, that credit appears to have been a minor part of the financing that allowed the Hunts to increase their positions on the upside of the market. Moreover, no one would, of course, argue that speculation does not have a legitimate and important economic role in the proper functioning of the commodity markets. But clearly there are potentials for market manipulation and the development of speculative fervor that can be exacerbated by excessive extensions of credit. While only a portion of that credit--and perhaps typically a small proportion--is provided by the banks, as I indicated earlier, steps are being taken to improve our surveillance capabilities. More importantly, our study of the broader relationships and functioning of the "financial futures" and related markets will provide the basis for determining the nature and extent of regulatory or legislative actions that are necessary to discourage these speculative episodes.

I look forward to working with you as we move toward the most effective solution to this problem.

Sincerely,

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225-4247

June 12, 1980

The Honorable Paul A. Volcker
Chairman
Board of Governors
Federal Reserve System
Washington, D.C.

Dear Chairman Volcker:

The silver bubble that burst on March 26-27 put the Federal Reserve's Special Credit Restraint Program to an early and severe test. Now that the initial excitement has abated it is time, I believe, for a thorough appraisal of the actions that the Federal Reserve took during the crisis, and of the effectiveness of current procedures and policies in meeting and thwarting speculative outrages in the future. The Federal Reserve has made a significant contribution to such an appraisal already, both in your testimony of April 30 to the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Government Operations Committee, and in the "Interim Report" on silver that was released on May 23. Nevertheless important questions remain. I am taking this opportunity to set out my initial questions; after receiving your written response I will look forward to taking up the matter with you at the Banking Committee's hearings on the conduct of monetary policy next July.

As you know, silver prices rose sharply over the last six months of 1979, peaking near $50 per ounce in the third week of January, 1980. In the nature of futures trading, the position of the Hunts during this initial period of increasing prices was financed without bank credit. After the week of January 18, prices subsided to about $33 per ounce, and remained at about that level until the end of the first week in March. Thirty-three dollars represented the highest price at which the Hunts had purchased silver futures. However, in early February higher margin requirements forced the Hunts to borrow $350 million from U.S. banks to maintain their positions at that price.

Then prices fell, from about $33 on March 7 to about $17 on March 17, with the biggest drops on March 10 and March 13-17. The Hunts were hit with large margin calls, and were forced again to borrow from their banks and their brokers in order to meet them -- about $250 million according to the "Interim Report". According to your testimony of April

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30, 1980, and according to the "Interim Report", the Hunts borrowed at least $800 million from domestic banks in February and March. This included $233 million from Bache Halsey Stuart Metals Co., which was financed by ten large banks: First National of Oklahoma City, U.S. Trust, Northern Trust, Irving Trust, Bankers Trust, First National of Chicago, Marine Midland, Harris Trust, Barclay's, and Citizen and Southern. In addition, there were direct loans to the Hunts from foreign and domestic banks, loans through Placid Oil Company, placed at $115 million by the Federal Reserve and at $400 million by the Economist magazine, direct broker loans, indirect loans by foreign and domestic banks through other brokers, and indirect loans through the International Metals Investment Co., Ltd., as detailed in the "Interim Report".

These loans temporarily rescued the Hunts' silver speculation. They helped forestall the liquidation of the Hunts' silver futures positions, and hence helped sustain the silver price. The loans through Bache, plus some of the direct U.S. and foreign bank loans, and most of the indirect foreign bank loans, the direct broker loans and the IMIC loans were collateralized with silver bullion, and hence clearly depended for their continued viability on the success of the rescue operation. These silver bars constitute a "smoking revolver" pointing to guilty participation in silver speculation. The temporary effect of these loans can perhaps be seen in the rise of the silver price from $17 to $20 on March 19.

On March 26-27 this round of speculation collapsed. Silver spot futures prices on the COMEX fell from $20.20 on the 25th to $10.80 on the 27th. The Hunts were hit with further margin calls which they could not meet, forcing liquidation of their silver futures positions, and the value of the silver bullion posted as collateral for the first-round speculative bail-out declined sharply, forcing the Hunts to seek a restructuring of their debts. The eventual result was the negotiation of a $1.1 billion loan to a partnership consisting of Placid Oil Company and the three Hunt brothers, about which you were questioned intensively on April 30, and which the "Interim Report" describes and defends in detail.

The April restructuring through Placid Oil was, as you have testified, a recuperative effort rather than a new speculation -- a bail-out of the banks rather than of the Hunts. It is extremely important, of course, that it be done in a way that ensures the orderly liquidation of the Hunts' silver holdings and that precludes further speculation of any kind by the Hunts. Recent press reports have cast some doubt on whether this has been achieved. I hope that you will be able to assure me that it has. But beyond this necessary rearguard action, few significant issues of public policy have so far been posed by the efforts since March 30 to dig out from under the silver collapse.

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Far more serious, it would appear, was the readiness with which the banks and brokers rushed in to validate and sustain the Hunts' futures positions in the first, and undeniably speculative, round of lending. Placid Oil began to build up liquidity for an eventual rescue in November; the syndicate which lent to Bache made its commitments in March. As noted above, nearly $800 million, or 8.6 percent of lending by the nation's 14,000 banks and 12.9 percent of all bank business lending, flowed to the Hunts against silver in February and March. This, at a time when general credit conditions were very tight and when lending for small business, housing, consumers, farmers, and productive capital investment was being severely squeezed.

These loans were made despite the Federal Reserve's vigorous campaign against bank lending for speculative purposes, which have been in full swing since October. On October 6th, the Federal Reserve had imposed marginal reserve requirements on managed liabilities of member banks, stating,

> The purpose of this action is to better control the expansion of bank credit, help curb speculative excesses in financial, foreign exchange and commodity markets and thereby serve to dampen inflationary forces.

On October 10th and October 23rd, the Federal Reserve Board circulated letters to the chief executive officers of member banks, specifically requesting that they refrain from extending loans for speculative purposes. On October 10th, for instance, you wrote,

> ...the Board of Governors has stressed its particular concern that banks should take care to avoid financing essentially speculative transactions in commodity, gold, and foreign exchange markets. I have no doubt that your bank knows what loans best serve the continuing needs of your business and personal customers and of the nation.

On October 17th, in addition, you testified as follows to the Joint Economic Committee:

> ...our immediate objective is to forestall speculative excesses and anticipations of a new inflationary outburst that could only complicate, and ultimately make more severe, the process of economic adjustment that is underway. ...In that connection, we have asked the banks to take special care to avoid lending to support speculative activity, while giving particular attention to the continuing needs of their established customers for funds to maintain normal business operations. ...

These warnings were repeated with increasing vigor throughout the fall and winter, culminating in the Special Credit Restraint Program which was announced on March 14th and which required large banks to report all new loans for speculative purposes to the Federal Reserve.

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The Federal Reserve's attitude toward speculative lending was clear and unambiguous. Nevertheless, untold number of large banks went ahead with loans in huge amounts to rescue two of the largest speculators of all time. Why?

The procedures employed by the Federal Reserve to monitor commodity speculation were, and are, plainly inadequate. A major upgrading of your oversight function in this area is urgently required.

According to the records of the Commodity Futures Trading Commission, the Federal Reserve was first alerted to the presence of potentially troublesome speculative concentrations on the long side of the silver market in September 1979. As you testified on April 30, 1980 the Federal Reserve monitored the silver market "as part of our normal economic intelligence throughout the fall and winter." The "Interim Report" states that the Federal Reserve did consult with the Commodity Futures Trading Commission over the fall and winter.

Yet, it seems that the entire first round of bank loans to rescue the Hunts occurred without the Federal Reserve's knowledge. The "Interim Report" states that in February and March "the Federal Reserve had no direct knowledge of the size of the Hunt positions or of the fact that they were financing margin calls by borrowings of any kind." In your testimony of April 30 you stated that "the first indication of ... any potentially serious financial consequences arising from the sharp fall of the silver price" occurred at midday on March 26, and that prior to that time you had "no knowledge ... of any bank lending against silver."

By March 26, the banks had already lent the Hunts over $800 million -- nearly 13 percent of all bank business lending -- to shore up their positions, collateralized in large part by silver bullion. The fact that the Federal Reserve did not know this, either from its examiners, from its regular monitoring of events in the financial and commodity markets, or from the banks themselves, suggests something is seriously wrong with your market intelligence. Moreover, it would appear that the Federal Reserve does not have the independent early-warning capability that would enable it to predict such crises, and has not secured the kind of voluntary cooperation from bankers that would make up for this deficiency. Finally, it would appear very doubtful that the reporting requirements of the Special Credit Restraint Program effectively enable the Federal Reserve to monitor and discourage such speculative episodes.

My specific questions follow. First, with respect to the Federal Reserve's market surveillance capability:

1) Did any of the banks involved at any time before March 26 attempt to consult with the Federal Reserve at the time of the initial loans to ensure that such loans would not put them out of

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compliance with the Federal Reserve's directives of October or with the Special Credit Restraint Program? If so, what responses were they given? If not, what explanation do they now give for their behavior?

2) Did all of the banks involved directly or indirectly in the speculative extension of credit to the Hunts in March so report under the Special Credit Restraint Program? If not, was their failure to do so a dereliction on their part, or could the Program have been construed as not requiring such reports? At what time did information from the Special Credit Restraint Program become available to permit assessment of the degree of speculative lending?

3) What steps have been taken to assure that any new speculative loans will be brought rapidly to the Federal Reserve's attention? Specifically,

a) What steps have been taken to provide the Federal Reserve with early warning of a massive raid on the nation's credit markets such as that mounted in February and March by the Hunts?

b) What steps have been taken to assure that the reports required under the Special Credit Restraint Program are sufficient to require a full accounting of speculative activity by banks, and hence to deter banks from such activity?

Vigorous and effective surveillance is necessary but not sufficient. So long as high rollers like the Hunts and their brokers can write themselves their own loans at the bank, we will continue to face the danger of a new outbreak of speculative fever. Therefore I request that you address yourself to the following questions.

4) Were the direct loans from the banks to the Hunts part of an established relationship between the banks and the Hunts? Did the banks ask for and get from the Hunts a full and accurate account of the use to which the funds were to be put? Were the Hunts treated any differently by the banks in this respect than ordinary personal borrowers? In light of the Federal Reserve's October directives, did the banks make any special effort to ascertain whether the funds sought were part of a speculative venture? If not, why not?

5) If there was a special relationship between the Hunts and their banks, what steps has the Federal Reserve taken to discourage banks from permitting large customers to abuse such relationships as the Hunts did? If there was no special relationship, why were the loans made?

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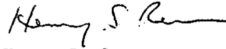
6) Were the loans that went through the brokers part of an established relationship between the banks and the brokers? Did the banks ask for and get a full and accurate account of the use to which the money was to be put, including the fact that the ultimate exposure was to the Hunts? Were the brokers treated any differently from ordinary business borrowers in this respect?

7) If the banks and the brokers did have a cozy no-questions-asked relationship, what steps is the Federal Reserve taking to curb such potentially explosive speculative ties? Again, if there was no such relationship, why were the loans made?

I look forward to your response, and to the July 23 hearing.

Sincerely,



Henry S. Reuss
Chairman

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 17, 1980

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Chairman Reuss:

As earlier promised, I am enclosing a detailed staff study of the data we collect on interest rates charged on short-term business lending by banks over recent years.

The study clearly indicates that much of the explanation for the phenomenon you noted of larger volumes of "below prime" lending at New York City and other large banks during recent quarters can be explained by very large loans of very short maturity. The share of those loans in banks' lending activity has increased in recent years as large banks have competed more actively with the open market -- particularly the commercial paper market -- to accommodate the very short-term financing requirements of businesses; and interest rates on such loans are therefore very closely related to money market rates. This approach, dating back at least to 1977, was initially developed to provide customers using commercial paper with transitional facilities to bridge gaps of a few days in commercial paper issuance.

Thus, the bulk of below-prime business at large banks is related to a special market that does not involve smaller loans or indeed large loans with maturities of more than a few days or weeks. After allowing for this factor, experience among banks of different size is much more comparable. Because these particular below-prime loans have such short maturity, their relative position in banks' portfolios is, of course, much less than would be indicated by their share in the volume of new extensions over any time interval.

I believe it is reasonable to, in effect, adjust the data for this activity with large borrowers -- borrowers which, in any event, have access to the commercial paper market. The question remains as to the situation with respect to more usual

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loans extending over longer periods. The study does not clearly indicate a more favored position for large borrowers in the market for credit at maturities that are more typically relied upon by both large and small borrowers. In fact, the average cost of short-term business loans maturing in more than a month has risen more for large loans than for small loans over the last three years, and at the peak rate period, rates for large loans appear to have exceeded those for small.

Analysis of these data is necessarily obscured by lack of information about precisely how many loans, and their distribution by size, during rising rate periods may have been made under pre-existing commitments having interest rate "caps." However, the data appear consistent with other indications that special loan programs for smaller businesses were one factor in moderating increases for those borrowers during periods of peak rates.

In sum, the data you cited in your letter do not themselves appear to justify sweeping charges of discrimination against particular groups of borrowers. A more subtle question that cannot be conclusively answered on the basis of available data remains as to whether the prime rate is somewhat less indicative of the minimum rate on the "best" ordinary business loans (i.e., those of more than a few days or weeks maturity) than the nomenclature implies. Moreover, I would note a lag in a reduction of the prime rate relative to short-term market rates may work in some instances to the relative disadvantage of customers that do not have access to the open market for large short-term business credit.

Sincerely yours,

Enclosure

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July, 1980

Short-term Business Lending at Rates
Below the Prime Rate*

I. Introduction and Summary

The cost of business credit, and interest rates generally, increased throughout most of the period from 1977 through 1979 and continued to rise until the spring of 1980, reflecting the underlying strength of demands for funds, boosted by accelerating inflation, and the efforts of the Federal Reserve to restrain monetary growth. As is illustrated in chart 1, however, quarterly survey data indicate that the average rate on new short-term business loans has increased less than the prime rate since early 1977, while the prime rate itself--with the exception of the second quarter of 1980--generally has stayed about 3/4 to 1-1/4 percentage points above the commercial paper rate.[1/] In part, the relatively slower rise in the average cost of short-term bank business credit reflects a growing volume of short-term bank loans made at rates below the prime rate. Below prime lending initially became significant at money center banks, where the spread between the average rate on these loans and the prime rate averaged

* Prepared by the staff of the Board of Governors of the Federal Reserve System.

1/ Beginning in the early 1970s, large banks began explicitly to link their prime rates to money market rates. Citibank, which introduced this practice, employs a formula that calls for a prime rate determined by a markup over a three week average of money market rates. From mid-1973 through 1978 the money market rate used was a measure of alternative costs of credit, the 90-day commercial paper rate. Since 1979, the markup has been over a measure of the bank's cost of funds, the 90-day certificate of deposit rate. The practice has been to review the formula weekly and, generally, to adhere to it. As money market rates plunged in the spring of this year, however, banks abandoned such formulas, and the prime rate recently has declined comparatively slowly. As a result, an unprecedented gap has opened between the prime rate and money market rates.

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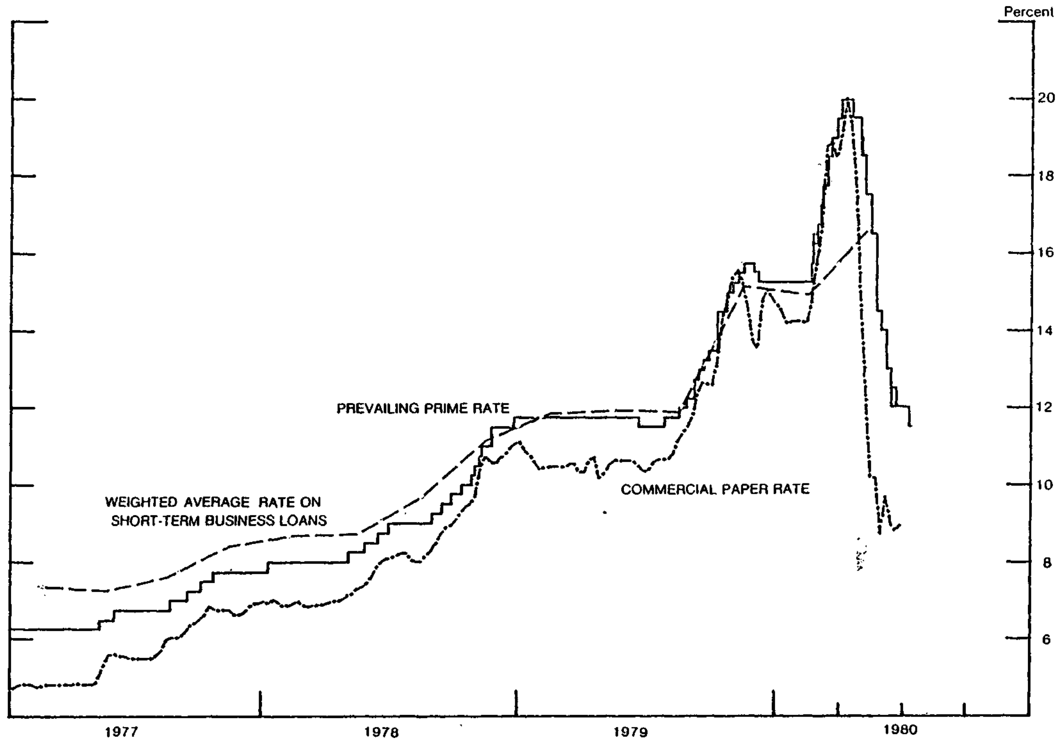
Chart 1

Selected Measures of the Cost of Short-term Credit



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between about one-half and one percentage point over the years 1977-1979. This spread widened in 1980 (see table 1). High percentages of short-term loan extensions at rates below prime also have developed at medium and smaller banks, generally at somewhat larger spreads below prime than at large banks.

Below prime lending at large money center banks mainly represents very large extensions of credit for very short periods at rates linked to money market rates.1/2/ At large non-money center banks and at medium sized and smaller banks, below prime lending appears primarily to reflect several other factors, including two-tier lending programs favoring small businesses (which may also explain some of the below prime lending at money center banks), the lesser reliance of many smaller banks on large denomination CDs and other relatively costly purchased funds, and the interaction of rising interest rates with the presence of cap provisions on the larger share of below prime loans extended under commitment at these banks.3/ Despite the growth of below prime lending and the relatively restrained increase in the overall cost of bank credit in recent years, the commercial bank share of outstanding short- and intermediate-term credit--comprising all business loans at commercial banks, commercial paper issued by nonfinancial businesses, business loans at finance companies, and bankers acceptances held outside banks--declined from 70 percent at the end of 1976 to 66-1/2 percent at the end of 1979.

1/ Below prime lending also has been examined in "Changes in Bank Lending Practices, 1977-79," Federal Reserve Bulletin, October 1979, pp. 797-815, and in P. Boltz and T. Campbell, "Innovations in Bank Loan Contracting: Some Recent Evidence," Staff study, Board of Governors of the Federal Reserve System.
2/ Since the prime rate is a measure of the cost of short-term credit, this report focuses on the relation between the prime rate and rates on short-term (one-year-and-under) bank loans.
3/ Also included in loans made at rates below prime at all sizes of banks is an unknown, but probably quite small, volume of "restructured" loans that have been renewed at reduced rates in order to prevent default.

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Table 1

Short-term Business Lending Below the Prevailing Prime Rate By Selected Classes of Banks 1/

Class of bank	Percent of Gross Loan Extensions Made at Rates Below Prime					Spread Between Prime Rate and Weighted Average Rate on Loans Made Below Prime (basis points)				
				1980p					1980p	
	1977	1978	1979	Feb.	May	1977	1978	1979	Feb.	May
48 Large	8.8	16.1	32.6	50.0	58.8	79	62	92	123	414
13 Money Center	12.2	17.5	38.3	55.2	67.5	77	67	84	116	431
Large Non-money Center	4.2	14.5	22.7	40.5	31.8	95	53	114	142	309
Large New York City	15.7	22.6	43.3	67.0	67.0	69	68	88	118	419
Large Non-NYC	3.5	11.1	22.0	31.5	51.7	111	57	97	134	410
Medium and Smaller	3.0	10.5	33.4	32.8 (15.2) 2/	43.3 (26.8) 2/	87	82	162	220 (211) 2/	245 (247) 2/

p--preliminary

NOTE: Annual data are averages for the four survey weeks in each year.

1/ Short-term loans have a maturity of one year or less. The prevailing prime is that posted at a majority of 31 large banks.

2/ Calculated using actual prime rates posted by respondent banks on survey dates. This information became available beginning with the August 1979 survey. With the exception of May 1980, at 48 large banks actual primes do not differ from the prevailing prime. For calculations using actual May primes, see appendix table 1.

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Survey data indicate that substantial volumes of gross loan extensions at rates below prime appeared earlier and have remained more important at large money center banks. However, the volume of below prime lending reported by money center banks is importantly influenced by the very short average maturity of these loans. When this factor is taken into account, there is nothing to suggest that the share of portfolios accounted for by loans made at rates below prime differs substantially between money center banks and other banks. Finally, an examination of average rates paid on loans of various sizes indicates that rates on small loans rose less than rates on large loans between early 1977 and early 1980. In fact, rates on small loans were actually below those on very large loans in late 1979 and early 1980. To the extent that size of borrower can be inferred from relative size of loan, these findings suggest that, in the recent environment of very rapid increases in nominal interest rates, the average cost of credit to smaller borrowers has at times been below the average cost to larger borrowers.

The survey data analyzed in this report provide information on several characteristics of loans made by respondent banks during the first full week of the middle month of each quarter. A sample of 340 banks--selected to represent all insured banks--reports the size of each loan (including renewals) made during this period, its term to maturity, its commitment status, the interest rate charged and whether the rate is fixed or floating. Beginning with the August 1979 survey, banks also report their prime rate in effect on the survey dates.[1/] Reported interest rates on loans may be affected

1/ Data are from the Survey of Terms of Bank Lending (STBL). Forty eight large banks report all loans made on certain specified days of the survey week, while other respondents report all loans made on all days of the survey week. The STBL is described in detail in the May 1977 Federal Reserve Bulletin, pp. 442-445.

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by a variety of unmeasured factors--for example, the presence and size of compensating balances, the nature of the collateral if the loan is secured, and other dealings between the bank and the borrower, such as cash management services. Thus, survey rates may not accurately measure the overall cost of the credit extended. Nevertheless, the survey does provide a fairly comprehensive, regularly collected series on bank lending terms, and the general trends that it reveals appear to be broadly reflective of bank lending developments.

II. Below Prime Lending at 48 Large Banks[1/]

As shown in table 2, the volume of short-term business loans extended at rates below prime by 48 large banks, expressed as a percentage of their total short-term business loans extended, has been rising since 1977, roughly doubling in 1978, 1979, and 1980. Typically, loans made below prime by these banks are far larger than their loans made at or above prime--on the order of 5 to 10 times as large--and have considerably shorter maturities--well under a month, on average, compared to 2 to 2-1/2 months for other loans. These size and maturity characteristics of below prime loans at large banks primarily reflect lending activities at money center banks (compare tables 3 and 4.)

In most survey weeks, almost all below prime lending at money center banks has been done at rates above money market rates. Lending at rates tied to the money market had its genesis at agencies and branches of foreign banks, which began around 1977 to make credit available at a markup over the LIBOR rate. Below prime lending at large money center banks appears to be aimed at countering both this development and competitive inroads also being

1/ As of December 31, 1979, the average assets of the 48 large banks were $10-1/2 billion, and the smallest of these was $2 billion. For all insured banks on that date, assets averaged $97 million.

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Table 2

Selected Characteristics of Gross
Short-term C&I Loans Extended by 48 Large Banks

	1977				1978				1979				1980^p	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
Percentage of gross loan extensions accounted for by loans made at														
rates below prime	8.0	4.3	13.6	9.3	15.4	13.2	16.0	19.8	34.2	39.8	37.5	18.7	50.0	58.8
rates below money market rates 1/	.9	.2	.7	.2	.4	.2	.1	3.7	2.8	1.8	.8	5.6	1.1	.7
rates below prime and not under commitment	6.6	2.6	10.6	5.6	9.1	7.6	8.6	10.6	20.8	23.5	24.8	12.6	27.6	24.9
Average maturity (months)														
- Loans above prime	2.1	1.8	2.4	2.2	2.3	2.1	2.3	2.5	2.6	2.7	2.2	2.1	2.3	2.5
- Loans below prime	.8	.7	1.5	1.0	.7	.4	.7	2.0	1.1	.7	.9	1.1	.5	.9
Average size ($1,000)														
- Loans above prime	141	167	166	162	145	186	153	206	138	184	202	361	227	208
- Loans below prime	2,385	1,724	1,958	731	1,229	1,445	421	343	534	994	1,011	237	1,115	1,233

p--preliminary

NOTE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

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Table 4

Selected Characteristics of Gross
Short-term C&I Loans Extended by Large Non-Money Center Banks

	1977				1978				1979				1980p	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
ercentage of gross loan xtensions accounted for y loans made at														
rates below prime	3.4	3.9	1.5	7.9	10.0	14.8	10.6	22.5	24.2	35.1	22.8	8.8	40.5	31.8
rates below money market rates 1/	.0	.0	.5	.3	.1	.4	.1	4.3	2.1	1.5	.9	2.9	2.6	1.2
rates below prime and not under commitment	.1	.5	1.0	4.4	6.5	6.2	3.5	13.8	9.1	12.8	10.8	2.2	16.9	9.9
verage maturity (months)														
Loans above prime	1.9	1.7	2.8	2.4	2.3	2.3	2.4	2.7	2.4	2.7	2.5	2.6	2.1	2.7
Loans below prime	.1	.9	4.0	1.3	.8	.5	.7	2.9	1.3	.7	1.2	1.6	.6	1.1
verage size ($1,000)														
Loans above prime	110	142	142	132	116	125	128	134	126	132	140	225	184	154
Loans below prime	540	1,152	170	492	476	900	158	240	269	540	338	64	437	274

--preliminary

OTE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

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Table 3

Selected Characteristics of Gross
Short-term C&I Loans Extended by 13 Money Center Banks

	1977				1978				1979				1980p	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
Percentage of gross loan extensions accounted for by loans made at														
- rates below prime	11.1	4.7	22.6	10.6	19.5	12.1	20.6	17.8	42.3	42.4	44.7	24.0	55.2	67.5
- rates below money market rates 1/	1.6	.5	1.0	.1	.0	.0	.1	3.2	3.3	1.9	.8	7.1	.3	.5
- rates below prime and not under commitment	11.1	4.7	17.7	6.8	11.1	8.5	12.9	8.1	30.1	29.5	31.6	17.5	33.5	29.8
Average maturity (months)														
- Loans above prime	2.3	1.9	2.0	1.9	2.4	2.0	2.2	2.3	2.7	2.7	1.9	1.7	2.4	2.4
- Loans below prime	.9	.5	1.4	.7	.6	.4	.6	1.0	1.0	.7	.9	1.0	.5	.9
Average size ($1,000)														
- Loans above prime	179	200	199	215	183	277	188	336	153	246	290	585	273	270
- Loans below prime	8,936	2,907	4,022	1,176	3,197	2,940	1,488	581	971	1,634	2,015	498	2,981	2,628

p--preliminary

NOTE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

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made by the commercial paper market and finance companies. In 1977, Morgan Guaranty announced a "commercial paper adjustment facility" designed to provide large sums of credit for very short periods (usually no more than 10 days) to those of its customers having lines of credit used to secure borrowings in the commercial paper market. Similar credit facilities also were made available by other large banks. These programs were designed to allow customers to adjust the timing of their paper issuance in order to obtain the best terms possible. The price of these funds is set at a markup over their cost to the bank, typically as measured by the federal funds rate. Reports suggest that very short-term credit is also available in large volume at rates marked up over the commercial paper rate itself.

The market for such short-term below prime loans is described as very impersonal, with no sense of loyalty between lender and borrower. Money center banks make the funds available only if they cannot be more profitably employed elsewhere, while borrowers tend to "shop around" from bank to bank, and in the commercial paper market itself, in search of the cheapest source of credit. Generally less than a third of below prime lending at money center banks is done under commitment.

The importance of this type of lending by money center banks is illustrated by declines in the relative volume of their below prime lending when money market rates approach the prime rate, as happened in the fall of 1978 and again a year later (see chart 1). The surveys of November 1978 and November 1979 show sharp declines in the percent of loans made at rates below prime at money center banks. Moreover, about a quarter of the below prime loan made by these banks during these periods were priced below money market rates. Apparently, many of the "below prime" loans made

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Table 5

Selected Characteristics of Gross
Short-term C&I Loans Extended by Large NYC Banks

	1977				1978				1979				1980P	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
ercentage of gross loan xtensions accounted for y loans made at														
rates below prime	14.0	7.7	26.6	14.4	24.7	20.5	25.9	19.1	50.9	49.0	46.9	26.5	67.0	67.0
rates below money market rates 1/	.0	.5	1.2	.0	.0	.0	.1	4.5	2.3	2.2	1.0	9.4	.2	.4
rates below prime and not under commitment	14.0	5.2	21.0	8.9	21.0	14.1	14.8	13.8	38.4	33.1	38.1	20.5	46.4	45.0
Average maturity (months)														
Loans above prime	1.3	1.3	1.8	1.3	1.7	1.5	1.8	1.6	1.5	2.2	1.5	1.6	1.7	2.2
Loans below prime	1.1	.7	1.4	.6	.5	.3	.3	.8	.9	.6	.8	.9	.4	.9
Average size ($1,000)														
Loans above prime	231	284	261	251	300	310	269	329	182	347	365	535	338	310
Loans below prime	10,760	4,622	4,428	2,061	3,752	3,657	607	641	1,229	2,581	2,045	1,087	4,054	2,181

p--preliminary

NOTE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

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Table 6

Selected Characteristics of Gross
Short-term C&I Loans Extended by Large Non-NYC Banks

	1977				1978				1979				1980P	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
ercentage of gross loan xtensions accounted for y loans made at														
rates below prime	4.0	1.5	1.8	6.6	8.7	7.2	8.4	20.3	22.0	28.6	25.0	12.1	31.5	51.7
rates below money market rates 1/	1.5	.0	.4	.3	.1	.3	.1	3.2	3.1	1.2	.5	2.4	2.1	.9
rates below prime and not under commitment	1.8	.5	1.2	3.8	.5	2.3	4.0	8.6	7.9	11.9	7.0	5.1	7.1	7.6
verage maturity (months)														
Loans above prime	2.6	2.2	2.8	2.6	2.7	2.6	2.6	3.0	3.0	3.1	2.9	2.4	2.6	2.8
Loans below prime	.1	.8	2.9	1.4	1.1	.6	1.4	2.6	1.6	.9	1.4	1.5	.8	1.0
verage size ($1,000)														
Loans above prime	115	127	134	139	110	145	121	169	124	131	142	293	193	173
Loans below prime	863	468	234	421	513	601	245	272	273	437	447	97	416	828

--preliminary

OTE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

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by money center banks in November 1978 and November 1979 reflect the honoring of previous loan commitments featuring cap provisions, as the prime rate had been rising rapidly prior to both of these surveys.

At large non-money center banks (table 4), the average size of loans made below prime is only somewhat larger than other loans, and loans generally are much smaller than at money center banks. In addition, the disparity between the maturities of loans made below prime and those made at or above prime by these banks generally is not as pronounced as at money center banks. Finally, the share of below prime loans made under commitment is larger at large non-money center banks than at money center banks.[1/]

III. Medium and Smaller Banks

Below prime lending at medium sized and smaller banks has been substantial in all the surveys since November 1978. In contrast to the situation at large banks, a significant part of below prime lending at these other banks has been done below money market rates (see table 7). This pricing appears to reflect the tendency for loan rates at smaller banks, particularly on smaller loans, to adjust to general upward rate pressures much more slowly than the prevailing prime rate and other money market rates. In part, this sluggishness may arise from cap provisions on the larger share of below prime loans made under commitment by these banks. Increases in the proportion of loans made at rates below prime by medium and smaller banks in November 1978 and November 1979, for example, were likely due in part to the sharp upward movements in interest rates that had been in train for some time before each

1/ Table 5 and 6 show similar patterns for large banks located in New York City compared to large banks elsewhere. Of course, the similarities between the large money center and large New York City bank categories is in part attributable to their overlapping coverage.

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Table 7

Selected Characteristics of Gross
Short-term C&I Loans Extended by Medium Sized and Smaller Banks

	1977				1978				1979				1980[P]	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
ercentage of gross loan xtensions accounted for y loans made at														
rates below prime	1.8	2.2	3.2	4.9	3.7	7.0	7.7	23.5	30.6	24.6	32.9	45.5	32.8	43.3
rates below money market rates 1/	.1	.0	.7	.7	1.1	.8	1.5	6.7	13.0	11.3	17.8	26.0	11.9	2.3
rates below prime and not under commitment	.5	.8	1.1	2.4	1.5	4.7	5.9	14.6	19.7	17.6	22.5	32.7	25.7	27.0
verage maturity (months)														
Loans above prime	2.7	2.3	2.1	2.4	2.3	2.0	2.5	1.3	2.6	2.3	2.2	2.3	2.5	2.7
Loans below prime	1.0	1.0	2.0	1.1	1.2	2.8	2.4	2.3	2.7	2.9	2.7	3.0	2.5	2.8
verage size ($1,000)														
Loans above prime	27	28	35	30	29	31	34	69	41	39	40	61	52	56
Loans below prime	195	447	78	59	57	51	14	28	20	15	20	23	19	32

--preliminary
NOTE: Calculations are based on the prevailing prime rate. For calculations using the actual prime, available since August 1979, see table 7a.
1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

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Table 7a

Selected Characteristics of Gross
Short-term C&I Loans Extended by Medium Sized and Smaller Banks

	1979		1980[p]	
	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
Percentage of gross loan extensions accounted for by loans made at				
- rates below prime	21.2	26.6	15.2	26.8
- rates below money market rates[1/]	7.9	15.9	5.6	2.2
- rates below prime and not under commitment	12.9	16.9	9.2	14.4
Average maturity (months)				
- Loans above prime	2.4	2.3	2.5	2.7
- Loans below prime	2.4	3.4	2.6	2.7
Average size ($1,000)				
- Loans above prime	34	36	36	40
- Loans below prime	22	33	23	46

p--preliminary

NOTE: These calculations reflect the actual prime rate in effect at respondent banks on survey dates.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

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of these survey weeks. The increase in below prime lending during these survey weeks contrasts with simultaneous declines in the share of loans made below prime at money center banks. As discussed above, the strong upward rate pressures that characterized these periods had brought money market rates into close proximity with the prime rate, causing the rate on loans tied to money market rates to approach or exceed the prime rate.

At medium and smaller banks, the average size and maturity characteristics of loans made below prime tend to be quite similar to those for loans made at prime and above. Indeed, to the extent that they differ, below prime loans at these banks tend to have longer maturities and smaller average sizes than other loans--the opposite of the situation at large banks.

IV. Implications of Relative Maturity

As already noted, gross loans made below prime by money center banks have very short average maturities relative to their other short-term loans and to short-term loans made at other banks. This large disparity in average loan maturities makes it difficult to use gross extensions data to infer anything about the share of outstanding bank loans that were made at rates below prime. Consider, for example, a bank whose outstanding loans are equally divided between those made at rates of prime and above those made at rates below prime. If, in addition, the average maturity of loans made below prime were half that of loans made at or above prime, then gross loan extension data would show that the volume of loans made below prime was twice the volume made at prime or above. In general, since loans with shorter maturities tend to be made more often their importance in gross extensions data will exaggerate the share of a bank's portfolios for which they account.

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To obtain some indication of the proportion of outstanding bank credit accounted for by loans made at rates below prime, the percentages of loans made below prime were recalculated after adjusting the gross loan extension data for differing loan maturities. The results of this adjustment, presented in table 8, show substantially reduced proportions of loans made below prime at large banks--typically lower by a factor of about 1/2--and generally higher proportions for medium and smaller banks, where average maturities of below prime loans have tended to exceed somewhat average maturities of loans made at or above prime in recent surveys.1/ The adjusted percentages suggest that lending at rates below prime did not reach sizable proportions at large banks until late 1978, about the same time as at smaller banks. Removing the effect of maturity differences also indicates that below prime lending was more extensive at medium sized and small banks than at 48 large banks for every survey since that of May 1978, calculated on the basis of the prevailing prime. When the prevailing prime is replaced by the actual prime, below prime lending is more prevalent at large banks than at medium and smaller banks in May 1980.

V. Loan Rates by Size of Loan

Many of the developments discussed above can also be seen in the behavior of rates classified by size of loan. The relative cost of credit for various sizes of loans has changed considerably in recent years. As

1/ The percentages calculated in table 8 are based on the volume of loans made below prime adjusted to account for the difference between the average maturity of these loans and that of all loans surveyed. Specifically, to adjust for the contribution that the maturity of loans makes to the frequency with which they appear, on average, in gross loan extensions data, the ratio of a bank's gross loan extensions made at rates below prime to total gross loan extensions (the unadjusted proportion of loans made below prime) was multiplied by the ratio of the average maturity of loans made at rates below prime to the average maturity of all loans made by the bank.

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Table 8

The Percent of Gross Short-term C&I Loan Extensions
Made at Rates Below The Prevailing Prime By Selected Classes of Banks
(Adjusted for Maturity) 1/

Class of Bank	1977				1978				1979				1980p	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
48 Large	3.1	1.7	9.1	4.4	5.1	3.0	5.1	16.2	18.8	14.7	20.6	10.8	18.6	34.0
13 Money Center	4.8	1.3	17.3	4.0	6.0	2.4	6.7	8.5	21.8	15.5	26.6	15.3	20.9	43.4
Large Non-Money Center	.2	2.1	2.0	4.6	3.9	3.8	3.5	23.9	15.2	12.8	12.4	5.7	15.3	15.6
New York City	11.8	4.1	22.6	7.2	8.9	5.4	6.2	10.1	36.8	19.9	31.5	16.3	32.7	45.5
Large Non-NYC	.2	.5	1.9	3.7	3.5	1.9	4.6	18.1	12.9	10.8	14.0	8.0	12.1	27.1
Medium and Smaller	.6	.9	3.0	2.4	1.9	9.2	7.2	36.0	31.2	29.1	38.1 (21.8)2/	52.3 (35.0)2/	32.8 (15.8)2/	44.4 (26.9)2/

p--preliminary

1/ Percentages from row 1 of tables 2-7 were adjusted by multiplying them by the ratio of the average maturity of loans made at rates below prime to the average maturity of all loans. See text, p. 7, for a fuller explanation.

2/ These percentages reflect the actual prime rate posted by respondent banks and are based on the data in table 7a. With the exception of May 1980, at 48 large banks actual primes do not differ from the prevailing prime. For calculations using the actual May 1980 prime at the several classes of large banks, see appendix table 1.

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shown in chart 2, the general increases in all interest rates from 1977 through 1979 were reflected least in rates on smaller denomination loans. As a result, the spreads between average rates on smaller loans and on the largest loans at all banks narrowed over this period and actually reversed by late 1979. That is, in November 1979 and February 1980, the average rate on the largest loans, even including many below prime loans, exceeded the average rate on the smallest loans. To the extent that relative size of borrower can be inferred from relative size of loans, smaller borrowers, on average, acquired credit more cheaply in late 1979 and early 1980 than large borrowers.[1/] This reversal occurred even earlier if loans having a maturity of one month or less are excluded when calculating average rates by size of loan. On this basis, the average rate on very large loans was above that of small loans in three of the four survey weeks in 1979 and remained above through May 1980 (see chart 3).

Several factors may have contributed to these changes in relative rates on large and small loans.[2/] Borrowers of large amounts of funds typically find the cost of bank credit moving in concert with rates generally, since banks price larger loans--even apart from those directly linked to money market rates--competitively to reflect the cost of funds in money markets. The rate on large loans moved fairly closely with the prime rate over the 1977-79 period. Smaller borrowers, on the other hand, often acquire funds from smaller banks, and for many of these banks a relatively substantial share of their lendable funds

1/ Research based on a special 1972 survey indicates a strong average relationship between loan size and size of borrower, as measured by total assets. "A Model of Bank Lending to Business" by R. Puckett and M. Scanlon (mimeo, Board of Governors).

2/ Smaller loans generally tend to have higher interest rates than large loans owing to the higher per dollar expenses of origination and servicing they impose on banks as well as to relative risk considerations.

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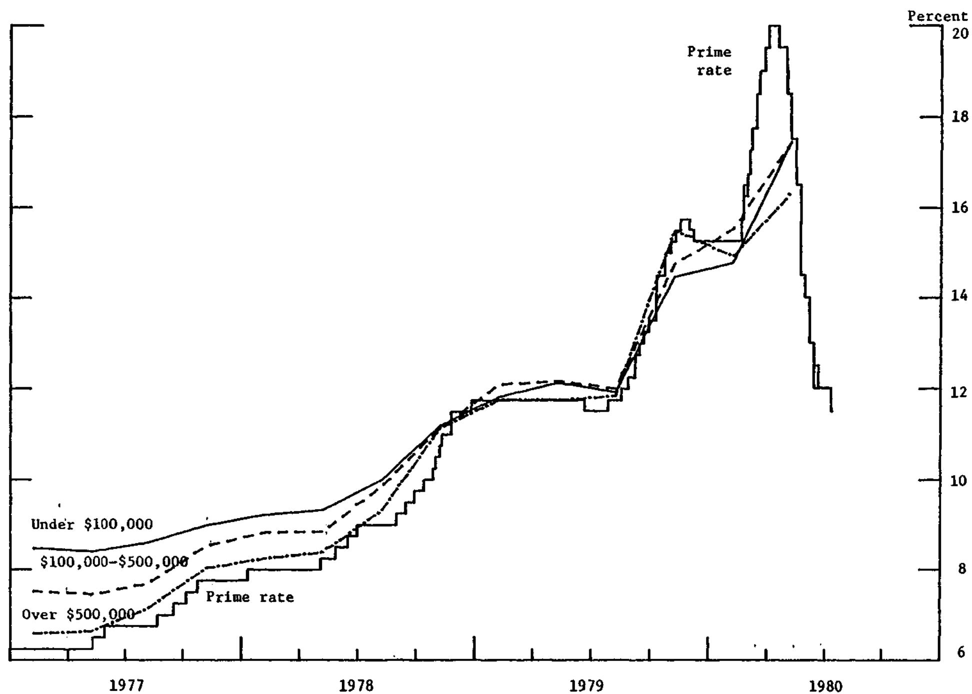
Chart 2

The Average Cost of Short-term Business Loans by Size of Loan, All Loan Maturities



Source: STBL

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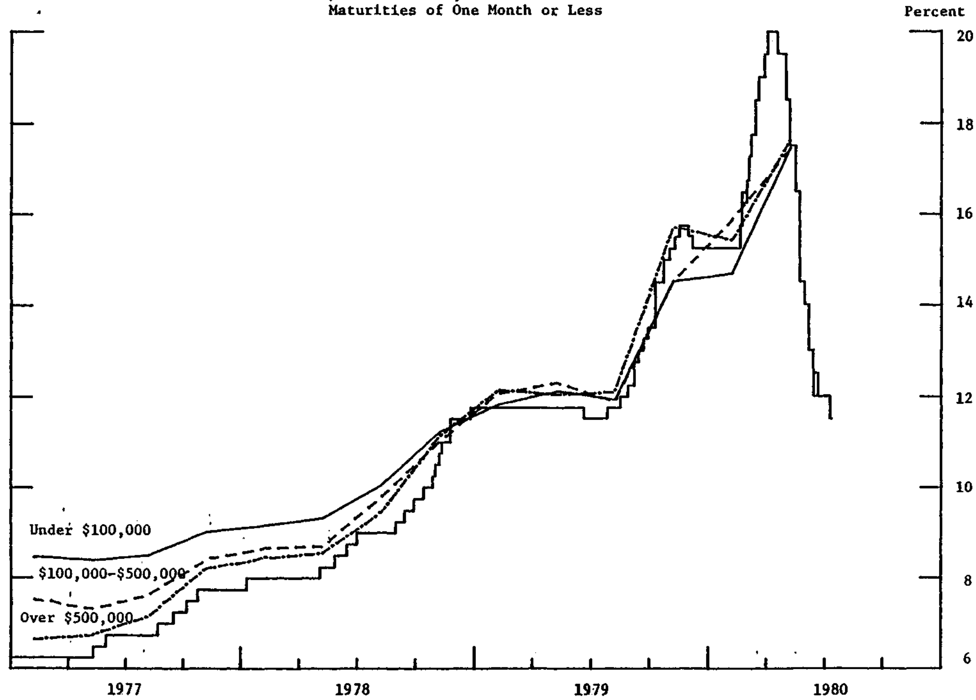
Chart 3

The Average Cost of Short-term Business Loans by Size of Loan, Exclusive of Loans with Maturities of One Month or Less



Source; STBL

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may be obtained from demand and savings deposits whose costs do not vary greatly in the short run. Sluggish movements in average rates on small loans also likely reflect "two-tier" loan policies and other loan programs adopted by both large and small banks to aid small borrowers.[1]

VI. Conclusions

Traditionally, a bank's prime rate has referred to the rate of interest offered its most creditworthy customers, and banks appear to continue to use a base rate in pricing a large share of their lending activities. However, the data examined in this report indicate that significant volumes of short-term loans at both large and small banks have been made below the prime rate since the second half of 1978. In part, this development appears to be related to the environment of high and rising interest rates in which it appeared. If interest rates remain relatively low or continue to fall during the recession, below prime lending at medium and smaller banks--in part attributable to the establishment of special loan programs for smaller businesses, with base lending rates set below the prime rate, and to the extension of loan commitments with maximum rates that were surpassed by the rapidly rising prime rate--is likely to decline. At large money center banks, on the other hand, below prime lending is also traceable to the substantial growth in very large, short-term loans tied to money market rates, suggesting that below prime lending at these institutions may remain important even as interest rates stabilize. An extended period of stable or declining rates is also likely to see the reemergence of a more typical relation between rates on large and small loans, and the average rate on very large loans, even defined to exclude loans with maturities of a month or less, is likely to fall below that for small loans.

1/ As of early 1979, the Small Business Administration had identified over 100 banks--about a fifth of them very large banks--that had established two-tier loan programs. Typically, these programs use a base rate of 1-1/4 to 1-1/2 percentage points below the prevailing prime to price loans to small businesses. More recently, responses by large banks to surveys taken under the Special Credit Restraint Program indicated that about half of these institutions had established a program to assist small businesses.

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Appendix Table 1

Lending Characteristics For Selected Classes of Banks
Calculated on the Basis of Actual Prime Rates Posted, May 5-10, 1980

	Class of Bank				
	48 Large	13 Money Center	Large Non-Money Center	Large NYC	Large Non NYC
Percentage of gross loan extensions accounted for by loans made at					
- rates below prime	53.0	61.1	32.0	60.7	44.3
- rates below prime and not under commitment	25.4	31.4	9.8	42.0	6.8
- rates below prime, and adjusted for maturity 1/	30.1	38.3	16.1	38.5	24.4
Average maturity (months)					
- Loans at or above prime	2.5	2.4	2.7	2.1	2.9
- Loans below prime	1.0	.9	1.1	0.8	1.1
Average size ($1,000)					
- Loans at or above prime	205	264	154	342	156
- Loans below prime	1,091	2,632	278	2,726	568

1/ See footnote 1, table 8.

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225-4247

May 23, 1980

Honorable Paul A. Volcker
Chairman, Board of Governors
Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman:

Information received from the Federal Reserve for the first quarter of 1980 indicates that 66.96 percent of business loans by "large New York banks" were made at below the prime rate. This compares with 28.85 percent below-prime loans made in the previous quarter (4th quarter, 1979), and with the 30.22 percent below-prime rate average for all previous quarters since the series started in 1977. For "44 large banks," which includes large banks in New York, the first quarter of 1980 percentage of below-prime loans was 50 percent. This compared with 19.78 percent for the previous quarter, and 21.4 percent average for all previous quarters.

The nation's 14,500 other banks did not engage in comparable below-prime lending. Their first quarter percentage of below-prime business loans was a modest 15.18 percent, compared to 26.59 percent for the previous quarter and 12.91 percentage for the average since 1977.

Information from published sources indicates that during this period, large corporate borrowers were obtaining loans as much as 6 percent under the prime rate. Obviously the big banks were unfairly discriminating against small business, farmers, home builders, and others who were charged more than the posted prime rate.

Those who watch the prime rate as an indicator of what's going on in the economy have been misled by the banks' posted rates. How can bank examiners enforce such laws as The Equal Credit Opportunity Act, which bans discrimination against women and minorities, if the examiners have been flim-flammed on the real prime rate?

I would appreciate an investigation and report concerning this entire situation.

Sincerely,

Henry S. Reuss
Chairman

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Federal Reserve Bank of St. Louis

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 21, 1980

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairman Reuss:

The staff here and at the Reserve Banks have been looking into the loan agreement that Mr. Stuart Tisdale of Sta-Rite Industries, Inc. sent to you.

We have learned that the parties to the loan agreement felt committed to the loan prior to my October 23 letter and that there are indications that negotiations had been underway since early in October. The October 23 letter was the first communication that specifically emphasized take-over loans. Nevertheless, a question remains in my mind as to why the banks had not been sensitive to the relevance of this commitment to earlier admonitions about financing purely financial and speculative activity that did not contribute to economic performance. In that connection, I have noted the provision in the loan agreement that the proceeds of the loan will be used to acquire an unidentified "target." If the "target" was also unknown to the lenders, it is difficult to see how they could show that the loan was a transaction that would contribute to the economy's performance.

The general request for restraint in this type of lending--and before October 23 it was admittedly less explicit--does not, of course, have the force of regulation. However, the loan raises a question as to whether the banks consciously misconstrued or disregarded the spirit of the Federal Reserve's efforts in this area. I have asked the Reserve Bank Presidents to discuss this loan with the top officials of the banks involved, emphasizing the nature of my concerns about the transaction and making certain that the need for cooperation in such efforts is understood.

Sincerely,

Paul A. Volcker

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225-4247

June 26, 1980

Honorable Paul Volcker
Chairman, Board of Governors
Federal Reserve System
Washington, D.C. 20551

Dear Chairman Volcker:

Mr. Stuart Tisdale, Chairman and President of Sta-Rite Industries, Inc., has called to my attention the enclosed loan agreement, between five large banks and Nortek, Inc., in the amount of $40,000,000. The purpose of the loan, as stated on page 3, is explicit:

> "(i) to purchase outstanding equity securities and securities convertible into or rights to acquire equity securities of a corporation (a 'Target') pursuant to a solicitation by the Company or a subsidiary of the Company of tenders of such securities, or in one or more negotiated, block, market or other transactions not involving a tender offer, or a combination of any of the foregoing;
> (ii) to make a Target a Subsidiary pursuant to a merger, purchase of assets or other reorganization providing for the issuance to the holders of the Target's then outstanding equity and convertible securities, in exchange for such securities, of cash or securities of the Company or a Subsidiary, or a combination thereof;
> (iii) to purchase the business or integral part of the business of a Target; and
> (iv) to pay fees and expenses related to any of the foregoing."

This loan agreement is dated October 25, 1979, just two weeks after your letter to large member banks of October 10, 1979, in which you stated,

> "This is not the time to finance activities that have little to do with the performance of the American economy."

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Your letter of October 23 to all member banks made this point even clearer:

"...credits for extraordinary financial transactions would be viewed as questionable by the Board. Examples would include loans ... for corporate takeovers that simply substitute one source of financing for another and do not clearly promise improvement in economic performance."

Please provide this Committee, in advance of your appearance on July 23rd, a written report that answers the following questions:

1) What, if anything, does the proposed Nortek takeover of Sta-Rite contribute to the performance of the American economy?

2) Given your explicit injunctions of October 10 and 23, and the unambiguous nature of this loan, why was it made?

3) At what time did the Federal Reserve become aware of this loan, through the reporting requirements of the Special Credit Restraint Program or otherwise, and how?

4) What actions do you consider appropriate for the Federal Reserve to take under these circumstances, and

5) What actions have you taken?

On a related matter, I am disturbed by news that Mr. N. B. Hunt's daughter has entered the silver business. Her purchase of a stake in the Goldfield Corp. silver exploration business suggests that the Hunt brothers are determined to use their extensive network of family and other relationships to carry on the speculative activities that they themselves are precluded from by their loan agreement with the banks and with Placid Oil.

The 'Interim Report' presented by the Federal Reserve to Congress in May includes the following statement of the terms of the bank loan to Placid and the Hunts:

"The agreements relating to the partnership and the Hunt guarantee provide that the Hunts and all related entities cannot make any new investments in securities (except appropriate money market instruments) or take any position in commodities or any other futures position for any speculative purpose or otherwise while the Placid loan is outstanding or the partnership is in existence except investments necessary for the prudent operation of the farm, ranching and sugar businesses owned by the Hunts. Furthermore, the Placid loan agreement prohibits Placid, while the loan is outstanding, from engaging in any similar speculative activity including using the proceeds of the loan to finance acquisitions that would be inconsistent with the intent and purpose of the credit facility."

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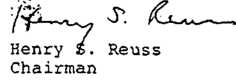
The banks should not permit the Hunts to engage in so transparent a circumvention of the terms of the loan. The Federal Reserve, which has repeatedly assured the Congress that a watertight guarantee against new silver ventures would be included and enforced, should not allow the banks to wink at this transgression.

Sincerely,



Henry S. Reuss
Chairman

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 21, 1980

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Chairman Reuss:

In reference to your earlier correspondence in which you expressed interest in the Board's monitoring of the Special Credit Restraint Program, I am pleased to enclose a staff interim report on that program. The report describes the program and summarizes the statistical and other information, especially that pertaining to bank lending to small businesses and loans for purely financial or speculative purposes, provided in the reports for March and April which certain large financial institutions were required to file. Reports for the month of June, including the first reports from intermediate-size banks, are now being reviewed and processed at each Federal Reserve Bank.

There are also enclosed reports by the staff on the other parts of the Federal Reserve Credit Restraint Program.

I hope you find these reports useful.

Sincerely,

S/Paul A. Volcker

Enclosures
EJS:JPB:vcd (#V-155)
bcc: Ms. Stockwell
Mrs. Mallardi (2)

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FEDERAL RESERVE CREDIT RESTRAINT PROGRAM

Interim reports by the staff
Board of Governors of the Federal Reserve System

THE SPECIAL CREDIT RESTRAINT PROGRAM

The Special Credit Restraint Program (SCRP) was one of several credit restraint measures announced by the Board of Governors on March 14, 1980, in coordination with the overall anti-inflation program announced by President Carter that day. The purpose of these credit restraint measures, which were adopted in part under authority given to the Board by the President's invocation of the Credit Control Act of 1969, was to supplement and reinforce the more general measures of monetary and credit control. They were viewed as temporary measures, to be phased out as quickly as appropriate; accordingly, the restraints were relaxed on May 22, and on July 3 the Board announced their termination. (See Appendix A for the Executive Order and the Board's statements of March 14, May 22, and July 3.)

The Special Credit Restraint Program was designed to limit expansion in bank loans in 1980 to a rate consistent with the announced growth ranges for money and credit, and to do so by discouraging certain types of lending while putting no special restraint on others. This report describes its nature and administration, and summarizes the information collected in connection with the program. Experience with SCRP, though brief, may provide a basis for evaluating this general method of influencing the growth in bank credit.

Background

Growth in bank loans outstanding, after slowing markedly in the fourth quarter of 1979, increased sharply in January and February of this year. The acceleration was widespread. Expansion in total loans to

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domestic borrowers, at both large and small domestic banks, was about three times as rapid in January-February as in the fourth quarter, and at foreign-related institutions it increased from a 20 percent seasonally adjusted annual rate to 30 percent in January and to more than 40 percent in February. Data for large banks indicated a continuation of strong growth in total loans through early March.

The rebound in loan expansion was especially pronounced for business loans which increased at an annual rate of more than 20 percent in both January and February, compared with 6 percent in the fourth quarter. Outstanding commercial paper of nonfinancial firms also increased at rates substantially above those in the final quarter of last year. Although business loans at finance companies actually declined during this period, total short- and intermediate-term business credit, which had increased at a 6-1/2 percent annual rate in the fourth quarter, grew at almost a 25 percent rate during both January and February. Moreover, unused commitments for commercial and industrial loans at banks expanded at a 40 percent annual rate from December to February, perhaps reflecting anticipation of additional official actions to slow credit growth but in any event creating the potential for substantial loan growth in coming months.

Although the increases in real estate and consumer loans were at about the same rate in January and February as in the last quarter of 1979, and security and nonbank financial loans showed almost no change over the two months, the accelerated growth in total loans could not continue without threatening achievement of the restrained growth in

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money and credit in 1980 which was deemed necessary to help curb inflation. In the circumstances then prevailing, longer-term competitive considerations apparently made many banks reluctant to restrain new credits or commitments (except by increasing interest rates) even though loan growth raised questions about their ability to acquire the necessary funds within the framework of the Federal Reserve's own targets for money and credit expansion. In this environment, a supplemental program to restrain loan growth seemed appropriate, so long as the burden of the restraint did not fall on those classes of borrowers least able to bear it.

Nature of the Special Credit Restraint Program

The program which the Board adopted was directed primarily at domestic lending by banks and finance companies, but other lenders were requested to observe its guidelines. Under the program, banks were asked to keep expansion of their total loans to U.S. borrowers in 1980 to a rate which did not exceed 6 to 9 percent. In order to avoid interfering with banks' own lending decisions so far as possible and to permit flexibility in meeting customer requirements, the program included no quantitative guidelines with respect to the allocation among classes of borrowers or loan types of the total amount of credit that could be advanced under the 6 to 9 percent growth limitation. Rather, qualitative guidelines were provided; these were included in the March 14 announcement of the program.

> "The Board does not intend to set forth numerical guidelines for particular types of credit. However, banks are encouraged particularly:
>
> (1) To restrain unsecured lending to consumers, including credit cards and other revolving credits. Credit for auto, home mortgage and home improvement loans should not be subject to extraordinary restraint.

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(2) To discourage financing of corporate takeovers or mergers and the retirement of corporate stock, except in those limited instances in which there is a clear justification in terms of production or economic efficiency commensurate with the size of the loan.

(3) To avoid financing of purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation out of keeping with business operating needs.

(4) To maintain reasonable availabilty of funds to small businesses, farmers, and others without access to other forms of financing.

(5) To restrain the growth in commitments for backup lines in support of commercial paper.

(6) To maintain adequate flow of credit to smaller correspondent banks serving agricultural areas and small business needs and thrift institutions.

The terms and pricing of bank loans are expected to reflect the general circumstances of the marketplace. No specific guidelines or formulas are suggested. However, the Board does not feel it appropriate that lending rates be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirements on managed liabilities. Moreover, the Board expects that banks, as appropriate and possible, will adjust lending rates and other terms to take account of the special needs of small businesses, including farmers and others."

As questions arose about the application of these guidelines, they were further explained and developed in press releases or letters to all respondents. (See Appendix B.) For example, guidelines (4) and (6) above reportedly were being interpreted too narrowly by many banks, while other banks anticipated difficulties in observing them. Applications from certain types of borrowers apparently were being denied on the justification that borrowers not specifically mentioned in guidelines (4) and (6) had no preferred status in the program; there were complaints, for instance, that auto dealers were finding it impossible to obtain bank financing even

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though most of them would qualify as small businesses. At the same time, banks that specialize in lending to small businesses and/or farmers anticipated that they would be unable to meet the needs of these customers without exceeding the 6 to 9 percent limitation. In letters of April 17 and May 22 from Chairman Volcker to all banking institutions, it was made clear that priority borrowers included auto dealers and buyers, homebuilders, and homebuyers (including home improvement and energy conservation loans), and banks were told that exceeding the 9 percent ceiling would be acceptable if they could demonstrate that loan expansion was essentially restricted to priority areas.

In order to assist in monitoring compliance of individual lenders with the program guidelines, regular reports were required from certain institutions. Monthly reports were required from U.S. commercial banks with consolidated U.S. total assets of $1 billion or more, U.S. branches and agencies of foreign banks with worldwide banking assets of more than $1 billion, U.S. bank holding companies with U.S. consolidated financial assets of $1 billion or more, and finance companies with total business receivables of $1 billion or more. Reporting by these institutions changed to bi-monthly when the overall credit restraint program was relaxed on May 22.

In order to assist in monitoring shifts to other sources of financing when the ceiling on bank loan growth constrained availability of bank loans to such borrowers, a group of large corporations was required to file monthly reports which covered their borrowing in the commercial paper market and from foreign sources. This reporting requirement was rescinded on May 22, effective with the report for April.

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Finally, U.S. commercial banks with consolidated U.S. total assets of $300 million or more but less than $1 billion were to file quarterly reports; the first and only report for these banks covered activity through June.

All reports were filed with and reviewed by the Federal Reserve Bank in which the respondent was located.

The reporting forms were designed to impose as little additional reporting burden on respondents as possible, even at the loss of some desirable precision. Information required from banking institutions and finance companies was largely qualitative in nature and primarily involved check answers on the strength of credit demands and the proportion of loan applications approved during the reporting month. Several items of explanatory material were also required, including brief descriptions of small-business loan programs and of any approvals or takedowns during the month of loans for purely financial or speculative purposes.

The statistical information which the respondents had to provide was for the most part identical in definition to data they provide regularly for other reports. For example, most items of statistical information on the reporting form for commercial banks were defined exactly as on the quarterly Report of Condition and could be referenced to that report.

In some cases, however, data which respondents were asked to supply either were not available from their records or were not available on a timely basis. Although they were asked to provide their best estimate if actual data were not available, a number of respondents were most reluctant to do so, even when pressed, since they had no related or past records on which to base such an estimate. As was anticipated, the item

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on loans to smaller businesses--a very important item for assessing compliance with the program guidelines--was particularly difficult for respondents to provide. (Since reporting of financial and speculative loans would have been even more difficult, if not impossible, dollar amounts for such lending were requested only for loan approvals and takedowns during the reporting month.)

Other troublesome items were those involving data for foreign offices. Such information generally was not available either as of the reporting date or by the date when the report was supposed to be filed; this difficulty was resolved by adjustment of the reporting date, use of preliminary estimates, or a moderate extension of the filing date. The group of nonfinancial companies, which was asked for items of statistical information only, reportedly found it quite burdensome to develop data on their indebtedness to foreign entities, especially their net position with their foreign subsidiaries.

Dissemination of Information about the Program

Detailed information about the Special Credit Restraint Program was conveyed quickly by Reserve Banks to financial institutions, and by them to their lending officers.

Immediately after announcement of the program, officials of every Federal Reserve Bank began meeting with lenders and others in the District to describe the program to them and answer their initial questions. Subjects covered included: the need for such a program and the general philosophy of this one; the qualitative and quantitative guidelines; reporting requirements; and plans for monitoring individual-lender performance.

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The way in which lenders were informed about the program varied from one Reserve Bank to another mainly in the extent to which lenders were contacted individually or were invited to a group meeting. A fairly typical procedure was for the president of the Bank to contact each of the largest commercial banks in the District individually, by phone or personal visit. This was followed by a series of group meetings with the president and/or other officers of the Bank. Invitations to attend were extended to lending institutions subject to the program's reporting requirements and also to those that did not need to file reports but were expected to observe the program guidelines--as well as to the large nonfinancial corporations that were required to report on certain of their borrowing activities. Meetings were held not only at the Reserve Bank but also in cities throughout the District.

An equally important part of the dissemination process was the adoption of procedures for providing prompt answers to questions about SCRP and the other credit restraint measures, raised by lenders as they began reexamining their lending policies, discussing the program within their institution and preparing to file their first reports. Given the lack of experience with these kinds of measures, the short lead time between announcement of the program and the first SCRP reporting date, and the even shorter lead time for Board staff to develop report forms, instructions and definitions for the various parts of the program, it was inevitable that a host of ambiguities, omissions and inconsistencies would need to be resolved. Some Reserve Banks received several thousand phone inquiries during the early stages of the credit restraint program and assembled special teams to respond to them. Coordination and guidance in resolving difficult questions were provided by daily conference calls between Reserve Banks and Board staff.

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Reactions of lenders at their individual and group meetings with Reserve Bank officials had been generally very cooperative. They had expressed understanding of the overall intent of the SCRP program and had indicated their willingness to comply with the guidelines, which many of them felt would reinforce lending policies they already had in train. The 6 to 9 percent limitation was considered reasonable, even by those who expected to have difficulty staying within it. These attitudes were reflected in the guidelines institutions issued to their lending officers.

A question on the report form asked whether the institution had transmitted the content of the Board's March 14 announcement to the appropriate lending officers at each of its U.S. offices. A second question asked whether it had issued specific guidelines to these officers; if so, a copy was to be enclosed with the institution's March report.

Examination of the responses by banks to these questions shows that they moved quickly to inform loan officers of the content of the program and to develop guidelines to ensure achieving its goals. The few banks that had not issued specific guidelines by the end of March reported that they were still in the process of developing appropriate ones.

Although the guidelines issued by many banks were simply paraphrases of those included in the Board's announcement, the more detailed ones followed a general pattern. There was an emphasis at regional banks on continuing to serve local and regional businesses and existing customers. Where changes from this policy were noted, most banks said that no loans for speculative purposes would be considered, even if they had been made in the past, and most placed restrictions on the types of

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financial loans that would be made. Particular consideration was to be given to loans to support or finance acquisitions of local and regional businesses that otherwise might fail. The guidelines issued by many banks reflected considerable concern over the impact of the recession on their local economy, and placed increased emphasis on quality considerations in approving loans.

Most "families" of U.S. branches and agencies indicated that they had informed loan officers of the contents of the Board's announcement, and most of the larger families had issued specific guidelines to them--either by writing their own or simply sending a copy of the Board's guidelines. In many cases, the reporting institution noted that it did not need to issue formal written guidelines--because it had a small number of loan officers or only one office, because all commitments were reviewed and controlled at one office, or because it had frequent meetings of loan officers at which compliance with the Board's guidelines would be discussed.

Summary of Information Provided in SCRP Reports

SCRP reports were required for the months of March, April and June. The reports for March, of course,--especially for banks which reported as of the last Wednesday of the month--for the most part reflected developments prior to announcement of the program. Reports for June, which were due by July 10 for most respondents, are now being reviewed and processed at the Reserve Banks. Thus, the reports examined in this summary are largely those for the month of April. Information provided

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by respondents with respect to lending to smaller businesses and loans for purely financial and speculative purposes are discussed in separate sections. (See Appendix C for statistical summaries of responses by each type of reporter; additional tabulations, providing selected data by size of institution and by Federal Reserve District, will be available shortly.)

Weekly data for large banks indicated a continuation of sharp loan growth through early March, followed by much slower growth over the remainder of the month which reduced total loan expansion in March to a seasonally adjusted annual rate of only 2-1/2 percent compared with growth rates of 15-20 percent in January and February. In April, loans outstanding declined at a 5 percent annual rate, and they dropped further in May and June.

It is difficult, if not impossible, to say how much of the weakness in bank loans since early March has been due to the recession, how much to reaction to fiscal announcements and general credit conditions (including expectational effects), how much to the cumulative effects of earlier overall restraints, and how much to the credit restraint programs. But the timing and the abruptness of the change in loan growth trends suggest that announcement of the programs played a significant role. Indeed the immediate effect of the programs on bank lending may have been exaggerated by the initial reactions of lenders to these restraints, as they sought to evaluate what the Federal Reserve actions--especially the 6 to 9 percent limitation--would mean in their particular case, and to obtain clarification on a number of points.

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As of mid-March, it appeared that loan growth at a number of banks in the first quarter alone was already close to the 9 percent ceiling for the entire year, and that at many other banks it had been running at an annualized (not seasonally adjusted) rate in excess of 9 percent. By the end of April, however, loan growth for the year to date exceeded 9 percent at only three banks. Each had experienced rapid loan growth early in the year; one had already greatly slowed its rate by loan expansion, one was still showing rapid growth because of its large volume of prior binding commitments but expected to be under the ceiling by year-end, and much of the overage for the third in April reflected a temporary situation.

At 27 additional banks, loan expansion over the first four months of the year amounted to more than 3 percent (annualized rate of more than 9 percent) but, given the continuing weakness in loans, it appeared unlikely that they would have had difficulty staying under the ceiling. For 78, or nearly half, of the reporting banks, total loans declined over the first four months. (Loans usually decline seasonally in the early months of the year.)

Among the 139 U.S. branch and agency families that were required to file reports, 62 reported declines in total loans to U.S. borrowers through April, but 58 showed increases of more than 9 percent. This apparent gross noncompliance needs to be viewed in the context of the very rapid growth in their loans earlier in the year--more than 35 percent at a seasonally adjusted annual rate in January-February, compared with about 15 percent for U.S.-chartered commercial banks. The adjustments they faced in reducing their loan growth to the 6 to 9 percent range by year-end were bound to be difficult and costly. Consultations were held

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with families that reported significant excesses, and they assured the Reserve Bank that they would do all they could to restrain their domestic loan growth so as to show no more than a 9 percent increase by year-end.

The SCRP guidelines encouraged banks to maintain a reasonable flow of credit to such borrowers as homebuyers and farmers. Whether they did so is rather difficult to tell from the data available from the SCRP reports filed by banks for March and April. Real estate loans on residential properties increased slightly less in April than in the same month of 1979, as they did in March, but their relative importance in the banks' portfolios edged up--the only loan category to do so, of those included on the SCRP reporting form, except for loans to smaller businesses. Loans to farmers declined in April, in contrast to an increase in the year-earlier month. But loans to farmers account for only 1 percent of the total loans of these banks--that is, banks with assets of $1 billion or more--and for even less at well over half of the group. Thus the slight decline in agricultural loans which they reported for April may be without significance. The bulk of residential mortgage and particularly agricultural loans by banks are made by smaller banks not covered in this report.

Examination of responses to qualitative questions on the reporting form shows not only a decline in demands for bank credit in April but also reduced willingness on the part of banks to approve loan applications. Respondents were asked to indicate whether total private demands for credit from U.S. borrowers in the current month were significantly greater, essentially unchanged, or significantly less,

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as compared with the situation generally prevailing in February 1980 and taking account of seasonal patterns. For commercial and industrial loans they were asked to provide the same classification of applications for loans or loan commitments and of the proportion of such applications approved, compared with the same month in recent years.

In both the March and April reports, most banks answered "essentially unchanged" to all three questions. But between March and April, there were marked shifts toward answers of "significantly less." In reporting for the month of March, 18 banks had characterized total private credit demands in this way; for April, 61 did. Only five banks (as compared with 26 in March) were still reporting total credit demands as signficantly greater than usual.

Responses to the question about applications for commercial and industrial loans showed a similar though less dramatic shift, but they also indicated somewhat more strength in such loans than in total credit demands. Nineteen banks in April and 63 in March reported that the number of applications from commercial and industrial borrowers was significantly larger than usual. Loan applications from smaller business borrowers, however, were reported by practically every bank as being unchanged to significantly below normal. Only two banks in April and four in March reported a signficantly larger than usual number of applications from such borrowers. Fifty-two in April and 35 in March (a considerably higher frequency than for all commercial and industrial loans or total credit

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demands) reported the number of applications from smaller businesses as being considerably smaller than usual.

Responses to the questions on loan approvals also differed for smaller borrowers than for all business borrowers. These questions, it should be noted, applied to the proportion of loan applications approved, not to the number. Only three banks reported a significantly higher than usual proportion in April (17 in March) for all commercial and industrial loan applications; for loans to smaller businesses the figures were zero and two, respectively. But 34 banks in April (29 in March) reported a significantly lower than normal proportion of approvals for all business loans, while only 19 banks in April and 13 in March gave this response for approvals of smaller-business loan applications. Thus it appears that, although an increased number of banks have reduced the proportion of business loan applications they approve, the change in policy has affected larger business borrowers more than smaller ones. Further discussion of lending to smaller businesses appears in the next section.

Lending to Small Businesses

Each of the large U.S. commercial banks, bank holding companies, and finance companies, and U.S. branches and agencies of large foreign banks which was required to file monthly SCRP reports was asked to answer, and explain, a general question as to whether it has developed a special

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small-business loan program, and all except bank holding companies were asked to provide statistical data on loans to smaller businesses.[1]

The summary of responses which follows relates primarily to commercial banks. Branches and agencies of foreign banks, with only one or two exceptions, do little lending to small, local businesses (or even to regional ones); they are basically wholesale banks. Bank holding companies, on the other hand, which were asked to report for those bank and nonbank subsidiaries that were not required to file separate reports, indicated that these smaller subsidiaries are generally regional institutions. As such, they do not need to develop special small-business programs because most of their business customers are small and lending officers are attuned to their individual credit needs and problems. Finance company respondents also reported that almost all of their business customers are local, or at most regional, firms and are better served by flexible adjustment of lending terms rather than by establishment of a formal program.

Special Lending Programs

Roughly 60 percent of the reporting banks answered "yes" to the question of whether they had "developed a special program to assist the financing needs of smaller businesses." The distinction between "yes" and "no" answers to this question was quite blurred, however; for example, some banks that answered "yes" described their special program as active partici-

1. With respect to the definition of smaller businesses, respondents were instructed as follows: "As a general guideline, a smaller business might be one whose activities are local, or at most regional, in scope; whose loan takedowns normally do not exceed $500 thousand; and whose total loans outstanding are less than $1-1/2 million. In the event that you cannot classify borrowers according to this definition, use your best judgment as to which of your business customers come closest to it."

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pation in Small Business Administration programs, while some that answered "no" gave such participation as the reason why they had not developed their own program. For this reason, some of the descriptive responses need to be considered together, regardless of whether they were submitted in explanation of a "yes" or a "no" answer to the general question.

About half of the banks that reported having a special program for loans to small businesses (and 29 percent of all reporting banks) said that their program included a small-business base rate which was below the bank's prime rate. (See table on page 18.) The spread below prime varied from 1/2 to 2-1/2 percentage points. A few banks reported a cap on small-business loan rates, but in some cases these caps exceeded 20 percent. Many respondents indicated that the special base rate would disappear if other interest rates fell below some specified levels--for example, if the large-business prime was 12 percent or less. It is not possible to tell from the individual bank responses how many banks plan to make their small-business rate a permanent feature of their lending policies, and how many have adopted such a rate only to provide some relief to their smaller business customers during a period of extraordinarily high interest rates.

Only two banks had established programs designed to alleviate short-term cash flow problems of small firms by maintaining a level payment of interest or interest plus principal. Under such programs, interest liabilities continue to accrue but payments are deferred until, for example, interest rates decline or the principal is repaid. One bank allowed for the possibility of extending the loan maturity in order to hold down periodic payments. Among banks without a formal program of this type, several said

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Commercial Bank Programs to Assist Small Business Financing Needs
Summary of Special Credit Restraint Program Reports

	Number of banks	Percent of Total [1/]	
All large reporting banks	168	100	
YES, have special program	98	58	100
NO, do not have special program	70	42	100
If "YES," program described as including:			
a. Small business base rate below prime	48	29	49
b. Active participation in SBA or other government program	39	23	40
c. Special small business department or community program	22	13	22
d. Deferred interest payment	2		2
e. Other	13		13
If "NO," reason given:			
a. Most loans are to small business	21	13	30
b. Participate in SBA program	8	5	11
c. Wholesale bank, make no or few small business loans	8	5	11
d. In process of formalizing special program	17	10	24
e. Other	19	11	27

1/ Sums are greater than 100 percent because some banks reported more than one characteristic or reason.

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they had asked their lending officers to consult with regular customers concerning potential cash flow problems.

Somewhat over one-fourth of all reporting banks cited participation in SBA or other government-guaranteed assistance programs as either the primary feature, or one of several features, of their lending to small business. About half that many indicated that they had special small-business loan departments or community programs within the bank, or were active members of local development groups.

A variety of statements about their small-business lending activities, provided by nearly one-fifth of the respondent banks (either to justify "yes" answers to the general question or to explain "no" answers) have been classified as "other" in the table. Examples of such activities are: seeking out new businesses or other small firms that may need credit, rather than waiting for such businesses to come to them; assignment of a senior vice-president to work with small businesses; establishment of a "small-business loan team" within the commercial loan department; preparation of advertisements and brochures on the kinds of available loan arrangements and how to draw up a loan application; custom-tailoring of each loan agreement to the needs and repayment ability of the particular borrower; an ongoing and aggressive marketing strategy to increase the bank's lending to smaller businesses; willingness to accept higher than usual credit risks, to be more lenient with the borrower's performance, or otherwise to give preferential treatment to smaller businesses.

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Ten percent of the banks reported that, while they have no formal small-business loan program at present, they are in the process of developing one. Another 13 percent said that they do not need a special program, since they are small-business oriented and almost all the loans on their books have been extended to such firms.

Finally, five percent of the banks characterized themselves as wholesale banks, with no use for a special small-business lending policy because they make virtually no loans to such businesses. Only a very few banks stated bluntly that no special program was needed since all legitimate demands were being met.

In short, almost every bank reporting under the program claimed that, in one way or another, it is making a serious effort to meet the credit needs of the smaller businesses in its market area. Only small businesses themselves could say how effective these efforts really are. While other Federal Reserve data suggest banks have extended significant amounts of loans at rates below prime, the volume of bank loans outstanding to smaller firms appears to have increased less this year than loans to larger businesses. It should be noted, however, that present bank records seldom permit precise measurement of loan totals by size of borrower, and thus the data summarized below rest primarily on good-faith estimates.

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Volume of Small-Business Loans

The data that banks reported on loans outstanding suggest that, despite the banks' own small-business programs and the guidelines of the Special Credit Restraint Program with respect to loans to smaller businesses, growth in such loans has lagged the growth in loans to larger firms. It is possible, of course, that the shortfall has been primarily demand-induced.

On a year-to-year basis, growth in loans to smaller businesses in March and April was only half as large as the growth in commercial and industrial loans to all U.S. addressees. (See table on page 22.) The shortfall in February (not shown in the table) was somewhat smaller. On a month-to-month basis, differences in March and April between the change in commercial and industrial loans to smaller businesses and in such loans to all U.S. addressees were less uniform. However, the data do indicate sharper cutbacks in lending to large businesses than to smaller ones in April--the first full month of the Special Credit Restraint Program.

For the reporting banks as a group, loans to smaller businesses have accounted for a slightly smaller proportion of total commercial and industrial loans this year--the proportion was 20 to 20-1/2 percent in February, March and April 1980, compared with 21-1/2 percent in each of the same months last year. Median proportions, however, are running a bit higher this year than last. It should be noted that all of these proportions are understated to an unknown extent. A number of banks, including some with rather extensive small-business loan programs, said they were unable to provide even an estimate of the volume of loans

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Selected Data on Commercial and Industrial
Loans to Smaller Businesses and All U.S. Addressees
All Reporting Banks

	March		April	
	1979	1980	1979	1980
	Percent change from year earlier			
Aggregate change				
Smaller businesses	n.a.	8.9	n.a.	7.1
All U.S. addressees	n.a.	18.1	n.a.	14.2
Median change				
Smaller businesses	n.a.	6.5	n.a.	4.9
All U.S. addressees	n.a.	11.5	n.a.	9.4
	Percent change from preceding month			
Aggregate change				
Smaller businesses	2.2	0.4	2.9	1.2
All U.S. addressees	2.0	1.6	3.1	-0.2
Median change				
Smaller businesses	1.3	0.4	1.9	-0.5
All U.S. addressees	2.3	1.0	2.6	-0.3
	Percent of total commercial and industrial loans			
Aggregate				
Smaller businesses	21.5	20.0	21.5	20.6
All U.S. addressees	93.7	94.4	94.0	96.0
Median				
Smaller businesses	29.3	30.0	28.9	30.8
All U.S. addressees	98.3	98.1	98.1	98.3

Note: For more detail, see tables in Appendix C.

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outstanding to smaller businesses; some said they were revising their computer programs to enable them to provide such information in the future.

For other reporters, the ratio of small-business loans to total commercial and industrial loans has shown no change this year. It has continued at less than 2 percent for U.S. branches and agencies as a group and at over 60 percent for reporting finance companies. Bank holding companies were not asked to provide data on loans outstanding to smaller businesses.

Loans for Purely Financial or for Speculative Purposes

In October 1979, Chairman Volcker requested commercial banks to refrain from financing corporate takeovers, except where fully justified in terms of increased production or improved efficiency, and to refrain also from financing speculative activities. These requests were repeated in the SCRP guidelines, and the report forms for banks--as well as for U.S. branches and agencies, bank holding companies, and finance companies--asked a set of questions about such loans. Separately for each type of purpose (purely financial and speculative), each respondent was to indicate whether, during the current month and with respect to commercial and industrial loans, there had been any requests, any approvals, or any takedowns under prior (before March 1980) commitments. A brief description of the loan was required for each approval or takedown.

Two aspects of these questions are important in interpreting the answers given: the questions covered activity during the current month, not outstandings; and they related to commercial and industrial loans only, not to loans in other call report categories. This means that some

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well-publicized takeover and speculative loans would not have been reported if they were approved and disbursed prior to March 1980, or if the loan would normally be classified elsewhere, for example, as a loan to an individual or financial instituion, or as a security loan. On the other hand, some banks apparently did include these other loan categories in answering the question, thus overstating the number of approvals and takedowns of commercial and industrial loans for financial and speculative purposes.

Loans for Purely Financial Purposes

Of the 170 large commercial banks reporting under the program, 71 indicated that they had received one or more requests or applications in April for loans or loan commitments for this purpose. Thirty-four reported having approved such financings in April and 23 said there had been takedowns under commitments made before March 1980. Comparable figures for March were somewhat higher--80, 38, and 32, respectively.

For U.S. branches and agencies of foreign banks, 13 of the 139 reporters indicated that they had received requests for this type of financing in April, but only two reported approvals and two reported takedowns on prior commitments. Twenty-nine of the 161 bank holding company respondents reported applications in April for loans for financial purposes, with 10 reporting approvals and 5 reporting takedowns. Only 1 of the 15 large finance companies reported such a request and 1 reported an approval.

Commercial banks reported 45 separate approvals of loans for purely financial purposes in April and 30 separate takedowns on prior commitments. The average size of these loans was surprisingly small:

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a significant proportion were for $500 thousand or less, and the median size was $900 thousand for approvals and $800 thousand for takedowns. Only five approvals and two takedowns were for more than $5 million. Size of loan was not indicated for three approvals and four takedowns, but only one of each seems likely to have been larger than $5 million.

Loans for Purely Financial Purposes
Size Distribution

	Number of Loans, April, 1980	
	Approvals	Takedowns on prior commitments
(Median size, thousands of dollars	900	800)
$500 thousand or less	16	11
$500 thousand - $1 million	8	3
$1 million - $2 million	6	6
$2 million - $5 million	7	4
More than $5 million	5	2
Size not available	3	4
	45	30

Most of the approvals of loans for financial purposes reported by commercial banks for April appear to have been for financings that were consistent with the program guidelines. As may be seen from the table on page 26, the majority approved in April, as in March, were for acquistions of one kind or another. Eight were to finance purchases from retiring owners (and thereby keep the firm in existence) or to acquire failing or bankrupt businesses, and four were to provide the firm with new management which the bank felt would improve its productive efficiency or better meet the needs of the community. Five were to finance the acquisition of a bank by (generally) a new one-bank holding company. Three were associated

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Loans for Purely Financial Purposes
Nature of Loans Approved in April 1980

	Number of Loans
Acquisition	32
To buy interest of retiring or deceased owners	6
To purchase failing or bankrupt firm	2
To improve efficiency or service to community	4
By present management or employees (ESOP)	2
By one-bank holding company	5
To complete prior purchase	2
For expansion of own business line	3
Detail not provided	8
Financial restructuring or debt refinancing	5
Purchase of own shares	4
From retiring shareholder or partner	2
Under contractual agreement with shareholder	1
To transfer ownership to ESOP	1
Other	2
To purchase stock from estate	1
To increase contribution to partnership	1
Nature not indicated	

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with transfer of ownership to the firm's current management or to its employees through an employee stock ownership plan. None of the approvals of loans to finance purchase of the company's own shares was for the sole purpose of permitting the firm to retire the stock; retirement, if it in fact occurred, was incidental to the primary reason for the repurchase.

However, some of the loans approved in April may have supported financings which were not in compliance with the spirit of the program or which could reasonably have been postponed. Acquisitions for expansion purposes are an example, as are at least some of the loans for financial restructuring or debt refinancing (although one of the latter--an advance approval of part of the huge loan finalized later for refinancing of silver debts--was rather urgent). And the possibility exists that some of the eight loans for vague acquisition purposes and the two loans to individuals for unspecified purposes were contrary to the program guidelines.

Much less information was provided for takedowns on prior commitments than for loan approvals. Of the 30 such takedowns in April reported by commercial banks, 15 were for acquisition or merger financing and 11 of these were not identified further. Six takedowns were to finance purchase of own stock; in three cases, no further description of the purchase was given, and in three the purchase was defined only as for retirement of the stock. Seven of the remaining takedowns were loans for the purpose of purchasing securities or unidentified loans to individuals.

Although at least some of the acquisitions and stock repurchases financed by these takedowns undoubtedly were for purposes that would not have been justifiable under the program if the commitment had been made after March 14, all of the takedowns reported here were under commitments

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made before that date. It was recognized from the start of the program that the need to honor pre-existing binding commitments would limit the ability of many banks to take on new loans of the types favored in the guidelines. Banks did pull back on some prior negotiations; borrower complaints reaching the Federal Reserve after the program was announced indicated that banks were refusing to honor some understandings with respect to loans for relatively unproductive purposes if the commitment was not legally or morally binding.

With respect to the binding commitments which had to be honored, however, it may be noted that the reported date of the commitment underlying the actual takedowns in April of loans for purely financial purposes was in late 1979 or early 1980 in almost every case--before announcement of SCRP but after receipt of Chairman Volcker's letters of last October discouraging such loans. Negotiations on some of these commitments may have been so far along by October that the bank felt obligated to carry them through to completion. But it may also be that the more detailed guidelines and the reporting requirements announced in March were more effective deterrents than the earlier cautionary statements. In any event, the Federal Reserve Banks, in selected instances, are reviewing these situations with individual banks.

As the program continued, but before its termination, increasingly urgent questions arose concerning the appropriateness of particular propositions for takeover loans. The question of "defensive" financing of possible U.S. buyers arose in several instances where there were potential foreign buyers. No affirmative indications were given, but

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prolongation of the program would necessarily have entailed difficult and potentially arbitrary decisions.

Loans for Speculative Purposes

Very few respondents reported approvals or takedowns of commercial and industrial loans or commitments for speculative purposes in March or April. As suggested earlier, there may have been additional disbursements for such purposes, which would not be classified as commercial and industrial loans.

Among reporting commercial banks, 41 indicated that in April they had received requests or applications for commercial and industrial loans or commitments for speculative purposes, but only 5 reported approvals for such requests and only 4 reported takedowns under commitments made before March 1980; comparable figures for the month of March were 47 requests, 9 approvals, and 7 takedowns. Three U.S. branches and agencies reported requests in April (5 in March) for such financings, but no approvals or takedowns (2 takedowns in March were reported). Requests were reported by 26 bank holding companies, approvals by 4, and takedowns by 3. No finance company respondent reported any requests, approvals or takedowns in either month.

Although, as noted above, five banks reported approvals in April of commercial and industrial loans or commitments for financing of speculative activities, there is some question as to whether all of them should have been so classified. Three banks included their participation in the

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Placid Oil/Hunt silver refinancing.[1] (Another bank had considered its participation to be a loan for a purely financial purpose.) Another April approval was a small, very short-term loan to an individual for a speculative commodity purchase. The remaining approvals reported were also for relatively modest amounts. They included: a loan to a developer to enable him to acquire land adjacent to land he already owned; inventory loans to protect the business against an anticipated interruption in the flow of supplies or to take advantage of a reduced price for materials; and a loan to a small-business customer to acquire land adjacent to its plant.

All takedowns under prior commitments for financing of speculative activities reported by banks for the month of April involved relatively small amounts--a few hundred thousand dollars at most. As was the case with loans for financial purposes, less information was provided on the nature of the prior commitment than on new approvals. Two banks reported what appear to be several very small takedowns, without identifying each one. Another reported takedowns under several commitments for land banking, but indicated that it was making no new commitments of this type. The fourth classified as a speculative loan a takedown to finance an additional contribution of equity to the borrower's company.

As with takeover loans, narrow distinctions are sometimes involved as to what is a speculative loan and what is not. Distinctions of this kind become increasingly difficult to handle in the context of a prolonged program.

1. In March, it may be noted, two U.S. banks and one U.S. branch of a foreign bank had reported financings involving the related speculative activities in the silver market.

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APPENDIX A

Executive Order 12201
Principal Statements on the Program

EXECUTIVE ORDER

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CREDIT CONTROL

By the authority vested in me as President of the United States of America by Section 205 of the Credit Control Act (12 U.S.C. 1904), and having determined that the regulation and control of credit is necessary and appropriate for the purpose of preventing and controlling inflation generated by the extension of credit in an excessive volume, it is hereby ordered as follows:

1-101. The Board of Governors of the Federal Reserve System is authorized to exercise all the authority under the Credit Control Act (12 U.S.C. 1901 et seq.) to regulate and control consumer credit.

1-102. The Board of Governors of the Federal Reserve System is authorized to exercise all the authority under the Credit Control Act to regulate and control credit extended by those financial intermediaries which are not subject, as of the date hereof, to either the amendments of law effected by Public Law 89-597, as amended, or Section 19 of the Federal Reserve Act, as amended (12 U.S.C. 461), and which are primarily engaged in the extension of short-term credit.

1-103. The Board of Governors of the Federal Reserve System is authorized to exercise all the authority under the Credit Control Act to regulate and control credit extended to commercial banks that are not members of the Federal Reserve System in the form of managed liabilities.

1-104. The Board of Governors of the Federal Reserve System is authorized to exercise the authority under Section 206(4) of the Credit Control Act (12 U.S.C. 1905(4)) to prescribe appropriate requirements as to the keeping of records with respect to all forms of credit.

1-105. For the purposes of this Order "consumer credit," "financial intermediaries," "short-term credit," "commercial banks," and "managed liabilities" shall have such meaning as may be reasonably prescribed by the regulations of the Board of Governors of the Federal Reserve System.

1-106. The authorizations granted by this Order shall remain in effect for an indefinite period of time and until revoked by the President.

JIMMY CARTER

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FEDERAL RESERVE press release

For immediate release

March 19, 1980

The following corrections should be made in the material distributed in connection with the Federal Reserve Board's anti-inflation program announced March 14:

1. Covering news release: Page 4, third paragraph, fifth line, at the beginning, read $1 billion (not $5 billion).

2. Part 204--Marginal Reserve Requirement amendments:
   --Page 5 -- Section 204.5(f)(3)(i)(B), fourth line, read "of other institutions19/ or institutions" omitting "to"; and
   --Fifth line down in next paragraph read "balances due from foreign offices of other institutions19/ or institutions" omitting "to".

   --Page 5 -- Fourth line from bottom, make line read:
   "such differences shall be rounded to the next lowest multiple of $2 million." (inserting "multiple of").

3. Credit Restraint (Subpart B) -- Short Term Financial Intermediaries:
   --Page 4 -- Place a reference to footnote 1 at end of second line (after word "instrument,") in Paragraph (c), Sec. 229.12.
   --Page 5 -- Place a reference to footnote 2 in 13th line of Paragraph (d) after the word "less".

4. Part 229--Credit Restraint (Subpart C) -- Nonmember Commercial Banks:
   --Page 1 -- Effective Date, read dates in the first two sentences as follows:
   "The special deposit requirement is effective on marginal total managed liabilities outstanding during the seven-day computation period beginning March 20, 1980, and each seven-day period thereafter. The non-interest bearing special deposit for the computation periods beginning March 20, 27 and April 3, 1980, must be held during the deposit maintenance period beginning April 17, 1980."
   --Page 5 -- Computation and Maintenance of Non-Interest bearing Special Deposits, 16 lines from bottom, read March 19 (not 12) and 10 lines from bottom read March 20 (not 13).
   --Page 8 -- First sentence in Paragraph (a) read dates April 17 in second line (not 10) and March 20, 27 and April 3 in fifth line (not March 13, 20 and 27), and April 24 in seventh line (not 17).
   --Page 10 -- Second line of paragraph (b) read date March 20 (not 13).

All these corrections will have been made as this material appears in the Federal Register.

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FEDERAL RESERVE press release

For immediate release MARCH 14, 1980

The Federal Reserve Board today announced a series of monetary and credit actions as part of a general government program to help curb inflationary pressures. The actions are:

1. A voluntary Special Credit Restraint Program that will apply to all domestic commercial banks, bank holding companies, business credit extended by finance companies, and credit extended to U.S. residents by the U.S. agencies and branches of foreign banks. The parents and affiliates of those foreign banks are urged to cooperate in similarly restricting their lending to U.S. companies. Special effort will be made to maintain credit for farmers and small businessmen.

2. A program of restraint on certain types of consumer credit, including credit cards, check credit overdraft plans, unsecured personal loans and secured credit where the proceeds are not used to finance the collateral. The Board has established a special deposit requirement of 15 percent for all lenders on increases in covered types of credit. Automobile credit, credit specifically used to finance the purchase of household goods such as furniture and appliances, home improvement loans and mortgage credit are not covered by the program.

3. An increase from 8 percent to 10 percent in the marginal reserve requirement on the managed liabilities of large banks that was first imposed last October 6, and a reduction in the base upon which the reserve requirement is calculated.

4. Restraint on the amount of credit raised by large non-member banks by establishing a special deposit requirement of 10 percent on increases in their managed liabilities.

5. Restraint on the rapid expansion of money market mutual funds by establishing a special deposit requirement of 15 percent on increases in their total assets above the level of March 14.

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6. A surcharge on discount borrowings by large banks to discourage frequent use of the discount window and to speed bank adjustments in response to restraint on bank reserves. A surcharge of 3 percentage points applies to borrowings by banks with deposits of $500 million or more for more than one week in a row or more than four weeks in any calendar quarter. The basic discount rate remains at 13 percent.

In making the announcement, the Board said:

"President Carter has announced a broad program of fiscal, energy, credit and other measures designed to moderate and reduce inflationary forces in a manner that can also lay the ground work for a return to stable economic growth.

"Consistent with that objective and with the continuing intent of the Federal Reserve to restrain growth in money and credit during 1980, the Federal Reserve has at the same time taken certain further actions to reinforce the effectiveness of the measures announced in October of 1979. These actions include an increase in the marginal reserve requirements on managed liabilities established on October 6 and a surcharge for large banks on borrowings through the Federal Reserve discount window.

"The President has also provided the Federal Reserve, under the terms of the Credit Control Act of 1969, with authority to exercise particular restraint on the growth of certain types of consumer credit extended by banks and others. That restraint will be achieved through the imposition of a requirement for special deposits equivalent to 15 percent of any expansion of credit provided by credit cards, other forms of unsecured revolving credit, and personal loans.

"One consequence of strong demands for money and credit generated in part by inflationary forces and expectations has been to bring heavy pressure on credit and financial markets generally, with varying impacts on particular sectors of the economy. At the same time, restraint on growth in money and credit must be a fundamental part of the process of restoring stability. That restraint is, and will continue to be, based primarily on control of bank reserves and other traditional instruments of monetary policy. However, the Federal Reserve Board also believes the effectiveness and speed with which appropriate restraint can be achieved without disruptive effects on credit markets will be facilitated by a more formal program of voluntary restraint by important financial intermediaries, developing further the general criteria set forth in earlier communications to member banks."

Special Credit Restraint Program

In adopting this program, the Board said increases in lending this year should generally be consistent with the announced growth ranges for money and credit

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reported to Congress on February 19. Although growth trends will vary among banks and regions of the country, growth in bank loans should not generally exceed the upper part of the range of 6-9 percent indicated for bank credit (that is, loans and investments). Banks whose past lending patterns suggest relatively slow growth should expect to confine their growth to the lower portion or even below the range for bank credit.

The Board said the commercial paper market and finance companies--both a growing source of business credit--will be monitored closely in the program. Since activity in the commercial paper market is normally covered by bank credit lines, banks are expected to avoid increases in commitments for credit lines to support such borrowing out of keeping with normal business needs. Thrift institutions and credit unions will not be covered by the special program in light of the reduced trend in their asset growth.

No numerical guidelines for particular types of credit are planned but banks are encouraged particularly:

- To restrain unsecured lending to consumers, including credit cards and other revolving credits. Credit for automobiles, home mortgage and home improvement loans should be treated normally in the light of general market conditions.
- To discourage financing of corporate takeovers or mergers and the retirement of corporate stock, except in those limited instances in which there is a clear justification in terms of production or economic efficiency commensurate with the size of the loan.
- To avoid financing for purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation.
- To maintain availability of funds to small business, farmers nomebuyers and others without access to other forms of financing.
- To restrain the growth in commitments for back-up lines in support of commercial paper.

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No specific guidelines will be issued on the terms and pricing of bank loans. However, rates should not be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirement on managed liabilities. The Board also expects that banks, as appropriate and possible, will adjust lending rates and other terms to take account of the special needs of small business and others.

Lenders covered by the program are asked to supply certain data and information. The President, in activating the Credit Control Act, has provided the authority to require such reports.

Monthly reports are requested from domestic banks with assets in excess of $1 billion and for branches and agencies of foreign banks that have worldwide assets in excess of $1 billion. Monthly reports are also requested on the business credit activities of domestic affiliates of bank holding companies with total assets in excess of $5 billion. Banks with assets between $300 million and $1 billion are asked to report quarterly. Smaller institutions need not report unless subsequent developments warrant it.

Foreign banks will be asked to respect the substance and spirit of the guidelines in their loans to U.S. borrowers or loans designed to support U.S. activity.

A panel of large corporations will be asked to report monthly on their commercial paper issues and their borrowings abroad. Finance companies with more than $1 billion in business loans outstanding will also be asked to report monthly on their business credit outstanding.

Consumer Credit Restraint

The special deposit requirements of 15 percent on increases in some types of consumer credit is designed to encourage particular restraint on such credit extensions. Methods used by lenders to achieve such restraint are a matter for determination by the individual firms. Increases in covered credit above the base date—March 14—will be subject to the special deposit requirement.

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Among lenders subject to the regulation are commercial banks, finance companies, credit unions, savings and loan associations, mutual savings banks, retail establishments, gasoline companies and travel and entertainment card companies--in all instances where there is $2 million or more in covered credit.

Typical examples of credit that is covered are credit cards issued by financial institutions, retailers and oil companies; overdraft and special check-type credit plans; unsecured personal loans; loans for which the collateral is already owned by the borrower; open account and 30-day credit without regard to whether a finance charge is imposed; credit secured by financial assets when the collateral is not purchased with the proceeds of the loan.

Examples of consumer credit not covered are:

Secured credit where the security is purchased with the proceeds of the loan such as an automobile, mobile home, furniture or appliance; mortgage loans where the proceeds are used to purchase the home or for home improvements; insurance company policy loans, credit extended for utilities, health or educational services; credit extended under State or Federal government guaranteed loan programs; and savings passbook loans.

All creditors with $2 million or more of covered credit outstanding on March 14 must file a base report by April 1 directly with the Federal Reserve or through the Federal Home Loan Bank Board or the Federal Credit Union Administration. This report will state the amount of credit outstanding on March 14 or a figure for the nearest available date.

Thereafter, these creditors must file a monthly report on the amount of covered consumer credit outstanding during the month, based on the daily average amount of covered credit if that data is available, or the amount outstanding on other appropriate dates approved by the Federal Reserve. The first report--for the period from March 15 through April 30--is due by May 12. The report for subsequent months is due by the second Monday of the following month.

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The first 15 percent deposit requirement must be maintained beginning May 22 on increases in outstanding credit.

Marginal Reserve Requirement

On October 6, the Board established an 8 percent marginal reserve requirement on increases in managed liabilities that had been actively used to finance a rapid expansion in bank credit. The base for this reserve requirement was set at the larger of $100 million or the average amount of managed liabilities held by a member bank, an Edge corporation, or a family of U.S. agencies and branches of a foreign bank as of September 13-26. Any increase in managed liabilities above that base period was subject to the additional 8 percent reserve requirement.

Managed liabilities include large time deposits ($100,000 or more) with maturities of less than a year, Eurodollar borrowings, repurchase agreements against U.S. government and federal agency securities, and federal funds borrowed from a nonmember institution.

In today's action, the Board increased the reserve requirement to 10 percent and lowered the base by (a) 7 percent or (b) the decrease in a bank's gross loans to foreigners and gross balances due from foreign offices of other institutions between the base period and the week ending March 12, whichever is greater. In addition, the base will be reduced to the extent a bank's foreign loans continue to decline. The minimum base amount remains at $100 million.

Nonmember Banks

The special deposit requirement for nonmember banks is designed to restrain credit expansion in the same manner as the marginal reserve requirement on the managed liabilities of member banks.

For nonmembers, the base is the two-week period that ended March 12 or $100 million, whichever is greater. The 10 percent special deposit will be maintained

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at the Federal Reserve on increases in managed liabilities above the base amount. The base will be reduced in subsequent periods to the extent that a nonmember bank reduces its foreign loans.

Money Market Mutual Funds

Money market mutual funds and similar creditors must maintain a special deposit with the Federal Reserve equal to 15 percent of the increase in their total assets after March 14.

A covered fund must file by April 1 a base report of its outstanding assets as of March 14. Thereafter, a monthly report on the daily average amount of its assets must be filed by the 21st of the month. For example, a report on the first month's assets--from March 15 to April 14--must be filed by April 21 and the special deposit requirement will be maintained beginning May 1. A fund that registers as an investment company with the Securities and Exchange Commission after March 14 must file a base report within two weeks after it begins operations.

Discount Rate

In fixing the surcharge for large bank borrowing, the Board acted on requests from the directors of all 12 Federal Reserve Banks. The action is effective Monday. The discount rate is the interest rate that member banks are charged when they borrow from their district Federal Reserve Bank.

The surcharge above the basic discount rate would generally be related to market interest rates. It is designed to discourage frequent use of the discount window and to encourage banks with access to money markets to adjust their loans and investments more promptly to changing market conditions. This should facilitate the ability of the Federal Reserve to attain longer-run bank credit and money supply objectives.

The surcharge will apply to banks with more than $500 million in deposits on their borrowings for ordinary adjustment credit, when such borrowing occurs successively in two statement weeks or more, or when the borrowing occurs in more

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than four weeks in a calendar quarter. There will be no other change in the administration of the discount window with respect to adjustment credit. Such credit will continue to be available to member banks only on a short-term basis to assist them in meeting a temporary requirement for funds or to provide a cushion while orderly adjustments are made in response to more subtained charges in a bank's position.

The surcharge will not apply to borrowing under the seasonal loan program, which will continue at the basic discount rate, nor to borrowing under the emergency loan program.

Attached are copies of the following documents:

1. The Special Credit Restraint Program.
2. Regulation CC establishing a special deposit requirement on increases in certain types of consumer credit.
3. An amendment to Regulation D increasing the marginal reserve requirement on managed liabilities to 10 percent and reducing the base period.
4. A subpart of Regulation CC establishing a special deposit requirement for nonmember banks.
5. A subpart of Regulation CC establishing a special deposit requirement for money market mutual funds.

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Special Credit Restraint Program

Background

President Carter has announced a broad program of fiscal, energy, credit, and other measures designed to moderate and reduce inflationary forces in a manner that can also lay the groundwork for a return to stable economic growth.

In connection with those actions, and consistent with the continuing objective to restrain growth in money and credit during 1980, the Federal Reserve has also taken certain further actions to reinforce the effectiveness of the measures announced in October of 1979. These actions include an increase in the marginal reserve requirements on managed liabilities established on October 6 and the establishment of a surcharge on borrowings through the discount window by large banks.

The President has also authorized the Federal Reserve, under the terms of the Credit Control Act of 1969, to exercise particular restraint on certain types of credit. The Board has determined to restrain the growth of certain types of consumer credit through the imposition of a requirement for special deposits equivalent to 15% of any expansion of consumer credit provided by any lender through credit cards, other forms of unsecured revolving credit, and personal loans. Under the authority of the Credit Control Act, the Federal Reserve has also (a) applied a special deposit requirement on the growth of managed liabilities of large non-member banks and (b) imposed a special deposit requirement on the growth in the net assets of money market mutual funds and other similar entities.

One consequence of strong demands for money and credit generated in part by inflationary forces and expectations has been to bring heavy pressure on credit and financial markets generally, with varying impacts on particular sectors of the economy. At the same time, restraint on growth in money and credit must be a fundamental part of the process of restoring stability. That restraint is, and will continue to be, based primarily on control of bank reserves and other traditional instruments of monetary policy. However, the Federal Reserve Board also believes

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the effectiveness and speed with which appropriate restraint can be achieved without unnecessarily disruptive effects on credit markets will be facilitated by a program of voluntary credit restraint by important financial intermediaries. The program set forth here develops certain general criteria to help guide banks and others in their lending policies during the period ahead.

Statement of Purpose

The purpose of the Special Credit Restraint Program is to encourage lenders and borrowers, in their individual credit decisions, to take specific account of the overall aims and quantitative objectives of the Federal Reserve in restraining growth in money and credit generally. The guidelines set forth are consistent with the continuing interest of the Federal Reserve and individual institutions to:

- Meet the basic needs of established customers for normal operations, particularly smaller businesses, farmers, thrift institution bank customers, and agriculturally-oriented correspondent banks, and homebuyers with limited alternative sources of funds.
- Avoid use of available credit resources to support essentially speculative uses of funds, including voluntary buildup of inventories by businesses beyond operating needs, or to finance transactions such as takeovers or mergers that can resasonably be postponed, that do not contribute to economic efficiency or productivity, or may be financed from other sources of funds.
- Limit overall loan growth so that adequate provision is made for liquidity and acceptable capital ratios.

In requesting cooperation of individual institutional lenders in achieving the general objectives of this program, the Federal Reserve Board is strongly conscious of the fact that sound decisions concerning the distribution of credit and specific loans

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can be made only by individual institutions dealing directly in financial markets and intimately familiar with the needs and conditions of particular customers. We are also aware, however, that in existing market circumstances, individual institutions may be under competitive pressure to make loans or commitments that, in the aggregate, cannot be sustained within our overall monetary and credit objectives or that, for particular institutions, may exceed prudent limits. By more clearly considering individual lending and commitment decisions in the light of the national objectives reflected in this program, undue market pressures and disturbances can be avoided and available credit supplies be used to meet more urgent requirements.

Nature of the Program

Coverage

The Special Credit Restraint Program will be directed primarily toward the domestic credit supplied by commercial banks and the domestic business credit extended by finance companies. Surveillance will also be exercised over borrowing in the commercial paper market and borrowings abroad by U.S. corporations.

With regard to domestic commercial banks, the program is designed to cover credit extended to U.S. residents by both the domestic and overseas offices of such banks. Credit extended to U.S. residents by agencies and branches of foreign banks domiciled in the United States will be specifically covered. Affiliates abroad of banks operating in the U.S. are expected to respect the substance and spirit of the guidelines in their loans to U.S. borrowers or loans otherwise designed to support U.S. activity.

In recent months, the commercial paper market and finance companies have been a growing source of business credit. In recognition of this trend and to assure comparable competitive treatment, finance companies (including subsidiaries of bank holding companies) are asked to follow the general guidelines in their business lending.

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Activity in the commercial paper market is normally covered by bank credit lines. That practice is strongly encouraged in the interest of continuing to provide a sound base to that market. But the use of commercial paper should be restrained, and growth in the market and activity of the larger users of that market will be closely monitored. For their part, banks are expected to give special attention to avoiding increases in commitments for credit lines for purposes of supporting commercial paper borrowing for other than normal business operating purposes.

Thrift institutions and credit unions are not specifically covered by the Special Program in light of recent patterns in their asset growth.

Reporting arrangements are described below.

Quantitative Guidelines

The Federal Reserve has recently set forth growth ranges for the monetary aggregates for 1980 as follows:

M1A	3½% -	6%
M1B	4% -	6½%
M2	6% -	9%
M3	6½% -	9½%

The growth ranges set forth for M3 encompass almost all the relatively short-term liabilities of banks and other depository institutions. That liability growth was broadly estimated to be consistent with growth in total bank credit (loans and investments) of 6-9%. We are aware that in current market circumstances, banks may be requested to carry a larger than normal share of growth in business and certain other types of credit. However, prudent attention to liquidity and capital positions will also be required, and liquidity of banks is already somewhat depleted. Taking these factors into account, growth in bank loans, consistent with the monetary growth ranges and maintenance of prudent liquidity positions, should not generally exceed the upper part of the indicated range of growth in total bank credit. That growth should

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be spread out over time in an orderly fashion, taking account of normal seasonal patterns.

Growth trends vary among banks and regions of the country. Individual institutions will wish to appraise their own prospects and policies in that light. Banks whose past patterns suggest relatively slow growth, and particularly those serving more slowly growing areas, should expect to confine growth to the lower portion or even below the indicated range for bank credit, particularly in instances where liquidity or capital ratios are below average. More rapidly growing banks should also evaluate their ability to support such growth without impairing liquidity or capital ratios.

The Federal Reserve and other federal bank regulatory agencies will carefully review patterns of loans and commitments at institutions that are experiencing growth in lending at or above the top of the range specified. Account will be taken of their own past experience and regional trends as well as the banks' capacity to finance their loan portfolios without straining capital or liquidity. Increases in loans by banks resulting in lower capital or liquidity ratios, particularly when the bank ratios are below peer groups, will be especially closely reviewed to assure their position is not weakened. In that connection, other regulatory authorities will be consulted as appropriate.

Individual institutions should adopt commitment policies that enable them to maintain adequate control over growth in loan totals and to assure funds are available to meet the priority needs specified below.

Qualitative Guidelines

The Board does not intend to set forth numerical guidelines for particular types of credit. However, banks are encouraged particularly:

(1) To restrain unsecured lending to consumers, including credit cards and other revolving credits. Credit for auto,

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home mortgage and home improvement loans should not be subject to extraordinary restraint.

(2) To discourage financing of corporate takeovers or mergers and the retirement of corporate stock, except in those limited instances in which there is a clear justification in terms of production or economic efficiency commensurate with the size of the loan.

(3) To avoid financing of purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation out of keeping with business operating needs.

(4) To maintain reasonable availability of funds to small businesses, farmers, and others without access to other forms of financing.

(5) To restrain the growth in commitments for backup lines in support of commercial paper.

(6) To maintain adequate flow of credit to smaller correspondent banks serving agricultural areas and small business needs and thrift institutions.

The terms and pricing of bank loans are expected to reflect the general circumstances of the marketplace. No specific guidelines or formulas are suggested. However, the Board does not feel it appropriate that lending rates be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirements on managed liabilities. Moreover, the Board expects that banks, as appropriate and possible, will adjust lending rates and other terms to take account of the special needs of small businesses, including farmers, and others.

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Reporting

The Federal Reserve will closely monitor developments in all sectors of the credit markets and will ask that certain data and information be supplied by banks and others. The President, in activating the Credit Control Act of 1969, has provided authority for requiring such reports.

In the case of domestic banks with assets in excess of $1 billion, and for U.S. branches and agencies of foreign banks that have worldwide assets in excess of $1 billion, a monthly report will be requested. Monthly reports will also be requested on the business credit activities of domestic affiliates of bank holding companies with U.S. financial assets in excess of $1 billion. As will be noted, the bank reports include, apart from qualitative information, certain data on the movements in broad categories of loans and commitments, liquid asset holdings, and capital accounts. Certain data, including that on capital and liquidity, will be requested on a consolidated worldwide basis. Banks with less than $1 billion but more than $300 million in assets will report quarterly. Smaller institutions, while requested to observe the program, will not have special reporting requirements unless warranted by subsequent developments.

A group of large corporations will be requested to complete a brief monthly form about their activities in the commercial paper market, including the extent and usage of "backup" lines of credit at banks and their borrowing abroad. Finally, finance companies -- including subsidiaries of bank holding companies -- with more than $1 billion in loans outstanding to business borrowers will be requested to provide monthly reports concerning their business lending activities.

Consultative Arrangements

In instances warranted by trends in loans and commitments, Federal Reserve Bank officials in consultation with other federal bank regulatory agencies, will review with individual banks and others their progress in achieving and

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maintaining appropriate restraint on lending. In general, such consultations will be sought if:

(1) Bank or finance company lending is occurring at a pace that appears to be significantly in excess of the national objective, taking account of the location or past experience of the bank or other institution.

(2) Commitment policies appear to suggest the possibility of large subsequent increases in lending or exceptional expansion of commercial paper borrowing.

(3) Explanations of "takeover" or "speculative" financing contained in regular reports raise significant questions.

(4) The distribution of credit at an institution generally appears disproportionate in light of the qualitative guidelines above.

(5) Liquidity positions or capital ratios reflect developing strains, particularly in the case of institutions whose ratios are below peer group averages.

In the case of nonbanks, the Federal Reserve may also wish to hold informal discussions with such institutions if such discussions seem warranted by developments.

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FEDERAL RESERVE press release

For immediate release May 22, 1980

Evaluation of recent banking and other credit data, including trends in consumer credit, indicate that current developments are well within the framework of the basic monetary and credit objectives of the Federal Reserve and the special measures of credit restraint established last March 14. The Federal Reserve is accordingly modifying and simplifying the administration of the special programs.

These actions do not represent any change in basic monetary policy as reflected in the targets for restrained growth in money and credit over 1980 that were developed early this year to help bring inflation under control.

The actions announced today are consistent with the intent to phase out those special and extraordinary measures only as conditions clearly permit. Therefore, the basic framework of the special March measures remain. These were established in part in conjunction with the action of the President to invoke certain provisions of the Credit Control Act of 1969.

Actions taken by the Board are:

--A reduction in the marginal reserve requirement on managed liabilities of large member banks and agencies and branches of foreign banks from 10 percent to 5 percent, and an upward adjustment of 7-1/2 percent in the base upon which the reserve requirement is calculated.

--A reduction in the special deposit requirement on managed liabilities of large nonmember institutions from 10 percent to 5 percent, together with a similar upward adjustment in their base.

--A decrease from 15 percent to 7-1/2 percent in the special deposit requirement that applies to increases in covered consumer credit.

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--A decrease from 15 percent to 7-1/2 percent in the special deposit requirement that applies to increases in covered assets of money market mutual funds and other similar institutions.

--Modification of the Special Credit Restraint Program to ensure that more urgent credit needs are being met--such as those for small business, auto dealers and buyers, the housing market, agriculture and energy products and conservation--and to reduce reporting burdens as described in the attached letter to the Chief Executive Officer of commercial banks.

The lower marginal reserve requirement on the managed liabilities of member banks and foreign agencies and branches will apply to liabilities effective with the statement week of May 29-June 5. Effective that week also, the marginal reserve base will be increased by 7-1/2 percent above the base used to calculate the marginal reserve in the statement week of May 14-21. Declines in outstanding loans to foreigners will continue, as before, to reduce the base in subsequent weeks. The upward adjustment does not apply to the $100 million minimum base amount.

The same effective date and adjustment in base will apply to nonmember banks subject to the special deposit requirement on increases in managed liabilities.

The new special deposit requirement on covered consumer credit will be effective beginning with the average amount of credit outstanding in June, with the special deposit due July 24. For money market funds, the new requirement will be effective with assets in the week beginning June 16, and the deposit will be maintained in the week beginning June 30.

Attachment

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

PAUL A. VOLCKER
CHAIRMAN

May 22, 1980

To the Chief Executive Officer of Banking Institutions:

Preliminary review of reports of large banks under the Special Credit Restraint Program, together with analysis of other banking data, now indicates that bank loans appear to be running comfortably within the 6 to 9 percent guideline set forth in the Special Credit Restraint Program. Moreover, the most recent data suggest the rate of growth has been at a significantly reduced pace, and some categories of loans, such as consumer loans, have actually been falling.

As you will recall, the 6-9 percent guideline was directly related to the objectives and targets set by the Federal Reserve to achieve restrained growth in the overall supply of money and credit during 1980 for the nation as a whole. While present trends appear fully consistent with reaching those goals, we recognize individual banks, or banks in some regions of the country, may face conditions that make it particularly difficult to meet the quantitative guidelines while fully respecting the qualitative guidelines. In that connection, the administration of the program will henceforth reflect the following criteria. These criteria are broadly consistent with the existing program, but are designed to provide for individual banks facing local conditions that may inhibit their ability to meet the overall objectives:

(1) Lending by small banks as a group (those under $100 million of deposits) has clearly been within the quantitative guidelines. Those banks should not feel under any special restraint in meeting the needs of their regular local customers, consistent with their individual capital and liquidity requirements. In particular, the program is not designed to exert restraint on agricultural, small business, home construction and improvement (including energy conservation), home mortgage, and auto-related credit. Small banks that find their lending exceeding the general guideline should refrain from extending their normal lending area or participating in larger credits to those with other potential sources of funds.

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(2) Larger banks, consistent with the program, are also expected to treat loan requests from farmers, small businessmen, homebuilders, homebuyers (including home improvement and energy conservation loans), and auto dealers and buyers in a normal manner -- that is, consistent with the banks' credit standards and liquidity and capital needs. Customers particularly dependent on bank financing and enlarging production capability in response to urgent needs, such as energy, may warrant accommodation. If in meeting these needs, total loans appear to be rising to or above the 9% guideline, banks are expected to restrain loans to other borrowers, including those with access to other sources of funds and those outside the normal lending area. Banks respecting these priorities finding their total loans rising faster than consistent with the 9 percent guideline will be expected to demonstrate that their policies are consistent with these priorities in their reports and reviews with the regional Federal Reserve Banks. Banks will be justified in exceeding the quantitative guidelines when such a demonstration can be made.

(3) All banks are requested, as before, to avoid use of available credit resources to support essentially speculative uses of funds, or to finance transactions such as takeovers or mergers that can reasonably be postponed and that do not contribute to eonomic efficiency or productivity.

(4) The Board will continue to monitor the program through special reports and evaluation of the continuous flow of data on bank loans that it obtains through its regular reporting channels. To reduce the administrative burden of the program, however, the number of special reports will be reduced. Reports from large banks will henceforth be obtained on a bi-monthly rather than a monthly basis. Reports from large corporate borrowers will be discontinued. The first quarterly report from intermediate-size banks will be simplified, and the need for any further report will be considered after that check point is passed. As before, no reports will be required from small banks.

Sincerely,

Paul A. Volcker

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FEDERAL RESERVE press release

July 3, 1980

For immediate release

The Federal Reserve Board today announced plans to complete the phase-out of the special measures of credit restraint that had been put in place, or reinforced, on March 14 of this year.

The special measures were designed to supplement, temporarily, more general measures of credit and monetary control, and recent evidence indicates that the need for those extraordinary measures has ended. For the year to date, credit expansion, particularly at banks, is clearly running at a moderate pace. In recent months, there has been apparent contraction in consumer borrowing, indications are that anticipatory and speculative demands for credit have subsided, and funds have been in more ample supply.

While the special conditions necessitating the extraordinary credit restraints are no longer present, the Board emphasized that its general goals of achieving restrained growth in money and credit aggregates are unchanged. Those continuing goals are closely related to its concern with further reduction of inflationary pressures in the economy.

The Board previously, on May 22, had halved the special deposit requirements in connection with the credit restraint program and had modified the guidelines for the special program for restraining bank credit growth.

Today, the Board scheduled completion of the phase-out by taking the following measures:

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--Elimination of the remaining 5 percent marginal reserve requirement on managed liabilities of large banks and agencies and branches of foreign banks. This action applies to managed liabilities beginning July 10, for reserves required beginning July 24. In addition, the Board eliminated, effective the same date, the 2 percent supplementary reserve requirement applicable to member banks on large time deposits. This requirement had been initiated in November 1978.

--Elimination of the remaining 7-1/2 percent special deposit requirement that applies to increases in covered consumer credit, effective for covered credit extended in June and thereafter. Thus, no further special deposits will be required after the present deposit maintenance period ends on July 23. To permit orderly implementation of changes now in process and to assure adequate notice of such changes to credit users, the Board's rule permitting creditors to modify the terms of credit accounts will remain in effect for notices mailed only on or before September 5.[1/]

--Elimination of the remaining 7-1/2 percent special deposit requirement that applies to increases in covered assets of money market mutual funds and other similar institutions. This action applies to covered assets beginning July 28, and hence no special deposits will be required beginning August 11.

--Phase-out of the Special Credit Restraint Program under which banking institutions and finance companies were asked to limit domestic loan growth to a range of 6 to 9 percent in 1980. Available data for the first five months of this year indicate that bank loans to domestic borrowers have increased at around a 3 percent annual rate. Banking institutions with $300 million or

1/ Under the consumer credit restraint program, to make certain changes in terms of accounts, a creditor must send a 30-day advance notice explaining the changes and giving the consumer the option of paying down the existing balance according to the original terms. Subsequent use of the account by the consumer is deemed to be acceptance of the new terms.

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more deposits will be expected to complete reports (either the quarterly report or the monthly report for the larger institutions) due under this program July 10 for data as of June 30. After those reports are received, discussions will be held with individual banks to review experience with the special program.

In phasing out the aggregate 6-9 percent guideline for individual institutions, the Board feels that normal competitive and market incentives can again be relied upon to assure the flow of credit consistent with normal banking standards, and that qualitative guidelines are therefore no longer appropriate. However, the Board remains concerned over the volume of credit that appears to have flowed to essentially speculative purposes in the past, and is considering the need for additional means of monitoring such developments in the future.

The Board's orders in these matters are attached.

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APPENDIX B

Special Credit Restraint Program
Answers to Questions

FEDERAL RESERVE press release

For immediate release March 26, 1980

The staff of the Federal Reserve Board has supplied the attached answers to frequently asked questions it has received concerning the Board's anti-inflation program announced March 14.

Other sets of questions and answers will be issued as they become available.

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1. Does the Special Credit Restraint Program apply to sales of federal funds?

Answer: No.

2. Are loans to non-U.S. residents covered by the guidelines under the Special Credit Restraint Program?

Answer: Loans by domestic or foreign offices to non-U.S. residents are not specifically covered. However, excessive growth in such loans may have an undesirable effect on the liquidity and/or capital positions of the bank and the Federal Reserve intends to monitor such positions carefully.

3. Will the reporting forms be revised to add, to the statistical information requested of banking organizations, a memo item for loans to foreigners?

Answer: It has been decided not to revise the forms for the additional item. In their contacts with banks, Reserve Banks will suggest that, when a respondent has a special situation regarding loans to foreigners (e.g., a large increase in total loans that mostly reflects loans to foreigners), this fact should be called to the attention of the Reserve Bank by noting it in the space provided for explanations (section D).

4. To what period does the limitation on loan growth "in 1980" refer?

Answer: It refers to the period from December 1979 to December 1980.

5. The reporting forms do not ask for the December 1979 "base period." How will we obtain these base-period levels?

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Answer: For almost all respondents subject to the lending constraint, data for the December 1979 base period are generally available from reports they file regularly with the Federal Reserve or with one of the other bank supervisory agencies.

6. Does "December 1979" mean December 31?

Answer: In order to avoid the distortions in base period levels that could arise from calculating them as of a single day, an average for the month of December should be used to the extent permitted by available data. For weekly reporting banks, an average of the four Wednesdays in December 1979 seems appropriate. For businesses (e.g. finance companies) from which we have been receiving end-of-month reports, November and December figures should be averaged. For respondents such as nonmember banks, however, December 31 data will have to be used for the base period.

7. Is it essential that reporting of data by bank holding companies be as of the last Wednesday of the month, or are data as of the last business day of the month acceptable?

Answer: Data as of the last business day are entirely acceptable, especially if this reduces the reporting burden on respondents.

8. Should the statistical information on loan commitments outstanding include lines or just commitments? -- Total amounts or just the unused portions?

Answers: The figures reported for loan commitments should be unused confirmed lines plus unused commitments, to both nonfinancial and nonbank financial business customers.

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9. Are any classes of bank loans (such as loans to small business) to U.S. residents "exempt" or excluded from the 6 to 9 percent quantitative guideline for growth in bank loans in the Special Credit Restraint Program?

Answer: No. The qualitative objectives of the program call upon banks and other lenders to ensure that flows of credit to small business, farmers, homebuyers, smaller correspondent banks and others as stipulated in the Program are maintained. However, growth in these loan categories are included in the overall quantitative guidelines relating to lending. Consequently, where necessary, individual banks are expected to exercise special restraint on loans to large business customers or others that have access to other sources of funds so that credit to groups requiring special attention can be maintained. The guidelines thus apply to overall loan growth; the special categories are not "exempt" in judging overall growth, but the restraint should fall on other sectors.

10. How can a bank that is already high in or above the 6 to 9 range cope with takedowns of legally binding commitments that would push the bank's overall loans over or further beyond the 9 percent limit?

Answer: As a first step, banks should review existing commitments carefully to determine which are, in fact, legally binding. Also, banks in such a position should attempt aggressively to encourage prospective borrowers to postpone such takedowns where possible and/or to consider alternate sources of funding. If these options are not realistic and the loans are made, the Federal Reserve would fully expect that such a bank would be extraordinarily careful about making new commitments, and that it would not accommodate such loans by reducing credit to small business, homebuyers, farmers and other similar customers. Moreover, in these circumstances, the Federal Reserve's attitude toward the bank's performance will be importantly influenced by the bank's liquidity and capital position relative to that of its peers.

11. How firm is the 6 to 9 percent limit on loan growth? Under what circumstances will faster growth be acceptable?

Answer: In the current economic and market circumstances, the 6 to 9 percent range is a firm guideline for the December 1979-December 1980 period. Banks should judge current trends in the light of that yearly target. It is recognized that loans or commitments made during the first two months of the year, seasonal peaks in lending (as, for example, around tax dates), exceptionally strong local growth, or other particular factors might cause some banks temporarily to exceed a path consistent with the guideline. In such cases, special consultations will be held with the regional Federal Reserve Bank in which the bank(s) should be prepared to explain and justify the

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*Questions and answers were last previously supplied under this heading in the set of questions and answers dated March 26.

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circumstances surrounding the departure and to discuss plans for slowing the pace of lending, particularly in areas not subject to special treatment, so as to move back within the range. One important element in such special consultations will be the lending pattern of the bank in relation to its capital and liquidity position.

12. Does the 6 to 9 percent growth limit apply equally to the credit extended by nonbank subsidiaries of bank holding companies?

Answer: Yes, the general limitation on loan growth does apply to the bank and nonbank subsidiaries of bank holding companies. The Federal Reserve is mindful of the possibility that each unit in a bank holding company may not experience the same rate of credit expansion. In these circumstances the Federal Reserve will look at the aggregate rate of credit expansion by the overall holding company as well as the performance of individual reporting units within the holding company structure.

13. Does the 6 to 9 percent growth limit apply to the credit extended by finance companies that are not affiliated with bank holding companies?

Answer: Finance companies are expected to respect the overall intent of the program. Consistent with the framework of the program, no special restraint is suggested for consumers and small business lending, which would include auto dealers with credit lines of $1.5 million or less. Lending to larger businesses should be reduced to accommodate any increases in consumer and automobile paper so that the overall growth can stay within the guideline. The Federal Reserve recognizes that in some instances the firm's customer base and/or seasonal or cyclical patterns of lending by such finance companies may require evaluation on a case by case basis. In such instances, finance companies should, in their subsequent reporting to their respective Federal Reserve Banks, provide appropriate information bearing on such circumstances.

14. Page 1 of the Fed press release states that special efforts will be made to maintain credit for farmers and small businessmen, including accommodation of the needs of correspondent banks serving such customers. What is the nature of these special efforts?

Answer: The Federal Reserve expects that individual banks without special lending and credit availability programs will design appropriate programs to maintain the flow of such credit and promptly put them into effect. These programs should reflect the nature of that bank's business, its existing customer base, and other appropriate circumstances. While the nature and substance of such programs must and should be determined by the individual banks, the banks are asked to inform their Federal Reserve Bank of their programs. Moreover, bank examiners will monitor the implementation of these special programs as part of the usual examination process.

15. The program states that account will be taken of a bank's capacity to finance its loan portfolio without straining capital or liquidity. How will this be done?

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Answer: The Federal Reserve is mindful of the fact that both the capital and liquidity positions of some banks are lower than may be desirable over time and that some banks are therefore not as well equipped as others to absorb increases in lending. In view of this, and in the light of the continuing interest of the Federal Reserve and the other federal bank regulatory agencies in promoting stronger capital and liquidity positions in the banking industry, the Federal Reserve will be especially sensitive to those banks with loan growth in the upper area of, or temporarily above, the guideline range at the expense of further declines in already relatively low capital and liquidity positions. In some instances, capital and liquidity considerations may require special consultations even when a bank's loan growth is well within the specified range.

16. Are export loans included in the total of loans subject to the 6 to 9 percent growth limitation?

Answer: They are. But the Board would not want banks to reduce the availability of export loans in order to make less desirable types of loans. Any bank that exceeds the growth limit because of export loans should note that fact in Section D of its report.

17. Are extensions of credit by Edge Act subsidiaries included in the 6-9 percent guideline?

Answer: Loans by Edge Act subsidiaries to U.S. addressees are to be included in total loans and leases to U.S. addressees by banks, branches and agencies, and bank holding companies. The 6-9 percent growth limitation applies to this measure of bank lending. Thus, Edge Corporations are not exempt from the growth limit on bank loans.

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18. If a corporation reporting on form FR 2062e does not have timely, or any, records for some components of the corporation's indebtedness to non-U.S. entities--in particular, debt initially placed in the United States through third parties, and open-book credit--and is unable even to make a "good faith" estimate of such components, how should these items be reported?

Answer: It is not necessary for reporting corporations to determine the amount of debt issued directly to U.S. lenders or raised through U.S. dealers or other U.S. third parties that is now held by non-U.S. entities. No part of the outstanding amounts of such debt should be reported in item A2 of form FR 2062e. However, a shift toward placing debt abroad through U.S. third parties for other than normal business reasons would, of course, not be consistent with the spirit of the Special Credit Restraint Program.

Reporting corporations are expected to include open-book credit (trade notes and accounts payable) in reporting their indebtedness to non-U.S. entities, if this is feasible. If data on net payables to non-U.S. subsidiaries and affiliates and/or gross payables to other non-U.S. entities are available, but not on a timely basis, the corporation should consult with its Reserve Bank as to whether to include this component with a lag or to make some other adjustment. If there is no practical way for the corporation to develop data on open-book credit owed to non-U.S. entities, this component may be omitted from item A2 but the Reserve Bank should be informed of the omission. In any event, open-book credit--and all other components as well--should be reported on a consistent basis from month to month.

19. May data be reported as of some day other than the one called for on the reporting forms--that is, other than the last Wednesday of the month for commercial banks, branches and agencies of foreign banks and bank holding companies, and the last business day of the month for all other reporting entities?

Answer: It is not necessary to develop data as of the stipulated day if records for all or part of the reporting entity are generally available only as of some other day during the month. However, data should be reported on a consistent basis from month to month, and the date (or dates, in the case of mixed reporting) to which they refer should be noted on the reporting form.

20. At least part of the data for a bank's foreign offices that are required to complete the bank's (or holding company's) Special Credit Restraint Program report normally do not become available to the U.S. parent in time to permit filing the report with the Reserve Bank by the stipulated deadline. Is an extended deadline available? May some or all data be reported with a one-month lag? For example for the April report, may the "current month" in fact be March either for some items in their entirety, or for the foreign-office component of all items?

Answer: Reporting problems of this kind should be discussed with the Reserve Bank, since they will be considered on a case-by-case basis. In general, extension of the reporting deadline by a few days is preferable to lagged reporting, especially for data relating to loans. In cases where lack of timely data for

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foreign offices relates only to the liquidity and capital measures, reporting with a one-month lag of items affected by the foreign data will be considered. Any such adjustments in reporting must be approved by the Reserve Bank in advance.

21. Are industrial revenue bonds to be included in total loans and leases subject to the 6 to 9 percent growth limitation?

Answer: No. Industrial revenue bonds are defined as investments, not loans. However, Reserve Banks should be alert to the possibility of a bank's arranging an industrial revenue bond financing as a substitute for the commercial and industrial loan the bank would have made in the absence of the Special Credit Restraint Program. Any bank that appears to be acquiring an unusually large amount of industrial revenue bonds should be asked for an explanation.

22. Are factoring receivables included in total loans subject to the 6 to 9 percent limitation?

Answer: Since the instructions to the Call Report appear to define such accounts as loans, they should be defined as loans for purposes of the Special Credit Restraint Program.

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APPENDIX C

Special Credit Restraint Program
Statistical Tables

Table IA1
Credit Demands and Loan Policies

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	March	April
	(number of respondents)	
	170	170
Current strength of total private credit demands from U.S. addressees, as compared with the situation generally prevailing during February 1980 and taking account of seasonal patterns.		
Significantly greater	26	5
Essentially unchanged	126	104
Significantly less	18	61
Applications for commercial and industrial loans or loan commitments to meet basic credit demands for normal operations, as compared with the same month in recent years.		
Significantly larger	63	19
Essentially unchanged	83	95
Significantly less	24	56
Proportion of such applications approved.		
Significantly larger than usual	17	3
Essentially unchanged	124	133
Significantly smaller than usual	29	34
Applications for commercial and industrial loans to meet basic and emerging needs for smaller businesses, as compared with the same month in recent years.		
Significantly larger	4	2
Essentially unchanged	131	116
Significantly less	35	52
Proportion of such applications approved.		
Significantly larger than usual	2	0
Essentially unchanged	155	151
Significantly smaller than usual	13	19

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Table IA1 (cont'd)

	March	April
Commercial and industrial loans for purely financial activities.		
Requests: Yes	80	71
No	90	99
Approvals: Yes	38	34
No	132	136
Commitment takedowns: Yes	32	23
No	138	147
Loans to business customers for speculative purposes.		
Requests: Yes	47	41
No	123	129
Approvals: Yes	9	5
No	161	165
Commitment takedowns: Yes	7	4
No	163	166
Applications for commercial and industrial loans or loan commitments for non-U.S. affiliates of U.S. firms, as compared with the same month in recent years.		
Significantly larger	3	1
Essentially unchanged	161	158
Significantly less	6	11
Proportion of such applications approved.		
Significantly larger than usual	0	0
Essentially unchanged	163	161
Significantly smaller than usual	7	9

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Table IB1
Selected Financial Data
(Amounts outstanding, in billions of dollars)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	February 1979	February 1980	March 1979	March 1980	April 1979	April 1980
Total loans and investments	453.5	514.0	456.1	514.9	461.4	515.2
Total loans	346.6	401.8	348.3	403.6	353.7	403.4
Total C & I loans	135.8	159.4	138.2	161.9	142.0	159.0
To U.S. addressees	126.9	150.5	129.4	152.9	133.5	152.5
To smaller businesses	29.0	32.2	29.7	32.3	30.6	32.7
Real estate loans, resid. prop.	50.6	60.7	51.5	61.5	51.8	61.6
Agricultural loans	4.6	5.1	4.7	5.2	4.8	5.2
All other loans	155.6	175.3	153.8	174.8	155.0	174.2
Lease financing receivables	6.0	8.5	6.2	8.7	6.3	8.8
U.S. customers' liability on acceptances	8.7	13.1	9.1	13.6	8.5	13.2
Loan commitments	228.1	293.3	247.8	334.0	249.4	341.1
C & I loans by foreign offices to U.S. addressees	4.0	5.1	4.3	5.0	4.3	5.2
Total liquid assets	171.7	193.2	175.6	187.5	175.2	197.3
Total discretionary liabilities	423.1	505.7	430.9	502.4	429.7	506.7
Total assets	867.2	994.6	880.1	1001.6	893.2	1011.7
Total equity capital	39.4	46.7	42.7	46.9	43.0	47.9
Total loans and leases	338.4	398.8	343.0	401.9	349.1	403.5

Memo:	December 1979	March 14, 1980
Total loans and leases to U.S. addressees	398.1	xxxxxx
Loan commitments to U.S. addressees	294.1	328.8

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Table IB2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

U.S. Commercial Banks
Assets $1 Billion or more

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total loans and investments	60.5	58.8	53.9
Total loans	55.2	55.3	49.7
Total C & I loans	23.6	23.7	16.9
To U.S. addressees	23.6	23.4	19.0
To smaller businesses	3.2	2.6	2.2
Real estate loans, resid. prop.	10.1	10.1	9.8
Agricultural loans	0.5	0.4	0.4
All other loans	19.7	21.0	19.2
Lease financing receivables	2.4	2.5	2.4
U.S. customers' liability on acceptances	4.4	4.4	4.7
Loan commitments	65.2	87.1	91.7
C & I loans by foreign offices	1.1	0.7	0.9
to U.S. addressees	60.3	59.0	54.3
Total loans and leases			

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total loans and investments	2.6	0.9	5.3	0.3
Total loans	1.7	1.8	5.4	-0.2
Total C & I loans	2.5	2.5	3.8	-2.9
To U.S. addressees	2.6	2.4	4.1	-0.3
To smaller businesses	0.6	0.1	0.1	0.3
Real estate loans, resid. prop.	0.9	0.8	1.2	0.1
Agricultural loans	0.1	0.1	0.2	-0.0
All other loans	-1.7	-0.5	1.1	-0.6
Lease financing receivables	0.1	0.2	0.2	0.1
U.S. customers' liability on acceptances	0.4	0.4	-0.7	-0.4
Loan commitments	19.7	40.6	1.6	7.2
C & I loans by foreign offices to U.S. addressees	0.3	-0.1	0.0	0.2
Total loans and leases	4 5	3.2	6.1	-1.5

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	0.6	3.8	5.3
Loan commitments to U.S. addressees	-0.8	39.9	47.1

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Table IB3
Selected Financial Data
(Percent changes in amounts outstanding)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total loans and investments	13.3	12.9	11.7
Total loans	15.9	15.9	14.1
Total C & I loans	17.4	17.1	11.9
To U.S. addressees	18.6	18.1	14.2
To smaller businesses	10.9	8.9	7.1
Real estate loans, resid. prop.	20.0	19.6	18.9
Agricultural loans	10.5	9.5	7.6
All other loans	12.7	13.6	12.4
Lease financing receivables	40.6	40.1	38.6
U.S. customers' liability on acceptances	50.8	48.7	55.6
Loan commitments	28.6	34.8	36.8
C & I loans by foreign offices to U.S. addressees	27.8	16.3	20.8
Total loans and leases	17.8	17.2	15.6

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total loans and investments	0.6	0.2	1.2	0.1
Total loans	0.5	0.4	1.5	-0.0
Total C & I loans	1.8	1.6	2.7	-1.8
To U.S. addressees	2.0	1.6	3.1	-0.2
To smaller businesses	2.2	0.4	2.9	1.2
Real estate loans, resid. prop.	1.7	1.4	0.7	0.2
Agricultural loans	2.0	1.1	1.3	-0.4
All other loans	-1.1	-0.3	0.8	-0.3
Lease financing receivables	2.4	2.1	2.6	1.5
U.S. customers' liability on acceptances	5.1	3.6	-7.3	-3.0
Loan commitments	8.6	13.9	0.6	2.2
C & I loans by foreign offices to U.S. addressees	6.8	-2.9	0.8	4.7
Total loans and leases	1.3	0.8	1.8	0.4

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	0.2	1.0	1.3
Loan commitments to U.S. addressees	-0.3	13.6	16.0

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Table IB4
Loans, by Type
(Percentage distribution)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

Type of loan	February 1979	February 1980	March 1979	March 1980	April 1979	April 1980
Total loans	100.0	100.0	100.0	100.0	100.0	100.0
Total C & I loans	39.2	39.7	39.7	40.1	40.2	39.4
To U.S. addressees	36.6	37.4	37.2	37.9	37.7	37.8
To smaller businesses	8.4	8.0	8.5	8.0	8.6	8.1
Real estate loans, resid. prop.	14.6	15.1	14.8	15.2	14.7	15.3
Agricultural loans	1.3	1.3	1.4	1.3	1.4	1.3
All other loans	44.9	43.6	44.2	43.3	43.8	43.2
Total C & I loans	100.0	100.0	100.0	100.0	100.0	100.0
To U.S. addressees	93.5	94.4	93.7	94.4	94.0	96.0
To smaller businesses	21.4	20.2	21.5	20.0	21.5	20.6

Table IB5
Relationship of Unused Loan Commitments to Total Loans and Leases

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	1979 December	1980 February	1980 March	1980 April
	(percent)			
Unused commitments/ Total loans and leases	73.9	73.6	83.1	84.6

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Table IB6
Liquidity and Capital Ratios
(Percent)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

Ratio	February		March		April	
	1979	1980	1979	1980	1979	1980
Liquid assets/Total assets	19.8	19.4	20.0	18.7	19.6	19.5
Discretionary liabilities/ Total assets	48.8	50.8	49.0	50.2	48.1	50.1
Liquid assets minus disc. liab./ Total assets	-29.0	-31.4	-29.0	-31.4	-28.5	-30.6
Liquid assets/Discretionary liabilities	40.6	38.2	40.7	37.3	40.8	38.9
Total equity capital/Total assets	4.5	4.7	4.9	4.7	4.8	4.7

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Table ICI
Selected Financial Data
(Distributions of individual respondent percent changes in amounts outstanding)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month (quartiles)								
	February			March			April		
	1	2	3	1	2	3	1	2	3
Total loans & investments	4.8	10.1	15.6	3.8	9.4	15.1	2.9	7.6	13.2
Total loans	6.8	11.6	17.5	5.8	11.5	16.9	3.9	9.1	15.4
Total C & I loans	2.2	11.7	21.0	2.1	11.1	22.3	1.2	8.8	18.4
To U.S. addressees	3.3	12.0	22.4	2.2	11.5	22.6	1.6	9.4	16.9
To smaller businesses	0.4	8.4	21.3	-0.6	6.5	19.2	-2.1	4.9	16.6
Real estate loans, resid. prop.	5.1	13.3	26.0	4.8	12.3	27.3	3.8	12.9	24.9
Agricultural loans	-22.8	4.0	24.3	-27.5	0.6	21.1	-25.9	-2.5	24.0
All other loans	2.2	9.0	16.4	3.1	9.0	15.8	0.3	7.6	14.1
Lease financing receivables	-5.3	15.3	40.6	-5.1	16.6	44.4	-5.4	14.9	39.7
U.S. customers' liability on acceptances	-18.8	43.2	143.7	-4.5	53.3	136.6	-2.5	71.3	199.2
Loan commitments	8.9	18.4	30.7	9.2	18.4	30.7	8.4	18.6	34.3
C & I loans by foreign offices to U.S. addressees	-29.3	14.9	65.6	-33.3	19.6	81.5	-20.4	19.9	103.9
Total liquid assets	-12.0	4.6	27.1	15.0	3.8	25.1	-12.3	10.9	40.9
Total discretionary liabilities	4.1	16.4	29.4	2.8	15.0	26.9	1.8	14.4	28.8
Total assets	5.2	10.3	16.0	6.7	11.0	16.7	4.6	10.7	16.7
Total equity capital	5.3	9.5	12.2	5.4	9.1	11.5	5.2	9.1	12.0
Total loans and leases	7.0	11.9	18.5	5.6	11.4	18.8	3.9	9.5	15.4

	Change from preceding month (quartiles)											
	March 1979			March 1980			April 1979			April 1980		
	1	2	3	1	2	3	1	2	3	1	2	3
Total loans & investments	-0.6	0.6	1.7	-1.0	0.0	1.4	0.0	1.3	2.8	-1.6	-0.1	1.5
Total loans	-0.4	0.9	1.9	-0.7	0.3	1.4	0.4	1.3	2.8	-1.5	-0.1	1.0
Total C & I loans	-0.1	1.9	4.0	-1.0	0.7	3.4	0.3	2.2	4.2	-2.2	-0.1	2.5
To U.S. addressees	0.1	2.3	4.3	-0.9	1.0	3.8	0.4	2.6	4.6	-2.2	-0.3	2.6
To smaller businesses	-0.4	1.3	4.1	-1.2	0.4	2.6	-0.4	1.9	5.7	-3.5	-0.5	3.4
Real estate loans resid. prop.	-0.2	0.9	2.0	-0.5	0.3	1.3	-0.2	0.9	2.9	-1.2	0.4	2.3
Agricultural loans	-4.3	0.6	6.5	-3.0	0.0	3.8	-6.6	0.4	6.0	-8.9	-0.9	4.1
All other loans	-2.4	-0.1	1.7	-1.9	-0.3	1.2	-1.3	1.1	3.0	-2.8	-0.8	1.4
Lease financing receivables	-0.7	0.0	2.0	-0.8	0.0	2.1	-1.2	0.2	3.0	-1.3	-0.0	2.3
U.S. customers' liability on acceptances	-12.7	1.4	19.7	-12.3	2.5	21.5	-16.3	-0.9	13.8	-15.8	1.6	31.0
Loan commitments'	-0.8	1.4	3.8	0.0	2.3	5.6	-3.0	0.8	3.5	-2.2	0.3	3.3
C & I loans by foreign offices to U.S. addressees	-5.6	0.0	6.1	-10.3	0.0	5.3	-4.4	0.0	18.7	-10.2	0.0	7.3
Total liquid assets	-11.3	-0.8	10.4	-10.6	0.7	11.1	-9.2	0.2	13.5	-9.7	2.6	20.7
Total discretionary liab.	-3.0	0.6	6.2	-4.6	-0.4	3.7	-3.8	1.4	6.8	-4.3	0.0	5.9
Total assets	-2.2	-0.3	2.0	-1.2	0.4	2.8	0.4	2.3	4.4	-0.4	1.6	3.9
Total equity capital	-0.3	0.8	1.5	-0.5	0.4	1.1	-0.0	0.8	1.3	0.0	1.0	1.9
Total loans and leases	-0.1	0.9	2.0	-0.6	0.3	1.6	0.4	1.6	3.3	-1.5	0.0	1.1

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Table IC1 (cont'd)

	Change from December 1979 (quartiles)								
	February			March			April		
	1	2	3	1	2	3	1	2	3
Loan commitments to U.S. addressees	0.0	2.6	7.1	1.6	5.3	10.7	0.0	6.5	13.5
Total loans and leases to U.S. addressees	-2.0	-0.1	1.5	-1.7	0.1	2.1	-2.1	0.2	2.1

	Change from December 1979 (percent)	February	March	April
		(Number of respondents)		
Total loans and leases to U.S. addressees	Actual:			
	less than 0.0	87	76	78
	0.0-5.99	82	87	86
	6.00-9.00	1	4	3
	over 9.00	0	3	3
	Annualized:			
	less than 0.0	87	76	78
	0.0-5.99	24	39	44
	6.00-9.00	16	15	18
	over 9.00	43	40	30

Table IC2
Loans, by Type
(Individual respondent data)

U.S. Commercial Banks
Assets $1 Billion or more

All Federal Reserve Districts

	March 1979			March 1980			April 1979			April 1980		
	(quartiles)											
Type of loan	1	2	3	1	2	3	1	2	3	1	2	3
	Percent of total loans											
C & I loans	28.0	35.3	44.6	27.7	36.8	44.4	29.1	36.1	43.9	27.9	37.1	44.6
To U.S. add.	26.6	33.7	43.5	26.4	35.0	42.9	27.7	34.4	43.6	26.7	34.8	44.1
To smaller bus.	4.2	10.3	17.3	4.8	9.9	17.3	4.2	9.9	17.5	4.7	9.9	17.2
Real estate, resid.	7.0	14.7	23.1	7.7	14.6	23.2	7.2	14.7	22.4	7.8	15.0	23.2
Agricultural	0.0	0.4	1.3	0.0	0.4	1.4	0.0	0.4	1.3	0.0	0.3	1.4
All other	40.6	45.7	52.3	39.8	45.4	51.2	40.3	45.9	53.3	39.6	45.4	51.4
	Percent of C & I loans											
C & I to U.S. add.	94.4	98.3	100.0	94.7	98.1	100.0	94.3	98.1	100.0	94.4	98.3	100.0
To smaller bus.	11.6	29.3	54.8	12.5	30.0	55.0	10.8	28.9	54.2	11.4	30.8	56.6

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Table IC3
Relationship of Unused Loan Commitments to
Total Loans and Leases
(Distribution of individual respondent ratios)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	1979 December			1980 February			March			April		
	(quartiles)											
	1	2	3	1	2	3	1	2	3	1	2	3
Unused commitments (percent of total loans and leases)	31.7	52.0	86.0	33.3	53.0	91.0	33.5	54.2	94.3	34.1	56.4	97.3

Table IC4
Liquidity and Capital Ratios
(Distribution of individual respondent ratios)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

Ratio	Quartile	February 1979	February 1980	March 1979	March 1980	April 1979	April 1980
		(percent)					
Liquid assets/Total assets	1	8.6	7.4	8.5	7.6	8.2	8.0
	2	12.9	13.0	13.1	12.7	13.1	12.7
	3	20.3	18.6	20.7	18.0	19.0	19.1
Discretionary liabilities/ Total assets	1	25.4	27.1	26.6	25.9	25.5	25.9
	2	34.9	37.0	34.8	37.0	34.3	36.8
	3	45.8	48.4	46.1	49.0	46.3	49.7
Liquid assets minus disc. liab./Total assets	1	-28.4	-32.8	-29.6	-32.6	-30.0	-32.8
	2	-20.3	-22.9	-21.5	-23.7	-20.6	-22.7
	3	-12.7	-14.1	-12.3	-14.7	-13.5	-14.0
Liquid assets/Discretionary liabilities	1	28.7	25.2	27.7	24.1	28.4	25.4
	2	39.0	36.3	38.5	35.7	38.6	35.9
	3	54.4	50.0	54.5	50.8	54.8	53.4
Total equity capital/ Total assets	1	5.0	5.1	5.1	5.0	5.0	4.9
	2	5.9	5.8	5.9	5.8	5.8	5.7
	3	6.8	6.8	6.8	6.7	6.7	6.6

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Table IIA1
Credit Demands and Loan Policies

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	March	April
	(number of respondents)	
	139	139
Current strength of total private credit demands from U.S. addressees, as compared with the situation generally prevailing during February 1980 and taking account of seasonal patterns.		
Significantly greater	23	8
Essentially unchanged	110	118
Significantly less	6	13
Applications for commercial and industrial loans or loan commitments to meet basic credit demands for normal operations, as compared with the same month in recent years.		
Significantly larger	34	18
Essentially unchanged	98	110
Significantly less	7	11
Proportion of such applications approved.		
Significantly larger than usual	8	3
Essentially unchanged	116	118
Significantly smaller than usual	15	18
Applications for commercial and industrial loans to meet basic and emerging needs for smaller businesses, as compared with the same month in recent years.		
Significantly larger	5	3
Essentially unchanged	127	129
Significantly less	7	7
Proportion of such applications approved.		
Significantly larger than usual	3	1
Essentially unchanged	131	132
Significantly smaller than usual	5	6

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Table IIA1 (cont'd)

	March	April
Commercial and industrial loans for purely financial activities.		
Requests: Yes	19	13
No	120	126
Approvals: Yes	1	2
No	138	137
Commitment takedowns: Yes	7	2
No	132	137
Loans to business customers for speculative purposes.		
Requests: Yes	5	3
No	134	136
Approvals: Yes	0	0
No	139	139
Commitment takedowns: Yes	2	0
No	137	139
Shifts out of United States, during the current month, of commercial and industrial lending to U.S. addressees.		
Rebooking of maturing loans offshore		
Yes	4	3
No	135	136
Sale of loans to non-U.S. offices of foreign parent		
Yes	0	2
No	139	137
Booking of new loans abroad rather than in United States		
Yes	1	2
No	138	137
Applications for foreign-booked commercial and industrial loans or loan commitments for U.S. addressees, as compared with the same month in recent years.		
Significantly larger	6	2
Essentially unchanged	129	133
Significantly less	4	4
Proportion of such applications approved.		
Significantly larger than usual	1	0
Essentially unchanged	134	133
Significantly smaller than usual	4	6

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Table IIA1 (cont'd)

	March	April
Applications for foreign-booked commercial and industrial loans or loan commitments for non-U.S. affiliates of U.S. firms, as compared with the same month in recent years.		
Significantly larger	1	0
Essentiallly unchanged	134	135
Significantly less	4	4
Proportion of such applications approved.		
Significantly larger than usual	0	1
Essentially unchanged	134	133
Significantly smaller than usual	5	5

Table IIB1
Selected Financial Data
(Amounts outstanding, in billions of dollars)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	February		March		April	
	1979	1980	1979	1980	1979	1980
Total loans and investments	65.0	72.7	56.5	75.8	56.6	74.1
Total loans	50.2	68.7	53.1	71.5	53.4	70.8
Total C & I loans	28.1	38.9	29.7	40.3	29.6	38.9
To U.S. addressees	18.2	25.2	18.8	26.1	18.7	24.9
To smaller businesses	0.5	0.7	0.5	0.7	0.5	0.7
Real estate loans, resid. prop.	0.1	0.1	0.1	0.1	0.1	0.1
Agricultural loans	*	*	*	*	*	*
All other loans	22.0	29.7	23.3	31.0	23.8	31.8
Lease financing receivables	*	*	*	*	*	*
U.S. customers' liability on acceptances	3.4	4.4	3.8	4.6	3.9	4.7
Loan commitments	32.5	59.4	33.3	64.5	35.1	65.0
Total loans and leases	28.0	42.0	27.9	43.5	28.5	40.9

	December 1979	March 14, 1980
Memo: Total loans and leases to U.S. addressees	39.8	xxxxxx
Loan commitments to U.S. addressees	51.1	62.8

* Less than $50 million.

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Table IIB2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total loans and investments	7.7	19.3	17.4
Total loans	18.5	18.4	17.4
Total C & I loans	10.8	10.6	9.3
To U.S. addressees	7.0	7.3	6.2
To smaller businesses	0.2	0.2	0.2
Real estate loans, resid. prop.	0.0	0.0	0.0
Agricultural loans	--	--	--
All other loans	7.7	7.7	8.0
Lease financing receivables	--	--	--
U.S. customers' liability on acceptances	1.0	0.8	0.8
Loan commitments	26.8	31.2	29.9
Total loans and leases	14.0	15.6	12.4

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total loans and investments	-8.5	3.0	0.1	-1.7
Total loans	2.9	2.8	0.4	-0.7
Total C & I loans	1.6	1.4	-0.1	-1.5
To U.S. addressees	0.7	0.9	-0.1	-1.2
To smaller businesses	0.0	0.0	0.0	0.0
Real estate loans, resid. prop.	0.0	0.0	0.0	0.0
Agricultural loans	--	--	--	--
All other loans	1.3	1.4	0.5	0.8
Lease financing receivables	--	--	--	--
U.S. customers' liability on acceptances	0.4	0.2	0.1	0.1
Loan commitments	0.7	5.1	1.9	0.6
Total loans and leases	-0.1	1.5	0.7	-2.6

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	2.1	3.7	1.1
Loan commitments to U.S. addressees	8.2	13.3	13.9

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Table IIB3
Selected Financial Data
(Percent changes in amounts outstanding)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total loans and investments	11.9	34.1	30.8
Total loans	36.8	34.7	32.5
Total C & I loans	38.3	35.8	31.3
To U.S. addressees	38.7	38.8	32.9
To smaller businesses	37.2	41.2	27.6
Real estate loans, resid. prop.	--	--	--
Agricultural loans	--	--	--
All other loans	34.8	33.2	33.9
Lease financing receivables	--	--	--
U.S. customers' liability on acceptances	28.8	21.8	19.2
Loan commitments	82.5	93.8	85.1
Total loans and leases	50.0	56.0	43.4

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total loans and investments	-13.1	4.2	0.2	-2.3
Total loans	5.7	4.1	0.7	-0.9
Total C & I loans	5.6	3.7	-0.3	-3.6
To U.S. addressees	3.6	3.7	-0.4	-4.7
To smaller businesses	--	--	--	--
Real estate loans, resid. prop.	--	--	--	--
Agricultural loans	--	--	--	--
All other loans	5.8	4.6	2.0	2.5
Lease financing receivables	--	--	--	--
U.S. customers' liability on acceptances	11.3	5.3	3.8	1.5
Loan commitments	2.3	8.6	5.6	0.9
Total loans and leases	-0.3	3.7	2.3	-5.9

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	5.3	9.2	2.7
Loan commitments to U.S. addressees	16.1	26.1	27.2

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Table IIB4
Loans, by Type
(Percentage distribution)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

Type of loan	February 1979	February 1980	March 1979	March 1980	April 1979	April 1980
Total loans	100.0	100.0	100.0	100.0	100.0	100.0
Total C & I loans	56.0	56.6	55.9	56.4	55.4	54.9
To U.S. addressees	36.2	36.7	35.5	36.5	35.0	35.2
To smaller businesses	1.0	1.0	1.0	1.0	1.0	1.0
Real estate loans, resid. prop.	0.1	0.1	0.1	0.1	0.1	0.2
Agricultural loans	0.0	0.0	0.0	0.0	0.0	0.0
All other loans	43.8	43.2	43.9	43.4	44.5	44.9
Total C & I loans	100.0	100.0	100.0	100.0	100.0	100.0
To U.S. addressees	64.6	64.8	63.4	64.8	63.3	64.0
To smaller businesses	1.9	1.8	1.7	1.8	1.8	1.8

Table IIB5
Relationship of Unused Loan Commitments to Total Loans and Leases

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	1979 December	1980 February	1980 March	1980 April
		(percent)		
Unused commitments/ Total loans and leases	128.3	141.4	148.1	158.8

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Table IIC1
Selected Financial Data
(Distributions of individual respondent percent changes in amounts outstanding)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	Change from year-ago month (quartiles)								
	February			March			April		
	1	2	3	1	2	3	1	2	3
Total loans and investments	4.5	40.0	76.4	6.4	38.5	70.7	8.6	34.2	70.0
Total loans	9.4	41.5	81.6	7.9	41.0	71.6	8.0	35.8	71.8
Total C & I loans	4.1	36.6	98.3	3.7	29.0	86.6	2.4	33.0	83.6
To U.S. addressees	3.9	42.1	132.8	-0.2	30.7	116.7	-3.1	28.0	93.8
To smaller businesses	-9.4	31.0	80.8	-7.4	14.7	103.1	-17.6	4.6	56.4
Real estate loans, resid. prop.	6.6	38.6	90.8	-7.1	21.0	61.2	-7.9	28.1	60.6
Agricultural loans	*	*	*	*	*	*	*	*	*
All other loans	2.8	51.2	151.9	0.0	49.8	171.1	-4.5	37.4	125.4
Lease financing receivables	*	*	*	*	*	*	*	*	*
U.S. customers' liability on acceptances	-52.2	15.9	138.7	-62.9	-1.2	85.8	-62.6	7.8	186.8
Loan commitments	22.3	65.7	136.7	20.3	72.6	195.3	13.5	62.8	154.9
Total loans and leases	1.6	41.4	93.7	4.7	45.3	116.6	3.5	35.8	123.3

	Change from preceding month (quartiles)											
	March 1979			March 1980			April 1979			April 1980		
	1	2	3	1	2	3	1	2	3	1	2	3
Total loans and investments	-2.3	5.1	17.8	-1.8	3.9	13.2	-6.0	0.8	10.0	-8.8	0.0	6.6
Total loans	-2.1	5.3	17.9	-1.8	4.7	12.4	-5.2	1.1	9.6	-9.2	-0.4	7.2
Total C & I loans	-2.1	3.9	16.3	-4.5	1.9	11.9	-6.6	1.8	9.0	-10.5	-0.1	7.6
To U.S. addressees	-2.8	3.5	14.1	-9.7	0.0	12.1	-9.5	2.1	8.9	-10.6	-1.1	10.0
To smaller businesses	-10.7	0.0	7.3	-6.1	-0.3	8.9	-7.8	3.3	22.2	-17.9	-0.9	5.5
Real estate loans, resid. prop.	-0.5	0.9	5.6	-0.6	0.0	3.8	-2.1	0.0	1.8	-2.0	0.0	2.9
Agricultural loans	*	*	*	*	*	*	*	*	*	*	*	*
All other loans	-7.7	3.4	25.3	-2.9	8.2	28.6	-12.6	2.8	29.3	-18.8	-1.4	15.7
Lease financing receivables	*	*	*	*	*	*	*	*	*	*	*	*
U.S. customers' liability on acceptances	-8.5	5.1	20.8	-28.7	-4.8	11.7	-41.6	-0.9	20.7	-28.7	-2.0	44.7
Loan commitments	-1.3	0.0	7.8	-0.5	2.6	13.7	-3.2	0.4	12.7	-9.1	-0.3	3.8
Total loans and leases	-6.4	1.3	14.0	-2.6	3.6	17.6	-6.6	2.7	14.4	-17.4	-1.2	7.9

* The number of institutions reporting amounts in these categories is too small to compute quartiles.

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Table IIC1 (cont'd)

	Change from December 1979 (quartiles)								
	February			March			April		
	1	2	3	1	2	3	1	2	3
Loan commitments to U.S. addressees	0.0	8.8	38.9	0.0	13.5	51.2	-2.5	13.2	48.1
Total loans and leases to U.S. addressees	-9.0	2.2	16.2	-6.4	8.1	26.5	-20.9	-1.9	24.1

	Change from December 1979* (percent)	February	March	April
		(number of respondents)		
Total loans and leases to U.S. addressees	Actual:			
	less than 0.0	48	34	62
	0.0-5.99	19	18	6
	6.0-9.00	8	8	5
	over 9.00	56	71	58
	Annualized:			
	less than 0.0	48	34	62
	0.0-5.99	6	7	3
	6.0-9.00	2	0	1
	over 9.00	75	90	65

* Excludes eight respondents with no loans and leases to U.S. addressees in December, 1979.

Table IIC2
Relationship of Unused Loan Commitments to
Total Loans and Leases
(Distribution of individual respondent ratios)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	1979 December			1980 February			March			April		
	(quartiles)											
			3	1	2	3	1	2	3	1		
Unused commitments (percent of total loans and leases)	1.4	49.4	124.0	0.3	53.1	154.2	3.0	58.4	152.0	1.1	56.7	171.5

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Table IIIA1
Credit Demands and Loan Policies

Bank Holding Companies
Assets $1 Billion or More

All Federal Reserve Districts

	March	April
	(number of respondents)	
	161	161
Current strength of total private credit demands from U.S. addressees, as compared with the situation generally prevailing during February 1980 and taking account of seasonal patterns.		
Significantly greater	7	1
Essentially unchanged	138	123
Significantly less	16	37
Applications for commercial and industrial loans or loan commitments to meet basic credit demands for normal operations, as compared with the same month in recent years.		
Significantly larger	9	3
Essentially unchanged	127	109
Significantly less	25	49
Proportion of such applications approved.		
Significantly larger than usual	1	1
Essentially unchanged	133	135
Significantly smaller than usual	27	25
Applications for commercial and industrial loans to meet basic and emerging needs for smaller businesses, as compared with the same month in recent years.		
Significantly larger	3	3
Essentially unchanged	131	112
Significantly less	27	46
Proportion of such applications approved.		
Significantly larger than usual	0	0
Essentially unchanged	145	139
Significantly smaller than usual	16	22

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Table IIIA1 (cont'd)

	March	April
Commercial and industrial loans for purely financial activities.		
Requests: Yes	38	29
No	123	132
Approvals: Yes	10	10
No	151	151
Commitment takedowns: Yes	8	5
No	153	156
Loans to business customers for speculative purposes.		
Requests: Yes	36	26
No	125	135
Approvals: Yes	8	4
No	153	157
Commitment takedowns: Yes	6	3
No	155	158

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Table IIIB1
Selected Financial Data
(Amounts outstanding, in billions of dollars)

Bank Holding Companies
Assets $1 Billion or More

All Federal Reserve Districts

	February 1979	February 1980	March 1979	March 1980	April 1979	April 1980
Nonreporting subsidiaries						
U.S. nonbank						
C & I loans, U.S. addressees	7.4	9.3	7.6	9.6	7.7	9.6
U.S. commercial bank						
C & I loans, U.S. addressees	18.7	20.6	19.1	20.6	19.6	20.6
Non-U.S. bank and nonbank						
C & I loans, U.S. addressees	0.2	0.2	0.2	0.2	0.2	0.2
U.S. & non-U.S. commercial bank						
U.S. cust. liab. on accept.	*	0.1	0.1	0.1	*	0.1
Loan commitments	12.0	14.2	13.2	15.3	13.0	15.4
All nonreporting subsidiaries						
Total loans and leases	85.0	97.3	86.0	98.2	83.9	93.8

	December 1979	March 14, 1980
Memo: Total loans and leases to U.S. addressees	94.8	xxxxxx
Loan commitments to U.S. addressees by nonreporting bank subsidiaries	14.4	14.7

* Less than $50 million.

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Table IIIB2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

Bank Holding Companies
Assets $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Nonreporting subsidiaries			
U.S. nonbank			
C & I loans, U.S. addressees	1.9	2.0	1.9
U.S. commercial bank			
C & I loans, U.S. addressees	1.9	1.5	1.0
Non-U.S. bank and nonbank			
C & I loans, U.S. addressees	*	*	*
U.S. & non-U.S. commercial bank			
U.S. cust. liab. on accept.	*	*	*
Loan commitments	2.2	2.1	2.4
All nonreporting subsidiaries			
Total loans and leases	12.3	12.2	9.9

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Nonreporting subsidiaries				
U.S. nonbank				
C & I loans, U.S. addressees	0.2	0.3	0.1	*
U.S. commercial bank				
C & I loans, U.S. addressees	0.4	0.0	0.5	*
Non-U.S. bank and nonbank				
C & I loans, U.S. addressees	*	*	*	*
U.S. & non-U.S. commercial bank				
U.S. cust. liab. on accept.	*	*	*	*
Loan commitments	1.2	1.1	-0.2	0.1
All nonreporting subsidiaries				
Total loans and leases	1.0	0.9	-2.1	-4.4

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	2.5	3.4	-1.0
Loan commitments to U.S. addressees by nonreporting subsidiaries	-0.2	0.9	1.0

* Less than $50 million.

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Table IIIB3
Selected Financial Data
(Percent changes in amounts outstanding)

Bank Holding Companies
Assets $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Nonreporting subsidiaries			
U.S. nonbank			
C & I loans, U.S. addressees	25.7	26.3	24.7
U.S. commercial bank			
C & I loans, U.S. addressees	10.2	7.9	5.1
Non-U.S. bank and nonbank			
C & I loans, U.S. addressees	--	--	--
U.S. & non-U.S. commercial bank			
U.S. cust. liab. on accept.	--	--	--
Loan commitments	18.3	15.9	18.5
All nonreporting subsidiaries			
Total loans and leases	14.4	14.2	11.8

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Nonreporting subsidiaries				
U.S. nonbank				
C & I loans, U.S. addressees	2.7	3.2	1.3	
U.S. commercial bank				
C & I loans, U.S. addressees	2.1	--	2.6	
Non-U.S. bank and nonbank				
C & I loans, U.S. addressees	--	--	--	
U.S. & non-U.S. commercial bank				
U.S. cust. liab. on accept.	--	--	--	--
Loan commitments	10.0	7.7	1.5	0.7
All nonreporting subsidiaries				
Total loans and leases	1.2	0.9	-2.4	-4.5

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	2.6	3.6	-1.1
Loan commitments to U.S. addressees by nonreporting subsidiaries	-1.4	6.2	6.9

Table IIIB4
Relationship of Unused Loan Commitments to Total Loans and Leases

Bank Holding Companies
U.S. Assets $1 Billion or More

All Federal Reserve Districts

	1979	1980		
	December	February	March	April
	(percent)			
Unused commitments/ Total loans and leases	15.2	14.6	15.6	16.4

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Table IIIC1
Total Loans and Leases to U.S. Addressees
(Distributions of individual respondent percent changes)

Bank Holding Companies
U.S. Assets $1 Billion or More

All Federal Reserve Districts

Change from year-ago month (quartiles)								
February			March			April		
1	2	3	1	2	3	1	2	3
2.7	9.0	15.7	2.4	8.6	14.6	0.8	5.9	12.6

Change from preceding month (quartiles)											
March 1979			March 1980			April 1979			April 1980		
1	2	3	1	2	3	1	2	3	1	2	3
0.0	1.0	1.8	-0.5	0.0	1.1	-1.2	1.1	2.7	-2.0	-0.3	0.9

Change from December 1979 (quartiles)								
February			March			April		
1	2	3	1	2	3	1	2	3
-2.3	-0.3	1.2	-1.9	-0.1	1.8	-5.4	-0.5	2.3

Change from December 1979* (percent)	February	March	April
	(number of respondents)		
Actual:			
less than 0.0	83	79	85
0.0-5.99	54	54	43
6.0-9.00	5	7	10
over 9.00	10	12	14
Annualized:			
less than 0.0	83	79	85
0.0-5.99	27	29	28
6.0-9.00	4	9	4
over 9.00	38	35	35

* Excludes nine respondents with no loans and leases to U.S. addressees in December, 1979.

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Table IVA1
Credit Demands and Loan Policies

Finance Companies
Business Receivables $1 Billion or More

All Federal Reserve Districts

	March	April
	(number of respondents)	
	15	15
Current strength of total private credit demands from U.S. addressees, as compared with the situation generally prevailing during February 1980 and taking account of seasonal patterns.		
Significantly greater	4	1
Essentially unchanged	9	8
Significantly less	2	6
Applications for business loans to meet basic credit demands for normal operations, as compared with the same month in recent years.		
Significantly larger	6	3
Essentially unchanged	6	7
Significantly less	3	5
Proportion of such applications approved.		
Significantly larger than usual	2	1
Essentially unchanged	9	12
Significantly smaller than usual	4	2
Applications for business loans to meet basic and emerging needs for smaller businesses, as compared with the same month in recent years.		
Significantly larger	3	0
Essentially unchanged	9	10
Significantly less	3	5
Proportion of such applications approved.		
Significantly larger than usual	1	0
Essentially unchanged	10	13
Significantly smaller than usual	4	2
Business loans for purely financial activities.		
Requests: Yes	3	1
No	12	14
Approvals: Yes	0	1
No	15	14
Commitment takedowns: Yes	0	0
No	15	15
Loans to business customers for speculative purposes.		
Requests: Yes	0	0
No	15	15
Approvals: Yes	0	0
No	15	15
Commitment takedowns: Yes	0	0
No	15	15

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Table IVB1
Selected Financial Data
(Amounts outstanding, in billions of dollars)

Finance Companies
Business Receivables $1 Billion or More

All Federal Reserve Districts

	February		March		April	
	1979	1980	1979	1980	1979	1980
Total accounts receivable	68.3	76.5	73.0	81.0	74.5	81.6
Total business receivables	40.6	43.1	40.1	45.5	44.4	45.7
From U.S. addressees	38.6	40.4	39.5	40.5	43.8	44.9
From smaller businesses	26.9	28.0	27.7	28.0	30.0	29.6
Lease financing receivables	9.1	9.5	10.3	9.5	10.3	10.8
Business loans by foreign offices to U.S. addressees	0.0	0.0	0.0	0.0	0.0	0.0

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Table IVB2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

Finance Companies
Business Receivables $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total accounts receivables	8.2	8.0	7.1
Total business receivables	2.5	5.4	1.3
From U.S. addressees	1.8	1.0	1.1
From smaller businesses	1.1	0.3	-0.4
Lease financing receivables	0.4	-0.8	0.5
Business loans by foreign offices to U.S. addressees			

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total accounts receivables	4.7	4.5	1.5	0.6
Total business receivables	-0.5	2.4	4.3	0.2
From U.S. addressees	0.9	0.1	4.3	4.4
From smaller businesses	0.8	*	2.3	1.6
Lease financing receivables	1.2	*	*	1.3
Business loans by foreign offices to U.S. addressees				

* Less than $50 million.

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Table IVB3
Selected Financial Data
(Percent changes in amounts outstanding)

Finance Companies
Business Receivables $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total accounts receivables	12.0	11.0	9.5
Total business receivables	6.2	13.5	2.9
From U.S. addressees	4.7	2.5	2.5
From smaller businesses	4.1	1.1	-1.3
Lease financing receivables	4.4	-7.8	4.9
Business loans by foreign offices to U.S. addressees			

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total accounts receivables	6.9	0.1	2.1	0.7
Total business receivables	*	5 6	10.7	0.4
From U.S. addressees	2.3	0.2	10.9	10.9
From smaller businesses	3.0	*	8.3	5.7
Lease financing receivables	13.2	*	*	13.7
Business loans by foreign offices to U.S. addressees				

* Less than .05 percent.

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Table VA1
Selected Financial Data
(Amounts outstanding, in billions of dollars)

Selected Corporations

All Federal Reserve Districts

	February		March		April	
	1979	1980	1979	1980	1979	1980
			365 Respondents			
Commercial paper issued in U.S.	xx	xx	xx	xx	xx	xx
Amount outstanding	58.7	75.1	58.8	75.2	62.3	79.1
Total backup U.S. bank lines	73.4	100.0	74.9	125.3	76.1	107.0
Indebtedness to non-U.S. entities	13.4	19.3	14.4	20.4	12.5	19.6
Foreign offices of U.S. banks	2.0	2.0	2.1	2.0	1.8	2.0
Foreign offices non-U.S. banks	2.6	3.9	2.7	4.7	2.7	5.0
Non-U.S. affiliates (net)	3.1	6.0	3.4	6.4	1.9	5.5
Other non-U.S. sources	5.7	7.1	6.2	7.4	6.1	7.2

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Table VA2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

Selected Corporations

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Commercial paper issued in U.S.	xx	xx	xx
Amount outstanding	16.4	16.4	16.8
Total backup U.S. bank lines	26.6	50.4	30.9
Indebtedness to non-U.S. entities	5.9	6.0	7.1
Foreign offices of U.S. banks	*	-0.1	0.2
Foreign offices non-U.S. banks	1.3	2.0	2.3
Non-U.S. affiliates (net)	2.9	3.0	3.6
Other non-U.S. sources	1.4	1.2	1.1

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Commercial paper issued in U.S.				
Amount outstanding	0.1	0.1	3.5	3.9
Total backup U.S. bank lines	1.5	25.3	1.2	-18.3
Indebtedness to non-U.S. entities	1.0	1.1	-1.9	-0.8
Foreign offices of U.S. banks	0.1	*	-0.3	*
Foreign offices non-U.S. banks	0.1	0.8	*	0.3
Non-U.S. affiliates (net)	0.3	0.4	-1.5	-0.9
Other non-U.S. sources	0.5	0.3	-0.1	-0.2

* Less than $50 million.

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THE CONSUMER CREDIT RESTRAINT PROGRAM

One element of the credit restraint package was designed to limit the growth of certain types of consumer credit--all open-end credit, such as credit-card debt, and closed-end credit either unsecured or secured by collateral not being purchased with the proceeds of the credit. As with other elements of the program, consumer credit controls were regarded as supplementary to the pursuit of restraint through traditional tools of monetary policy, and were intended to discourage the flow of available funds into unproductive or speculative uses. Selected types of closed-end consumer credit, such as auto loans, were exempted from this part of the program in view of the evident weakness in demands for various types of consumer durable goods. Borrowing for the purchase or improvement of a home also was excluded.

To discourage overly expansive growth in covered consumer credit, the Board's program required that creditors maintain a non-interest-bearing deposit with the Federal Reserve equal to 15 percent of any increase above a base amount in covered consumer credit outstanding. Originally, the base amount was to have been the amount of covered credit outstanding on March 14, 1980, but the Board subsequently provided for an optional base calculation that would permit, without penalty, seasonal fluctuation and some initial underlying growth. Creditors with less than $2 million of covered credit were exempted.

The special deposit requirement tied to credit growth created a cost disincentive against expansion of covered types of credit, but allowed lending institutions considerable flexibility regarding the specific means used to slow credit growth. It contrasted with credit controls programs during the Korean and Second World War periods, in which the Board had established maximum loan maturity and minimum downpayment requirements for a wide variety of loans.

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In both 1977 and 1978, prior to the credit controls program, consumer credit outstanding had expanded by almost 20 percent, with particular strength in auto credit and in revolving credit. As sales of domestically produced automobiles weakened in the spring of 1979, however, growth in automobile (and total) consumer credit began to slow, while revolving credit remained generally strong. By the second half of last year, expansion in total consumer installment credit had fallen to an 11 percent annual rate, and it eased further, to a 7 percent pace, in the first quarter of 1980. By the end of last year, revolving credit also was growing at a reduced rate, but accelerating inflation in early 1980 raised the possibility that card-holders might decide to draw more heavily upon their open lines of credit. The application of controls to revolving credit and other selected types of personal loans was intended to reinforce the emerging trend toward less intensive use of credit.

In the first few weeks after controls were announced, many commercial banks, other lending institutions, and some retailers took initial or further steps to restrict the supply of consumer credit, most often by adopting more stringent credit approval standards. Many banks instituted user fees on credit cards, lowered maximum borrowing limits, or stopped issuing credit cards altogether. Several banks had taken such measures before March 14 in response to sharply higher costs of funds and statutory ceilings on lending rates, but the announcement of controls triggered a marked stepup in such actions. Retailers most commonly tightened credit terms through stricter lending standards and by raising minimum monthly payment requirements.

Meanwhile, consumers voluntarily cut back substantially on borrowing after the credit restraints were invoked. Retail stores in particular reported

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a steep decline in credit card usage and a sudden drop in applications for new accounts. Banks also noted sharply reduced credit card use and loan demand. Some consumers may have been confused about how controls would affect them, or may have expected repayment terms to be tightened severely, which motivated them to avoid new credit purchases. Some may have reacted cautiously to uncertainty over the economic impact that controls would exert, particularly in light of the historically high levels of consumer indebtedness and the low rate of saving that had been reached in recent months.

Consumer installment credit contracted at a seasonally adjusted annual rate of 8 percent in April, the first full month under credit controls, and 13 percent in May, compared with increases of 5 percent in March and 7 percent during the first quarter as a whole. By May, the volume of new credit extended was 25 percent below the peak level in September 1979. The April-May decline in outstanding debt was the largest--in percentage as well as in dollar terms--since the World War II period. Still unclear is the extent to which the restraints on consumer credit, as well as the Board's guidelines for overall loan expansion at commercial banks and finance companies, contributed to the decline in credit outstanding in April-May. However, the suddenness of the shift from positive to negative growth, and qualitative information from Federal Reserve System surveys and other sources, indicates that the program did exert downward pressure on both credit supply and demand.

Although consumer credit outstanding declined on balance in April and May, about one-sixth of the institutions subject to the program experienced increases in covered credit and thus were liable for maintaining a special deposit with the Federal Reserve. In April a total of 1,027 institutions placed an aggregate of $81.4 million in special depostis. The total special deposit

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remained at $81 million in May. The largest aggregate deposits in April were reported by groups designated as savings and loan associations, followed by commercial banks and bank holding companies (see table). (Multiunit firms were classified into whichever category represented 60 percent or more of their business; thus reporting categories do not correspond precisely to customary industry groupings.)

On May 22, in view of the broadly curtailed use of credit since mid-March, the Board modified its credit restraint program. Under the consumer credit controls, the deposit requirement on increases in covered credit was lowered to 7-1/2 percent from 15 percent for credit outstanding in June. On July 3, the Board announced plans to complete the phase-out of the special measures of credit restraint, as evidence accumulated that the need for such extraordinary measures had ended. Thus no further special deposits were to be required after the end of the then-prevailing deposit maintenance period on July 23, 1980.

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COVERED CONSUMER CREDIT AND SPECIAL DEPOSITS BY TYPE OF CREDITOR,[1]
APRIL 1980
(Amounts in millions of dollars)

Type of institution	Institutions with covered credit above base				All institutions with covered credit	
	Amount					
	Credit base	Credit above base	Special deposit	Number	Amount of credit base	Number
Commercial banks and bank holding companies	9,130	107.8	16.1	287	205,515	2,815
Mutual savings banks	1,078	53.5	8.0	109	2,589	243
Credit unions	1,603	22.0	3.3	163	16,629	1,824
Savings and loan associations	13,005	247.8	37.2	409	33,626	1,050
Finance companies	2,221	28.5	4.3	10	13,871	152
Retail stores	321	3.0	0.5	22	9,496	244
Oil companies	1,928	61.3	9.2	17	2,532	28
Conglomerates and others	709	18.9	2.9	10	15,165	46
All Groups	29,995	542.8	81.4	1,027	299,424	6,402

Note: Multi-unit firms operating within two or more separate categories are classified in whichever category accounts for at least 60 percent of the firm's business. If no unit accounts for 60 percent of a firm's business, the firm is classified as a conglomerate.

1. Disaggregated data for May not yet available.

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THE MANAGED LIABILITY MARGINAL RESERVE AND SPECIAL DEPOSIT PROGRAMS

The Board's reserve action of October 6 established an 8 percent marginal reserve requirement for large member banks, Edge Corporations, and the U.S. branches and agencies of foreign banks against net increases in covered managed liabilities above a base period level.[1] This program was designed to damp the rate of expansion of bank credit available to domestic residents by increasing the cost of managed liablities used to finance such expansion. It was announced as part of a policy package intended to better control bank credit and the monetary aggregates.[2]

As shown in Table 1, the amount of managed liabilities in excess of base levels at all institutions, and thus subject to marginal reserve requirements, declined during the fourth quarter. This was largely attributable to a reduction in reservable managed liabilities at agencies and branches.

Table 2 shows detail for a sample consisting of 25 large domestic chartered banks that held over $120 billion of managed liabilities during the base period, which accounted for roughly 60 percent of total covered

1. The original base period was the two statement weeks ending September 26, 1979. For institutions whose managed liabilities were less than $100 million during the base period, the base level was calculated as follows: if managed liabilities were positive, the base was set equal to $100 million; if managed liabilities were negative--that is, the institution was a net creditor of its foreign offices--the base was set equal to the algebraic sum of $100 million and the base period level of managed liabilities. Covered managed liabilities included large time deposits with original maturity of less than one year, certain Eurodollar borrowings, repurchase agreements net of trading accounts, and federal funds borrowings from institutions not subject to the marginal requirement.
2. Other actions taken were an increase in the discount rate from 11 to 12 percent and a change in the method used to conduct monetary policy. The latter involved a shift in emphasis in day-to-day operations away from confining federal funds rate fluctuations toward controlling the supply of bank reserves.

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member bank managed liabilities at that time.[1] Managed liabilities at these 25 banks declined between the base period and the week ending December 26 by about $5-1/4 billion. As of this week, 22 of these banks were not required to hold marginal reserves, since their managed liabilities were below their base levels. For these 22 banks, this "cushion" below base levels totaled about $5-1/2 billion.

Table 3 shows detail for branches and agencies of foreign banks. Of the 132 foreign bank "families" represented, only 11 were over their bases as of the week ending December 26 by a total amount of about $1/2 billion.[2] As a group, branches and agencies were below their aggregate base by about $9-1/4 billion at this time. This net cushion was about one-fourth of these institutions' total managed liabilities.

The decline of covered managed liabilities during the fourth quarter appears largely to have been the by-product of slow bank credit growth. The resulting large net cushion below base levels by the end of the fourth quarter indicated an absence of pressure resulting from the marginal reserve program on bank costs of funds, since the cushion at banks below their bases could easily be transmitted to those banks above. Banks below their bases could acquire funds through issuing managed liabilities without being subject to marginal reserve requirements.

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1. There were 251 member banks with managed liabilities of more than $100 million and thus required to file base reports. These banks had total managed liabilities of about $220 billion. No individual bank data on managed liabilities are available throughout the full period for the banks other than those in the 25 bank sample.
2. All U.S. branches and agencies of a foreign bank reported on a consolidated basis. The 132 foreign bank families were those that reported each week throughout the period.

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Further, since federal funds borrowed from member banks and branches and agencies of foreign banks were exempt from the program, funds raised by banks below their bases could be passed to banks at or above their base levels. Thus, banks were in a position to fund additional credit growth without incurring significant marginal reserve requirements.

During January and February, as bank credit growth began to accelerate, bank reliance on managed liabilities increased. As shown in Table 1, both the number of institutions above their base levels and the amounts in excess increased somewhat during this period. Table 2 shows that, at the 25 large member banks, the number of banks in excess increased from 3 to 5 from the week ending December 26 to the week ending February 27. The net cushion below the 25 banks' aggregate base fell substantially, from $5-1/4 billion to $2 billion. As shown in Table 3, the number of agencies and branches in excess of their base levels also increased during this period--from 11 to 19--while the foreign bank families' net cushion below their aggregate base fell from $9-1/4 billion to about $7 billion.

The discrepancy between strong credit growth and somewhat slower growth in reservable managed liabilities reflected a reduction in the net cushion and efforts to economize on covered managed liabilities as a source of funding. One method for economizing involved purchases of federal funds from small member banks well below their bases of $100 million. Small banks financed such sales in part with funds obtained from money market certificates which grew strongly during the first quarter. In addition, banks apparently stepped up sales of large CDs with original maturity of one year or more.

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On March 14, as part of the overall credit restraint program, the Board announced a tightening of the marginal reserve program. This involved an increase from 8 to 10 percent in the marginal reserve requirement and a reduction in the base used to calculate the reserve requirement. The base, effective the week ending March 26, was reduced by either 7 percent or by the net reduction in foreign loans that had occurred between the September base period and the week ending March 12, whichever was greater.[1] Additional reductions in foreign loans after March 12 would further reduce the base. The reduction in the base resulted in a substantial increase in managed liabilities above the new base during the week ending March 26.

In addition to the tightening of the marginal reserve program, the March action extended similar requirements to nonmember banks with managed liabilities of over $100 million. These banks were required to maintain non-interest-bearing special deposits equal to 10 percent of any increases in their managed liabilities over their base levels as of the two-week period ending March 12. Sixty-one nonmember banks had managed liabilities of at least $100 million during the base period.[2] These banks had total managed liabilities during the base period of about $17 billion.

1. The latter provision affected primarily 30 foreign bank families whose bases were reduced by an average of about one-fourth. Prior to the March action, banks were able to finance domestic credit growth without incurring marginal reserve requirements by reducing foreign loans.
2. Subsequently, a few additional nonmember banks' managed liabilities went above $100 million and thus became subject to the program.

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As shown on Table 1, the number of member banks and foreign bank families in excess of their base levels, as well as the amounts in excess, were substantially increased as a result of the March actions. In addition, 43 nonmember banks were in excess of their bases during the week ending March 26. However, the aggregate amount in excess of base levels at these banks was only about $1/2 billion. Table 2 displays the reversal of the position of the 25 member banks relative to their bases, from a net cushion of $2 billion for the week ending February 27 to a net excess of about $10 billion for the week ending March 26. Foreign bank family data, shown in Table 3, reveal the virtual elimination of the net cushion below base levels at these institutions. The sharp reduction of the net cushion at foreign bank families and the development of a substantial net excess at the 25 member banks had the result of increasing the cost of managed liability funding to covered institutions.[1]

During April and May, the weakening of bank credit was accompanied by a sharp reduction of the amounts in excess of base levels at member banks and foreign bank families (Table 1). At nonmember banks, both the number of institutions over their base levels and the aggregate amount in excess fell by about one-half.

1. This increased cost of managed liabilities was reflected in the substantial spread that developed during this period between rates on nonreservable federal funds purchased from member banks and reservable federal funds purchased from nonmembers.

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As part of the overall easing of the credit restraint package announced on May 22, base levels at all covered institutions were increased by 7-1/2 percent[1] while the marginal reserve and special deposit requirements were reduced from 10 to 5 percent, effective the week ending June 4. As shown in Table 1, by June 25 the number of member banks and foreign bank families over their bases and the amounts in excess had fallen to about the same levels that existed just prior to the March action. At nonmember banks, the number of banks and the amounts in excess of base levels declined further. Tables 2 and 3 show that substantial cushions had developed by June 25 at both the 25 member banks and the foreign bank families.

On July 3, the Board announced the removal of the marginal reserve requirement on managed liabilities at member banks and foreign bank families, as well as the special deposit requirement on managed liabilities at nonmember banks, effective the week beginning July 10.

1. Banks whose original bases were $100 million or less were not affected by this action.

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Table 1

Covered Managed Liabilities

Week Ending	Number of Institutions above Base Levels			Amount in Excess of Base ($ billions)			
	Members[1/]	Branches and Agencies	Non-members	Members[1/]	Branches and Agencies	Non-members	Total
1979--Oct. 31	102	28		2.9	1.5		4.4
Nov. 28	126	10		4.7	.3		5.0
Dec. 26	92	11		2.3	.4		2.7
1980--Jan. 30	111	11		2.9	.4		3.2
Feb. 27	115	19		3.0	1.1		4.0
Mar. 26	199	44	43	16.8	3.8	6	21.2
Apr. 30	138	24	20	7.9	1.6	.4	9.9
May 28	155	24	17	10.2	2.0	.3	12.6
June 25	95	22	10	3.3	1.5	.3	5.1

1/ Includes Edge Act corporations.
Figures may not add due to rounding.

Week Ending[1/]	Marginal Reserves[2/] ($ millions)[3/]		Special Deposits[2/] ($ million) [3/]
	Member Banks	Branches and Agencies	Nonmember Banks
1979--Oct. 31	230	120	
Nov. 28	380	20	
Dec. 26	180	30	
1980--Jan. 30	230	30	
Feb. 27	240	90	
Mar. 26	1,680	380	60
Apr. 30	790	160	40
May 28	1,030	200	30
June 25	170	70	20

1/ These are the statement weeks during which the managed liabilities in excess of base levels were reported. The marginal reserves and special deposits were required to be held 2 weeks after the statement week.
2/ The required marginal reserves and special deposits are calculated by multiplying the amounts in excess of base levels by the appropriate marginal reserve or special deposit requirement ratios.
3/ Rounded to nearest $10 million.

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Table 2

25 Member Banks*

Week Ending		Number of Institutions (1)	($ billions) Current Managed Liabilities (2)	Base Level (3)	Excess (+) or Cushion (-) (2) - (3)
1979--Nov. 28	over base	9	62.7	60.1	+2.6
	under base	16	60.2	62.7	-2.5
	total	25	122.9	122.8	+0.1
Dec. 26	over base	3	25.1	24.7	+0.4
	under base	22	92.5	98.1	-5.6
	total	25	117.6	122.8	-5.2
1980--Jan. 30	over base	6	37.3	36.9	+0.4
	under base	19	81.9	85.9	-4.0
	total	25	119.2	122.8	-3.6
Feb. 27	over base	5	31.8	31.2	+0.6
	under base	20	89.0	91.6	-2.6
	total	25	120.8	122.8	-2.0
Mar. 26	over base	23	117.1	106.6	+10.5
	under base	2	6.4	6.8	-0.4
	total	25	123.5	113.4	+10.1
Apr. 30	over base	13	70.3	66.5	+3.8
	under base	12	45.1	46.3	-1.2
	total	25	115.4	112.9	+2.6
May 28	over base	14	67.4	61.1	+6.3
	under base	11	50.0	51.8	-1.8
	total	25	117.4	112.9	+4.5
June 25	over base	6	31.3	29.9	+1.5
	under base	19	84.3	91.6	-7.4
	total	25	115.6	121.5	-5.9

Figures may not add due to rounding.
*25 large member banks that reported throughout the period.

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Table 3

Foreign Bank Families*

($ billions)

Week Ending		Number of Institutions (1)	Current Managed Liabilities (2)	Base Level (3)	Excess (+) or Cushion (-) (2) - (3)
1979—Nov. 28	over base	10	6.3	6.0	+0.3
	under base	122	32.6	42.5	-9.9
	total	132	38.9	48.5	-9.6
Dec. 26	over base	11	5.0	4.6	+0.4
	under base	121	34.2	43.9	-9.7
	total	132	39.2	48.5	-9.3
1980—Jan. 30	over base	11	7.4	7.0	+0.4
	under base	121	32.1	41.5	-9.4
	total	132	39.4	48.5	-9.1
Feb. 27	over base	19	14.8	13.7	+1.1
	under base	113	26.8	34.8	-8.0
	total	132	41.6	48.5	-6.9
Mar. 26	over base	43	24.8	21.0	+3.8
	under base	89	15.7	20.6	-4.9
	total	132	40.5	41.5	-1.0
Apr. 30	over base	24	13.2	11.6	+1.7
	under base	108	23.4	29.6	-6.3
	total	132	36.6	41.2	-4.6
May 28	over base	24	13.8	11.7	+2.1
	under base	108	21.9	29.3	-7.3
	total	132	35.7	40.9	-5.2
June 25	over base	22	12.0	10.5	+1.5
	under base	110	23.5	33.2	-9.7
	total	132	35.5	43.7	-8.2

Figures may not add due to rounding.

* 132 foreign bank families that reported throughout the period.

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CREDIT RESTRAINT PROGRAM FOR MONEY MARKET FUNDS AND SIMILAR CREDITORS

As short-term interest rates rose to extraordinary levels in late 1979 and early 1980, the assets of money market mutual funds (MMMFs) and similar creditors climbed sharply. For example, MMMF assets increased almost $15 billion in the first two months of 1980. This unprecedented growth was diverting funds from thrift institutions and smaller commercial banks, and it threatened to interfere with reasonable flows of credit to several important segments of the economy, including housing, small businesses, and agriculture. The tendency for money market funds to channel funds from around the country to the central money market helped large borrowers meet their credit demands with relatively little restraint. One aspect of the set of monetary and credit actions adopted by the Board on March 14 was a provision requiring money market funds and similar creditors to maintain a special non-interest bearing deposit with the Federal Reserve equal to 15 percent of the amount by which the investment assets of these creditors exceeded their assets on March 14, 1980. The aim of the special deposit requirement was to restrain the growth of money market funds by reducing the returns on marginal increases in their shareholdings, and thereby to provide some greater assurance of the continued availability of funds to worthy borrowers who have access to only a limited range of credit sources while restraining flows of credit to other borrowers.

Total assets of MMMFs declined more than $1.0 billion over the four-week period following the mid-March announcement of the Credit Restraint Program (table 1). This decline probably was in response both to some uncertainty among investors about the impact of the special deposit requirement and, as anticipated, to decisions by many MMMF trustees to restrict or suspend

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sales of shares to new depositors.[1] To accommodate new depositors, a number of MMMF management companies organized and promoted new "clone" money market funds that are similar to their original counterparts except that all of their non-exempt assets are subject to the special non-interest bearing deposit requirement.

On March 28, the Board announced several modifications in the regulation applying to money market funds and similar entities to assure a more equitable treatment of similar types of shareholders. Among other actions, the Board extended the exemption for bank-operated collective investment funds to bona fide personal trusts, pension, retirement, and tax-exempt assets of money market funds that allocate at least 80 percent of their assets to short-term tax-exempt obligations, as well as providing a minimum base ($100 million) for money market funds engaged in continuous public offering on March 14. These Board actions, together with a wider availability of "clone" MMMFs, contributed to the beginning of a resurgence in growth in the assets of these creditors in the second half of April. Sales of MMMFs were

1/ On March 14, 1980, the SEC issued a general statement of policy (Investment Company Act of 1940; Release No. 11088) concerning some of the implications of the money market fund regulation in order to provide guidance to fund management companies and trustees. The statement expressed the view that money market fund boards of directors and investment advisers, consistent with their fiduciary obligations, should consider the appropriateness of continued sales of fund shares and the implementation of measures designed to protect the interests of existing shareholders against dilution. On April 22, 1980, the SEC promulgated additional rules (Investment Company Act of 1940; Release No. 11137) designed to facilitate the creation and issuance of more than one class of shares for MMMFs. Under these rules, a MMMF can create three classes of stock: one held primarily by existing shareholders, a second held by exempt accounts, and a third offered to new shareholders.

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buoyed further in May when several funds whose covered credit totals were below their base levels began accepting deposits of new shareholders.

Non-interest bearing special deposits totaled $215 million over the week of April 14--the first week that such deposits were required at Federal Reserve Banks; approximately one-third of 101 reporting managed creditors maintained deposits (table 2).[1/] By late May, special deposits totaled $433 million, and one-half of the 127 reporting creditors were maintaining deposits. On May 22, the Board announced modifications of its March 14 credit restraint program, including a reduction--effective for assets held in the week beginning June 16--from 15 to 7-1/2 percent in the special deposit requirement. Special non-interest bearing deposits peaked at $869 million in the week before the reduction; more recently, deposits totaled $547 million with approximately three-fourths of reporting creditors maintaining deposits. Since outstanding credit of reporting money market funds and similar creditors climbed $21.6 billion from early April to early July and covered credit increased only $9.4 billion, more than one-half of the increase in assets of these creditors have been in accounts that are exempt from the Board's special deposit requirement. In fact, almost one-half of the gain in MMMF assets since mid-March has been at funds that limit their depositors to institutional investors (these MMMFs accounted for less than one-fifth of total MMMF assets in early March), and a large portion of these accounts presumably are fiduciary in nature and exempt from the deposit requirement.

1/ During the 7-day deposit maintenance period beginning April 14, 1980, each managed creditor was required to maintain a special deposit equal to the sum of the special deposits required for the reporting periods beginning March 14, March 24, and March 31.

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The imposition of the special deposit requirement reduced the average net yield to MMMF shareholders. For example, the average 7-day net yield to shareholders of "clone" MMMFs was about 160 basis points less than "first generation" MMMFs over the seven day period ending July 3, 1980, and about two-thirds of this difference can be attributed to the 7-1/2 percent special non-interest bearing deposit requirement that was in effect over this period.[1/] (The remaining portion is attributable to the portfolio mix and average maturity of the "clone" assets.) Indeed, total assets of "clone" MMMFs have increased by less than $3.7 billion since the program was announced on March 14. However, total assets of non-clone MMMFs have climbed by more than $14.8 billion over this period. One reason for this large increase is that MMMF portfolio managers lengthened the average maturity of their portfolios in early April, thereby retarding the decline in their net yields to shareholders as the yield curve became upward sloping (table 3). Perhaps even more important, a sizable number of MMMFs calculate their net yields to shareholders by "marking to market" all or a portion of their assets on a daily basis. As a result, the sharp decline in money market interest rates resulted in annualized net yields to shareholders that were, because of the capital gains associated with the rise in prices of the money market obligations, well in excess of returns available on alternative investments. For example, the 7-day net yield to shareholders of first generation MMMFs exceeded the effective yields available on MMCs by 3-1/2 percentage points, on average, in the first four weeks of May, although this spread vanished in early July. In addition, MMMF portfolio managers also appear to have reallocated their investable funds away from lower yielding U.S. Treasury securities and toward other higher yielding money market obligations in order to maintain relatively attractive net yields to their portfolios.

1/ Net yields exclude capital gains or losses.

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Table 1
ASSETS AND NET YIELDS TO SHAREHOLDERS
OF MONEY MARKET MUTUAL FUNDS

End of period	Total assets	Change from previous period: First generation	Change from previous period: Clones	Average 7-day net yield to shareholders 1/: First generation	Average 7-day net yield to shareholders 1/: Clones	Memo: MMC effective yield at thrifts
	------- Millions of dollars	------		----------------- Percent	----------------	
Feb. 6	55,232	2,179	--	12.78	--	12.37
13	56,889	1,657	--	12.77	--	12.52
20	58,148	1,259	--	12.78	--	12.81
27	59,858	1,710	--	13.04	--	12.63
Mar. 5	60,620	762	--	13.22	--	14.30
12	60,769	149	--	13.79		15.56
19	61,288	519	--	14.13	--	15.74
26	61,130	-158	--	14.59	--	15.73
Apr. 2	60,456	-699	25	15.04	--	16.55
9	60,446	-75	65	15.56	15.80	15.57
16	60,045	-472	71	16.03	17.00	14.95
23	60,388	204	139	16.32	15.46	14.21
30	60,689	98	203	16.03	13.90	12.42
May 7	63,028	2,075	254	15.52	11.89	11.24
14	65,212	1,955	229	13.61	9.93	9.86
21	67,642	2,152	278	12.72	10.06	9.33
28	69,306	1,273	391	11.99	8.76	9.33
June 4	71,243	1,604	333	10.73	8.16	8.28
11	72,851	1,608	216	10.63	8.16	8.98
18	74,324	1,179	294	9.79	7.76	8.01
25	75,595	1,054	217	9.19	7.53	8.01
July 2	76,848	940	313	8.66	7.50	8.01
9	78,175	1,016	311	8.82	7.83	8.91
16	79,170	685	310	8.57	7.71	8.93

1/ Net yield to shareholders after deduction of management fees and other expenses. Includes, in some cases, realized and unrealized capital gains or losses on existing portfolios.

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Table 2
OUTSTANDING CREDIT, COVERED CREDIT AND NON-INTEREST BEARING SPECIAL DEPOSITS OF SHORT-TERM FINANCIAL INTERMEDIARIES
(Millions of dollars)

Period	Outstanding credit (1)	Covered credit (2)	(2)/(1)	Non-interest bearing special deposits
Apr. 6	n.a.	n.a.	--	--
14	59,472	48,325	0.8126	215
20	60,712	49,520	0.8157	123
27	61,688	49,732	0.8062	125
May 4	62,542	50,014	0.7997	157
11	63,123	50,080	0.7934	186
18	68,696	50,444	0.7343	231
25	70,511	52,185	0.7401	433
June 1	71,928	54,354	0.7557	555
8	71,487	54,640	0.7643	681
15	73,277	54,813	0.7480	778
22	74,840	56,052	0.7490	869
29	76,759	56,247	0.7677	486
July 6	79,666	57,039	0.7160	511
13p	81,064	57,755	0.7125	547

n.a.--not available. p--preliminary.

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Table 3
PORTFOLIO COMPOSITION AND AVERAGE MATURITY
OF MONEY MARKET MUTUAL FUNDS
(Billions of dollars)

End of period	Total assets	Type of obligation								Average maturity (days)
		U.S. Gov't.								
		Treas.	Other	RPs	CDs	Euro CDs	CP	BA	Other	
1977	4.0	0.4	0.3	0.3	1.7	0.2	1.0	0.1	0.1	75
1978	11.0	0.4	1.0	0.4	4.8	0.5	2.9	0.8	0.1	48
1979-Q1	17.7	0.3	2.0	0.7	6.3	1.4	5.1	1.6	0.3	48
Q2	26.0	1.5	2.1	0.6	7.8	2.6	7.8	3.1	0.4	55
Q3	34.8	1.3	2.8	1.0	11.4	5.4	8.0	3.3	0.5	44
Q4	45.4	1.1	3.0	2.6	14.0	4.4	14.0	5.4	0.5	34
1980-Jan.	53.1	3.0	3.8	2.2	14.0	5.9	17.9	6.4	1.0	41
Feb.	60.3	4.1	3.6	2.8	16.0	6.3	18.7	7.9	0.9	38
Mar.	60.5	7.0	3.6	2.6	14.0	6.3	19.5	6.6	0.9	29
Apr.	60.7	5.3	4.0	2.4	13.9	5.4	20.6	8.6	0.6	38
May	70.0	6.6	4.2	3.4	15.3	6.4	24.3	8.3	1.5	38
June[p]	76.7	4.4	6.8	3.6	16.2	6.8	28.2	9.1	1.6	49
Memo: Change										
12/31 to 3/31	+15.1	+5.9	+0.6	--	--	+1.9	+4.5	+1.2	+0.4	--
3/31 to 6/30[p]	+16.2	-2.6	+3.2	+1.0	+2.2	+0.5	+8.7	+2.5	+0.7	--

p--preliminary.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 31, 1980

The Honorable Parren J. Mitchell
Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Mr. Mitchell:

I fully appreciate the evident frustration you feel over a situation that has, contrary to the conventional "wisdom" of a few years ago, left us with both inflation and unemployment at excessive levels. I share that frustration, but I also feel some optimism that we are beginning to come to grips with problems and policies that have been "shoved" aside for years. It seems to me evident that the kind of problems we face have accumulated over a long period of time and there is growing realization that the solutions cannot lie in a painless "quick fix." That understanding seems to me, in turn, to lay the kind of base we need to in fact deal with the problems effectively. Monetary policy is an important part--but only a part-- of that picture.

It is against that background that I'm glad to answer your specific questions.

Question 1 indicates your doubts about our intent in not providing specific numerical targets for money growth for 1981 in our Humphrey-Hawkins Report. I regret the confusion that arose on this score, and I believe your specific questions are answered fully in the attached letter to Chairman Reuss. If you have any remaining questions about our intentions with respect to the monetary aggregates or doubts about our wish for effective communications with the Congress, I hope you will bring those concerns to my attention.

Your second question inquires as to the meaning of the short fall in actual M-1 growth from targets in April and May (prior to that time, money growth was relatively strong). I would note, in responding, that in recent weeks M-1 growth has been relatively strong, with M-1B returning within the target range; M-2 is currently in the upper part of its range. Very few economists, to my knowledge, attach real significance to fluctuations in monetary growth lasting for less than, say, one quarter.

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As I explained in my statement before the Committee, the sharp April-May drop was both unexpected and unusually large in relation to economic activity and interest rates. The Federal Reserve actively supplied reserves through open market operations in accordance with our targeting procedures, but it was apparent, always in retrospect, that demands for money (and credit) were dropping rapidly; banks repaid borrowings for a time so rapidly that those repayments offset the provision of reserves through open market operations. The precipitous decline in interest rates at the virtual onset of recession--historically unusual at least in degree--certainly has been anti-recessionary in effect.

The argument can be made, hypothetically, that with greater foresight and even more aggressive open market operations, all of the April-May shortfall could have been forestalled, and interest rates would have declined more. But then a further judgment would have to be made as to whether, after all, that would have been desirable in the light of such questions as: (1) whether strong momentum in the money supply figures would not soon have required cutbacks in the provision of reserves through open market operations, with an abrupt change in the direction of interest rates; (2) whether perceptions of a weakening of the resolve of the Federal Reserve to deal with inflation might not have actually delayed or frustrated the downward adjustment of critical long-term interest rates and led to intensified inflationary expectations generally; (3) whether the potential "whip sawing" of markets and market perceptions, by fermenting widespread public confusion, would not have been ultimately damaging to our efforts to maintain policy consistency.

These matters of judgment cannot be escaped when, in the technical jargon, the "money demand function" gyrates over a period of a few months in a manner that cannot be explained on the basis of past relationships. I am convinced, in the context of the frustration about the inflation/unemployment dilemma you expressed, that we do not have the simple choice of abandoning concern about inflation and inflationary perceptions as we deal with recession. Indeed, in my judgment, failure to deal with inflation will ultimately be reflected in an unsatisfactory recovery. Viewed in that light, I am not at all convinced, even in retrospect, that leaning much harder against the temporary falling away of money demand in recent months would have been constructive.

I believe the reply to your third question about why the money supply declined so precipitously in April and May is discussed above, as well as in my statement to the Committee. Given

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the nature of our open market operations during the period, it is evident the impetus for the decline came from the demand side. There are precedents as recently as late 1978 and early 1979 for a decline in M-1 demand following a sharp rise in interest rates; this year, there is some evidence the extraordinary declines are also related to decisions by consumers to rapidly cut their indebtedness, drawing on cash balances in the process. Of course, a substantial part of the decline was related to the decline in business activity itself. Questions of cause and effect in that relationship have been a matter of controversy among economists for many years, but I know of no analysis that suggests that a decline in the money supply has an instantaneous effect on business activity.

Your fourth question about the "intent" of the Federal Reserve in permitting money growth to accelerate from 1976 to 1979 can, I believe, be generally answered by saying that the responsible officials indeed felt that their decisions would contribute over time to growth and employment. Obviously, those officials were reaching those decisions in a particular context, constrained and influenced by existing circumstances. In fact, an enormous growth in employment was achieved during those years, but I share your sense of dissatisfaction over the level of both unemployment and inflation. This is not the place for an extended analysis of the extent to which other policies and developments (e.g., rising energy prices) affected our economic performance during that period, or indeed constrained the actions of the Federal Reserve, but I am sure you recognize that monetary policy decisions (and ultimately growth of the money supply) cannot be analyzed without taking those other policies and circumstances into full account.

In retrospect, I too would wish the Federal Reserve had pressed somewhat harder to curtail monetary growth in those years, as implied by your question 5. But that simple hindsight judgment can hardly do justice to the difficulty and complexity of the decision-making at the time.

What is important is that we recognize the need for monetary discipline as we move ahead, and that we also recognize the need for complementary policies in other areas. Your own leadership in achieving that understanding has, in my opinion, been a signal public service. Indeed, it is only that kind of understanding and public support that, over time, will provide a solid base for the Federal Reserve to "follow through" on our intent to reduce over time monetary growth to non-inflationary levels-- the essence of your last question. That is why I consider frank and open relations with you and other members of the Committee and the Congress of such crucial importance, and I look forward to working with you in your leadership role in the future.

Sincerely,

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U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-SIXTH CONGRESS
WASHINGTON, D.C. 20515

July 24, 1980

The Honorable Paul Volcker
Chairman
Board of Governors
Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman:

I listened to your testimony on the "Conduct of Monetary Policy", which was delivered before the Banking Committee last Wednesday, with great interest. Unfortunately, a schedule conflict forced me to leave the hearing before my turn to question you came up. I had prepared a seven question sequence which I intended to put to you at the time. Let me ask that you give me written answers to these questions at your earliest convenience. It is my intention to circulate both my questions and your answers.

I want to focus on the relationship between the Federal Reserve's conduct of monetary policy and our apparent inability as a nation either (1) to prevent unemployment from growing, or (2) to get inflation under control. A few years ago, nearly all economic commentators would have said that we couldn't possibly fail on both counts. However, somehow we did. While I recognize that we had a run of bad luck and that other policies played a part, I want to explore with you the Federal Reserve's role in this incredible double failure as well as your present and future course.

Question 1

In your July 22 Report to the Congress, pursuant to the Hawkins-Humphrey Act, you and your fellow governors on the Federal Reserve Board present projections for our economy's performance --for real GNP growth, inflation and unemployment-- in 1981. However, you refuse to target money growth for 1981. This suggests that you and your colleagues think that money growth doesn't matter, or matter very much anyway. How do you explain this? Do you really believe that how well or badly our economy performs in 1981 is independent of how slow or fast our money supply (use the M1B measure) grows that year?

Before going on to the next question, let me put myself on record as being sorely disappointed with your failure to present 1981 monetary growth targets. The spirit of the Hawkins-Humphrey Act for sure, and I believe the letter of the law as well, requires it; although in some artful, self-serving techinical sense, your lawyers may construe the act otherwise. Long ago, Sam Rayburn said, "I have been forced to the conclusion that the Federal Reserve authorities. . .consider themselves immune to any direction or suggestion by the Congress. . . ." I had hoped that today's Federal Reserve officers, especially you, were more open and less elitist than past Federal Reserve authorities.

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However, in view of your unilateral waiving of the provisions of Section 2A of the Federal Reserve Act, as amended by the Hawkins-Humphrey Act, there now appears little if any reason to think that.

Question 2

For three years from September 1976 to September 1979, M1B, our basic money supply, had grown faster, on average, than 8½ percent per year. Then it plunged. Between the fourth quarter of 1979 and the second quarter of 1980, M1B grew only 1.7 percent, and from December 1979 to May 1980 it didn't grow at all.

The historical record indicates that when money growth is caused or allowed to decelerate as sharply as it did during the first half of this year, recessions develop or, if already underway, are exacerbated. Is there any reason to think differently; to believe that sharp declines in money growth are anti-recessionary in their effects? Specifically, consider the latest sharp decline, the one that's been developing since early this year. Has this helped to keep the economy moving forward and to prevent unemployment from rising this year?

Question 3

Why was money growth caused or allowed to decelerate so precipitously and dangerously this year?

Question 4

In the quarter of a century since the Korean War, when money growth has accelerated, by and large and on average inflation has followed along two years later; and when money growth has declined, two years later, inflation also has dropped. In the late 1970's, money growth jumped beginning in the second half of 1976 from 5 percent per year to over 8 percent per year. In the twelve months ending September 1976, M1B grew only 5%. For the next three years, from September 1976 to September 1979, as was earlier noted, it averaged over 8½% per year. What was the Federal Reserve trying to do when it caused or allowed this explosion of money growth to develop? If the effort was made to increase real growth and reduce unemployment, did it succeed?

Question 5

Could the Federal Reserve have prevented the soaring of money growth in the late 1970's? (I note in passing, that it occurred together with declining budget deficits. Thus it occurs to me that you were not prevented from doing your job by growing fiscal excesses.)

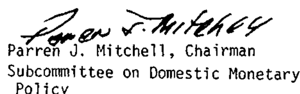
Question 6

Where are you taking money growth from here?

Question 7

How can we be sure you'll follow through?

Sincerely,



Parren J. Mitchell, Chairman
Subcommittee on Domestic Monetary Policy

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

August 22, 1980

The Honorable Jim Leach
House of Representatives
Washington, D. C. 20515

Dear Jim:

I have hesitated for too long in answering your inquiry about money market funds for one reason: I frankly am not comfortable that I have an adequate answer to the concerns you express.

As a starting point, I certainly agree with your observation that the money funds have attracted deposits from both banks and thrifts. In a period of high interest rates, investors obviously have found the yield and liquidity characteristics of the funds to be superior to deposits for many purposes--a disparity that reflects to a substantial extent the more restrictive regulations faced by banks and thrifts.

As you also suggest, the diversion of deposits to money funds probably has had its greatest impact on the availability of credit at smaller institutions, such as those often prominent in rural areas. This distortion of credit flows was especially serious when financial conditions generally were under extraordinary strain, and it led to the March 14 actions imposing a special deposit requirement on growth in money fund assets. The requirement was removed only after the pressures in financial markets had eased substantially and credit increasingly was available to a wide variety of borrowers at lower interest rates.

The relaxation of these immediate difficulties, of course, does not signal any change in the fundamental competitive positions of money funds and depository institutions. A number of factors constrain the ability of banks and thrifts to compete with money funds. Recognizing the particular problem of ceiling rates, the Depository Institutions Deregulation Committee moved to raise permissible rates a bit on certain time deposits relative to market interest rates, as a first step in the Congressionally mandated process of phasing out these ceilings. But there are obvious limitations on the extent to which that can be an answer in the near term, given the existing assets and earnings of the

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institutions. Even when the "deregulatory" process is completed, depository institutions still will operate under much more pervasive regulations than money funds, including reserve requirements on transactions and nonpersonal time accounts.

There is, of course, another side of the story. Partially offsetting the regulatory disadvantages are insurance on deposits and the ability of depository institutions to offer customers a wide variety of services in one location. I have been surprised recently with the rapid growth in passbook savings accounts at both banks and thrift institutions even though money fund rates are well over yields on these accounts. More broadly, from the savings and consumer standpoint, money market funds are attractive and efficient; they contribute to both consumer satisfaction and the national interest in savings.

Nevertheless, savers have become extremely sensitive to even small changes in the relative advantages of holding different assets. In the still uncertain financial environment we face, a substantial diversion of flows from depository institutions to money funds could recur, and, indeed, except for the past few weeks, the money funds have remained in a relatively strong competitive position.

Given the urgent need to encourage savings that can be channeled into investment, it would obviously be preferable to redress competitive imbalances by removing restrictions on banks and thrifts when possible rather than to impose limits on money funds. But given the restraints on progress in that direction, I am left with the nagging concern that the situation is unbalanced. Imposing an interest rate ceiling, a la Reg. Q, seems neither desirable nor feasible. One approach toward balance might be to, in effect, force a choice between reserve requirements or conducting only a "non-transaction account" business. But that would be a substantial departure from the traditions of mutual fund regulation. Moreover, we need to balance the needs of consumers and savers.

In sum, I have no legislative proposal now--but I do believe the situation bears watching. And I would be delighted to explore your own thinking further.

Sincerely,

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JIM LEACH
1st District, Iowa

COMMITTEES:
BANKING, FINANCE AND URBAN AFFAIRS
POST OFFICE AND CIVIL SERVICE

CONGRESS OF THE UNITED STATES

July 24, 1980

The Honorable Paul A. Volcker
Chairman, Board of Governors
Federal Reserve
21st Street and Constitution Ave. NW
Washington, DC 20551

Dear Mr. Chairman:

During the Banking Committee hearing yesterday I briefly raised the problem of insuring equitable competition between financial institutions and money market mutual funds. The current advantages enjoyed by money funds have caused massive deposits to be shifted from banks and savings and loans into near-bank operations. The money fund development would appear to be particularly damaging to small, rural financial institutions, compared to money-center ones, and consequently to the overall rural economy.

I would be appreciative of any thoughts you might have on this problem and if you could indicate whether the Federal Reserve intends to utilize its authority and/or recommend legislation to establish competitive equality between financial institutions and money funds.

Thank you for your consideration.

Sincerely,

Jim Leach
Member of Congress

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Congressional Research Service
The Library of Congress

Washington, D.C. 20540

BRIEFING MATERIALS FOR MID-YEAR 1980 MONETARY POLICY OVERSIGHT

Prepared for the Committee on Banking,
Finance and Urban Affairs
United States House of Representatives

by

F. Jean Wells
Roger S. White
Specialists in Money and Banking
Economics Division

July 21, 1980

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BRIEFING MATERIALS FOR MID-YEAR 1980 MONETARY POLICY OVERSIGHT

Congressional review of economic policies, including monetary policy, is conducted on a coordinated basis pursuant to the Full Employment and Balanced Growth Act of 1978 (P.L. 95-523). The Act requires the Federal Reserve to submit a monetary policy report to the Congress twice annually. These reports are to present a review of recent economic trends, a statement of objectives for growth of money and credit, and an assessment of the relationship of the growth objectives to economic goals set forth in the Economic Report of the President. In the mid-year report, objectives for growth of money and credit are to be stated for the next calendar year as well as the year in progress. This briefing document is designed to assist the House Committee on Banking, Finance and Urban Affairs in reviewing the Federal Reserve's monetary policy report to the Congress for mid-year 1980.

The first section contains presentations relating to monetary and financial measures. It includes charts portraying money and credit growth for the year in progress in relation to targets set in February 1980 for this year. A development influencing monetary and financial measures during the first half of 1980 was a series of special monetary and credit restraint programs initiated on March 14 and to be phased out by the end of July. Data pertaining directly to these programs are not included.

The remaining sections present budget data, forecasts for the economy, and data tracing past behavior of selected economic variables. This information is provided to assist the Committee in reviewing the Federal Reserve's plans

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and objectives for monetary policy as they relate to prevailing economic conditions and to economic goals set forth by the Administration. The Administration's mid-session budget review expected to be released Monday, July 21, will contain revised budget estimates and related economic assumptions and forecasts.

Assistance in preparing this report was obtained from Laura A. Layman, Economic Analyst; Barbara L. Miles, Specialist in Housing; Barry E. Molefsky, Analyst in Econometrics; Arlene E. Wilson, Analyst in International Trade and Finance; Philip D. Winters, Analyst in Regional Economics; and Nancy Drexler, Editorial Assistant.

Listing of tables and graphs

Monetary and financial measures:

Monetary and credit aggregates--actual levels and growth rates, 1977-1980, and Federal Reserve projected growth ranges announced February 1980:

Money supply: M-1A and M-1B (graphs).............................
Money supply: M-2 and M-3 (graphs) ....
Bank credit (graph)..

Growth rates for selected monetary and credit aggregates, 1975-1980 and Federal Reserve one-year targets announced February 1980 (table)...

Growth rates for selected reserve aggregates and the monetary base, 1975-1980 (table).............................

Income velocity of money, M-1A and M-1B, rates of change, 1975 through second quarter 1980 (graphs)....................

Selected interest rates, 1975 through June 1980:

Graph..
Table..

Funds raised in U.S. credit markets, 1975 through first quarter 1980 (table).......................................

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I. Federal budget data:

Federal budget receipts and outlays, fiscal years 1975-1980 (table)......................................

Budget receipts and outlays as a percent of GNP, 1958-1983 (table)..

III. Economic forecasts and economic goals:

1980 and 1981 economic forecasts of Chase Econometrics Associates, Inc. and Data Resources, Inc., released June 1980..

1980 economic projections of the the Board of Governors of the Federal Reserve System, released February 1980........

1980 and 1981 economic forecasts of the Administration, released January 1980 and revised March 1980..................

Summary of Administration's economic goals consistent with the objectives of the Humphrey-Hawkins Act, released January 1980..

V. Past behavior of economic goal variables:

Employment--total civilian employment, persons aged 16 and over, 1975-1980 (graph)............................

Unemployment--percent of total civilian labor force, persons aged 16 and over, 1975-1980 (graph)..................

Production--real gross national product, rates of change, 1975-1980 (graph)...

Real income--real disposable income, rates of change, 1975-1980 (graph)...

Productivity--nonfarm business sector, rates of change, 1975-1980 (graph)...

Prices--consumer price index, rates of change, 1975-1980 (graph)..

Prices--GNP implicit price deflator, 1975-1980 (graph)...........

Selected international statistics:

Exports, imports, trade balance and trade-weighted exchange value of the U.S. Dollar, 1975-1980 (table).....

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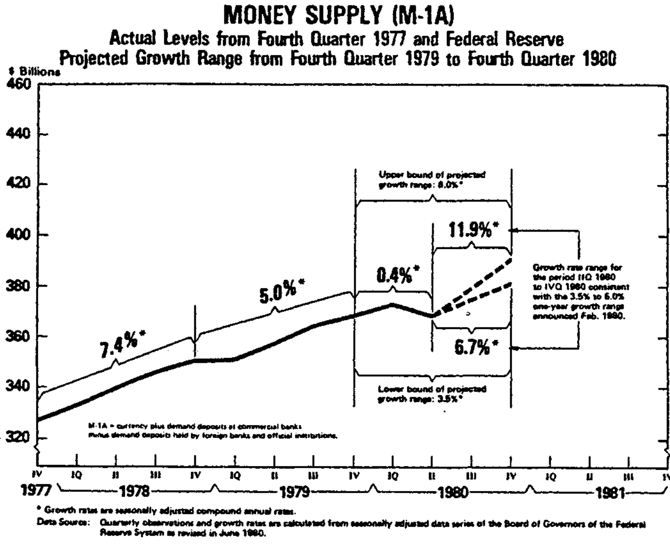
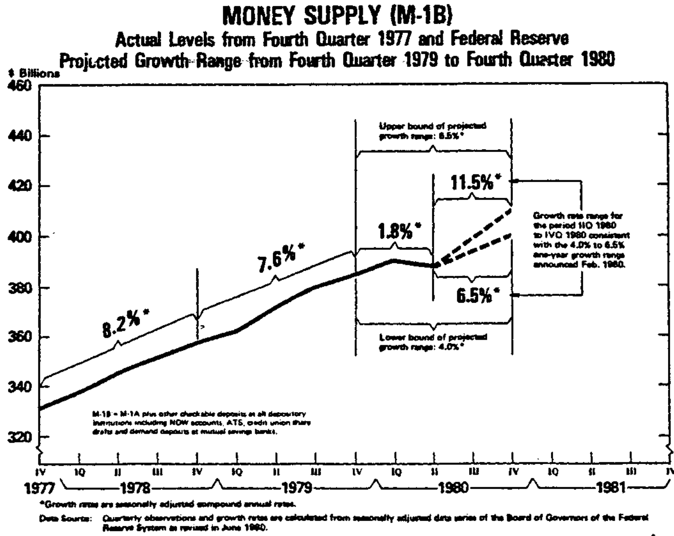
MONEY SUPPLY (M-1A)
Actual Levels from Fourth Quarter 1977 and Federal Reserve Projected Growth Range from Fourth Quarter 1979 to Fourth Quarter 1980



* Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in June 1980.

MONEY SUPPLY (M-1B)
Actual Levels from Fourth Quarter 1977 and Federal Reserve Projected Growth Range from Fourth Quarter 1979 to Fourth Quarter 1980



*Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in June 1980.

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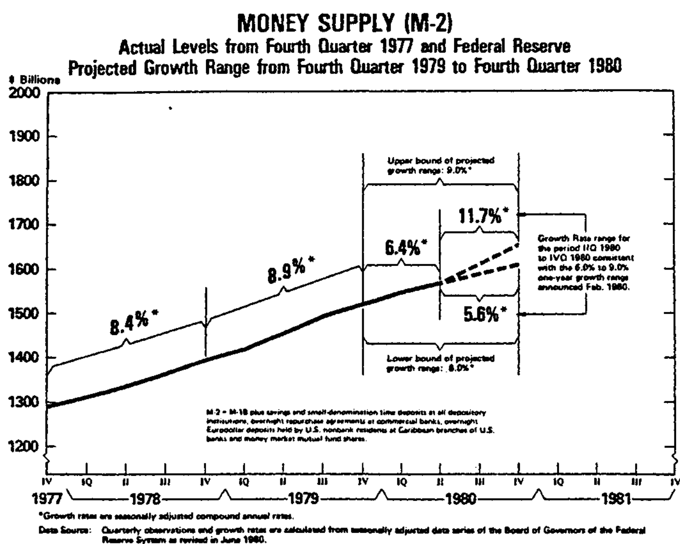
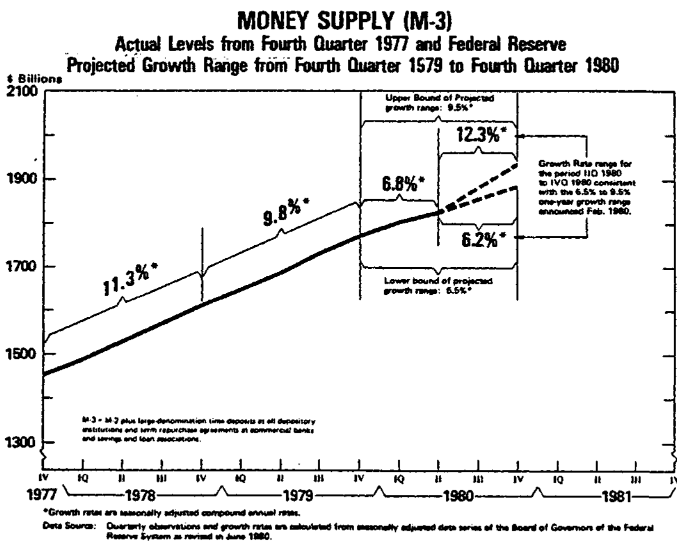
MONEY SUPPLY (M-2)
Actual Levels from Fourth Quarter 1977 and Federal Reserve Projected Growth Range from Fourth Quarter 1979 to Fourth Quarter 1980



*Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in June 1980.

MONEY SUPPLY (M-3)
Actual Levels from Fourth Quarter 1977 and Federal Reserve Projected Growth Range from Fourth Quarter 1579 to Fourth Quarter 1980



*Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in June 1980.

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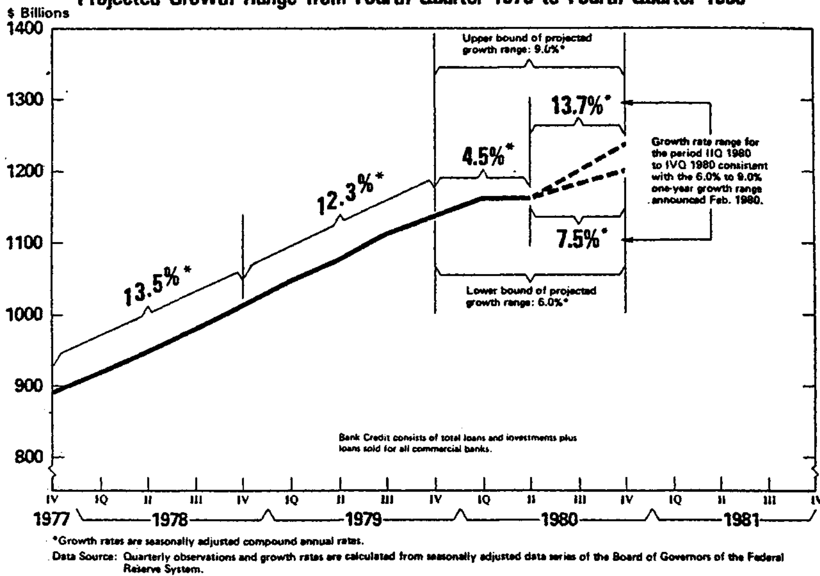

*Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System.

GROWTH RATES FOR SELECTED MONETARY AND CREDIT AGGREGATES, 1975-1980
AND FEDERAL RESERVE ONE-YEAR TARGETS, 1980-1981
(Seasonally adjusted compound annual growth rates, percent)

time period 1/	Monetary aggregates				Bank credit
	M-1A	M-1B	M-2	M-3	
1975	4.7	4.9	12.3	9.4	4.1
1976	5.5	6.0	13.7	11.4	7.5
1977	7.7	8.1	11.5	12.6	11.1
1978	7.4	8.2	8.4	11.3	13.5
1979	5.0	7.6	8.9	9.8	12.3
1980-first quarter	4.9	6.1	7.4	8.0	9.8
1980-first half	0.4	1.8	6.4	6.8	4.5
1980-targets 2/	3.5 to 6.0	4.0 to 6.5	6.0 to 9.0	6.5 to 9.5	6.0 to 9.0
1981-targets 3/					

1/ Annual data are for periods from the fourth quarter of the previous year to the fourth quarter of the year indicated. First quarter data are for the period from the fourth quarter of 1979 to the first quarter of 1980. First half data are for the period from the fourth quarter of 1979 to the second quarter of 1980.

2/ Announced by the Federal Reserve in its Monetary Report to the Congress, February 19, 1980.

3/ To be announced by the Federal Reserve in its 1980 mid-year report to the Congress on monetary policy.

Sources: Calculated from data series of the Board of Governors of the Federal Reserve System, accessed July 1980 from data files of Data Resources, Inc.

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GROWTH RATES FOR SELECTED RESERVE AGGREGATES AND THE MONETARY BASE, 1975-1980
(seasonally adjusted compound annual growth rates, adjusted for changes in reserve requirements, percent)

time period 1/	total reserves	required reserves	nonborrowed reserves	monetary base
1975	0.0	-0.2	3.2	5.8
1976	0.8	0.8	0.9	6.7
1977	5.1	5.2	2.9	8.2
1978	6.8	6.9	6.9	9.2
1979	2.9	2.7	0.9	7.6
1980-first quarter	4.5	5.5	3.6	7.7
1980-first half	3.3	3.8	6.0	6.6

1/ Annual data are for periods from the fourth quarter of the previous year to the fourth quarter of the year indicated. First quarter data are for the period from the fourth quarter of 1979 to the first quarter of 1980. First half data are for the period from the fourth quarter of 1979 to the second quarter of 1980.

Sources: Calculated from data series of the Board of Governors of the Federal Reserve System, accessed July 1980 from data files of Data Resources, Inc.

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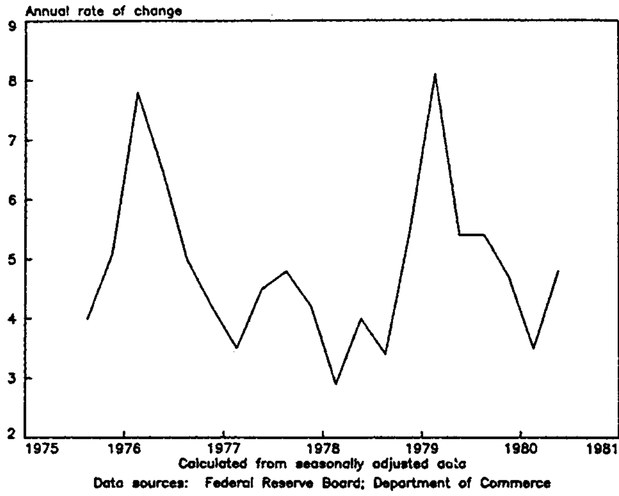
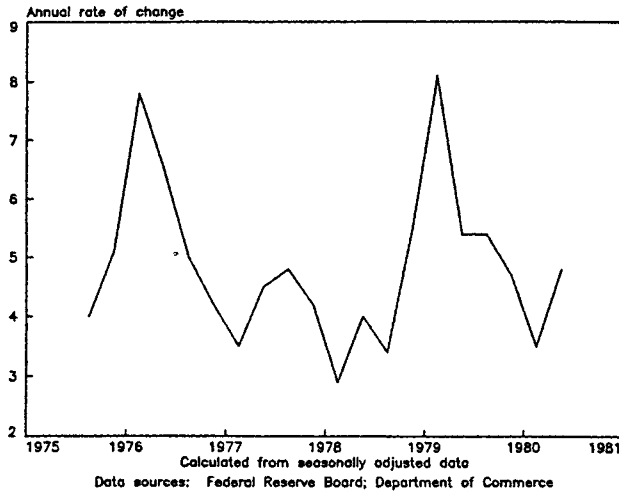
INCOME VELOCITY OF MONEY (M—1A)
% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



INCOME VELOCITY OF MONEY (M—1A)
% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



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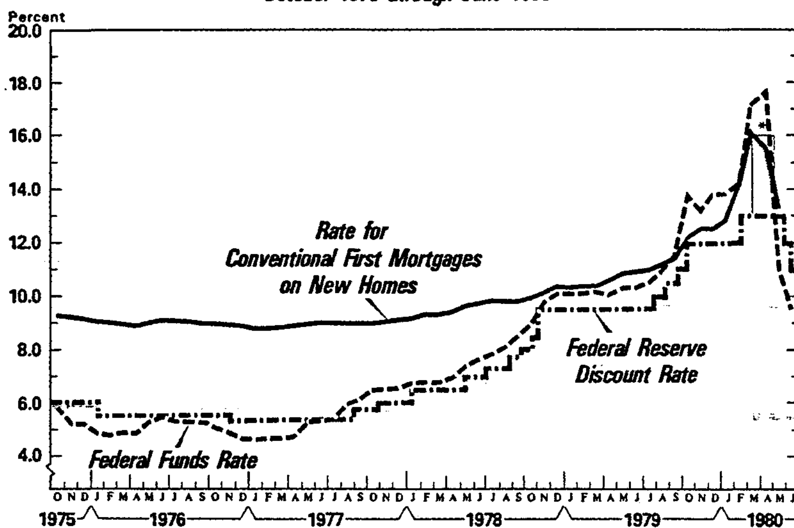
SELECTED INTEREST RATES

October 1975 through June 1980



*From March 14, 1980 through May 6, 1980, banks with deposits of $500 million or more were subject to a 3 percentage point surcharge on borrowings for more than one week in a row or more than 4 weeks in a calendar quarter.

Data Sources: Board of Governors of the Federal Reserve System and Federal Housing Administration Department of Housing and Urban Development.

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SELECTED INTEREST RATES, 1975-1980
(average, percent per annum)

Year or Month	Treasury bills, 3 month, new issues	Treasury bonds, over 10 years, composite	Corporate Aaa bonds, Moody's	Prime commercial paper, 3 months	Prime rate charged by banks	New home mortgage yields, FHA/HUD series	Federal Reserve Discount rate	Federal funds rate
1975	5.84	7.00	8.83	6.25	7.86	9.10	6.25	5.82
1976	4.99	6.79	8.43	5.24	6.84	9.00	5.50	5.05
1977	5.26	7.06	8.02	5.55	6.82	9.00	5.46	5.54
1978	7.22	7.89	8.73	7.94	9.06	9.70	7.46	7.94
1979	10.04	8.74	9.63	10.97	12.67	11.14	10.28	11.20
1980:								
Jan.	12.04	10.03	11.09	13.04	15.25	12.80	12.00	13.82
Feb.	12.81	11.55	12.38	13.78	15.63	14.10	12.50	14.13
Mar.	15.53	11.87	12.96	16.81	18.31	16.05	13.00	17.19
Apr.	14.00	10.83	12.04	15.78	19.77	15.55	13.00	17.61
May	9.15	9.82	10.99	9.49	16.57	13.20	12.90	10.98
June	7.00	9.40	10.58	8.27	12.63	NA	11.43	9.47

Sources: Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, and Moody's Investors Service.

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FUNDS RAISED IN U.S. CREDIT MARKETS

[In billions of dollars; quarterly data are seasonally adjusted at annual rates]

	1975	1976	1977	1978	1979	1979 (II)	1979 (III)	1979 (IV)	1980 (I)
Total funds raised, by instrument:	223.5	296.0	392.5	481.7	481.4	486.8	557.0	429.1	516.6
Investment company shares	-.1	-1.0	-.9	-1.0	-2.1	-.6	-2.7	-5.1	-1.0
Other corporate equities	10.8	12.9	4.9	4.7	7.3	5.8	8.3	9.5	13.5
Debt instruments:	212.8	284.1	388.5	478.0	476.2	481.6	551.4	424.7	504.1
U.S. Government securities	98.2	88.1	84.3	95.2	89.9	74.3	95.3	117.4	116.6
State and local obligations	16.1	15.7	23.7	28.3	21.4	12.5	25.3	25.3	21.1
Corporate and foreign bonds	36.4	37.2	36.1	31.6	32.2	35.8	35.4	22.8	25.4
Mortgages	57.2	87.1	134.0	149.0	158.1	164.5	161.0	148.6	140.7
Consumer credit	9.7	25.6	40.6	50.6	42.3	44.2	45.1	29.3	26.0
Bank loans, n.e.c.	-12.2	7.0	29.8	58.4	52.5	64.0	96.2	16.5	78.3
Open market paper	-1.2	8.1	15.0	26.4	40.5	44.9	55.3	24.1	50.6
Other loans	8.7	15.3	25.2	38.6	39.5	41.4	37.7	40.7	45.4

Source: Board of Governors of the Federal Reserve System. 1980(I) based on incomplete data.

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FEDERAL BUDGET RECEIPTS AND OUTLAYS
(in billions of dollars) 1/

Fiscal year or period	Budget receipts	Budget outlays	Budget surplus or deficit
1975	281.0	326.2	-45.2
1976	300.0	366.4	-66.4
Transition quarter	81.8	94.7	-13.0
1977	357.8	402.7	-45.0
1978	402.0	450.8	-48.8
1979	465.9	493.7	-27.7
1980 (estimates):			
Budget Revisions, March 1980 2/	532.4	568.9	-36.5
Third Concurrent Resolution, June 12, 1980	525.7	572.7	-47.0
1981 (estimates):			
Budget Revisions, March 1980 2/	628.0	611.5	16.5
First Concurrent Resolution, June 12, 1980	613.8	613.6	.2
Cumulative total, first 8 months:			
Fiscal year 1979	292.1	328.2	-36.0
Fiscal year 1980	325.8	381.9	-56.0

1/ Unified budget basis.

2/ Estimates from Office of Management and Budget, Fiscal Year 1981 Budget Revisions, March 1980.

Source: Economic Indicators, June 1980.

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BUDGET RECEIPTS AND OUTLAYS AS A PERCENT OF GNP, 1958-1983

Fiscal year	Gross national product ($ billions)	Budget receipts as percent of GNP	Budget outlays as percent of GNP
1958	442.1	18.0	18.7
1959	473.3	16.7	19.5
1960	497.3	18.6	18.5
1961	508.3	18.6	19.2
1962	546.9	18.2	19.5
1963	576.3	18.5	19.3
1964	616.2	18.3	19.2
1965	657.1	17.8	18.0
1965	721.1	18.1	18.7
1967	774.4	19.3	20.4
1968	829.9	18.5	21.5
1969	903.7	20.8	20.4
1970	959.0	20.2	20.5
1971	1,019.3	18.5	20.7
1972	1,110.5	18.8	20.9
1973	1,237.5	18.8	20.0
1974	1,359.2	19.5	19.8
1975	1,457.3	19.3	22.4
1976	1,621.0	18.5	22.6
(1/)			
1977	1,843.3	19.4	21.8
1978	2,060.4	19.5	21.9
1979	2,313.4	20.1	21.3
Budget, 1980:			
1980 estimate	2,518.0	20.8	22.4
1981 estimate	2,764.4	21.7	22.3
1982 estimate	3,107.6	22.2	22.1
1983 estimate	3,513.0	22.7	22.0
Budget revisions, March 1980:			
1980 estimate	2,554.6	20.8	22.3
1981 estimate	2,796.7	22.5	21.9
1982 estimate	3,151.0	23.0	21.7
1983 estimate	3,570.7	23.5	21.3

1/ Transition quarter omitted.

Source: Office of Management and Budget, Federal Government Finances, January and April 1980 editions.

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1980 AND 1981 ECONOMIC FORECASTS OF CHASE ECONOMETRICS ASSOCIATES, INC. AND DATA RESOURCES INC., RELEASED JUNE 1980

Item	1980 Chase 1/	1980 DRI 2/	1981 Chase 1/	1981 DRI 2/
	Level, fourth quarter 3/			
Employment (millions)	96.2	96.0	97.8	98.3
Unemployment (percent)	8.7	8.8	8.5	8.4
	Percent change, fourth quarter to fourth quarter			
Nominal gross national product	5.0	4.6	12.3	13.8
Real gross national product	-3.5	-4.0	3.1	4.4
Real disposable income	-2.2	-1.6	1.7	2.7
Productivity 4/				
total economy	--	--	--	--
private business	-1.0	--	1.3	--
private nonfarm	-2.9	-2.5	1.0	1.4
Consumer price index	12.9	11.5	9.7	9.1
GNP implicit price deflator	8.9	8.9	9.0	9.0

1/ The Chase forecast assumes that Federal personal income taxes will be cut by $16 billion beginning on October 1, 1980 and that corporate taxes will be reduced by $9 billion effective January 1, 1981. It is also assumed that there will be an easing in Federal Reserve policy. Chase expects some further increases in OPEC prices, but these advances are assumed to be much more modest than the hikes imposed over the past year.

2/ The DRI forecast assumes a $30 billion Federal tax cut will become effective January 1, 1981. This tax reduction provides $18 billion in personal tax relief and a $12 billion cut in corporate tax liabilities. Monetary policy is expected to become more accommodative, although it is assumed that the Federal Reserve will adhere to the monetary growth targets established in February 1980. The forecast also assumes a modest increase in the price of oil. OPEC is expected to raise its prices by 15 percent between the fourth quarter 1980 and the fourth quarter 1982.

3/ Seasonally adjusted.

4/ Based on total real GNP per hour worked.

Sources: Chase Econometrics Associates, Inc. Standard Forecast of June 20, 1980. Data Resources, Inc. Central Forecast of June 22, 1980.

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1980 ECONOMIC PROJECTIONS OF THE BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM,
RELEASED FEBRUARY 1980

	Year	
	Actual	Projected
Item	1979	1980
	Level, fourth quarter	
Employment (millions)	97.7	97 to 98 3/4
Unemployment rate (percent)	5.9	6 3/4 to 8
	Percent change, fourth quarter to fourth quarter	
Nominal gross national product	9.9	7 1/2 to 11
Real gross national product	0.8-	-2 1/2 to 1/2
Implicit price deflator	9.0	9 to 11
	Annual rate of change in fourth quarter, percent	
Consumer price index	13.2	8 3/4 to 12

Source: Board of Governors of the Federal Reserve System, Monetary Policy Report to Congress, February 19, 1980, p. 7.

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1980 AND 1981 ECONOMIC FORECASTS OF THE ADMINISTRATION,
RELEASED JANUARY 1980 AND REVISED MARCH 1980

Item	1980	1981
	Level, fourth quarter 1/	
Employment (millions)		
January 1980	97.8	99.7
March 1980 revisions	—	--
Unemployment rate (percent)		
January 1980	7.5	7.3
March 1980 revisions	7.2	7.3
	Percent change, fourth quarter to fourth quarter	
Nominal gross national product		
January 1980	7.9	11.7
March 1980 revisions	10.0	11.4
Real gross national product		
January 1980	-1.0	2.8
March 1980 revisions	-0.4	2.2
Real disposable income		
January 1980		1.1
March 1980 revisions		--
Productivity--total economy 2/		
January 1980		1.3
March 1980 revisions	--	--
Consumer price index		
January 1980	10.7	8.7
March 1980 revisions	12.8	9.0
GNP implicit price deflator		
Janaury 1980	9.0	8.6
March 1980 revisions	10.4	9.1

1/ Seasonally adjusted.

2/ Based on total real GNP per hour worked.

Sources: U.S. Council of Economic Advisers. Economic Report of the President. Washington. U.S. Govt. Print. Off., 1980.
Office of Management and Budget. Fiscal Year 1981 Budget Revisions, March 1980.

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SUMMARY OF ADMINISTRATION'S ECONOMIC GOALS CONSISTENT WITH THE OBJECTIVES OF THE HUMPHREY-HAWKINS ACT, RELEASED JANUARY 1980 1/

Item	YEAR					
	Goal Forecasts		Goal Requirements			
	1980	1981	1982	1983	1984	1985
	Level, fourth quarter 2/					
Employment (millions)	97.8	99.7	102.5	105.3	108.0	110.7
Unemployment (percent)	7.5	7.3	6.5	5.6	4.8	4.0
	Percent change, fourth quarter to fourth quarter					
Real gross national product	-1.0	2.8	5.0	5.0	4.8	4.6
Real disposable income	.5	1.1	4.7	4.7	4.6	4.4
Productivity 3/	-.3	1.3	2.3	2.5	2.5	2.5
Consumer prices	10.7	8.7	7.9	7.2	6.5	5.8

1/ Among the provisions of the Humphrey-Hawkins Act are those setting an unemployment goal of 4% among individuals aged 16 and over in the civilian labor force by 1983 and an inflation rate of 3% as measured by the consumer price index, also by 1983. The Act requires that beginning in the 1980 Economic Report the President review the numerical goals and timetables for reducing unemployment and inflation and report to the Congress on the degree of progress being made in these areas. From this time, if the President finds it necessary, he may recommend modification of the timetable(s) for achieving the unemployment and inflation goals.

According to the 1980 Economic Report:

> ...the President has used the authority provided to him in the Humphrey-Hawkins Act to extend the timetable for achieving a 4 percent unemployment rate and 3 percent inflation. The target year for achieving 4 percent unemployment is now 1985, a 2-year deferment. The target year for achieving 3 percent inflation has been postponed until 3 years beyond that. Economic goals through 1985 consistent with this timetable are shown [in the table above].
>
> The short-term goals represent a forecast for 1980 and 1981. The medium-term goals for 1982 through 1985 are not forecasts but projections of the economic performance needed to achieve the unemployment rate and inflation goals within the Administration's timetable... (p. 94)

In March 1980 some revised forecasts and projections were included in the Office of Management and Budget Fiscal Year 1981 Budget Revisions; these revisions have not been incorporated in the table above.

2/ Seasonally adjusted.

3/ Based on total real GNP per hour worked.

Source: U.S. Council of Economic Advisers. Economic Report of the President. Washington, U.S. Govt. Print. Off., 1980.

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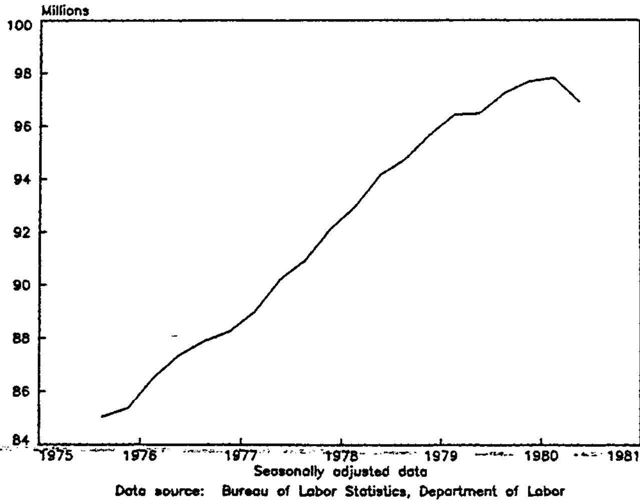

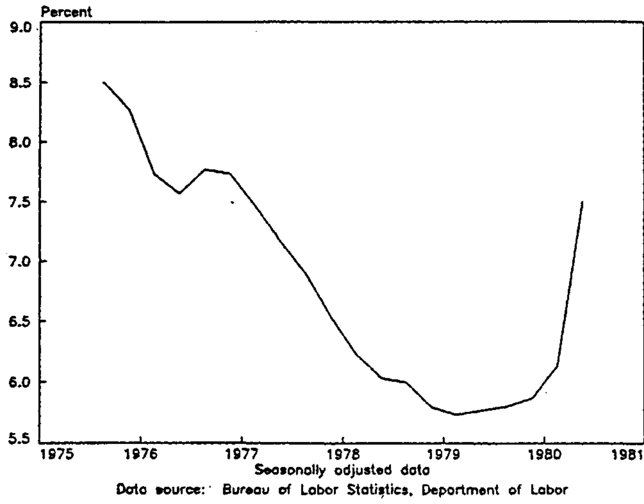

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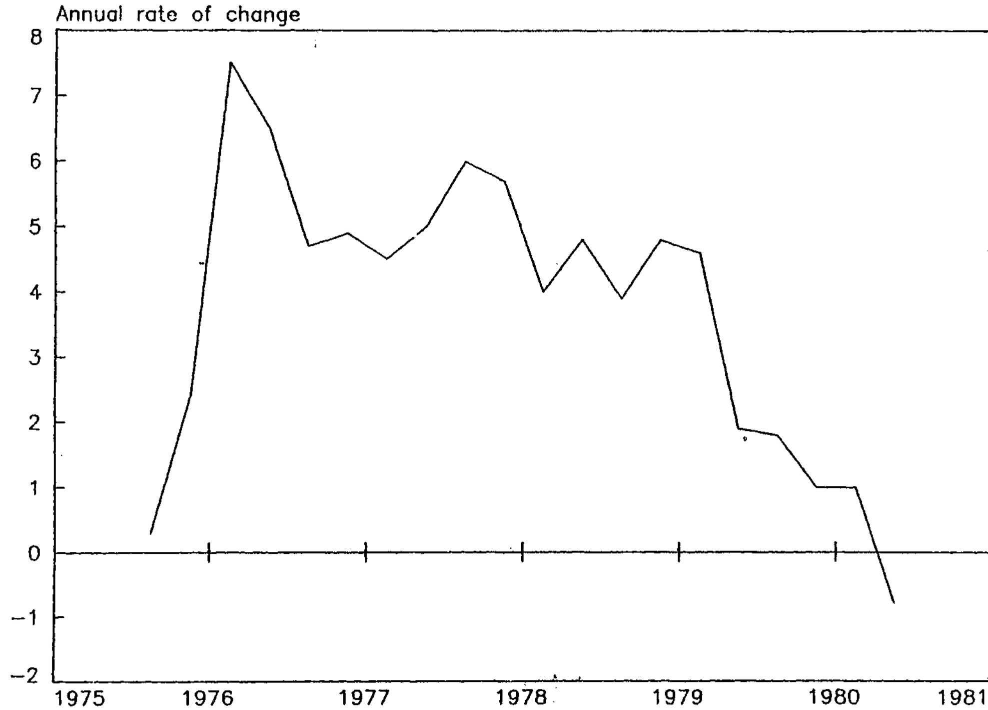

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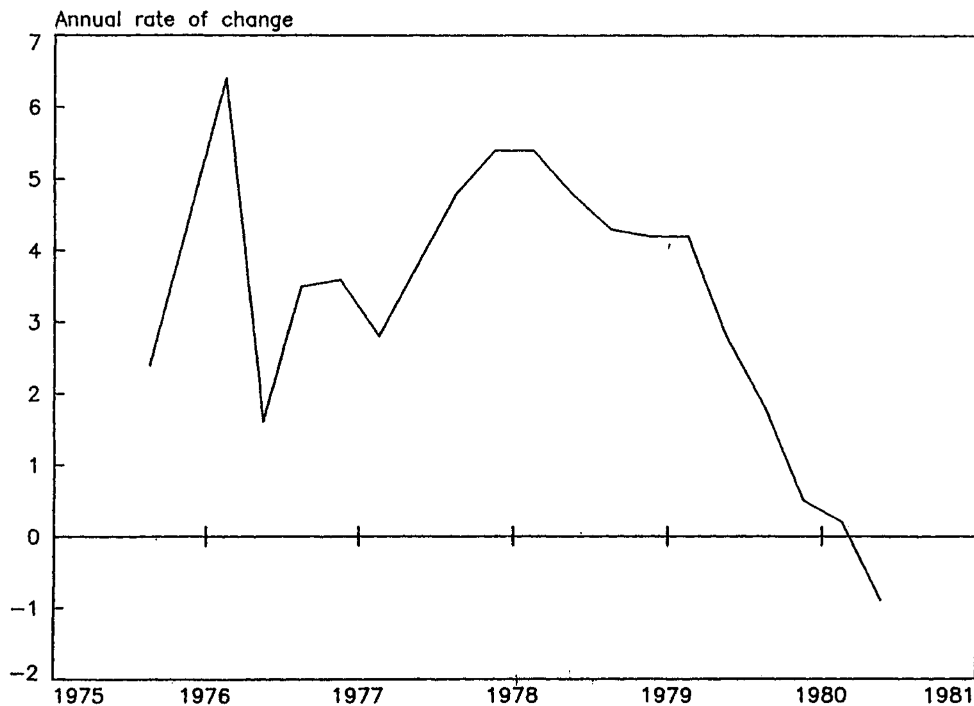
REAL INCOME: DISPOSABLE PERSONAL INCOME

% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



Calculated from seasonally adjusted data expressed in 1972 dollars

Data source: Bureau of Economic Analysis, Department of Commerce

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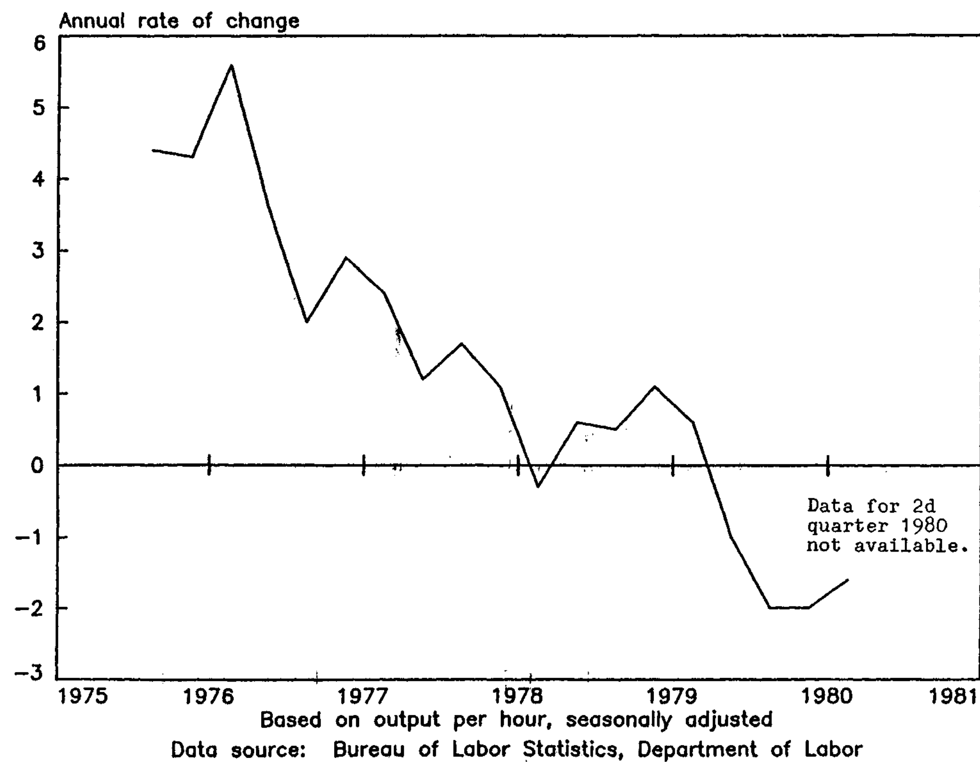
PRODUCTIVITY: NONFARM BUSINESS SECTOR
% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



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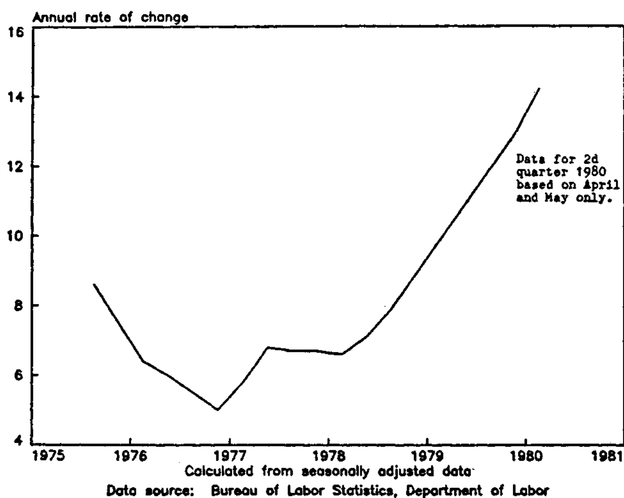

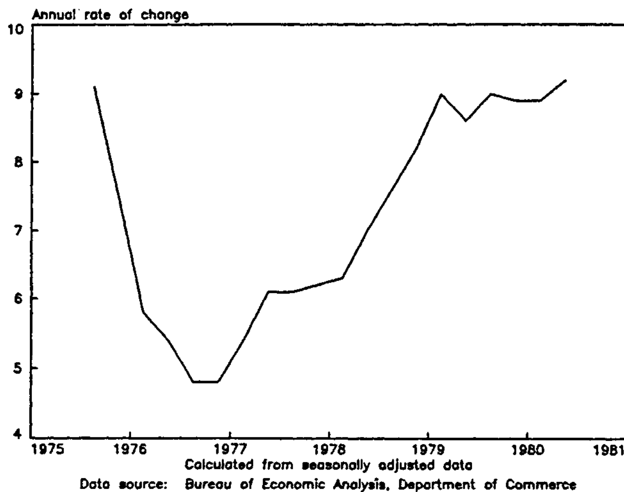

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EXPORTS, IMPORTS, TRADE BALANCE 1/ AND TRADE-WEIGHTED EXCHANGE VALUE OF THE U.S. DOLLAR 2/

	1975	1976	1977	1978	1979	1979				1980	
						I	II	III	IV	I p	II
(in billions of dollars; quarterly data seasonally adjusted)											
Exports	107.1	114.7	120.8	142.1	182.1	41.8	42.8	47.2	50.2	54.7	
Imports	98.0	124.0	151.7	175.8	211.5	46.9	50.9	54.3	59.5	65.6	
Trade balance	9.0	-9.4	-30.9	-33.8	-29.5	-5.1	-8.1	-7.1	-9.2	-10.9	
Memorandum item: Petroleum imports	27.0	34.6	45.0	42.3	60.0	11.6	13.5	16.1	18.9	21.6	
************											
Index of the weighted-average exchange value of the U.S. dollar	98.34	105.57	103.30	92.39	88.09	88.14	89.79	86.97	87.37	87.38	87.78

1/ Merchandise, excluding military, on balance of payments basis (adjusted from Census data for differences in timing and coverage).

2/ Index of weighted average exchange value of U.S. dollar against currencies of other G-10 countries (Germany, Japan, France, United Kingdom, Canada, Italy, Netherlands, Belgium, Sweden) and Switzerland. March 1973=100. Weights are 1972-1976 global trade of each of the 10 countries.

Sources: Exports, imports, and trade balance - Department of Commerce, Bureau of Economic Analysis. Trade-weighted exchange value of the U.S. Dollar - Board of Governors of the Federal Reserve System.

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BRIEFING MATERIALS

PREPARED FOR HEARINGS ON

THE CONDUCT OF MONETARY POLICY

PURSUANT TO P.L. 95 - 523

HELD BEFORE THE COMMITTEE ON

BANKING, FINANCE & URBAN AFFAIRS

JULY 23, 1980

PREPARED BY STAFF, SUBCOMMITTEE
ON DOMESTIC MONETARY POLICY

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The Economy in 1980, Midyear Forecast

Our economy's overall or in-the-large performance usually is judged by what happens to prices and production. Unemployment is linked to the latter. In February, we forecast that, in 1980, "prices will increase 7 to 10 percent and output will rise 1½ percent, give or take 1½ percent."

That forecast was conditioned on the assumption that the supply of coin, currency and checking deposits in depository institutions, collectively known as M1B, would grow 6½ percent between the fourth quarters of 1979 and 1980. However, in the first half of the year, that is, through the second quarter of 1980, M1B growth averaged less than 2 percent per annun. It is extremely unlikely therefore, that it will grow 6½ percent over the year as a whole. Instead, we now estimate that M1B will grow only 4 percent in 1980.

Based on this sharply lower estimate for money growth, we now forecast that the production of GNP goods and services will decline in 1980. Specifically, our new forecast is that output will fall 1½ percent this year, give or take 1½ percent. Here's why.

We continue to forecast that the GNP price deflator will rise 7 to 10 percent in 1980. In this regard, the die was cast by the money growth we had in 1977, 1978 and 1979. Our best bet is for an inflation rate, measured by GNP prices, of 8½ percent this year. Total spending on GNP goods and services, assuming M1B growth of 4 percent, will rise by only 7 percent. Subtracting the 8½ percent inflation from the increase of 7 percent in spending on GNP goods and services, we are led to forecast a point estimate of minus 1½ percent in the production of GNP goods and services. However, with good luck inflation will be only 7 percent this year, in which case production will neither rise nor fall; but with bad luck prices will rise 10 percent and in this case production will fall 3 percent.

What should we do now? Our answer is that M1B growth should be maintained at 4 percent per year through 1981, and then reduced to 2 percent per year in two yearly steps. This policy will assure that recovery from the current recession (which, incidentally, is in no small measure due to the failure of the Federal Reserve to prevent the collapse of M1B growth from over 8 percent per year to under 2 percent during the first half of this year) will occur together with the slowing of inflation.

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CHART 1. Exhibit 1 breaks the 1954-1977 period into nine consecutive 3-year periods: 1954-1956, 1957-1959, etc.* For each 3-year period, Chart 1A relates average M1B growth to the average rate of rise in the Gross National Product deflator (inflation); Chart 1B relates average M1B growth to the average rate of interest on 3-month Treasury bills; Chart 1C relates average M1B growth to the average rate of unemployment.

The exhibit shows that there is a close positive relationship between money growth and inflation (Chart 1A) and between money growth and the rate of interest (Chart 1B). It shows that as money growth increases, so do both inflation and the rate of interest.

The exhibit also shows that there is no relationship between the rate of money growth and the rate of unemployment (Chart 1C). This belies the Phillips Curve theory that inflation is inversely correlated with unemployment.

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*The last period consists only of two years --1978 and 1979.

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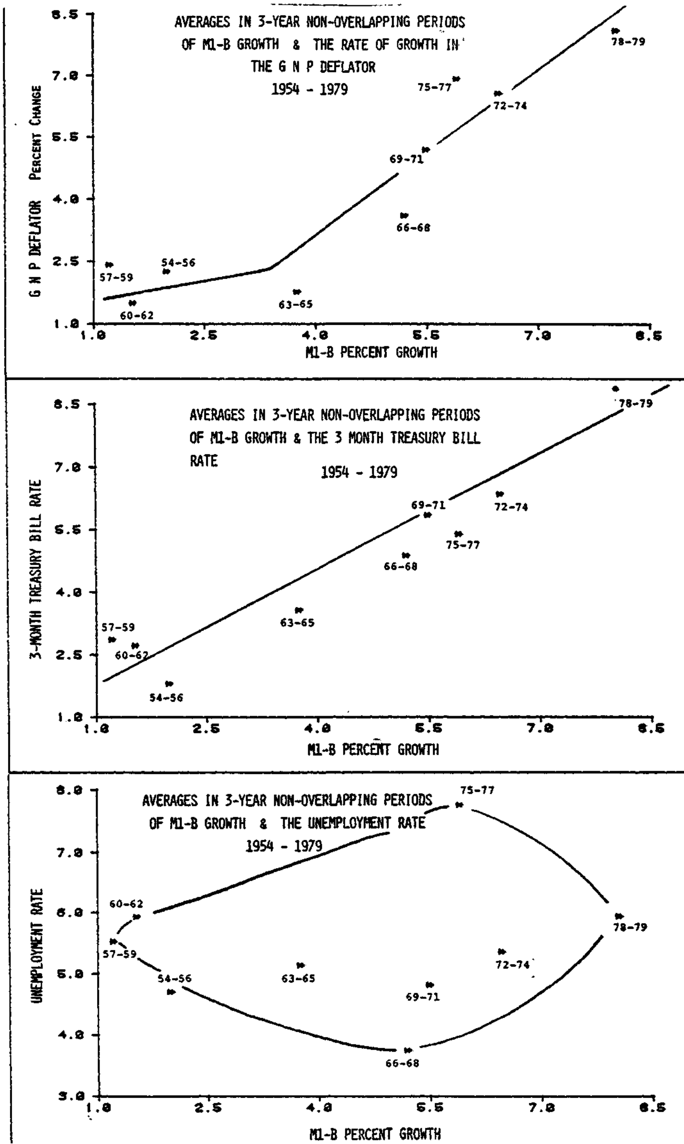

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CHART 2. In March 1979, pursuant to the Full Employment and Balanced Growth Act, the Committee recommended reducing money growth 1 percentage point a year over the next four to five years. Using the new M1B measure of money supply, which equals publicly held coin, currency and checkable deposits in all depository institutions, money growth averaged 8.2 percent between the fourth quarters of 1977 and 1978. Thus, the projection for 1979 was 7.2 percent. Unfortunately, this was not achieved. Actual money growth averaged 8 percent in 1979. Moreover, during the year, M1B growth first fell short of the projection and then moved up sharply beginning in April. The shortfall changed the economy's momentum from up to down during the first half of last year. The sharp resurgence halted the slide and generated new inflationary pressures during the third or summer quarter. In turn, the resurgence in money growth that occurred last year beginning in April prompted the Open Market Committee, beginning in October 1979, to focus on controlling money growth and to deemphasize control of interest rates.

Nonetheless, this year another shortfall in money growth has developed. It is greater than last year's shortfall and so is the accompanying recession of economic activity. Some commentators blame the shortfall in money growth which developed this year (after February) on the failure of the Federal Reserve to allow the Federal funds rate and other interest rates to fluctuate freely enough to prevent sharp fluctuations in money growth.

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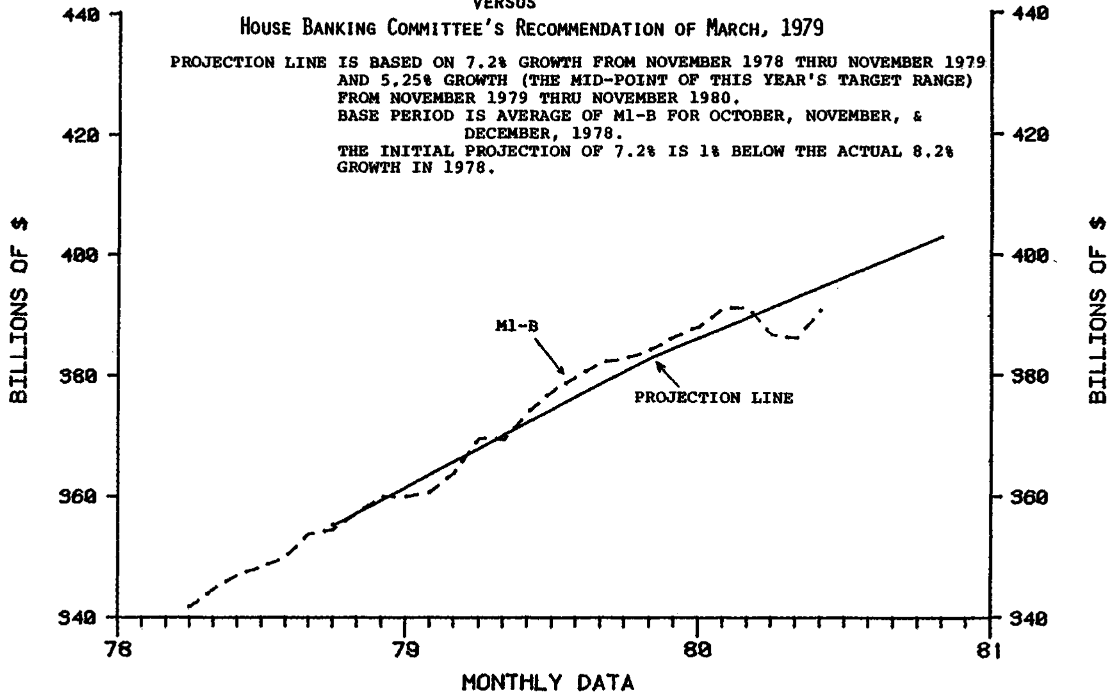

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CHART 3. M1B growth, measured between the same months of adjacent years (for example, January 1947 to January 1948), cycled down and up seven times between the end of World War II and 1978. Beginning in early 1979 it appeared to start down once again. However, that slide was quickly reversed in April 1979. But this year, as the chart shows, it has happened again for sure.

Our economy's performance in the post World War II period is mirrored in this chart of money growth. Inflation was broken after World War II and again after the Korean War by sustained low money growth. It was rekindled after 1964 by upsurges in money growth in the late 1960s, 1971-1973, and 1976-1979. Recessions, including the one we are now in, have occurred in the wake of sharp decelerations in M1B growth. Recession periods are delineated by the vertical lines on the time axis.

In February, we wrote that, "Barring (a) another sharp prolonged deceleration in money growth, or (b) disruption in the flow of foreign oil, we do not foresee a major recession developing in 1980." Unfortunately, condition (a) was violated. As the chart shows, the Federal Reserve permitted money growth to decline very sharply beginning in February.

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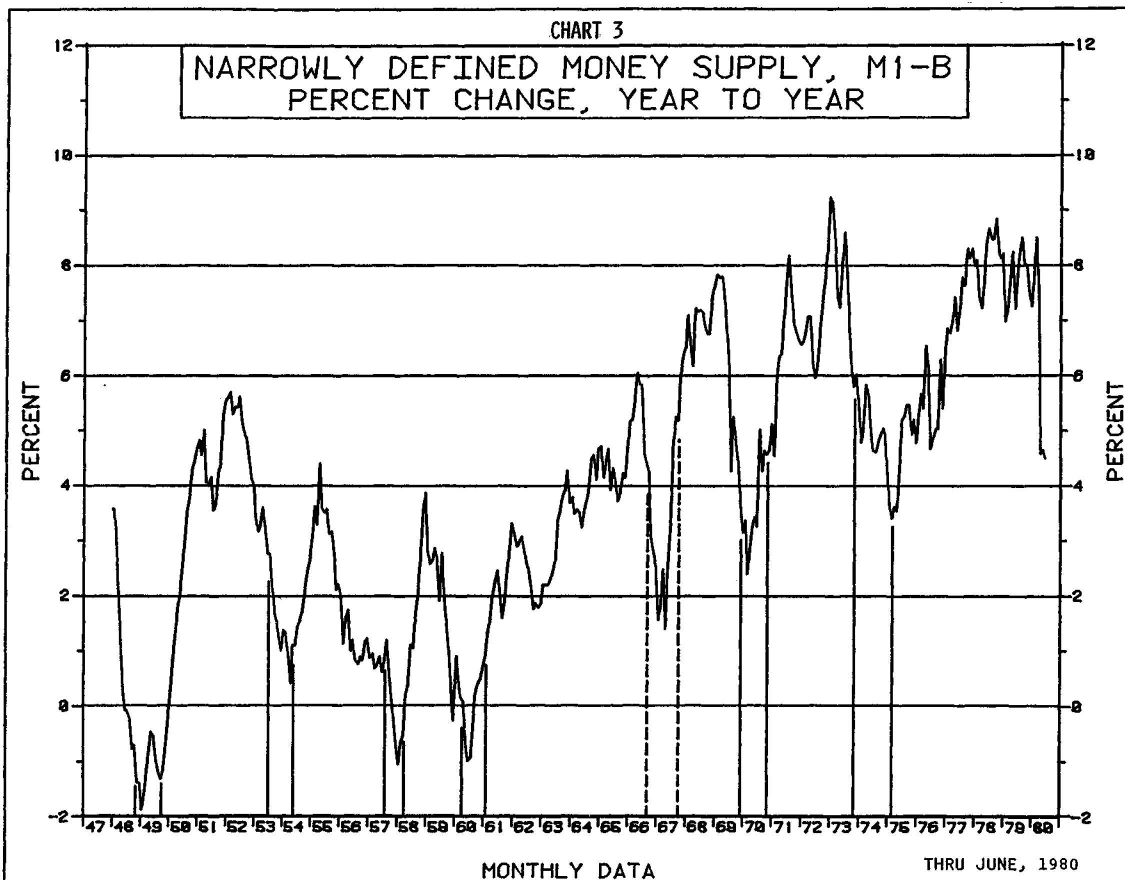

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EXHIBIT 4. Charts 4A and 4B map year-over-year percentage changes in the CPI and Gross National Product deflator, respectively, against year-over-year percentage changes in M1B (money supply) lagged two years. These charts show that the rate of inflation follows M1B growth of two years earlier fairly closely.

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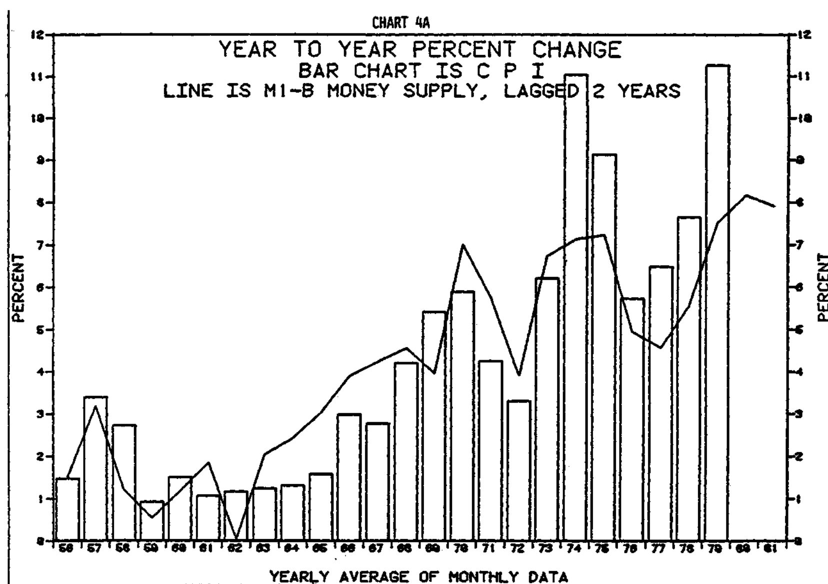
CHART 4A



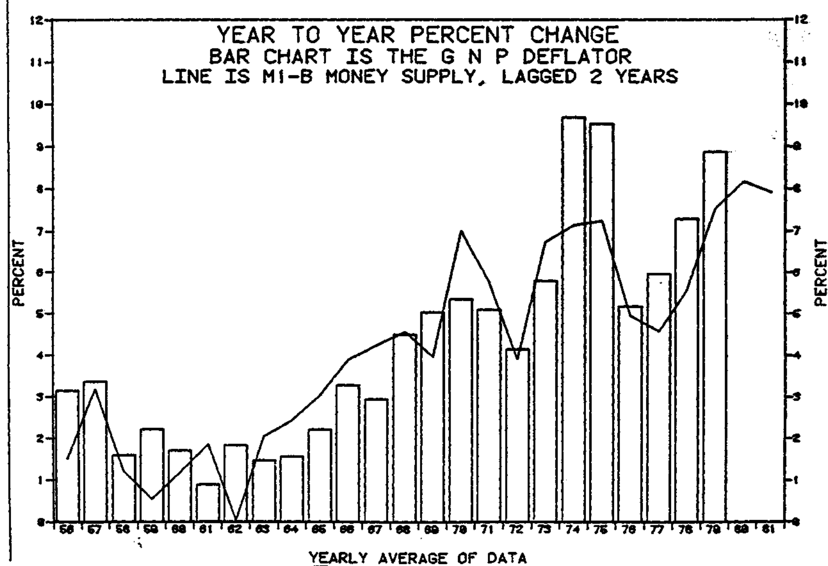


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CHART 4. (continued) Charts 4C and 4D map percentage changes measured between the same quarters from one year to the next in the Consumer Price Index (CPI) and the Gross National Product deflator, respectively, on percentage changes in the quarterly average in M1B, also measured between the same quarters from one year to the next but lagged eight quarters. These charts also show that the rate of inflation follows M1B growth of two years earlier fairly closely.

Together, the several exhibits of Chart 4 provide hope that inflation will begin to subside in 1981, or at the latest 1982.

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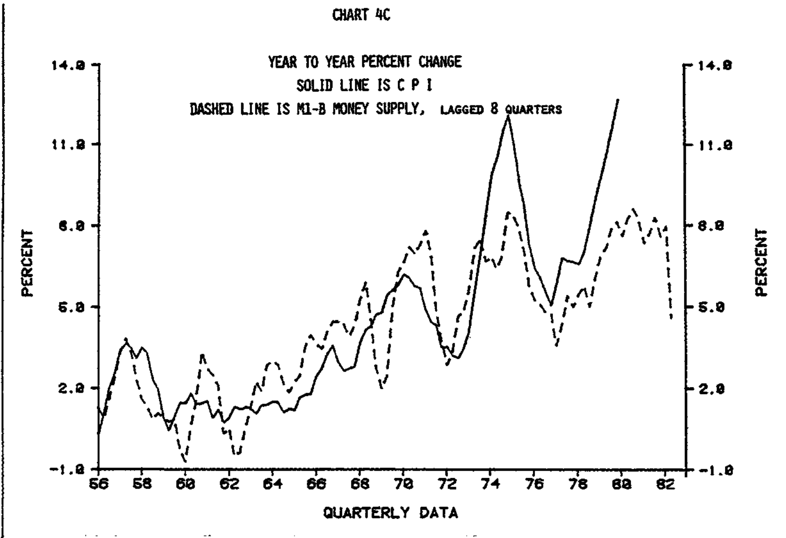

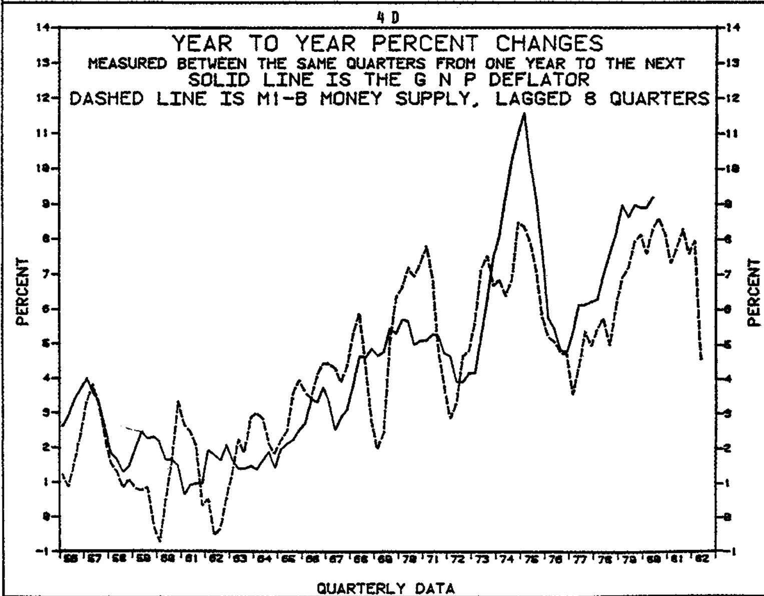

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CHART 5. This chart plots the monthly average of the Federal funds rate--the overnight inter-bank interest rate, and percentage changes in the Consumer Price Index (CPI) from twelve (12) months ago. It shows that monthly movements in the Federal funds rate occur very closely together with changes in the inflation rate measured from the same month a year ago. This indicates that even short-term interest rates are very powerfully affected by immediate past inflation.

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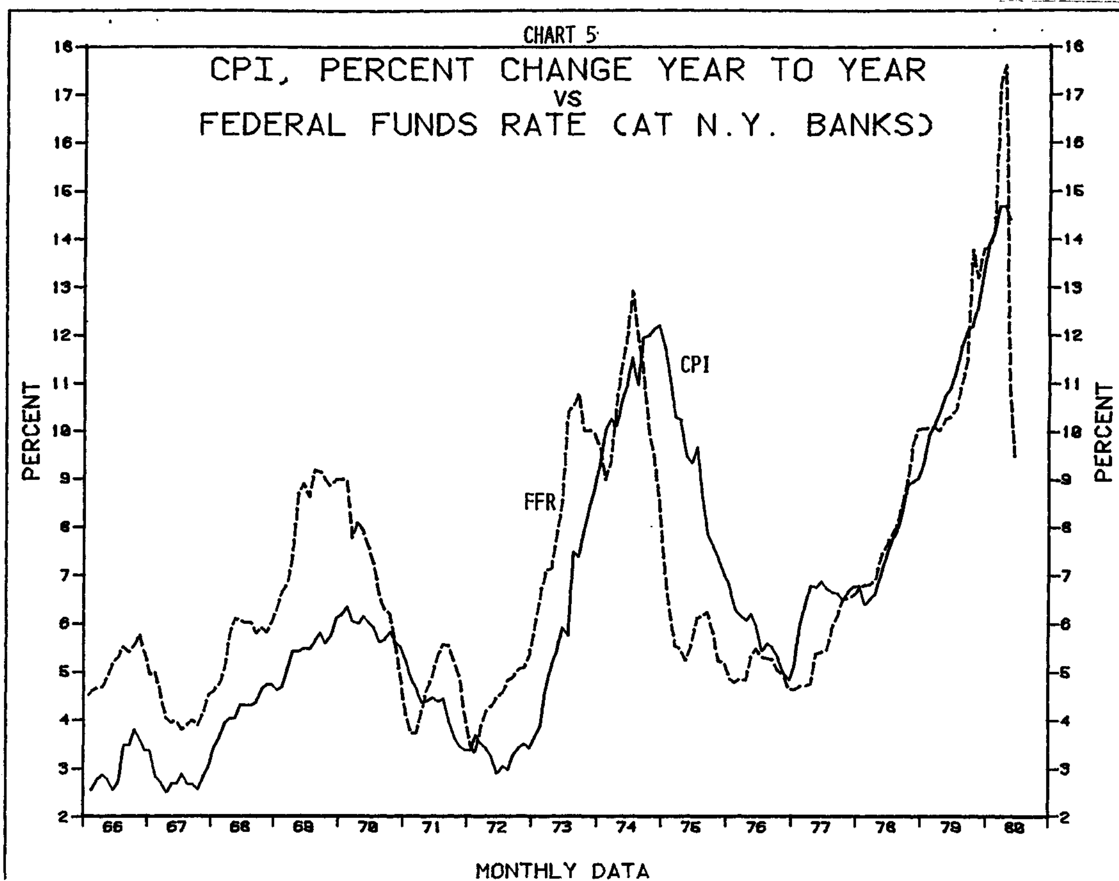

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CHART 6. This chart graphs year over year inflation (vertical axis) against yearly unemployment averages (horizontal axis). The top panel graphs the two concurrently, the middle panel lags unemployment 1 year, and the bottom panel lags inflation one year.

The concurrent panel (6A) reveals that the so-called Phillips curve is unstable. On average, the trade-off was highly favorable from 1954 to 1965 but has worsened significantly since then.

The middle panel (6B) reveals much the same story. Specifically, for an arbitrarily selected unemployment rate, the rate of inflation the following year is much higher today than it was in the 1950s and early 1960s.

Finally, the evidence plotted in the lower panel (6C) reinforces this story. As indicated here, there is even some tendency for accelerating inflation to be followed by higher unemployment.

Viewed together with Chart 1, these three panels show that unemployment cannot be reduced by accelerating money growth and inflation. The only enduring result of faster money growth is higher inflation.

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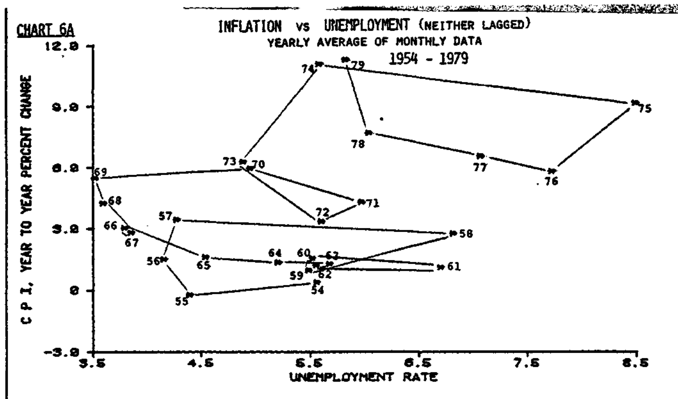

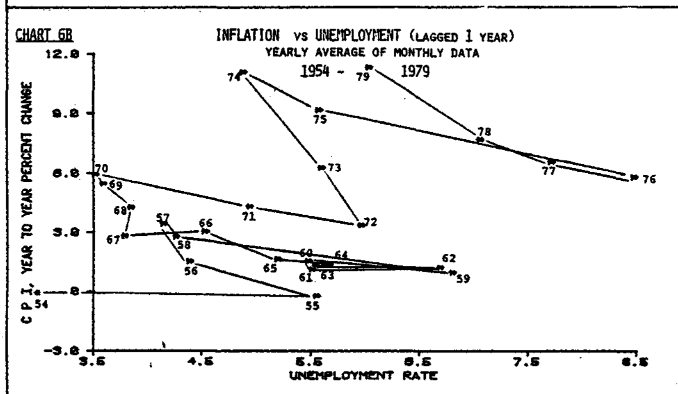

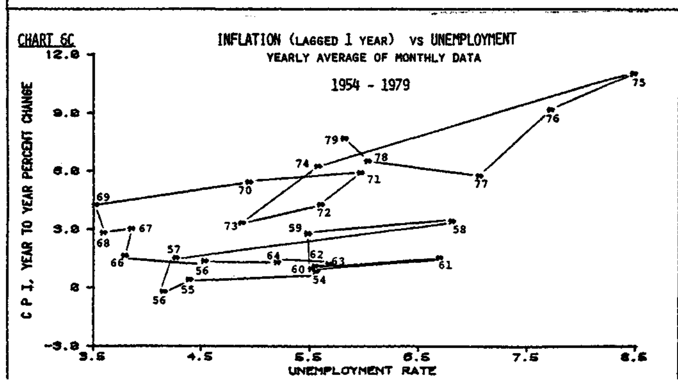

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