



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

*At Circ. No. 8667*

PAUL A. VOLCKER  
CHAIRMAN

October 23, 1979

TO THE CHIEF EXECUTIVE OFFICER OF EACH MEMBER BANK

Dear Sir or Madam:

As you know, on October 6, the Federal Reserve System took a number of actions designed to reduce inflationary pressures by providing greater assurance that growth in the money supply will be within our targets for the year and that recent excessive rates of credit expansion will be curbed. While I have written earlier about some of the implications of those actions, the Board of Governors, after consulting with the Federal Advisory Council, believes that a further amplification of its views may be useful as you make adjustments in your own policies to the new situation.

As a result of the Federal Reserve actions, growth in money and bank credit can be expected to moderate over the months ahead from the recent very rapid pace. However, consistent with the basic policies that have been pursued for some time, the Board fully intends that sufficient credit will continue to be available to finance orderly growth in economic activity.

In that connection, I should emphasize that success in dealing with inflationary pressures offers the best prospect of an early return to more equable conditions in financial markets, a better balance between demands and supplies of credit, and lower interest rates. That prospect can only be speeded by responsible policies during this critical period.

The Board has expressed particular concern about several aspects of credit extension under current conditions that I would like to bring to your attention. In doing so, I would underline our view that the effective distribution of credit among potential borrowers must, in the last analysis, rest with individual institutions responding to the continuing needs of those institutions, its customers, and the national economy within the framework of the market mechanism and incentives. We strongly believe that sound decisions in these respects

can only be made by your bank, and other banks, operating in the marketplace and able to evaluate the needs of millions of businesses and individuals. No regulatory agency can be in a position to substitute its own judgment in this area.

As I indicated in my letter of October 10 to member banks with deposits in excess of \$100 million explaining the new actions, the Board does request that banks take care to avoid financing essentially speculative transactions in commodity, gold, and foreign exchange markets. In addition, except as they may clearly involve an improvement in the nation's productive capabilities, credits advanced for extraordinary financial transactions would be viewed as questionable by the Board. Examples would include loans for the purpose of retiring stock or for corporate takeovers that simply substitute one source of financing for another and do not clearly promise improvement in economic performance. There should not, of course, be any questions about credit normally advanced to financial concerns and others in the ordinary course of business.

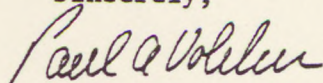
Conversely, lending institutions need to be alert to the continuing need for credit to finance the basic needs of the economy. In accommodating these needs, we believe banks should take particular care that small businesses, consumers, home buyers, and farmers continue to receive a reasonable share of available funds. Loans to such borrowers, as well as to larger business customers that require bank credit in support of their normal operations, will encourage an orderly process of economic adjustment toward greater stability and help to sustain key sectors of local and national economies.

In the judgment of the Board, the basic requirements of established customers deserve priority over opportunities that may arise in a period of unusual strain to reach out into new lending areas or to seek competitive advantage over other institutions seeking to meet such priority needs.

The Board is also conscious that, with its new operating procedures, there may be more volatility of money market rates from day-to-day or week-to-week, although we note that, within already established criteria, borrowing from the discount window remains available to help member banks in making short-term adjustments. We are also conscious that costs will be higher than otherwise for incremental additions to "managed liabilities" as a result of the new reserve requirements. In these circumstances, we believe banks should take care, as they adjust lending rates in response to market forces, to appraise carefully underlying demand and supply conditions. Sharp but clearly temporary variations in the cost of a small amount of marginal funds should not be the occasion for adjustments in the basic lending rates, although we recognize that movements in such rates will be related to the underlying trend in interest rates generally. In adjusting loan rates, the Board would also call your attention to the desirability of considering the special problems of smaller customers who have limited financing alternatives.

As I indicated earlier, the Board has consulted on this matter with the Federal Advisory Council, a statutory body established by the Federal Reserve Act, and with other leading bankers. I am convinced that adherence to the principles set forth in this letter by the banking community as a whole will contribute importantly to the success of our efforts to deal with inflation during a period of difficult economic adjustment, and will serve the longer range objectives of your institutions as well as the nation. I would appreciate it if you would share the contents of this letter with your lending, credit, and money management officers.

Sincerely,

A handwritten signature in dark ink, appearing to read "Paul A. Volcker". The signature is fluid and cursive, with the first name "Paul" and last name "Volcker" clearly distinguishable.

Paul A. Volcker