FIFTY-THIRD

Annual Report

BOARD OF GOVERNORS

OF THE FEDERAL RESERVE SYSTEM

COVERING OPERATIONS FOR THE YEAR

1966

Digest of Principal Federal Reserve Policy Actions in 1966

Period	*Action*	*Purpose*
January	Reduced System holdings of U.S. Government securities, on balance, by about $650 million. Member bank borrowings averaged about $400 million.	To continue to moderate money and credit market adjustments to the December 1965 discount rate increase early in the month, and then to offset seasonal reflow of funds and maintain about the same money market conditions that had prevailed in early January.
February–early June	Limited the increase in System holdings of U.S. Government securities to about $1.5 billion. Average member bank borrowings rose to nearly $600 million.	To effect gradual reduction in net reserve availability and thereby to restrain the growth in the reserve base, bank credit, and the money supply.
June	Raised from 4 to 5 per cent the reserve requirements against time deposits, other than savings deposits, in excess of $5 million at each member bank, effective July 14 and 21 for reserve city and country member banks, respectively, thereby increasing required reserves by about $420 million.	To exercise a tempering influence on the issuance of time certificates of deposit by larger banks and to apply some additional restraint on the expansion of banks' loanable funds, thus reinforcing the operations of other instruments of monetary policy in containing inflationary pressures.
	Made shorter-term bank promissory notes and similar instruments issued after June 26, 1966, subject to regulations governing reserve requirements and payment of interest on deposits, effective September 1, 1966.	To prevent future use of these relatively new instruments as a means of circumventing statutory and regulatory requirements applicable to bank deposits.

DIGEST OF PRINCIPAL FEDERAL RESERVE POLICY ACTIONS IN 1966—Continued

Period	*Action*	*Purpose*
Early June–September	Limited the increase in System holdings of U.S. Government securities to about $800 million. Average member bank borrowings rose to $750 million.	To continue to restrain bank credit expansion while maintaining about the same state of net reserve availability and/or money market conditions and taking account, at various times, of scheduled financings by the Treasury, any unusual liquidity pressures, and any significant deviations of required reserves or bank credit from current expectations.
July	Lowered from 5½ to 5 per cent the maximum rate payable by member banks on new multiple-maturity time deposits of 90 days or more, and from 5½ to 4 per cent the maximum rate payable on such deposits with maturities of less than 90 days.	To help forestall excessive interest rate competition among financial institutions for consumer-type time deposits.
	Granted temporary authority to the Federal Reserve Banks to provide emergency credit facilities, under certain conditions, to nonmember depositary-type institutions, including mutual savings banks and savings and loan associations. No lending was necessary under this authority.	To assure that funds could be provided to assist in meeting unusual withdrawals that might develop at nonmember depositary institutions and to safeguard against the possibility of additional pressures on mortgage and securities markets resulting from such exceptional withdrawals.
August	Raised reserve requirements from 5 to 6 per cent against time deposits, other than savings deposits, in excess of $5 million at each member bank, effective September 8 and 15 for reserve city and country banks, respectively, thereby increasing required reserves by about $450 million.	To exert a tempering influence on the issuance of certificates of deposit by the larger banks and to apply some additional restraint upon the expansion of bank credit to businesses and other borrowers.
September	Requested member banks to moderate their rate of expansion of loans, particularly business loans; indicated that bank use of Reserve Bank discount facilities would be expected to be in a manner consistent with this objective; and noted the continuing availability of discount facilities to cushion deposit shrinkages.	To moderate excessive expansion of business loans at banks and at the same time to avoid additional pressure on financial markets resulting from further substantial liquidation by banks of municipal securities and other investments to obtain loanable funds; also to reaffirm availability of Federal Reserve credit assistance in case of deposit shrinkages.
	In exercise of authority given by new temporary legislation, reduced from 5½ to 5 per cent the maximum interest rate payable on any time deposit under $100,000, other than savings deposits, effective September 26.	To limit further escalation of interest rates paid in competition for consumer savings, and to help keep the growth of commercial bank credit to a moderate pace.
October–late November	Increased System holdings of U.S Government securities by nearly $500 million. Average member bank borrowings declined to $680 million.	To permit somewhat less firm conditions in the money market in view of the recent lack of growth in bank credit.
Late November–December	Increased System holdings of U.S. Government securities by about $970 million, including about $660 million in repurchase agreements. Average member bank borrowings declined to $550 million.	To relax monetary restraint somewhat in the light of both the outlook for slower economic growth and persisting lack of expansion in bank credit.
December	Issued new 1967 guidelines for banks and other financial institutions as part of broader governmental program of voluntary foreign credit restraint.	To continue, and in some respects to intensify, the voluntary effort to restrain the outflow of private capital.
	Terminated special discount arrangements announced on September 1 when member banks were asked to curtail their business loan expansion.	To eliminate discount arrangements that were no longer needed, since expansion in business loans had been reduced to a moderate rate and banks were no longer unloading securities in unreceptive markets to obtain loanable funds.

substantially in an atmosphere of great uncertainty. The balance of payments continues to reflect a sizable underlying deficit. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to supplying the minimum amount of reserves consistent with the maintenance of orderly money market conditions and the moderation of unusual liquidity pressures; provided, however, that if bank credit expands more rapidly than expected, operations shall be conducted with a view to seeking still greater reliance on borrowed reserves.

Votes for this action: Messrs. Hayes, Bopp, Brimmer, Clay, Daane, Hickman, Irons, Maisel, Mitchell, Robertson, and Shepardson. Votes against this action: None.

September 13, 1966

1. Authority to effect transactions in System Account.

Economic expansion remained vigorous, according to reports at this meeting, with the main stimuli continuing to come from defense spending and business outlays on fixed investment. On September 8 the President proposed a number of fiscal actions to reduce inflationary pressures, including (1) measures to reduce lower-priority Federal spending and (2) a 16-month suspension of two tax incentives for corporate investment: the 7 per cent tax credit on machinery and equipment investment and the accelerated depreciation allowances on commercial and industrial building.

Defense spending was now estimated to be rising more rapidly in the third quarter than the second. Earlier estimates of the pace of business capital outlays were supported by results of the August Commerce–SEC survey of spending plans. That survey, like the May canvass, indicated that capital spending in 1966 as a whole would be 17 per cent above 1965, but would rise at a slower pace in the second half of the year than in the

first. With respect to consumer spending, a Census Bureau survey taken in mid-July indicated that consumer intentions to buy new automobiles were about as numerous as a year earlier, and that plans to buy household durable goods were considerably stronger.

Industrial production rose substantially further in August, according to preliminary estimates. Nonfarm employment also continued to rise quite vigorously, and the unemployment rate remained unchanged at 3.9 per cent. The gains in employment were somewhat more selective than earlier; in particular, advances in manufacturing were increasingly concentrated in industries oriented to defense and business capital goods. The latest data for manufacturers' inventories—for July—indicated a sharp step-up in the pace of accumulation from the high second-quarter level, with all of the acceleration in durable goods industries.

Estimates suggested that average wholesale prices rose further in August, but by less than in July. It appeared that food price advances were smaller than in the preceding month and that increases in industrial prices were at the reduced July rate. The recent moderation in the rise of average industrial prices was attributable mainly to declines for sensitive materials, which began in June. Price developments in the months ahead seemed likely to be especially influenced by the outcome of wage negotiations, more of which would take place in coming months than earlier in the year. An early-September wage settlement affecting telephone installers—like the August airline-machinists settlement—involved an increase well above administration guideposts.

The money supply declined somewhat further in August, bringing growth for the first 8 months of 1966 to an annual rate of about 1.5 per cent, compared with 4.8 per cent for the full preceding year. Time and savings deposits of commercial banks increased rapidly in the first half of August, but the rate of growth fell off sharply after midmonth when major banks began to experience declines in their negotiable CD's outstanding. Daily averages of both total deposits of member banks—the "bank credit proxy"—and required reserves were weaker in

August than had been expected earlier. Between the last Wednesdays of July and August total commercial bank credit expanded at about a 6 per cent annual rate, but the growth appeared to be attributable wholly to bank acquisitions of tax-anticipation bills issued by the Treasury late in August.

New staff projections for September, which allowed for a substantial further run-off in negotiable CD's, suggested little or no increase in total deposits of member banks, in contrast with an earlier expectation of moderate growth. At the same time, loan demands were expected to intensify, and the conjuncture of heavy loan demands with run-offs of CD's was expected to result in substantial pressures on banks in coming weeks.

On September 1 the Presidents of the Federal Reserve Banks addressed a letter [3] to all member banks indicating that, while the System considered orderly bank credit expansion appropriate in today's economy, it regarded the recent growth in business loans as excessive. The letter went on to indicate that the System believed a greater share of member bank adjustments should take the form of moderation in the rate of expansion of loans, particularly business loans, and it stated that member banks would be expected to cooperate in the System's efforts to hold down the rate of business loan expansion—apart from normal seasonal needs—and to use the discount facilities of the Reserve Banks in a manner consistent with those efforts. The letter added that Federal Reserve credit assistance to member banks to meet appropriate seasonal or emergency needs, including those resulting from shrinkages of deposits or of other sources of funds, would continue to be available as in the past.

The atmosphere of apprehension in security markets that had been evident before the August 23 meeting of the Committee intensified in the week following that meeting. Yields on Treasury, corporate, and municipal bonds rose sharply further and market conditions became increasingly unsettled, requiring special intervention in the market by the Federal Reserve to supply reserves. On August 30, however, following a statement by a Treasury official that was generally interpreted as foreshadowing a change in prospects for fiscal policy measures, a sharp, sustained rally began that brought bond yields down by the time of this meeting to levels below those of 3 weeks earlier. The downward tendency of yields was reinforced by the President's announcement concerning fiscal policy measures on September 8; by a Treasury announcement on September 10 that until year-end no additional new money would be raised in the open market by Government agencies and that there would be no sales of participation certificates in that interval unless market conditions warranted; and by the suggestion of the System's September 1 letter that banks would be under less pressure to liquidate securities.

In contrast, markets for short-term securities remained under strain, partly because of expectations that a large increase in Treasury bill financing would be required over the remainder of the year as a result of the change in Federal agency financing plans. Money market conditions became quite taut late in the period as the September tax and dividend dates approached. Banks in the major money centers experienced deep basic reserve deficits. Posted rates on dealer loans again reached new highs and, for the first time, some Federal funds transactions occurred at a rate as high as 6¼ per cent. Yields on 3-month Treasury bills advanced to about 5.30 per cent from a level that was slightly below 5 per cent at the time of the preceding meeting.

System open market operations continued to be directed toward keeping bank reserve positions under pressure, while at the same time giving close attention to the unsettled conditions that pervaded securities markets. Net borrowed reserves averaged $370 million in the three statement weeks ending September 7, compared with a revised figure of about $410 million in the preceding 3 weeks. Member bank borrowing averaged $720 million in the latest period, down about $45 million from the preceding 3 weeks.

The underlying international payments position of the United

[3] For the full text of the letter, see p. 103.

States remained one of substantial deficit; in July and August together, the deficit was estimated at an annual rate of roughly $2½ billion to $3 billion on the "liquidity" basis. The trade balance continued to deteriorate in July as imports increased sharply further. Inflows of liquid funds through foreign branches of U.S. banks kept U.S. payments in surplus in August on the "official reserve transactions" basis, but the rate of inflow in August was only about half that of July and appeared likely to slacken further. In foreign exchange markets, sterling continued under intermittent pressure.

One view expressed in the course of the Committee's discussion was that recent trends in bank credit and other monetary aggregates suggested that the degree of restraint resulting from the Committee's earlier policy actions was substantially greater than might have been thought, and that operations now might well be directed toward seeking more nearly normal growth rates. On the other hand, it was argued that a slowdown in bank credit expansion that simply reflected the process of financial "disintermediation" at banks (that is, shifts of depositor funds out of bank time deposits and into credit market instruments in response to relatively more attractive rates on the latter) need not importantly affect total credit availability, even though the distribution of total credit would undoubtedly be altered.

The Committee concluded that the current degree of monetary restraint should be maintained unless unusual liquidity pressures developed or there were significant deviations of bank credit from its expected course. An overt change in policy toward greater ease was considered undesirable at present in light of the persistence of inflationary pressures. At the same time, a number of factors were cited as militating against further intensification of restraint; these included the fiscal measures proposed by the President, the cumulating evidence that past monetary policy actions were having substantial impact, the continuing strains in markets for short-term securities, and the special pressures expected in financial markets over coming weeks.

It was noted that widely different levels of member bank borrowings and net borrowed reserves might be consistent with the current degree of monetary restraint, depending on the intensity of strains in financial markets and the extent to which banks chose to make reserve adjustments with or without recourse to the discount window under the terms of the System's September 1 letter. For this reason the Committee agreed that measures of net reserve availability should be given subordinate importance in operations and that the degree of restraint should be judged primarily by general money market conditions.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding vigorously, despite the substantial weakening in residential construction, with inflationary pressures persisting. Aggregate credit demands continue strong and short-term financial markets remain under strain. The balance of payments continues to reflect a sizable underlying deficit. In this situation, and in light of the new fiscal program announced by the President, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm but orderly conditions in the money market; provided, however, that operations shall be modified in the light of unusual liquidity pressures or of any apparently significant deviations of bank credit from current expectations.

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Daane, Hickman, Irons, Maisel, Mitchell, Robertson, and Shepardson. Votes against this action: None.

2. Ratification of amendment to authorization for System foreign currency operations.

At this meeting the Committee ratified an action taken by members on September 9, 1966, amending paragraph 2 of its authorization for System foreign currency operations to read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, *Relations with Foreign Banks and Bankers*, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Maximum period of arrangement (months)
Austrian National Bank	100	12
National Bank of Belgium	150	12
Bank of Canada	500	12
Bank of England	1,350	12
Bank of France	100	3
German Federal Bank	400	6
Bank of Italy	600	12
Bank of Japan	450	12
Netherlands Bank	150	3
Bank of Sweden	100	12
Swiss National Bank	200	6
Bank for International Settlements (System drawings in Swiss francs)	200	6
Bank for International Settlements (System drawings in authorized European currencies other than Swiss francs)	200	6

Votes for ratification of this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Daane, Hickman, Irons, Maisel, Mitchell, and Shepardson. Votes against ratification of this action: None.

This action increased the authorized amounts of the System's swap arrangements with most of the foreign banks with which such arrangements were maintained, for the purpose of providing a broader margin of safety for the stability of the international monetary system. The increases raised the aggregate size of the network to $4.5 billion from $2.8 billion.

At its preceding meeting the Committee had authorized the Special Manager of the System Open Market Account to undertake negotiations looking toward an enlargement of the swap network, subject to notification by the Secretary of the Treasury to the Chairman or Acting Chairman of the Board that the proposed program was fully consistent with U.S. international financial policy at this time. Following receipt of such notification by the Acting Chairman of the Board and advice from the Special Manager that preliminary discussions had been completed with the foreign banks involved, Committee members approved the amendment to the authorization. In addition to the revisions of the dollar amounts of individual arrangements, shown in the second column of the table contained in the affected paragraph, the caption to the third column was modified by adding the word "maximum" before the words "period of arrangement." This change was made to permit different maturities, not exceeding those indicated, to be employed for different portions of individual arrangements.

October 4, 1966

Authority to effect transactions in System Account.

GNP rose more in the third quarter than in the second, according to tentative staff estimates, as defense expenditures accelerated sharply. About half of the third-quarter rise in GNP apparently reflected higher prices. Further sizable increases in both defense spending and business capital outlays appeared