

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

<i>Period</i>	<i>Action</i>	<i>Purpose</i>
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. 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 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. 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

<i>Period</i>	<i>Action</i>	<i>Purpose</i>
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. Granted temporary authority to the Federal Reserve Banks to provide emergency credit facilities, under certain conditions, to nonmember depository-type institutions, including mutual savings banks and savings and loan associations. No lending was necessary under this authority.	To help forestall excessive interest rate competition among financial institutions for consumer-type time deposits. To assure that funds could be provided to assist in meeting unusual withdrawals that might develop at nonmember depository 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. 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 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. 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. Terminated special discount arrangements announced on September 1 when member banks were asked to curtail their business loan expansion.	To continue, and in some respects to intensify, the voluntary effort to restrain the outflow of private capital. 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.

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

probable in the fourth quarter—suggesting another large gain in GNP and continuing pressures on available manpower and plant resources. Wage rates were advancing more rapidly than earlier, and rising costs seemed likely to reinforce the effects of strong demands on prices.

While business activity continued to expand vigorously, sentiment appeared less ebullient than earlier, and signs of growing economic imbalance raised some uncertainties about the longer-run outlook. Average prices of common stocks, which had rallied in early September, later declined again. Residential construction activity continued to contract in August as the supply of mortgage funds remained highly limited; private nonresidential building also had declined appreciably in recent months. Some of an unusually large increase in manufacturers' inventories in July and August was probably involuntary; stock-sales ratios rose abruptly, and a Commerce Department survey of anticipations suggested a sharp drop in the growth of inventories in the fourth quarter.

The money supply, which had declined in July and August, was estimated to have risen at an annual rate of about 7 per cent in September. Total time and savings deposits of commercial banks increased much less than in preceding months as a substantial run-off occurred in negotiable CD's outstanding. Estimates indicated that growth in business loans was smaller than expected and considerably below the average rate of recent months—perhaps because of both restrictive lending policies of banks and lighter demands than anticipated. Daily-average figures on member bank deposits implied little change in total bank credit in September, and required reserves appeared to have declined slightly.

Business loan demand was expected to be strong in October, partly because cash needs would again be increased by accelerated payments of withheld Federal taxes. Reflecting this expectation, staff projections suggested resumed growth in daily-average member bank deposits—the “bank credit proxy”—at an annual rate of perhaps 5 or 6 per cent, and a more rapid increase in

required reserves. The projections allowed for a rise in Government and private demand deposits, the former as a result of an anticipated Treasury financing. Little or no increase was anticipated in total time and savings deposits, however, partly because further substantial run-offs of negotiable CD's were expected. Also, it appeared that banks would be in a slightly less favorable position than formerly in competing for other time deposits under the new ceiling rates that had been established for various depository institutions in late September, following enactment of new legislation.

The strains evident in short-term financial markets at the time of the preceding meeting of the Committee continued through the mid-September tax and dividend dates, and the yield on 3-month Treasury bills rose by about 30 basis points further to a peak of 5.59 per cent. Subsequently, however, the atmosphere improved considerably, and the 3-month bill yield fell below 5.35 per cent. Federal funds rates and posted rates on dealer loans also moved down.

Yields on long-term securities had fluctuated widely in recent weeks, first rising and then declining in response chiefly to shifting expectations regarding fiscal and monetary policy and changing assessments of the buoyancy of the economy and the prospects for peace in Vietnam. On the whole, however, long-term yields remained significantly below their late-August levels and showed little net change over the interval. The volume of new corporate bond flotations in September was somewhat lower than had been anticipated, and the calendar for October was smaller than offerings in September, although larger than those of October 1965. On the other hand, the Treasury was expected to be making heavy demands on capital markets over the rest of the year, with gross new borrowings of perhaps \$8 billion. An announcement of an auction of \$3 billion to \$3½ billion in tax-anticipation bills, to be held around mid-October, was anticipated shortly; and the terms of the Treasury's November refunding, in which some new money probably also would be raised, were expected to be announced near the end of October.

System open market operations over most of the recent period were directed toward absorbing reserves supplied by movements in market factors, but day-to-day operations were conditioned by the shifting market atmosphere. Thus, only a moderate amount of reserves was absorbed early in the period, when short-term markets were under strain, but reserve absorption was stepped up later when market conditions became more comfortable. As a result, weekly-average figures for net borrowed reserves fluctuated over a wide range—from about \$190 million to \$570 million—with the bulk of the fluctuation occurring in excess reserve positions of country banks. For September as a whole, net borrowed reserves averaged about \$375 million, a little less than the August average; member bank borrowings, at \$765 million, were slightly above those of August.

The U.S. balance of payments in the third quarter was tentatively estimated to have been in deficit at a seasonally adjusted annual rate of about \$2 billion on the “liquidity” basis of calculation. However, a substantial surplus was recorded on the “official reserve transactions” basis. The divergence in the two measures was a consequence primarily of the substantial inflows of liquid funds through foreign branches of U.S. banks. The surplus on merchandise trade, which had declined markedly in the second quarter, fell further in the third quarter as imports increased more rapidly than exports.

Committee members differed somewhat in their assessments of the various elements in the economic outlook. Some stressed the implications of rising defense expenditures for the course of over-all developments and the persistence of inflationary pressures, while others placed greater emphasis on the evidences of recent and prospective weakening in the expansion of aggregate private demands.

The Committee agreed, however, that no change in policy should be made at this time, both because the economic situation at present did not appear to warrant an overt move in either direction and because Treasury financing activity was im-

minent. The desirability of encouraging moderate expansion in bank credit was noted, and it was agreed that account should be taken in open market operations of any apparently significant deviations of bank credit growth from current expectations.

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, uncertainties in equity markets, and a sharp increase in business inventories. Inflationary pressures are persisting and aggregate credit demands still remain strong. The balance of payments continues to show a sizable liquidity 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 continue efforts to restore reasonable equilibrium in the country’s balance of payments.

To implement this policy, and taking account of forthcoming Treasury financings, 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.

November 1, 1966

1. Authority to effect transactions in System Account.

Reports at this meeting indicated that economic activity was continuing to expand under the stimulus of rising defense expenditures, although moderating tendencies were appearing in some sectors of the private economy. The outlook was clouded by uncertainties relating to Vietnam and to prospects for fiscal policy actions in addition to the temporary suspension, approved