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.

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.

cies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $100 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

The Federal Reserve Bank of New York is also authorized and directed to make purchases of sterling on a covered or guaranteed basis in terms of the dollar up to a total of $200 million equivalent.

The Federal Reserve Bank of New York is also authorized and directed to assume commitments for forward sales of lire up to $500 million equivalent as a means of facilitating the retention of dollar holdings by private foreign holders.

The continuing authority directive on foreign currency operations was amended on one occasion, as noted in the entry for April 12, 1966, prior to the adoption of the new foreign currency instruments.

January 11, 1966

Authority to effect transactions in System Account.

Economic activity was rising vigorously at the end of 1965, according to reports at this meeting, and over the year it had grown more rapidly than previously estimated. Although both plant capacity and the labor force expanded substantially in 1965, the margins of unutilized resources at the year-end were the narrowest in more than 8 years. Price increases had remained selective and moderate, but rises persisted and the wholesale price index for industrial commodities in December was about 2 per cent higher than in the summer of 1964. Despite uncertainties regarding the course of hostilities in Vietnam and the size of Federal outlays for defense, the outlook appeared to be for continued large gains in activity and further upward pressures on prices. Optimism about business prospects was reflected in the stock market; average prices of common stocks ended the year at a record high.

Estimates of gross national product in the first three quarters

of 1965 had been raised substantially by the Department of Commerce. Preliminary indications were that GNP rose considerably further in the fourth quarter, and that for the year as a whole it was 7.5 per cent above 1964. The rate of capacity utilization in manufacturing, which had been rising since 1961, remained high throughout 1965. The total labor force expanded much more than expected—in the fourth quarter it was about 1.8 million persons larger than a year earlier, compared with the previous year's rise of 1.1 million persons—but employment increased by 2.2 million in the corresponding period, and the unemployment rate declined to 4.1 per cent in December 1965 from 5.0 per cent a year earlier.

Business plans called for another large increase in production facilities in 1966, and the labor force was expected to show substantial further growth. Nevertheless, if—as now seemed probable—GNP continued to expand at its recent high rate, it was likely that pressures on productive capacity would be as great or greater than in 1965 and that shortages of various types of labor would become increasingly severe. Under such circumstances prices probably would be under increased upward pressures.

Aggregate private demands for credit were particularly large in the fourth quarter of 1965, paralleling the vigorous rise in physical investment. Bank credit appeared to share about proportionately in the growth of total credit. For the year as a whole both bank credit and the money supply (private demand deposits plus currency outside of banks) rose more than in 1964—10 per cent and 4.8 per cent, respectively, compared with 8.4 per cent and 4.3 per cent in the prior year. Growth in time and savings deposits at commercial banks, at 16 per cent, also was more rapid than in 1964.

In December, bank credit expanded at a rate slightly faster than in the year as a whole, chiefly as a result of heavy demands for business loans. The money supply rose sharply during the month. The inflow of time and savings deposits slackened, however, despite advances in interest rates on new certificates of deposit (CD's), particularly on certificates of shorter maturity. Required reserves of member banks increased markedly, not only because of rapid growth in total deposits, but also because of relative shifts in the deposit "mix," involving accelerated rates of expansion in high-requirement demand deposits and in deposits at high-requirement reserve city banks.

The Treasury had been active in security markets recently. On the day before this meeting subscriptions had been accepted for a cash offering of $1.5 billion of 10-month certificates, bearing a 4¾ per cent coupon and priced to yield 4.85 per cent; early indications were that the offering had been well received by investors. Near the end of December $1 billion of tax-anticipation bills maturing in June had been auctioned, and beginning in January the size of the weekly auctions of 3-month bills was increased from $1.2 billion to $1.3 billion to raise $100 million in new cash each week. The next Treasury financing operation would involve the refunding of $4.8 billion in notes maturing February 15, of which $2.5 billion were held by the public. An announcement concerning the terms of the refunding was anticipated late in January.

Conditions in financial markets had been unsettled in recent weeks as a result of the conjunction of year-end seasonal pressures, heavy private credit demands, the successive Treasury financing operations, continuing adjustments to the official actions of early December increasing the discount rate and the maximum rates permitted to be paid on time deposits, and a transit strike in New York City, which reduced the efficiency with which market transactions could be conducted. At the same time, investor expectations were affected by conflicting reports of developments with respect to Vietnam, growing concern over inflationary pressures, and uncertainty about Federal budget prospects. On balance, yields on long-term securities changed little after the rises of early December that followed the official rate actions. Short- and intermediate-term yields advanced substantially further, however, with the market rate on 3-month Treasury bills

moving up about 20 basis points to 4.55 per cent on the day preceding this meeting. Money market conditions were quite firm, partly because of the large increase in required reserves of member banks and the concentration of pressures on large banks.

Open market operations during the period were directed at accommodating the enlarged needs for reserves and at moderating the upward pressures on short-term rates. As a result of these operations, in December the supply of nonborrowed reserves of member banks increased at the unusually rapid annual rate of 21 per cent, and borrowings of member banks on the average exceeded their excess reserves by only $25 million, as compared with $80 million in November and $135 million in October.

Tentative estimates of the U.S. balance of payments in 1965 suggested that the deficit was substantially diminished from the prior year on both the "liquidity" and "official reserve transactions" bases of calculation.[1] On the former basis the deficit appeared likely to have been about $1¼ billion, or less than half that in 1964, and on the latter basis it was estimated at about $750 million, compared with $1.2 billion in the prior year. Prospects for further substantial reductions in the "liquidity" deficit in 1966 appeared to depend heavily on improvement in the U.S. trade surplus; changes from recent levels in other categories of the payments accounts seemed likely to be roughly offsetting.

In the discussion of policy, Committee members noted that short-term interest rates were higher at present than had been expected at the time of the preceding meeting as a result of developments in the market and despite sizable additions to the supply of bank reserves. The Committee decided that open market

[1] The balance on the "liquidity" basis is measured by changes in U.S. reserves and in liquid U.S. liabilities to all foreigners. The balance on the "official reserve transactions" basis is measured by changes in U.S. reserves and in liquid and certain nonliquid liabilities to foreign official agencies, mainly monetary authorities. The latter balance differs from the former by (1) treating changes in liquid U.S. liabilities to foreigners other than official agencies as ordinary capital flows, and (2) treating changes in certain nonliquid liabilities to foreign monetary authorities as financing items rather than as ordinary capital flows.

operations until the next meeting should be directed toward maintaining about the prevailing conditions in the money market. It recognized, however, that economic, military, or Federal budget developments might lead to sharp changes in market conditions, which System operations should be expected only to moderate.

The Treasury financing schedule was a primary consideration in the decision to maintain relatively steady money market conditions, but other reasons for this course also were advanced. Thus, it was noted that the need for actively seeking changes in conditions could be determined better after the President's Budget Message and Economic Report were transmitted to the Congress later in the month; that market adjustments to the official rate actions of December were still under way; and that more time was required to appraise the effects of recent increases in interest rates.

At the same time, a number of members expressed concern over the recent pace of growth in reserves, bank credit, and the money supply, in view of the potential for inflationary developments in the period ahead. The Committee agreed that for the longer run some moderation in these growth rates would be desirable and, accordingly, it modified the statement of policy in the first paragraph of its current economic policy directive to the Federal Reserve Bank of New York. The directive issued read as follows:

The economic and financial developments reviewed at this meeting indicate that domestic economic expansion has strengthened further in a climate of optimistic business sentiment and with some further upward creep in prices. Interest rates are higher in most markets in response to strong credit demands and recent official rate actions. Our international payments position improved considerably during 1965 but further progress is needed to attain effective balance. In this situation, it is the Federal Open Market Committee's policy to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, by moderating the growth in the reserve base, bank credit, and the money supply.

In light of the Treasury financing schedule, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current conditions in the money market.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Patterson, Robertson, Scanlon, and Shepardson. Votes against this action: None.

February 8, 1966

Authority to effect transactions in System Account.

Business activity continued to advance vigorously in early 1966, and the outlook was becoming increasingly expansive. In addition to sharply rising Federal expenditures, large consumer demands, and record business outlays on plant and equipment, heavy inventory accumulation was adding to aggregate demands. Total business inventories had risen sharply in the fourth quarter of 1965 despite rapid liquidation of steel stocks following the wage settlement in that industry; and in the current quarter, with liquidation of steel stocks ending, further substantial accumulation seemed probable.

The recent surge in activity carried rates of resource use to advanced levels. In December the rate of capacity utilization in manufacturing edged up to a 10-year high. In January the unemployment rate declined again, reaching the administration's "interim" target of 4.0 per cent. As yet, pressure on resources had not been reflected in an accelerated rate of advance in average industrial prices—the price index continued to creep up at about the 1.5 per cent annual rate of the last 15 months—but reports of moderate price advances were becoming more frequent.

Loan expansion at commercial banks was unusually strong in January as business borrowing remained heavy. The money supply continued to rise rapidly, although the increase was concentrated in the early part of January and for the month as a whole was less than the sharp December advance. The inflow of