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.

gradual reduction in net reserve availability, and a greater reduction if growth in required reserves does not moderate substantially.

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

June 7, 1966

1. *Authority to effect transactions in System Account.*

Reports at this meeting indicated that the pace of economic expansion had slowed thus far in the second quarter, mainly because of a sharp decline in sales of new automobiles, but that activity was likely to accelerate again in the third quarter. Experienced labor continued in short supply, although employment rose in May among teenagers and other new entrants to the labor force and the over-all unemployment rate increased to 4.0 per cent from 3.7 per cent in April.

Prices of industrial commodities, which rose on average at an annual rate of about 3.5 per cent in the first 4 months of the year, apparently advanced in May also and were expected to remain under upward pressure. Consumer prices increased further in April to a level 2.9 per cent above a year earlier.

Total retail sales declined again in May, according to preliminary indications, as a result of a further reduction in new-automobile sales. Consumer spending of other types remained strong, however, and renewed strength in demand for autos over coming months was suggested by results of a buying intentions survey conducted by the Census Bureau in mid-April. Also, consumer spending was expected to be stimulated after midyear by inauguration of payments under the medicare program and by pay increases now under consideration in Congress for Federal military and civilian employees.

Both defense expenditures and business capital outlays continued to be strong expansive forces. While the rate of defense spending after midyear was uncertain, available information on new defense orders and on order backlogs through April suggested a further substantial rise in the third quarter. Additional indications that business capital outlays would continue to expand sharply throughout 1966 were contained in a Commerce–SEC survey of spending plans taken in May. For the year as a whole, the survey showed a rise in capital spending of 17 per cent over 1965, compared with 16 per cent shown by the corresponding February survey. An 18 per cent increase was found in a May "recheck" of results of a private survey that had yielded a 19 per cent figure in a March canvass.

Residential construction activity, on the other hand, appeared likely to decline in coming months. Mortgage market conditions continued to tighten through April as many lenders cut back new commitments because of reduced net inflows of savings funds, concern about possible outflows after the midyear interest-crediting date, and uncertainties about prospective market conditions and other factors. The cutbacks, which reportedly were particularly large at savings and loan associations and mutual savings banks, were not as yet fully reflected in current mortgage lending, much of which was based on takedowns of earlier commitments.

Growth in time and savings deposits at commercial banks moderated somewhat in May. The money supply declined sharply following rapid gains in March and April, and bank credit expanded at a rate only half that of the two preceding months. Banks liquidated a substantial volume of Treasury securities but increased by nearly the same amount their holdings of other securities, including Federal agency issues. Business loan demand was strong and was expected to continue so in coming weeks, partly because of large tax payments by corporations.

Interest rates on most types of market securities had increased since the preceding meeting of the Committee as a result of heavy demands for funds. Treasury, corporate, and municipal bond yields all advanced, with yields on new corporate issues moving above the previous postwar highs reached in early March. In short-term markets, rates rose on Federal agency issues, a large volume of which were sold in the period, and on bankers' acceptances, finance company paper, and commercial paper. The effective rate in Federal funds transactions reached 5¼ per cent late in the period. The 3-month Treasury bill rate, however, declined somewhat to 4.54 per cent on the day before this meeting. Contributing to the bill rate decline were reduced market supplies of short-term Treasury issues, heavy demands for bills by corporations and other investors, and Federal Reserve purchases.

Recent System open market operations were directed toward reducing net reserve availability further. In May net borrowed reserves averaged about $340 million compared with about $275 million in April, and member bank borrowings rose slightly to $650 million. Country banks were especially heavy borrowers from the Reserve Banks; for the first time since 1933, their borrowings exceeded their excess reserves. Nonborrowed reserves declined in May, following a large rise in April.

The U.S. balance of payments deficit in April and May together appeared to have been at roughly the same seasonally adjusted annual rate as in the first quarter, now estimated at $2½ billion on the "liquidity" basis of calculation. Most of the increase from the $1½ billion rate of deficit in the fourth quarter of 1965 resulted from a decline in the merchandise trade surplus. The deficit thus far in 1966 would have been larger if a sizable volume of liquid assets held by foreign official and international institutions had not been shifted into long-term time deposits and U.S. Government agency bonds and notes—assets not classified as liquid in the U.S. balance of payments statistics.

The Committee concluded that continuing inflationary pressures in the economy warranted maintaining the lower net reserve availability and tighter money market conditions that had prevailed recently. It was agreed that a further gradual reduction in net reserve availability, such as had been called for at most of the recent meetings, would not be desirable at present unless

required reserves of member banks expanded considerably more than would be expected on seasonal grounds. Several reasons were advanced against deepening the net borrowed reserve position of member banks at this particular time in the absence of unusually large growth in required reserves. These included the tight conditions prevailing in mortgage markets and the uncertainties regarding flows of funds at savings and loan associations and mutual savings banks around the midyear interest-crediting date; the currently slower pace of the domestic economic expansion; and the reduced rate of growth in bank credit. Also mentioned in this connection were the stresses expected in financial markets later in June in association with corporate tax and dividend payments and the large prospective volume of corporate, municipal, and Federal agency financing.

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, while the mortgage market is tight, automobile sales have fallen off, and some concern exists about the liquidity of nonbank financial institutions, the domestic economy is continuing to expand, with industrial prices rising further and credit demands remaining strong. The foreign trade surplus has declined and the international payments deficit has increased. 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 maintaining net reserve availability and related money market conditions in about their recent ranges; provided, however, that if required reserves expand considerably more than seasonally expected, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions.

Votes for this action: Messrs. Martin, Brimmer, Clay, Irons, Maisel, Mitchell, Robertson, Shepardson, Scanlon, Treiber, and Wayne. Votes against this action: None.

2. Authority to purchase and sell foreign currencies.

At this meeting the Committee replaced its three previously existing instruments governing System foreign currency operations with two new instruments, primarily for the purpose of simplifying and clarifying its instructions on this subject. The three instruments previously in effect—an authorization regarding open market transactions in foreign currencies, a statement of guidelines for System foreign currency operations, and a continuing authority directive on System foreign currency operations—are set forth in the form in which they were outstanding at the beginning of the year 1966 in the preface to this record of policy actions, and an amendment to the continuing authority directive made on April 12, 1966, is recorded in the entry for that date. The two new instruments adopted by the Committee—an authorization for System foreign currency operations and a foreign currency directive—are shown at the end of this entry.

Votes for these actions: Messrs. Martin, Brimmer, Clay, Daane, Irons, Maisel, Mitchell, Robertson, Shepardson, Scanlon, Treiber, and Wayne. Votes against these actions: None.

With one exception noted below, no changes were made in the substance of the Committee's instructions on foreign currency operations. The main purpose of recasting the instruments was to reformulate their essential content in a clearer and more concise manner by (1) removing duplication of content; (2) drawing together related instructions previously occurring at separate points and clarifying their language; (3) deleting language considered superfluous in light of operating experience; and (4) simplifying language found to be unnecessarily detailed. Other clarifying changes also were made, such as listing in the new authorization all of the reciprocal currency arrangements that had been individually authorized by the Committee.

The one substantive change made in the new instruments related to the authority of the Special Manager for foreign currency operations to engage in market transactions when exchange market instability threatened to produce disorderly conditions. Previously, the Special Manager was required (by the terms of the fourth paragraph of Section 3 of the Guidelines for System Foreign Currency Operations) to consult with the Committee, or in an emergency with the members of the Committee designated for that purpose, prior to engaging in transactions at such times. Experience at the time of the assassination of President Kennedy had demonstrated that in a sudden major crisis it might be impossible for the Special Manager to reach all of the designated Committee members in time to obtain authorization for necessary protective operations, although he might have no doubt that the required authority would have been granted by them. Accordingly, the Special Manager was authorized (by the terms of paragraph 2(C) of the new foreign currency directive) to engage in operations on his own initiative to meet a threat of disorderly conditions, with the requirement that he consult as soon as practicable with the Committee or, in an emergency, with the members of a Subcommittee designated (in paragraph 6 of the new authorization) for that purpose. The new instruction was intended to require advance consultation if practicable, but to permit operations if it were not.

The two new foreign currency instruments approved by the Committee at this meeting were as follows:

Authorization for System Foreign Currency Operations

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, and with the Bank for International Settlements:

Austrian schillings
Belgian francs
Canadian dollars
Pounds sterling
French francs
German marks
Italian lire
Japanese yen
Netherlands guilders
Swedish kronor
Swiss francs

B. To hold foreign currencies listed in paragraph A above, up to the following limits:

(1) Currencies held spot or purchased forward, up to the amounts necessary to fulfill outstanding forward commitments;

(2) Additional currencies held spot or purchased forward, up to the amount necessary for System operations to exert a market influence but not exceeding $150 million equivalent; and

(3) Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $200 million equivalent.

C. To have outstanding forward commitments undertaken under paragraph A above to deliver foreign currencies, up to the following limits:

(1) Commitments to deliver to the Stabilization Fund foreign currencies in which the U.S. Treasury has outstanding indebtedness, up to $200 million equivalent;

(2) Commitments to deliver Italian lire, under special arrangements with the Bank of Italy, up to $500 million equivalent; and

(3) Other forward commitments to deliver foreign currencies, up to $275 million equivalent.

D. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

2. 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)	Period of arrangement (months)
Austrian National Bank	50	12
National Bank of Belgium	100	12
Bank of Canada	250	12
Bank of England	750	12
Bank of France	100	3
German Federal Bank	250	6
Bank of Italy	450	12
Bank of Japan	250	12
Netherlands Bank	100	3
Bank of Sweden	50	12
Swiss National Bank	150	6
Bank for International Settlements (System drawings in Swiss francs)	150	6
Bank for International Settlements (System drawings in authorized European currencies other than Swiss francs)	150	6

3. All transactions in foreign currencies undertaken under paragraph 1(A) above shall be at prevailing market rates and no attempt shall be made to establish rates that appear to be out of line with underlying market forces. Insofar as is practicable, foreign currencies shall be purchased through spot transactions when rates for those currencies are at or below par and sold through spot transactions when such rates are at or above par, except when transactions at other rates (i) are specifically authorized by the Committee, (ii) are necessary to acquire currencies to meet System commitments, or (iii) are necessary to acquire currencies for the Stabilization Fund, provided that these currencies are resold forward to the Stabilization Fund at the same rate.

4. It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating

arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested insofar as practicable, considering needs for minimum working balances. Such investments shall be in accordance with Section 14(e) of the Federal Reserve Act.

6. A Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) is authorized to act on behalf of the Committee when it is necessary to enable the Federal Reserve Bank of New York to engage in foreign currency operations before the Committee can be consulted. All actions taken by the Subcommittee under this paragraph shall be reported promptly to the Committee.

7. The Chairman (and in his absence the Vice Chairman of the Committee, and in the absence of both, the Vice Chairman of the Board of Governors) is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Secretary;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on such policy matters as may relate to the Secretary's responsibilities; and

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G (1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

10. The Special Manager of the System Open Market Account for foreign currency operations shall keep the Committee informed on conditions in foreign exchange markets and on transactions he has made and shall render such reports as the Committee may specify.

Foreign Currency Directive

1. The basic purposes of System operations in foreign currencies are:

A. To help safeguard the value of the dollar in international exchange markets;

B. To aid in making the system of international payments more efficient;

C. To further monetary cooperation with central banks of other countries having convertible currencies, with the International Monetary Fund, and with other international payments institutions;

D. To help insure that market movements in exchange rates, within the limits stated in the International Monetary Fund Agreement or established by central bank practices, reflect the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public; and

E. To facilitate growth in international liquidity in accordance with the needs of an expanding world economy.

2. Unless otherwise expressly authorized by the Federal Open Market Committee, System operations in foreign currencies shall be undertaken only when necessary:

A. To cushion or moderate fluctuations in the flows of international payments, if such fluctuations (1) are deemed to reflect transitional market unsettlement or other temporary forces and therefore are expected to be reversed in the foreseeable future; and (2) are deemed to be disequilibrating or otherwise to have potentially destabilizing effects on U.S. or foreign official reserves or on exchange markets, for example, by occasioning market anxieties, undesirable speculative activity, or excessive leads and lags in international payments;

B. To temper and smooth out abrupt changes in spot exchange rates, and to moderate forward premiums and discounts judged to be disequilibrating. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified or curtailed unless upon review and reassessment of the situation the Committee directs otherwise;

C. To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension, (2) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, and (3) market rumors of a character likely to stimulate speculative transactions. Whenever exchange market instability threatens to produce disorderly conditions, System transactions may be undertaken if the Special Manager reaches a judgment that they may help to reestablish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. In such cases, the Special Manager shall consult as soon as practicable with the Committee or, in an emergency, with the members of the Subcommittee designated for that purpose in paragraph 6 of the Authorization for System foreign currency operations; and

D. To adjust System balances within the limits established in the Authorization for System foreign currency operations in light of probable future needs for currencies.

3. System drawings under the swap arrangements are appropriate when necessary to obtain foreign currencies for the purposes stated in paragraph 2 above.

4. Unless otherwise expressly authorized by the Committee, transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken only (i) to prevent forward premiums or discounts from giving rise to disequilibrating movements of short-term funds; (ii) to minimize speculative disturbances; (iii) to supplement existing market supplies of forward cover, directly or indirectly, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders; (iv) to allow greater flexibility in covering System or Treasury commitments, including commitments under swap arrangements; (v) to facilitate the use of one currency for the settlement of System or Treasury commitments denominated in other currencies; and (vi) to provide cover for System holdings of foreign currencies.

June 28, 1966

1. Authority to effect transactions in System Account.

Despite the slowdown in the rate of economic expansion in the second quarter, pressures on industrial capacity, manpower, and prices remained strong. And because the pace of expansion was expected to accelerate again after midyear, there appeared to be little prospect for relaxation of these pressures.

Average industrial prices continued to rise in May at an annual rate of 3.5 per cent and were estimated to have increased further in June at about the same rate. Consumer prices advanced only slightly in May following 3 months of rapid increase. In various current labor negotiations unions reportedly were pressing for wage increases well above the administration's guideposts, against a background of strong demands for labor, high corporate profits, and rising consumer prices.

The rate of growth in GNP appeared likely to be higher in the second half of 1966 than in the quarter now ending, although somewhat lower than the exceptionally high rates of the two preceding quarters. Large further gains were anticipated in business capital outlays and Federal defense expenditures, and growth in consumer spending—the lag in which accounted for most of the second-quarter slowdown in GNP—was expected to pick up again as a result of more rapid increases in disposable income. Data for early June suggested that sales of new automobiles were recovering part of their declines of April and May.

Residential construction remained the main weak factor in the outlook; housing starts declined sharply in May, and further declines appeared likely. Interest rates on mortgages on new homes, which had been rising sharply in recent months, reached new highs in May as many lending institutions drastically reduced their commitments to make new loans. Net inflows of funds to savings and loan associations and mutual savings banks were much smaller in May and early June than in comparable periods of other recent years. There was considerable apprehension among such institutions that large net outflows would occur around midyear—after quarterly and semiannual interest accruals were credited—as customers shifted funds to higher-yielding market securities and to commercial bank time deposit instruments.

At commercial banks total time and savings deposits were estimated to be expanding in June at a rate slightly below that of May and well below that of April. Growth in outstanding