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.

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 negotiable CD's moderated sharply at city banks, although major New York banks had recently increased posted rates to 5½ per cent—the maximum permitted under Regulation Q—on negotiable CD's with maturities of 3 months, and some reportedly were willing to negotiate that rate on maturities as short as 30 days. Loan demands were strong, particularly after mid-June when businesses needed funds to finance income tax payments and accelerated payments of withheld individual and social security taxes. The money supply was estimated to be increasing in June about as sharply as it had declined in May.

Long-term interest rates changed little on balance in recent weeks despite heavy flotations of corporate and municipal bonds. A lower volume of such security issues was in prospect for July; and Federal agency offerings, which were at an unprecedented level in June, also were expected to diminish. Most short-term interest rates were stable or somewhat higher. However, yields on 3-month Treasury bills declined by about 20 basis points further, to 4.33 per cent on the day before this meeting, as strong demands continued to press against extremely scarce market supplies.

System open market operations since the previous meeting had been directed toward maintaining net reserve availability in about the range of recent weeks, as required reserves of member banks increased on balance about in line with expectations. Money market conditions were firm throughout the period and had become quite firm in recent days in response to strong loan demands. Bank lending rates to Government securities dealers were raised to new high levels, and the effective rate on Federal funds reached a record 5½ per cent, with some transactions at 5⅝ per cent.

The deficit in the U.S. balance of payments for the first 5 months of 1966 was now estimated to have been at a seasonally adjusted annual rate of $2¼ billion on the "liquidity" basis of calculation. Prospects favored some recovery in the trade surplus from the unusually low levels to which it fell in April and May,

but deterioration seemed probable in other categories of U.S. international payments.

On the day before this meeting, the Board of Governors announced two actions designed to moderate further growth of bank credit and deposits. Reserve requirements were increased from 4 to 5 per cent against time deposits (other than savings deposits) in excess of $5 million at each member bank, effective with the reserve computation period beginning July 14, 1966, for reserve city banks and July 21, 1966, for all other member banks. This action, which would increase required reserves by an estimated $420 million, was expected to exert a tempering influence on issuance of CD's and thereby to apply a moderate additional measure of restraint upon the expansion of banks' loanable funds. At the same time, the Board brought shorter-term bank promissory notes and similar instruments under the regulations governing reserve requirements and payment of interest on deposits, effective September 1, 1966.

In its discussion of policy the Committee agreed that net reserve availability should be reduced if the pace of bank credit expansion led to larger than expected increases in required reserves. At the same time it was agreed that operations might need to be modified to ease reserve conditions if unusual liquidity pressures developed at financial institutions as the result of deposit or share account withdrawals.

Divergent judgments were expressed regarding the appropriate level of net reserve availability if increases in required reserves were not unusually large. Some members felt that deeper net borrowed reserves should be sought. They cited the economic outlook, the strong continuing demands for bank credit, and the undesirability of offsetting the full impact on net borrowed reserves of the Board's action on reserve requirements. Other members favored maintaining net reserve availability around its recent levels, primarily because of the uncertainties with respect to possible financial developments in the period immediately ahead. There was considerable sentiment for giving the Account

Manager latitude to reduce net reserve availability somewhat if and when he thought financial conditions permitted.

At the conclusion of the discussion 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 there has been some reduction in automobile sales and residential construction, over-all domestic economic activity is continuing to expand, with industrial prices rising further. Mortgage market conditions remain tight and total credit demands continue 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 about the current state of net reserve availability and related money market conditions, except as changes may be needed to moderate unusual liquidity pressures at financial institutions; provided, however, that if such liquidity pressures are not unusually strong and required reserve increases are larger than 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, Hayes, Bopp, Brimmer, Clay, Daane, Hickman, Irons, Maisel, and Mitchell. Votes against this action: None.

2. Amendment of continuing authority directive.

The Committee amended Section 1(c) of the continuing authority directive to the Federal Reserve Bank of New York regarding domestic open market operations, to remove the 24-month maturity limitation on Government securities that might be held under repurchase agreements with nonbank dealers. As amended, Section 1(c) read as follows:

To buy U.S. Government securities, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities covered by any such agreement are not repurchasd by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

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

This action was taken after the Account Manager described certain procedures that might prove necessary in supplying reserves to the banking system around the July 4 holiday period, when the usual seasonal rise in currency holdings of the public was expected to result in a large decline in reserves. It appeared that opportunities for outright purchases of bills might be limited because of the very low level of market supplies; and that supplying the needed reserves through repurchase agreements of the usual type—that is, agreements related to the dealers' current needs for financing—might not prove feasible because such needs recently had been minimal and might continue so. The procedure suggested was to arrange repurchase agreements with dealers in the expectation that they would obtain the necessary securities by entering into similar agreements with banks and others seeking a temporary supply of funds over a period of expected money stringency. A temporary removal of the maturity limitation was proposed in order to give maximum flexibility to the operations. The Committee's action was taken on the understanding that operations of the type described would be undertaken only if found necessary to supply needed reserves. It was expected that the continuing authority directive would be amended again to restore the maturity limitation after the current period of reserve need had passed.

July 26, 1966

1. Authority to effect transactions in System Account.

GNP was now officially estimated to have increased by $11 billion in the second quarter. This was considerably less than the $17 billion rise in the first quarter, with the slowdown attributable mainly to lack of growth in consumer spending for goods. Since prices advanced as much in the second quarter as in the first, real GNP rose at an annual rate of only 2.5 per cent, compared with 6 per cent in the first quarter. Growth in industrial production and nonfarm employment also slowed in the second quarter.

Imbalances in the economy appeared to have increased recently. Thus, the rate of business inventory accumulation in the second quarter was the highest in many years—partly because of a build-up in dealer stocks of automobiles—and probably was not sustainable; and the outlook for residential construction remained weak. However, substantial increases appeared in prospect in the third quarter for disposable incomes and consumer spending, and both business capital outlays and defense expenditures were likely to continue their upward trends. As a result, GNP was expected to grow more rapidly in the third quarter than in the second.

In June, industrial production rose moderately further, and retail sales increased following sharp declines in April and May. Nonfarm employment expanded substantially as a record number of teenagers entered the labor force and most of them found jobs. The over-all unemployment rate was unchanged at 4 per cent,

but there was a marked further decline in long-duration unemployment.

The advance in average industrial prices continued in June and apparently also in early July. The consumer price index rose substantially in June, partly for seasonal reasons, and was 2.5 per cent above a year earlier.

Private housing starts, which had dropped sharply in May, edged down somewhat further in June to the lowest rate in 5 years. The recent decline reflected acute pressures in mortgage markets, based in part on uncertainties about the extent of withdrawals from savings and loan associations and mutual savings banks at the midyear dividend-crediting period. As it turned out, withdrawals appeared to have been substantial but smaller than had been widely feared. Nevertheless, mortgage markets continued under great strain.

Commercial banks apparently benefited to some extent from the July withdrawals from competing institutions; total time and savings deposits were estimated to be increasing more rapidly than the May–June average rate of about 10 per cent. The money supply was declining in July after increasing sharply in June, as U.S. Government deposits were rebuilt following a substantial reduction in the preceding month. However, total deposits, including Government deposits, and required reserves of member banks were increasing substantially. Staff projections for August suggested a fairly low growth rate in total deposits and very small growth in required reserves.

Loan demand remained strong, and money markets tightened further in the period since the Committee's previous meeting. Yields on short-term instruments generally continued to increase. Dealer loan rates posted by major New York City banks reached new highs as those banks developed large basic reserve deficiencies and were heavy buyers of Federal funds at rates ranging up to 5¾ per cent. On June 29 the commercial bank prime lending rate was raised to 5¾ per cent from 5½ per cent. In this environment Treasury bill rates moved sharply higher to