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.

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 by Congress in late October, of the 7 per cent investment tax credit and accelerated depreciation allowances.

Preliminary figures of the Commerce Department indicated that growth in GNP had stepped up to about a $14 billion rate in the third quarter from $11 billion in the second, despite the sharp contraction in residential construction that brought housing starts in September down nearly to the recession trough of December 1960. The capacity utilization rate in manufacturing remained high, shortages of skilled workers persisted, and the unemployment rate continued low—3.8 per cent in September, little changed from the August figure of 3.9 per cent. A large increase in orders to defense-related industries in September implied that defense spending would continue to rise rapidly, and tentative staff estimates suggested that the faster pace of GNP growth of the third quarter would be maintained in the fourth.

The evidences of moderating tendencies in private demands included slight declines in retail sales in September and early October and lack of growth in both industrial production and nonfarm employment in September. In addition, recent private surveys of business plans suggested a marked slowing of growth in spending on plant and equipment in 1967.

Prices of industrial commodities remained generally stable in September, as further declines in prices of sensitive materials and some consumer appliances continued to offset increases in machinery and equipment and other metal products. Consumer prices rose slightly more than seasonally, partly because of continued rapid increases in the prices of services. Average hourly earnings of manufacturing employees were advancing faster than they had earlier, reflecting cost-of-living adjustments and the larger wage increases provided by contracts recently negotiated.

Both the money supply and total time and savings deposits of commercial banks appeared to have declined in October, the latter partly because of another sizable run-off in negotiable CD's. Commercial bank credit was estimated to have changed

little between the last Wednesdays of September and October; the step-up in business loan growth was smaller than expected, and banks liquidated a large volume of Government securities. With both demand and time deposits weaker than anticipated, the "bank credit proxy"—daily-average member bank deposits—declined at an annual rate of about 3 per cent in October in contrast with the earlier expectation of growth. Required reserves of member banks also fell short of expectations.

Staff projections for November suggested some further decline in member bank deposits—at perhaps a 2 per cent annual rate—and a slight reduction in required reserves. The projections allowed for continued run-offs in outstanding CD's, but at a slower rate than in September and October. Some reduction in the rate of business loan expansion was expected, mainly because corporate payments of withheld taxes normally made in November had been shifted into October.

Recent System open market operations were directed at maintaining generally steady but somewhat less firm conditions in the money market, in view of the lack of growth in bank credit. Net borrowed reserves averaged about $340 million in the last 2 weeks of October, compared with $495 million earlier in the month and $390 million (revised) in September. Member bank borrowings also declined in the second half of October, although the average for the month was about the same as in September. Yields on 3-month Treasury bills declined by about 10 basis points on balance to 5.22 per cent on the day before this meeting, and various other short-term rates had edged down since the preceding meeting. Yields on long-term securities had also declined, with those on Treasury bonds reaching their lowest levels since June.

The Treasury raised $3.5 billion of new cash in mid-October through an auction of tax-anticipation bills, and subscription books for the November refunding were open on the day of this meeting. The refunding involved a cash offering of $2.5 billion of 5⅝ per cent 15-month notes and $1.6 billion of 5⅜ per cent

5-year notes, to replace $4.1 billion of maturing obligations, of which $3.2 billion were held by the public.

The third-quarter deficit in the U.S. balance of payments on the "liquidity" basis was now estimated to have been at an annual rate of less than $1 billion. The revision from the earlier estimate of about $2 billion reflected special receipts at the end of September—consisting of foreign official debt prepayments and purchases of nominally nonliquid assets—rather than any fundamental change in underlying payments conditions. The inflows of liquid funds through foreign branches of U.S. banks, which had been extremely large in the third quarter, continued in October on a reduced, although still sizable, scale.

Committee members agreed that the recent tendency towards somewhat less firmness that had been allowed to develop in the absence of bank credit expansion was appropriate. The Committee concluded that the current Treasury financing precluded a marked shift in policy at present and that generally steady conditions in the money market should be sought. Most members felt that a significant change in policy was not warranted pending clarification of the outlook for the Federal budget and further evidence on the likely strength of private demands, although some members expressed concern about the risks of overstaying a policy of restraint in view of recent moderating tendencies in some sectors of the private economy. The Committee agreed that it would be desirable to foster expansion in bank credit at a moderate pace and that open market operations should be modified, insofar as feasible given the Treasury financing, if bank credit were either declining further or rising at an unduly rapid rate.

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 continuing to expand with sharply rising defense expenditures but some evidences of moderating tendencies in sectors of the private economy. While prices of some

materials have declined recently, upward demand and cost pressures persist for many finished goods and services. Bank credit expansion has slackened. Earlier strains in financial markets have abated and certain fiscal policy measures have recently been enacted by the Congress. The balance of payments remains a serious problem. In this situation, it is the Federal Open Market Committee's policy to maintain money and credit conditions conducive to the restraint of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, and taking account of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining generally steady conditions in the money market; provided, however, that operations shall be modified, insofar as the Treasury financing permits, in the light of bank credit developments during the month.

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Daane, Hickman, Irons, Maisel, Mitchell, Robertson, and Shepardson. 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 to authorize repurchase agreements in obligations of U.S. Government agencies. Previously, repurchase agreements had been authorized only in U.S. Government securities and bankers' acceptances. With this amendment, Section 1(c) read as follows:

To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, 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, obligations, 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 or agency issues covered by any such agreement are not repurchased 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, Mitchell, Robertson, and Shepardson. Votes against this action: None.

Section 6 of Public Law 89-597, enacted in late September, amended Section 14(b) of the Federal Reserve Act to authorize the Reserve Banks "To buy and sell in the open market, under the direction and regulations of the Federal Open Market Committee, any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States." The amendment of the continuing authority directive was made pursuant to that legislation, after the Account Manager indicated that he would consider repurchase agreements in agency issues to be a useful addition to the tools presently available for reserve management. It was agreed to postpone a decision regarding authorization of outright transactions in agency issues pending further study of their potential value in implementing monetary policy objectives.

November 22, 1966

1. Authority to effect transactions in System Account.

Evidences of moderating tendencies in the pace of business expansion were increasing. The Commerce Department had reduced its estimate of GNP for the third quarter and now indicated an increase only about $1 billion larger than that for the second quarter. Staff projections of fourth-quarter growth in GNP also had been lowered somewhat, primarily because of a downward revision in the estimate for consumer expenditures. Substantial gains in defense spending and business fixed investment were still projected for the fourth quarter.

Industrial production rose relatively little in October after

remaining stable in September, and with manufacturing capacity continuing to expand, the plant utilization rate apparently edged down. Total retail sales were about unchanged in October as declines at automobile dealers and other durable goods stores offset advances at nondurable goods stores. Housing starts dropped sharply further to the lowest level since World War II. Expansion in nonfarm employment resumed, however, and labor market conditions continued tight. The unemployment rate, at 3.9 per cent, was little different from the 3.8 per cent rate of September, and the average workweek in manufacturing continued close to the postwar peak.

The wholesale price index declined in October as a result of a substantial drop for foodstuffs. Average prices of industrial commodities, which had been stable for several months, continued unchanged in October and were about 2 per cent above a year earlier. The progressive decline in sensitive materials prices, which offset increases in prices of finished industrial products, seemed to be tapering off, however, and labor costs were rising as the pattern of larger wage increases continued. For both reasons average industrial prices appeared likely to begin rising again, although perhaps at a slower pace than early in the year.

The money supply declined in October by somewhat more than had been estimated earlier. Since April the money supply had fallen on balance at an annual rate of about 1.5 per cent. Commercial bank credit, on a last-Wednesday-of-the-month basis, was now estimated to have contracted further in October after declining on balance over the two preceding months. Growth in business loans slackened to an annual rate of about 7 per cent in the 3 months ending in October, from 21 per cent in the first 7 months of the year and more than 18 per cent in 1965 as a whole.

New staff projections for daily-average member bank deposits —the "bank credit proxy"—suggested a decline at an annual rate of 3 per cent in November, slightly more than anticipated