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Yves Maroni

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Petroleum, Politics and the Quest for Prosperity: the Venezuelan Case

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Petroleum, Politics and the Quest for Prosperity: the Venezuelan Case

Since 1958, Venezuela has been feeling the impact of a slower rate of growth in its key petroleum industry than prevailed in the years immediately after World War II. Since petroleum production accounts for about 30 per cent of the country's gross domestic product, the impact has been severe. In the period 1949-57, when crude petroleum production was rising at the average rate of 8.4 per cent per annum, real gross domestic product rose by about 9 per cent per annum. In the last nine years, crude petroleum production rose at only about 2.1 per cent per annum and real gross domestic product at about 4.3 per cent per annum. While there were cyclical fluctuations in both periods, in the recovery years of the more recent period, the rate of growth of real gross domestic product barely averaged 6 per cent, less than the lowest rate recorded in any year in the 1949-57 period. Inasmuch as Venezuela's population is growing at about 3 per cent a year, the rate of growth of real gross domestic product per capita in the last nine years has not been more than 1.3 per cent a year, down from about 6 per cent a year in the previous nine years. 1/

The slowdown in the expansion of Venezuelan oil output stems in part from decisions of the Venezuelan Government which made the exploitation of Venezuelan oil more difficult and less profitable. The granting of oil concessions to foreign companies was halted and taxes on the industry were sharply increased. This coincided with the opening of new high yielding oil fields in North Africa and with the adoption by the United States of restrictions against imports of residual fuel oil which constitute a large part of Venezuelan oil exports. While a Government Petroleum Corporation was set up to develop new fields, it was slow to get underway and has not become a dynamic factor in the industry.

The unfavorable trend of Venezuela's petroleum industry has had serious effects on Government revenues, about two-thirds of which come from royalty and tax payments by the industry, and on foreign exchange receipts of the Central Bank, over 90 per cent of which are derived from oil company expenditures in Venezuela. The resulting fiscal and balance-of-payments difficulties were accompanied by the emergence of upward price pressures. In

1/ Statistical tables will be found at the end of the paper.

September 1966, wholesale prices were 26 per cent higher than in 1958, compared with only a 1 per cent increase in the 1948-58 period. The acceleration of price increases since 1958 was primarily associated with a rise in domestic prices of imported goods as the bolivar was devalued in stages in 1961-64. In September 1966, these prices were nearly 50 per cent higher than in the 1956-57 period, whereas prices of domestic goods were only about 15 per cent higher. The price increase in the 1958-66 period, averaging about 2.7 per cent a year, tended to taper off in the last three years.

The 1958-61 Crisis.

The end of the oil boom in 1958 coincided with an increase in spending to pay for large construction projects of earlier years. The result was a severe fiscal and balance-of-payments crisis. Following the overthrow of the regime of dictator Marcos Perez Jimenez, in January 1958, the successor government decided to pay on schedule the huge debts left behind by the dictator. In view of the tapering off of the oil revenues, this necessitated a drastic curtailment of new public works and other construction. The result was a general decline in economic activity and in total government revenues. Large fiscal deficits were incurred in 1958, 1959 and 1960. In the four years 1958-61, real gross domestic product rose at an average rate of about 3 per cent per annum, only about as fast as population, and in three of those years, the rate was well below 2 per cent.

A large part of the debts left behind by the ex-dictator were in the form of notes which had been discounted abroad. Their repayment involved a net outflow of capital on official account of more than $500 million in 1958-60. 1/ This coincided with a virtual halt in new direct investment by foreign companies in 1958, followed by disinvestment, beginning with foreign companies outside the oil industry in 1959. At the same time, Venezuelan businesses and individuals also began to move their funds abroad, while repaying earlier foreign borrowings. The private capital outflow was triggered by uncertainties as to the general socio-politico-economic policies of the government. It assumed serious proportions after the middle of 1959, when fears arose about the stability of the currency, given the large fiscal deficit. In addition, a campaign of violence was launched by terrorist groups supported from Cuba, including the so-called Armed Forces of National Liberation. This raised the threat of a Castro style take-over of the Government.

1/ The gross repayments were about $875 million, but in this period the Government borrowed about $375 million, mainly from U. S. banks and from the oil and iron ore companies operating in Venezuela.

Approximate balance on private capital account was maintained in 1958 and 1959, as the oil companies completed investments already underway. This was already a drastic change from the large net inflows of 1956 ($612 million) and 1957 ($991 million). But in 1960 and 1961, more than $530 million in private funds were recorded as having left the country. In these two years, there were large negative errors and omissions in the balance-of-payments ($354 million in 1960 and $76 million in 1961), much of which probably represents an additional (unrecorded) outflow of capital.

In the four years 1958-61, the net capital outflow may have totalled $1.5 billion ($1.1 billion of which was recorded). This placed a serious strain on gold and foreign exchange reserves, inasmuch as the balance of payments on current account was in deficit in 1958 and 1959. While a current account surplus emerged in 1960 and grew further in 1961, the capital outflow was heavier in those years than it had been earlier and the pressure on reserves continued. In the four years 1958-61, gold and foreign exchange reserves fell by about $880 million (more than 50 per cent) from their 1957 peak. Gold holdings alone were reduced by $320 million.

The capital outflow also had a serious effect on the liquidity of commercial banks. Even though the public sector was financing its deficit mainly by drawing down its deposits at the Central Bank and later by borrowing from this institution, the additions to bank reserves from this source were not enough after the middle of 1959, to offset the drain on liquidity associated with the capital flight. From the end of June 1959, to the end of September 1960, money supply declined by 22.5 per cent, and the commercial banks were forced to contract credit to the private sector, thereby intensifying the general decline in economic activity. The Central Bank undertook for the first time to extend credit to the banks, but it did so mainly in cases where banks were threatened with collapse.

Faced with this crisis, the Government adopted quantitative import restrictions in 1959 and exchange controls in 1960. A free market emerged in which the rate soon reached Bs. 4.70 per dollar, compared with a rate of Bs. 3.35 per dollar for authorized payments. In March 1961, about one-fourth of the country's imports were shifted to the free market and the Central Bank stabilized the rate in that market at Bs. 4.58 per dollar. In April 1962, the proportion of imports paid through the free market was raised to about 85 per cent. These moves helped to reduce and hold down the demand for imports. Since the Central Bank purchased foreign exchange at Bs. 3.09 per dollar from the oil companies and at Bs. 3.33 per dollar from other parties,1/ the growing sales of foreign exchange in the free market also provided an increasingly large exchange profit. This profit was transferred to the government and helped turn the fiscal deficits into surpluses once again in 1962.

The balance of payments on current account recorded a $473 million surplus in 1961, compared with a $568 million deficit in 1957, even though exports were about $300 million less in 1961 than in 1957. This was made possible by a 40 per cent contraction in imports and by an equally large reduction in net payments for services (mainly in investment income payments).

The 1962-65 Recovery

The recorded outflow of capital continued in 1962 and 1963. In these two years, nearly $700 million in private capital is known to have left the country. But the unrecorded outflow apparently stopped in 1962 when the errors and omissions in the balance of payments turned strongly positive. Confidence improved as the efforts to eliminate the fiscal deficit bore fruit and as the Government gained in stature through its ability to survive in the face of growing terrorist acts and of occasional threats of military coups.

The fiscal surpluses were bolstered in 1962 and 1963 by a shift of oil company taxes to a pay-as-you-go basis and in 1964 by a revaluation of the foreign assets of the Central Bank. They were utilized to reduce Government indebtedness to the banking system and to rebuild Government deposits, mainly at the Central Bank. As the public's willingness to hold bolivar deposits increased and as the Government repaid debts to the commercial banks, the latter were able to resume expanding credit to the private sector and, especially in 1964, to repay some of the advances received from the Central Bank during the years of crisis.

Economic activity revived, and, in the years 1962-65, real gross domestic product rose at an average rate of nearly 6 per cent per annum. In the same period, commercial bank credit to the private sector rose nearly 50 per cent, roughly in line with the rise in deposits.

1/ Coffee and cacao exports received a variable subsidy which resulted in more depreciated rates for these commodities.

Gold and foreign exchange reserves, which stood at $580 million at the end of 1961, turned up and were $831 million three years later, even though, in this period, about $230 million in short-term debts, primarily to U. S. commercial banks, was repaid. These balance-of-payments surpluses were facilitated by the relatively low level of imports in 1962 and 1963 (in spite of the recovery of economic activity), by the shift of oil company taxes to a pay-as-you-go basis, and by a sharp bulge in oil exports in 1962 in response to an unusually severe winter in Europe. No part of the reserve gain was taken in the form of gold. At their end of 1964 level, reserves were still well below their 1957 peak of $1,459 million.

Exchange controls were partially lifted in 1962 and eased further in 1964. Early in 1964, the authorities, encouraged by the performance of the economy in 1962 and 1963, took a long step toward completing the process of partial devaluation started three years earlier. However, even with a further small change at the end of 1964, the reform did not go all the way to the adoption of a single exchange rate and declaration of a new par value to the International Monetary Fund.

Under the exchange system adopted in 1964 there are three deviations from a unified rate system: (a) the Central Bank purchases foreign exchange from the petroleum and iron ore exporting companies at a rate some 2 per cent below the rate of Bs. 4.485 per dollar at which it buys and sells foreign exchange for most purposes; (b) the Central Bank may subsidize exports of coffee and cacao (both minor exports) by making up the difference (if any) between the f.o.b. price of these products calculated at the 4.485 rate and the minimum export price specified by Government decree; and (c) the Central Bank grants a subsidy of Bs. 1.15 per dollar on exchange purchased to pay for imports of wheat and powdered milk (equivalent to less than 5 per cent of total imports).

The 1966 Pause

Even while the recovery from the 1959-61 crisis was still underway, the slow growth of petroleum output in the years 1963-65 was already sowing the seeds of difficulties to come, by limiting the growth of the Central Bank's foreign exchange receipts and of the Government's revenues. The Central Bank's foreign exchange receipts from the oil companies were virtually the same in each of the last four years. In view of the overwhelming importance of these receipts, this stagnation seriously limited the ability of the Central Bank to meet growing demands for foreign exchange. In spite of the ending of the recorded capital outflow in 1964, the reserve gains tended to shrink in 1964 and 1965, as imports and investment income payments recovered from their earlier depressed levels. In addition, even though the country's financial position looked strong, there were two bursts of capital flight, one in 1964, the other in 1965. 1/ These reflected nervousness over temporary surges in terrorist activities, uncertainties over the future course of Government social and economic policies, and rumors that a further devaluation of the bolivar was in the offing.

On the fiscal side, the slow growth of petroleum output meant that revenues from the oil companies did not rise fast enough to make up for the virtual disappearance of the exchange profits of 1962 and 1963, following the exchange reform of early 1964. As a result, the large fiscal surpluses of 1962-64 dwindled.

The economic upswing underway since the end of 1961 slowed down significantly in 1966 when petroleum production turned down for the first time since 1958. The 1966 petroleum output was nearly 3 per cent lower than that of 1965. Manufacturing output and construction activity continued to expand in 1966 but more slowly than in 1965. As a result, real gross domestic product was only about 3 per cent higher in 1966 than in 1965. This amounted to no gain on a per capita basis. Gold and foreign exchange reserves turned down, declining by $66 million in 1966.

The Government attempted to bolster its revenues in order to continue increasing its expenditures at the accustomed rate. It made claims for back taxes against the extractive industries, arguing that their revenues for tax purposes should be calculated on the basis of agreed prices rather than the actual selling prices which were lower. The Government also proposed new and higher taxes on business and individuals, including higher income taxes, stamp and inheritance taxes, and an excess profits tax on extractive companies, and announced plans to regulate private education and agricultural marketing. These proposals aroused considerable opposition. The ensuing controversy, coupled with business concern over the impact on the economy of lagging oil production and of the Government's dispute with the oil companies over back taxes, triggered a large capital flight in the third quarter of 1966.

An agreement on the question of back taxes was reached at the end of September and one of the companies involved made a special payment in October as part of the settlement. This probably kept the Government from incurring a deficit in 1966. Early in October, the

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1/ Errors and omissions in the balance of payments turned strongly negative in both years.

Government agreed to revamp its tax package, taking account of some of the objections of the business community, in particular dropping the excess profits tax proposal. The Government also abandoned its education and agriculture bills. The willingness of the Government to take account of business criticisms had a favorable effect on confidence as did the appointment, at about the same time, of private sector representatives on Government commissions dealing with development planning and trade negotiations. Some reflow of capital to Venezuela appears to have occurred in the fourth quarter. The revised income tax bill, which also introduces a tax on dividends, as well as the inheritance and stamp tax bills, were approved by Congress before the end of 1966.

The slowdown in the pace of economic expansion in 1966 was accompanied by a slower expansion of credit to the private sector by the commercial banks in the first half of the year. However, the capital flight of the third quarter produced a serious contraction in bank liquidity. In this quarter, money supply fell by more than 7 per cent. The banks ran their reserves down sharply and slightly reduced credit to the private sector, even though the Central Bank came to the rescue by modestly increasing its advances to them in August-November.

The squeeze on bank credit helped intensify the economic slowdown. However, a more serious crisis may have been averted when the tax controversy was resolved.

The Outlook

It remains to be seen how quickly the forward momentum of the economy will be resumed. The new tax bill, approved in December, will yield substantial increases in revenues, enabling the Government to increase spending this year without inflationary consequences. But the construction industry was hard hit by the slowdown and may take some time to revive. The new tax bill may also encourage the oil companies to increase production to some extent, through the operation of a new tax credit for expanding output. However, it is not likely to bring about increases of the size experienced in the pre-1958 era.

Venezuela's market for residual oil in the United States is threatened by new anti-air pollution regulations stipulating the maximum acceptable sulphur content of oil burned in and around New York City, the largest consuming area in this country. The new sulphur limit, which may take effect as early as the autumn of 1969,1/ would seriously hurt Venezuela whose oil has a naturally heavier sulphur content than oil from North Africa or Rumania. While the sulphur content of Venezuelan oil can probably be reduced by further refining, the cost of doing so may be prohibitive. The potential export loss for Venezuela may be as high as 500,000 barrels per day, equivalent to a 15 per cent cut in annual output from the 1966 level.

The days of dynamic petroleum growth appear to be over for Venezuela. This suggests that financial stability and external balance may be more difficult to maintain in the future than it was before 1958, in the face of demands for accelerated economic development, at least until a new dynamic sector emerges in the economy.

The desirability of reducing Venezuela's dependence on oil has led the Government to encourage the growth of other activities. Manufacturing has been especially pushed in recent years under the protection of quantitative import restrictions. But much of this industry is high cost and the recent Venezuelan decision to join the Latin American Free Trade Association has focussed attention on the need to find more promising fields. Venezuela may have a comparative advantage in intermediate and basic production, and the Government is now attempting to promote such industries as petrochemicals and metal working.

The development of this type of industries will require large amounts of capital, partly from abroad. Foreign capital may be available on an equity basis, but if necessary, there would be ample scope for obtaining it on a loan basis. Venezuela has borrowed very little abroad and is not burdened with heavy debt service payments, as so many other developing countries are. Its total public external debt totalled $296 million at the end of 1966 and public external debt service payments last year were about 2 per cent of total foreign exchange receipts. Total claims on Venezuela reported by U. S. banks at the end of 1966 were $315 million, compared with $228 million at the end of 1957.

Since 1961, private direct foreign investment in industries other than petroleum has been increasing slowly. In the five years 1961-65, the net increase in this investment was $150 million. This is a comparatively small amount, especially when compared with the net disinvestment by the oil companies, totalling $530 million in this period.

1/ The regulation is now scheduled to become effective in 1971, but there is talk of advancing the date.

Whether sufficient foreign equity capital flows to Venezuela in the next few years may well depend on the ability of the Government to stamp out or at least prevent the spread of terrorism in the cities and rebel activity in the mountains.

Table 1

Venezuela--Economic Growth and Petroleum Output

	Real Gross Domestic Product		Crude Petroleum Production	
	In millions of bolivares at 1957 prices	Annual Percentage Increase	In millions of barrels per day	Annual Percentage Increase
1957	23,848		2.78	
1958	24,164	1.3	2.60	-6.5
1959	26,065	7.9	2.77	6.5
1960	26,433	1.4	2.85	2.9
1961	26,881	1.7	2.92	2.5
1962	28,585	6.3	3.20	9.6
1963	29,765	4.1	3.25	1.6
1964	32,135	8.0	3.39	4.3
1965	33,766	5.1	3.47	2.4
1966 1/	34,800	3.1	3.37	-2.9

1/ Estimate.

SOURCE: Central Bank of Venezuela.

Table 2

Venezuela--Wholesale Prices

	Indices at end of year 1956-57 = 100			Percentage changes from previous year		
	All Commodities	Domestic Goods	Imported Goods	All Commodities	Domestic Goods	Imported Goods
1957	101.2	102.0	100.5			
1958	103.3	105.1	101.4	2.1	3.0	0.9
1959	105.6	106.5	105.0	2.2	1.3	3.6
1960	105.7	106.1	105.2	0.1	-0.4	0.2
1961	108.8	105.9	112.4	2.9	-0.2	6.8
1962	115.1	106.4	125.7	5.8	0.5	11.8
1963	117.2	108.3	128.0	1.8	1.8	1.8
1964	121.6	111.9	133.4	3.8	3.3	4.2
1965	125.0	116.1	142.0	2.8	3.8	6.4
1966 1/	127.2	115.4	149.8	1.8	-0.6	5.5

1/ September.

SOURCE: Central Bank of Venezuela.

Table 3

Venezuelan Government Operations since 1957
(in millions of bolivares)

	Revenues (Excluding Borrowings)	Expenditures (Excl. Debt Amortization)	Surplus or Deficit	Financing: Net Domestic Borrowing	Financing: Net Foreign Borrowing	Financing: Use of Cash Balance
1957	5,405	4,379	1,026	--	--	-1,026
1958	4,706	6,235	-1,529	- 4	- 17	1,550
1959	5,442	6,294	- 852	298	- 17	571
1960	4,968	5,820	- 852	203	650	- 1
1961	5,850	6,027	- 177	204	- 28	1
1962	5,913	5,270	643	-259	- 53	- 331
1963	6,596	5,983	613	-392	-203	- 28
1964	7,133 1/	6,444	689	-493	- 79	- 117
1965	7,264	7,118	146	-208	29	33
1966	7,751 2/	7,657	94	n.a.	n.a.	n.a.

1/ Includes profit on revaluation of Central Bank foreign assets.

2/ Includes 120 million bolivares for special settlement of back taxes.

SOURCE: International Monetary Fund, International Financial Statistics.

Table 4

Venezuela--Money Supply and Selected Central Bank Assets and Liabilities
(in millions of bolivares)

	Money Supply 1/		Central Bank Claims on Government				Central Bank Advances to Banks	
			Gross Claims		Govt. Deposits			
	at end of year	change from previous year	at end of year	change from previous year	at end of year	change from previous year	at end of year	change from previous year
1957	3,472		250		2,355		20	
1958	3,818	346	208	- 42	671	-1,684	1	- 19
1959	3,628	-190	227	- 19	61	- 610	212	211
1960	3,386	-242	366	139	25	- 36	292	80
1961	3,487	101	586	220	122	97	275	- 17
1962	3,411	- 76	661	75	432	310	278	3
1963	3,673	262	617	- 44	428	- 4	257	- 21
1964	4,166	493	412	-205	717 3/	289	159	- 98
1965	4,686	520	382	- 30	395	- 322	169	10
1966	4,850 2/	164	525	143	435	40	216	47

1/ Seasonally adjusted.

2/ November.

3/ Includes profit on revaluation of Central Bank foreign assets in January 1964, amounting to 438 million bolivares.

SOURCE: International Monetary Fund, International Financial Statistics.

Table 5

Venezuela--Commercial Bank
Selected Assets and Liabilities
(in millions of bolivares)

	Cash Reserves		Claims on Private Sector		Claims of Government (net)		Demand and Time Deposits	
	at end of year	change from previous year	at end of year	change from previous year	at end of year	change from previous year	at end of year	change from previous year
1957	1,048		3,526		- 40		3,814	
1958	1,356	308	4,105	623	-172	-132	4,491	677
1959	1,019	-337	4,735	630	-138	34	4,475	- 16
1960	904	-115	4,024	-711	5	143	3,736	-739
1961	1,098	194	4,002	- 22	136	131	3,894	158
1962	894	-204	4,200	198	- 1	-137	3,988	94
1963	1,160	266	4,494	294	- 7	- 6	4,571	583
1964	1,219	59	5,225	731	- 81	- 74	5,379	808
1965	1,218	- 1	5,928	703	-198	-117	5,868	489
1966 1/	1,262	44	5,996	68	-194	4	5,831	- 37

1/ November.

SOURCE: International Monetary Fund, International Financial Statistics.

Table 6

Venezuelan Gold and Foreign Exchange Reserves since 1957
(in millions of dollars)

End of	Gold	Foreign Exchange	IMF Gold Tranche	Total	Change from Preceding Year
1957	720	735	4	1,459	
1958	720	338	4	1,062	-397
1959	655	65	4	724	-338
1960	401	170	38	609	-115
1961	401	141	38	580	- 29
1962	401	144	38	583	3
1963	401	306	38	745	162
1964	401	393	38	831	86
1965	401	404	38	843	12
1966	401	313	63	777	- 66

SOURCE: International Monetary Fund, International Financial Statistics.

Table 7

Venezuela--External Accounts since 1956
(in million dollars)

	Exports (f.o.b.)	Imports (f.o.b.)	Trade Balance	Services and Transfers (net)1/	Current Account (net)	Capital Account (net)	Overall Balance (net)	Monetary Reserves (net)2/	Errors and Omissions (net)
1956	2,221	1,170	+1,051	-1,120	- 69	+ 867	+798	-420	-378
1957	2,764	1,775	+ 989	-1,557	-568	+1,485	+917	-502	-415
1958	2,508	1,512	+ 996	-1,113	-117	- 254	-371	+383	- 12
1959	2,326	1,520	+ 806	- 970	-164	- 259	-423	+367	+ 56
1960	2,384	1,145	+1,239	- 844	+395	- 150	+245	+109	-354
1961	2,453	1,055	+1,398	- 925	+473	- 428	+ 45	+ 31	- 76
1962	2,544	1,161	+1,383	- 997	+386	- 547	-161	+ 3	+158
1963	2,464	1,037	+1,427	- 950	+477	- 353	+124	-156	+ 32
1964	2,480	1,184	+1,296	-1,096	+200	- 9	+191	- 96	- 95
1965 3/	2,436	1,324	+1,112	-1,117	- 5	+ 52	+ 47	+ 14	- 61

1/ Including net transfer payments of less than $100 million each year.
2/ Including commercial banks. Increase: -.
3/ Preliminary.

SOURCE: International Monetary Fund, Balance of Payments Yearbook, various issues.

Table 8

Venezuela--Capital Movements since 1956
(in million dollars)

	Private Capital: Direct Investment: Oil Cos.	Private Capital: Direct Investment: Other	Private Capital: Other Long Term	Private Capital: Short Term (excl. banks)	Private Capital: Total (net)	Official Capital (net)	Total Recorded Capital (net)
1956	+385	+207	- 3	+ 23	+612	+255	+ 867
1957	+803	+178	+ 6	+ 4	+991	+494	+1,485
1958	+ 59	+ 20	+ 4	- 68	+ 15	-269	- 254
1959	+109	- 56	- 29	+ 12	+ 36	-295	- 259
1960	- 87	- 39	- 50	- 22	-198	+ 49	- 149
1961	- 76	+ 51	-249	- 64	-338	- 90	- 428
1962	-235	- 6	-166	- 50	-457	- 90	- 547
1963	-119	+ 36	- 73	- 85	-241	-112	- 353
1964	- 57	+ 33	- 1	+ 38	+ 13	- 22	- 9
1965 1/	- 43	+ 36	+ 52	- 6	+ 39	+ 13	+ 52

1/ Preliminary.

SOURCE: International Monetary Fund, Balance of Payments Yearbook, various issues.

Table 9

Claims on Venezuela
Reported by Banks in the United States
(in millions of dollars)

	Short-term Claims	Long-term Claims	Total Claims
December 1957	170	58	228
December 1958	142	50	192
December 1959	247	32	279
December 1960	234	190	424
December 1961	144	245	389
December 1962	102	167	269
December 1963	114	57	171
December 1964	165	100	265
December 1964 (a)	168	101	269
December 1965	220	98	318
December 1966	226	89	315

(a) Differs from data in line above because of the inclusion of certain claims held by banks which were not previously reported.

SOURCES: Federal Reserve Bulletin; U. S. Treasury Bulletin.