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FEDERAL RESERVE BANK OF NEW YORK

ANNUAL REPORT 1965

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FEDERAL RESERVE BANK OF NEW YORK

February 28, 1966

To the Member Banks in the
Second Federal Reserve District:

It is a pleasure to present our fifty-first Annual Report highlighting the major economic and financial developments of 1965.

The United States economy in 1965 recorded its fifth consecutive year of expansion. Rapid growth led to a gratifying decline in unemployment, but the Vietnam conflict cast a shadow upon prosperity, as did the appearance of inflationary pressures. The President's balance of payments program made a major contribution in cutting down the size of the payments deficit. Nevertheless, the deficit was still large.

Monetary policy last year, while permitting the largest growth of credit and liquidity of any year of the current business expansion, gradually shifted toward mild restraint. In December Federal Reserve discount rates were increased, and the Board of Governors raised ceiling rates on time deposits. These steps served both to ameliorate actual and potential distortions in the financial markets, and to strengthen the posture of monetary policy in countering price pressures and in backing up the President's balance of payments program for 1966.

Looking ahead, the monetary and fiscal authorities face the major challenge of further extending the remarkable record of real economic growth, while at the same time containing inflationary forces that, if unchecked, would jeopardize both growth itself and the achievement of balance of payments equilibrium.

Alfred Hayes

ALFRED HAYES
President

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FIFTY-FIRST ANNUAL REPORT

For the Year

Ended

December 31, 1965

Second Federal Reserve District

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Fifty-first Annual Report
Federal Reserve Bank of New York

Problems in the Midst of Prosperity

In an unprecedented fifth year of peacetime expansion, the United States economy in 1965 moved closer to full utilization of capacity than it had been in nearly a decade. This encouraging progress toward one of the nation's main economic objectives was, however, not without blemishes. Although the payments deficit was cut substantially, the goal of balance of payments equilibrium again proved elusive. At the same time, another principal aim of economic policy, price stability, was increasingly threatened. Monetary policy gradually shifted toward moderate restraint, including an increase in the Federal Reserve discount rates in early December. As total production, employment, and incomes rose to new highs, satisfaction with record prosperity was marred by the escalation of the Vietnam conflict and by the old problems of poverty in the midst of plenty and of racial barriers to equal opportunity.

When 1965 opened, the country faced two particularly troublesome economic issues: the alarmingly rapid increase in the payments deficit, and the danger of internal dislocations if labor negotiations in the steel industry were to result in either a prolonged strike or an inflationary settlement. The possibilities of a significant slowing in the pace of the domestic upswing and of an upheaval in the international financial system stemming from the sterling crisis were also very real. As it turned out, these threats did not materialize. Domestically a judicious mix of policies, and later in the year the growing pace of defense spending, spurred the economy to new records. In the steel industry, labor and management negotiated a responsible settlement that was broadly in line with the

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Administration's guideposts, and the economy absorbed a major swing in steel inventories with hardly a ripple. On the international plane, the two key-currency countries—the United States and the United Kingdom—took determined policy measures to improve their payments positions, and further progress was made in strengthening the world's monetary system.

Early in the year, the momentum of economic expansion accelerated under the temporary stimulus of strike-hedge steel inventory accumulation and of heavy automobile purchases—the latter in reaction to the strike-reduced availability of cars in the closing months of 1964. The over-all advance then continued at only a slightly slower pace, as all the major types of demand, except housing and exports, continued to grow rapidly. Fiscal policy remained expansionary as the second stage of the 1964 tax cut was reinforced after midyear by a reduction in excise taxes. In the second half of the year, the increased United States commitment in Vietnam lifted business and consumer expectations regarding the economic outlook and led to larger military outlays on top of growing civilian programs.

For the year as a whole, total output of the economy in real terms rose by a notable 5½ per cent. Industrial capacity and manpower came to be utilized more fully despite substantial growth of both. Especially heartening was the sizable absorption of the unemployed into the working population. The over-all unemployment rate was cut back by almost a full percentage point to 4.1 per cent at the end of the year, while the rate for married men—an important group of breadwinners—fell to a new low of 1.8 per cent. These advances, however, were not equally shared by all. In particular, unemployment rates among nonwhites—despite further declines—remained very substantially above those of whites. Further progress in this area is vital, not only on grounds of economic efficiency, but also—and even more importantly—on grounds of equity.

As the economy moved closer to full capacity, upward price pressures increased. Consumer prices began rising at a faster rate, and the long period of virtual stability of wholesale prices ended. The Administration's wage-price guideposts, which had made a major contribution to the remarkable steadiness of costs and prices over the first years of the expansion, continued to play a significant restraining role. The Government also took specific action to stabilize prices of some individual commodities, including sales from its stockpiles. But neither approach can be fully effective in an economy where swiftly rising demands threaten to outrun the growth of manpower and capital resources.

Against this background and with a still sizable—though much reduced—

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payments deficit, monetary policy shifted over the year from a posture of mild ease to mild restraint. Early in the year, free reserves moved from a moderate plus range to a moderate negative position. With the business expansion and resulting credit demands accelerating and with the escalation of the Vietnam conflict exerting an increasing impact on expectations, interest rates came under general pressure in the second half of the year. The increase in interest rates, largely confined to the short-term area earlier in the expansion, gradually spread into the market for long-term capital. Bank reserves, however, were supplied in sufficient volume to permit a record advance in commercial bank credit. Savings flows continued very large, and lending outside the commercial banking system also expanded rapidly. The pace of total borrowings by private non-financial borrowers accelerated and again exceeded the rate of advance of total output by a substantial percentage. With continued fast growth of both the money supply and time deposits and of other types of liquid assets, the over-all liquidity of the economy remained ample.

In the boom atmosphere that was developing toward the end of the year, the possibility of a breakout from the still tolerable pattern of price increases became very real. The remarkable performance of the economy in the last five years owes much to a successful mix of fiscal, monetary, and other policies over this period. But it would not have been possible without the eradication of the inflationary psychology of the 1950's. To avoid an inflationary degeneration of the expansion in late 1965, excessive demand pressures had to be countered before they gathered momentum. Assuring price stability, moreover, was also crucial to the achievement of a viable external balance.

Accordingly, on December 6, Federal Reserve Bank discount rates, which had remained unchanged since November 1964, were raised from 4 per cent to 4½ per cent, and the ceilings on time deposit interest rates were increased to 5½ per cent on all maturities of 30 days or more. (The maximum rate payable on commercial bank savings deposits was left unchanged at 4 per cent.) With money market rates above the discount rate and time deposit rates bumping against the ceilings, the discount rate and the time deposit ceilings had ceased to be compatible with conditions in the market; more importantly, they were no longer compatible with the objective of preventing additions to money and credit so large as to turn an orderly upswing into an inflationary boom.

The efforts to eliminate the United States balance of payments deficit have over the last few years involved some fundamental decisions. Policy makers have had to decide to what extent to use specific measures that would place obstacles

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in the way of international transactions, and to what extent to rely on policies that were general rather than specific. One of the most significant achievements in the world economy since World War II has been the broad sweep toward freer flows of trade, services, and capital. And to halt, or to reverse, this advance could not be a decision made lightly. The interest equalization tax proposal of 1963 and the President's voluntary restraint program of February 1965 were adopted only after it was concluded that general policies, including monetary policy, should not be required—particularly while unemployment remained serious—to deal by themselves with the threat of a rapid deterioration in the dollar's international position. Their adoption represented a practical compromise rather than a change in underlying philosophy.

The Federal Reserve-administered restraint program covering the banks and other financial institutions successfully and quickly met its objectives in 1965. The related Commerce Department program applying to nonfinancial corporations also made a major contribution to the balance of payments, particularly in reversing the outflow of short-term corporate funds. The entire voluntary restraint program, however, has always been thought of as a temporary measure. Achieving a lasting improvement in the balance of payments with a minimum of restrictions on our international transactions will require further efforts both by the United States and by the surplus countries of Europe. While it is largely up to the United States to take corrective action, there is much that the surplus countries could be doing, particularly in the way of enlarged contributions to economic aid and joint defense arrangements, further improvement in their monetary-fiscal policy mix, and reduced restrictions on borrowing by foreigners and on imports. The United States, for its part, needs further to strengthen its competitiveness both through maintaining stability of costs and prices and through a redoubling of efforts by business and labor and by the Government to improve the position of United States products in world markets.

No attempts at a solution of our balance of payments problem can be effective unless they are persistent and unless they deal in concerted fashion with all the major elements of our international accounts rather than with one or two. Throughout the past eight years of large deficits, improvements in one area have been offset by deterioration in others. Thus, in 1965 the gains from the substantial savings on our capital outflows were more than halved by a reduction in our trade surplus, as imports rose faster than exports. Over all, the payments deficit for 1965—measured on the liquidity basis—was cut back to $1.3 billion from the $2.8 billion of 1964.

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While our payments problem retained its high priority in 1965, the future shape of the international payments system received increased attention. The system has, of course, undergone significant evolution in recent years, as changes both within the International Monetary Fund and outside have strengthened the system's ability to serve a growing world economy. However, the prospect that the end of United States payments deficits would dry up this major source of international liquidity in the postwar period has raised some questions as to the adequacy of the future volume of international liquid assets under the present arrangements. Future liquidity needs should not necessarily be judged on the basis of the persistent large surpluses and deficits of recent years; the search for speedier and more effective methods of adjustment of such imbalances must continue. Although the danger of a general liquidity shortage should not be exaggerated, the international financial system must continue to evolve to meet the world's changing needs. International credit facilities have been substantially enlarged over recent years and have on innumerable occasions proved their flexibility and adaptability. All the potentialities of this approach have by no means been explored, including increases in international reserve assets through the further development of automatic drawing rights on multilateral credit facilities. A cardinal principle—one well worth emphasizing again—is that future arrangements to meet international liquidity needs should be carefully examined to make sure that they do not jeopardize the status of the dollar as a reserve currency.

The debate over international liquidity has to some extent obscured the seriousness of an at least equally grave international economic problem—the disappointingly slow and uncertain progress of the underdeveloped nations in raising their intolerably low living standards. No international liquidity scheme, however well meaning, can solve the diverse problems of development. Much larger and more flexible long-term external assistance is necessary, if income levels in the vast underdeveloped areas of the globe are to increase at a rate that would give even a minimum of hope for the future. Nevertheless, it is only on the basis of still more intensive efforts by the underdeveloped countries themselves that the high income countries can be asked to devote more resources to them. At the same time, it is encouraging that increased attention is being given to the slow growth and abrupt fluctuations of the export earnings of the underdeveloped countries. Such earnings after all exceed by several times the volume of foreign capital and aid received by them.

As 1966 began, it was clear that the sixth year of expansion presents a dif-

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ferent challenge for economic policy makers. The task of preserving reasonable price stability and balanced growth at high levels of capacity and manpower utilization poses problems for the United States economy that are the more exacting because of their very newness. At the same time, the long existence of the balance of payments problem makes its solution not less but more urgent. The achievement of these economic goals will not be easy. It will require judicious use of general monetary and fiscal policies, since selective measures alone, although some may be needed, cannot carry the load.

Monetary policy has played its part in facilitating this record-breaking expansion. Its flexibility makes it a particularly useful instrument whenever circumstances call for a shifting of gears. At the present juncture, moreover, it can contribute to both domestic and external equilibrium. Monetary policy, however, cannot bear the entire burden. Fiscal policy has scored a most significant breakthrough in the last two years when its great potential for propelling the economy forward has gained wide public acceptance and has proved most effective in practice. With the heavy military expenditures of the Vietnam conflict superimposed upon rapidly growing private and public demands, the posture of fiscal policy has begun to change. In recent years, when stimulating economic growth has been the order of the day, much has been said of the desirability of increasing the flexibility of fiscal policy. Such added flexibility would seem to be equally important now that restraint may be needed instead. The uncertainties of the Vietnam war may, in fact, have increased the urgency of finding a workable solution to this question. The speed with which temporary tax increases could be imposed in 1966 might spell the difference between continued balanced growth and inflationary excesses that could lead to recession. And should a settlement of the Vietnam conflict prove possible, fiscal as well as monetary policy must be prepared to meet promptly the demands of the new situation that might then emerge.

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THE UNITED STATES ECONOMY IN 1965

Business Conditions: The Economy Approaches Full Use of Resources

The year 1965 clearly represents a milestone on the road of this country's economic progress. A new record was established for length of an expansion—World War II excepted—and economic growth actually accelerated from the already rapid pace of 1964, while unemployment declined steadily. The total value of goods and services produced amounted to $676 billion, and the 5.5 per cent growth in real terms for the year as a whole equaled the most optimistic projections made at the start of the year. The year's record, on the other hand, also includes the revival of inflationary pressures and a continued, although reduced, balance of payments deficit. Nevertheless, the facts of the country's sustained economic growth and the concrete achievements during the expansion are worth recalling, as are the policy measures that prolonged and fostered this five-year advance.

BACKGROUND. From the first quarter of 1961—the trough of the last recession—through the fourth quarter of 1965, gross national product (GNP) in constant (1958) dollars rose by $142 billion, or more than 29 per cent, for an average annual compound rate of growth of over 5½ per cent (see Chart 1). This rapid growth in real output has been made possible, on the one hand, by increases in real GNP per employed person averaging about 3½ per cent per year and, on the other hand, by large additions to the work force. Since February 1961, some 6.8 million new jobs have been created—enough not only to absorb the growth in the civilian labor force but also to reduce the rolls of the unemployed by some 1.8 million. In consequence, the unemployment rate declined from 6.9 per cent in early 1961 to 4.1 per cent in December 1965.

The rate of increase in real output has, however, varied considerably over the course of the current upswing. Thus, from the trough of the recession in the first quarter of 1961 through the second quarter of 1962, the annual rate of growth of GNP in constant dollars exceeded 7 per cent. During the next twelve

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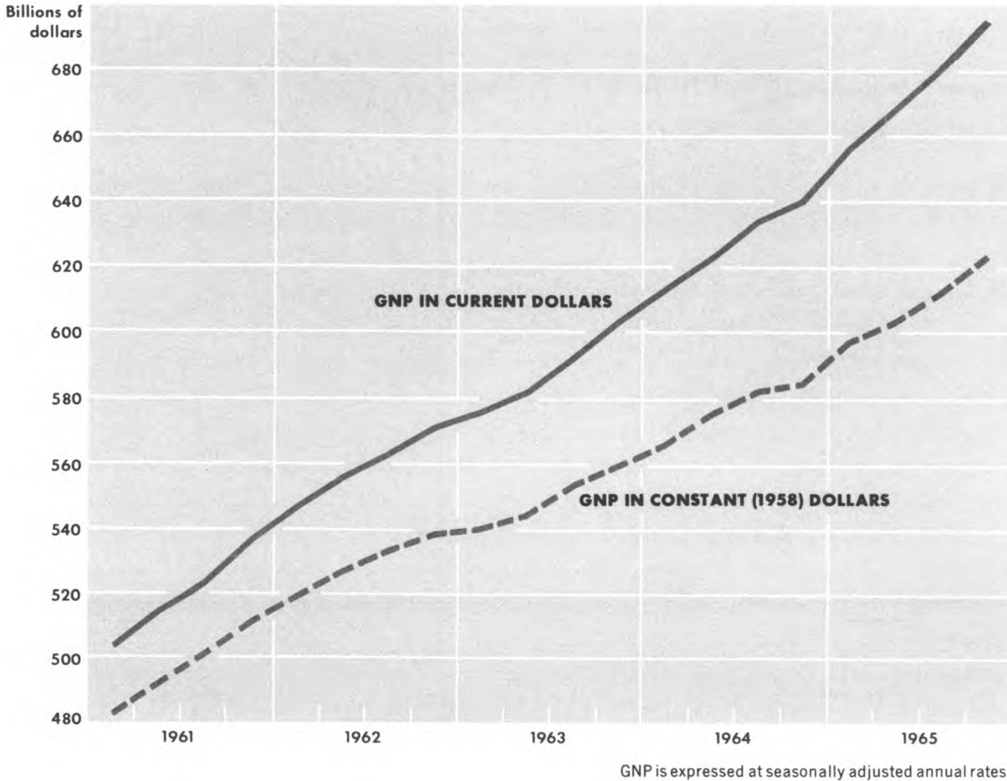
Chart 1. **GROSS NATIONAL PRODUCT: Throughout the past five years of expansion, GNP measured in money terms as well as in constant dollars has advanced steadily. The pace of the advance was rapid from 1961 to mid-1962, slowed between mid-1962 and mid-1963, and has since speeded up again, except for the strike-depressed fourth quarter of 1964.**



months, the annual growth rate dropped sharply to 3 per cent. Then the pace accelerated once again, and since then the economy has trended upward at an average annual rate of about 5½ per cent.

As just noted, the expansion from the recession low was very rapid during the first year, as had been typical of earlier periods of recovery. Unemployment fell steadily from the recession peak of about 7 per cent to around 5½ per cent in the spring of 1962. However, at that time a slowdown in the upward pace of eco-

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nomic activity became evident. This development had been partially foreshadowed a few months earlier by news that several key industries were planning little or no further increases in plant and equipment spending in 1962.

Once it had begun, several factors contributed to prolonging the slowdown in growth until about mid-1963. There was a clash between the Administration and the steel industry over proposed increases in steel prices. This conflict dampened business confidence temporarily and may well have contributed to the sharp stock market decline from the high price levels reached in 1961 and early 1962. The substantial loss in stock market values over the middle months of 1962 in turn probably had a pervasive, though short-run, effect on the economy.

Beyond these specific factors, it should also be recalled that the weakening of the recovery at such an early stage repeated the experience of the immediately previous expansions. The fact that expansions peaked well short of full resource utilization may in part have been related to the tendency for growing money incomes to raise the proportion of Federal taxes paid per dollar of income, a tendency accentuated by steeply progressive tax rates. Thus, the tax structure moved the Federal budget toward a surplus and cut into private spending—including capital outlays by business—well before the economy reached full employment output.

After mid-1963, the rate of advance in business activity picked up once again as business and consumer confidence improved. This favorable development can be attributed in part to the Federal Government's liberalized depreciation guidelines and the investment tax credit legislated by Congress late in 1962, which materially enhanced the rate of return on business plant and equipment outlays in 1963. Perhaps equally important, it was becoming apparent by then that the prospects for a cut in personal and business tax rates at the Federal level were steadily improving, and these expectations were mirrored in a substantial and orderly rise in stock prices throughout 1963. Monetary policy—which had made a significant contribution to sustaining the expansion in 1962 through the provision of ample liquidity—continued to be expansive in 1963, although balance of payments considerations necessitated a discount rate increase in July of that year. The balanced nature of the expansion, as reflected in both the absence of inventory speculation and continued price and wage stability, reinforced the outlook for further advances over the coming months and permitted the application of further stimuli through economic policy.

In 1964 the reduction in Federal taxes on personal and business incomes became a reality, with the reductions in personal withholding rates taking place in

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March. Business spending on plant and equipment moved ahead sharply and consumer spending quickly moved into line with the advance in after-tax personal incomes. Growth during that year was impressive and would have been even stronger but for the fact that strikes in the automobile industry depressed output late in the year. The credit and liquidity indicators once again moved up substantially even while monetary policy moved toward slightly less ease.

1965: A YEAR OF RAPID GROWTH. The accelerated rate of economic growth evident since the second half of 1963 continued through 1964 and into 1965. In fact, as the year opened, economic momentum was unusually high. Yet, the outlook at that time was not without elements of doubt, particularly with respect to impending contract negotiations between labor and management. A dock strike on the East and Gulf coasts was under way in January, and slow progress toward a contract settlement in the steel industry—with a contract expiration date in May—was inducing users to stockpile steel and steel products at a much faster than normal rate. This inventory buildup, coupled with a surge in automobile production and sales following earlier strikes in that industry, pushed the first-quarter growth rate to an unsustainable level, and raised some doubts as to the pace and even the continuance of general economic gains once that stimulus was removed. There were also longer run questions: the prolonged high rate of investment and consumer accumulation of durables might slacken in 1965, and the contract settlement in the automobile industry in late 1964—which exceeded the Council of Economic Advisers' wage-price guideposts of 3.2 per cent —might set the pattern for settlements in excess of the guideposts in other industries.

As it turned out, the economy followed up the fast pace set early in the year with further substantial progress throughout 1965. The year as a whole saw gains over a broad range of economic activity, which were reflected not only in the impressive GNP advance but also in many other indicators. Industrial production posted an 8.0 per cent advance, the strongest rise of the expansion. Business outlays on plant and equipment rose by 15.4 per cent, thus bettering the already considerable advance of 14.5 per cent in 1964. Outlays for goods and services by governments at all levels combined were a major stimulus throughout the year. The stock market reflected the buoyant economy and recovered from a brief decline in the second quarter to move up to record levels at the year-end.

Among individual demand sectors, personal consumption spending once again

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accounted for the largest part of the GNP advance. For the year, such spending rose by $30 billion, up almost 7½ per cent over 1964. As in that year, the sharpest gains were in outlays for durable goods, financed in part by a strong advance in consumer credit. Automobile sales topped 9 million units, and sales of major appliances such as washing machines, refrigerators, and color television sets surged ahead.

Living standards benefit from many types of government expenditures, including those at the state and local level where expenditures are heavily oriented toward education, highways, water facilities, and other services directly used by broad classes of consumers. During 1965, state and local purchases of goods and services exceeded those at the Federal level for the first time since 1950. The Federal Government contributed to individual welfare through stepped-up social programs associated with the Great Society objectives. The bulk of the enlargement of Federal spending, however, had to be directed toward a strengthening of the nation's defenses in connection with the Vietnam conflict—a development that also had a considerable impact on expectations and actions in the private sector of the economy throughout the second half of 1965.

In the business sector, strong production gains resulted in an increase in the capacity utilization rate in manufacturing industries early in the year and in another moderate move upward after mid-1965. A number of key industries, including nonferrous metals and automobiles, were operating at or above their preferred rates. This pressure on capacity was a major stimulus to continuing upward revisions in projected outlays on plant and equipment. Business also stepped up its inventory accumulation, and the ratio of inventories to sales stabilized for the year as a whole after an irregular decline during the first four years of the expansion.

Private residential construction was one major demand sector that failed to show any significant advance over the year, and the regional picture included a pronounced weakness in the Western states. The rate of addition of new housing units has leveled off in recent years, albeit at a high level, in spite of the ample availability of mortgage funds. While apartment construction in the last three years has remained well ahead of the early 1960's, the building of single-family houses has remained sluggish. It will be a few more years before the rapidly rising number of young married couples moves into the prime home-buying age groups.

Vigorous economic growth had a major impact on the level and structure of employment. Total employment showed a greater rise in 1965 than in any other year of the current expansion. By the year-end, average hours worked by pro-

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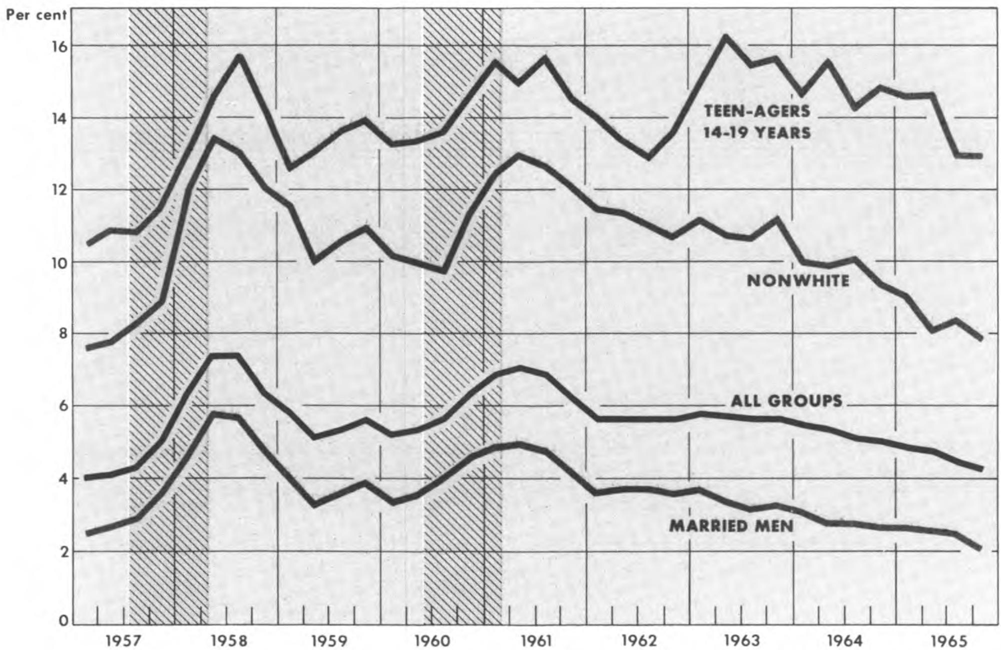
duction workers in manufacturing had reached a post-World War II record. Reports of shortages of skilled labor became more persistent as the year progressed, and in a few lines of activity, such as the machine tool industry, labor shortages appeared to be on the verge of becoming a limiting factor on further increases in production. The over-all unemployment rate moved down from 5 per cent at the end of 1964 (see Chart 2) to just above 4 per cent in December 1965, the lowest unemployment rate since the spring of 1957. The unemployment rate for teen-agers receded from 14.8 per cent in the fourth quarter of 1964 to 12.9 per cent in the fourth quarter of 1965, a decline particularly remarkable since it was achieved in the face of the largest gain in the teen-

Chart 2. UNEMPLOYMENT: The unemployment rate declined in 1965 to the lowest level in eight years. Unemployment among married men fell to a record low, and there was a distinct improvement in the employment situation of teen-agers and nonwhites.



All data are quarterly averages of seasonally adjusted monthly figures. Shaded areas denote periods of recession.

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age labor force ever recorded. Unemployment rates for all other categories of workers also moved lower: for married men—workers especially hurt by joblessness—unemployment fell below 2 per cent by the end of 1965, and unemployment of fifteen weeks or more duration as a percentage of the civilian labor force was below 1 per cent for the first time in eight years. Unemployment among nonwhite workers also moved down over the year but, at 7.3 per cent in December 1965, it was almost twice as large as that of whites. Clearly, the solution of the problem of high unemployment among minority groups requires a further concerted national effort.

Although the large growth in the labor force in 1965 was more than fully absorbed, the influx of new inexperienced workers involved problems over and above their initial absorption. With skilled workers increasingly in short supply, employers were adding workers with relatively little work experience. Over half the gain in the labor force in 1965 consisted of teen-agers, whose productivity could not be expected to match that of workers with more experience. Partly reflecting this fact, productivity (as measured by output per man-hour in the private economy) showed the smallest year-to-year gain of the current expansion. The 1965 productivity data may even conceal a more marked deterioration in the underlying ability of the economy to utilize labor and material inputs more efficiently. For example, there may have been a need for business at times to utilize older and hence less productive equipment—equipment which under conditions of less vigorous demand would have been retired. In addition, bottlenecks, delays, and shortages of parts and materials were reported in a few lines of activity. While these problems appeared to be temporary pending the completion of further planned capital outlays, a major long-run challenge to business centers around the problem of training new entrants into the labor force. A closer approach to full employment will inevitably create conditions under which some businesses will not be able to obtain all the skilled and experienced workers they would like. As a result, Government policies and business attitudes toward hiring must reflect the fact that the major sources of unutilized manpower in the economy now are younger, relatively untrained workers. Expanded vocational as well as on-the-job training and further improvements in general education are clearly required to promote further productivity gains and thus to curb upward pressures on costs.

The slowdown in the rate of productivity increase in the private economy as a whole also affected the manufacturing sector of the economy considered separately. But, despite the tightening in the labor market and despite some labor

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settlements late in 1964 and early 1965 well in excess of the wage-price guideposts, unit labor costs in manufacturing apparently did not move up. The guideposts settlement in steel in September appears to have been beneficial in stabilizing other wage settlements at a level more in line with productivity gains.

In contrast with the manufacturing sector of the economy, workers in many lines of nonmanufacturing activity experienced percentage increases in wages somewhat in excess of those of manufacturing workers. Wage levels in many lines of nonmanufacturing activity (particularly laundries, hotels, and retail trade) are, of course, well below wages in manufacturing. Nevertheless, increases in the general wage level in excess of productivity gains have a tendency to raise prices, especially in periods of high and rising economic activity.

In fact, while 1965 was an excellent year in terms of real economic gains, the record on prices was not so good. There was a distinct acceleration in the rate of price advances which, if not checked, could conceivably undermine the balanced nature of the expansion. The consumer price index moved up 2 per cent during 1965, a rate of advance considerably in excess of the average increases of the preceding four years. Furthermore, this increase would have been about 0.3 per cent higher if it had not been for excise tax cuts, implemented in July, which substantially reduced the rate of increase in the prices of commodities other than food. Food prices advanced by more than 3 per cent over the year, and the price of services, which had risen by close to 2 per cent in each of the past four years, posted a rise in excess of 2½ per cent.

Acceleration and broadening of price advances in 1965 were most clearly evident, however, in wholesale prices, which moved up more than 3 per cent in 1965 after remaining virtually flat for almost seven years. Prices of farm and food products accounted for a considerable part of the 1965 advance, but the step-up in price increases was also reflected in a 1.4 per cent rise in industrial commodities (see Chart 3). Expanding pressure on capital goods-producing industries had already begun to affect prices charged by those manufacturers in 1964, and in 1965 price pressures were generally spreading to industrial materials. To be sure, the 1965 price increases were still well below the rate of advance of nearly 5 per cent per year in industrial prices in the inflationary period from mid-1955 through 1956; and, while price increases affected a broad range of commodities, price reductions also took place. For example, prices of office copying machines, color television sets, cement, and some grades of steel were marked down in 1965. Nevertheless, the facts of specific price rises and the tendency for rising prices to become more widely diffused both underscored the

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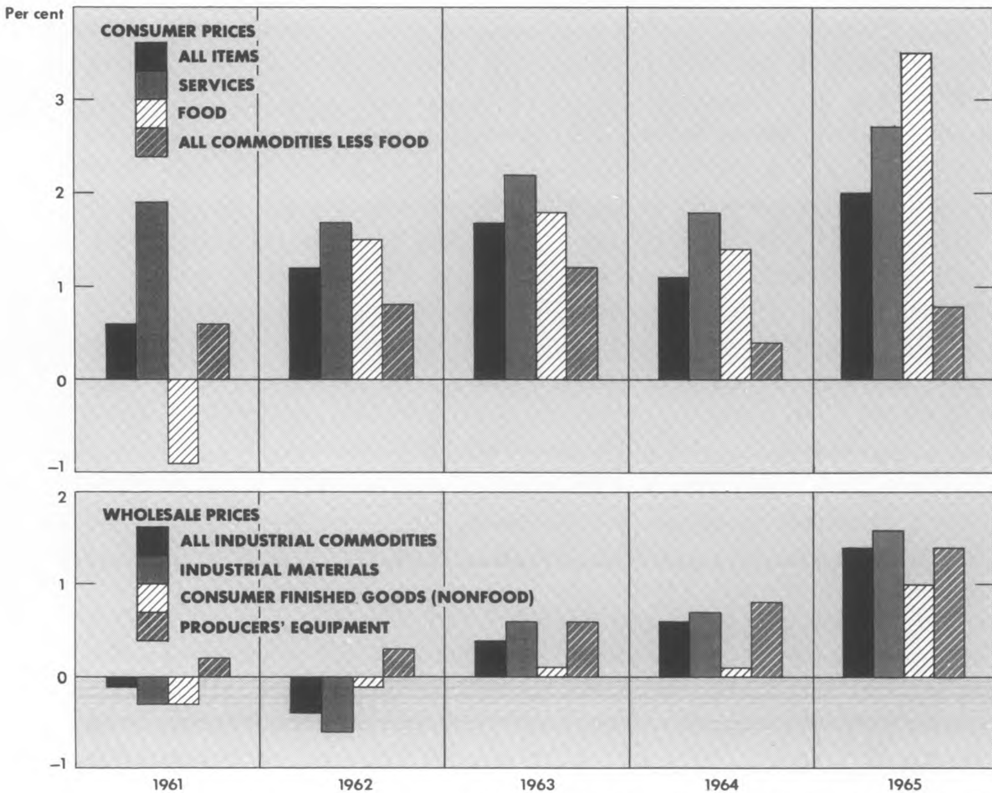
Chart 3. **CHANGES IN CONSUMER AND WHOLESALE PRICES:** Consumer prices moved up somewhat faster in 1965 than in previous years, with food prices rising most rapidly. Wholesale prices of industrial commodities also advanced considerably during the year, after four years of declines or small increases.



Data are percentage changes from December to December in the consumer and wholesale price indexes and their components (1957-59=100).

need for continued wage and price restraint. Such restraints will be most effective if they prevent inflationary movements before they get started. Policies aimed at curtailing an inflation once it is well under way face the burden of overcoming a speculative psychology—including the cumulation of price-wage increases that tends to develop once price rises have become widespread—and carry a greater risk of contributing to the onset of a recession.

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Monetary Policy: Moves Toward Restraint

Monetary policy in 1965 continued to promote real economic growth. However, the emphasis in System policy gradually changed from ease toward mild restraint in response to the increased evidence of the substantial reduction of previous slack in the economy, rising price pressures, enlarged credit demands, and the less than satisfactory balance of payments performance. In February and March, the System began supplying reserves with somewhat greater reluctance in response to an exceptionally rapid credit increase early in the year and to an unusually large deficit in the balance of payments in late 1964 and the first weeks of 1965. The System's policy stance then remained roughly unchanged until early December, when the discount rate and maximum rates on time deposits payable under Regulation Q ceilings were raised to combat mounting demand pressures in the financial markets and price increases in excess of those characteristic of earlier years of the expansion.

As 1965 opened, the money and credit markets had substantially completed the interest rate adjustments to the November 1964 increase to 4 per cent in the Federal Reserve discount rate, and to the new higher ceiling rates on bank time deposits, including time certificates of deposit. The money market was generally firm, with the rate on Federal funds averaging about 4 per cent (see Chart 4). In the longer term markets, investment demand was strong at prevailing rate levels, and in early January the United States Treasury found it possible to conduct a highly successful advance refunding, exchanging $9 billion of new long-term securities for outstanding issues of shorter maturity. Ninety-day Treasury bill rates, which were somewhat below the discount rate throughout January, edged upward in February along with the modest reduction in reserve availability effected by the System. Reflecting this change in the System's posture, total member bank borrowings at Federal Reserve Banks rose above excess reserves for the first time in the current expansion, so that member banks as a group moved from a small net free reserve position to average net borrowed reserves of about $150 million.

With the approach of spring, Treasury bill rates began to edge downward. State and local governments were heavy buyers of bills during this period, and the demand for bills was also bolstered by the reflux of short-term capital from abroad under the voluntary restraint program. Moreover, Federal income tax receipts were running considerably above expectations, while Federal expenditures were being kept under tight rein. Hence, the Treasury accumulated large

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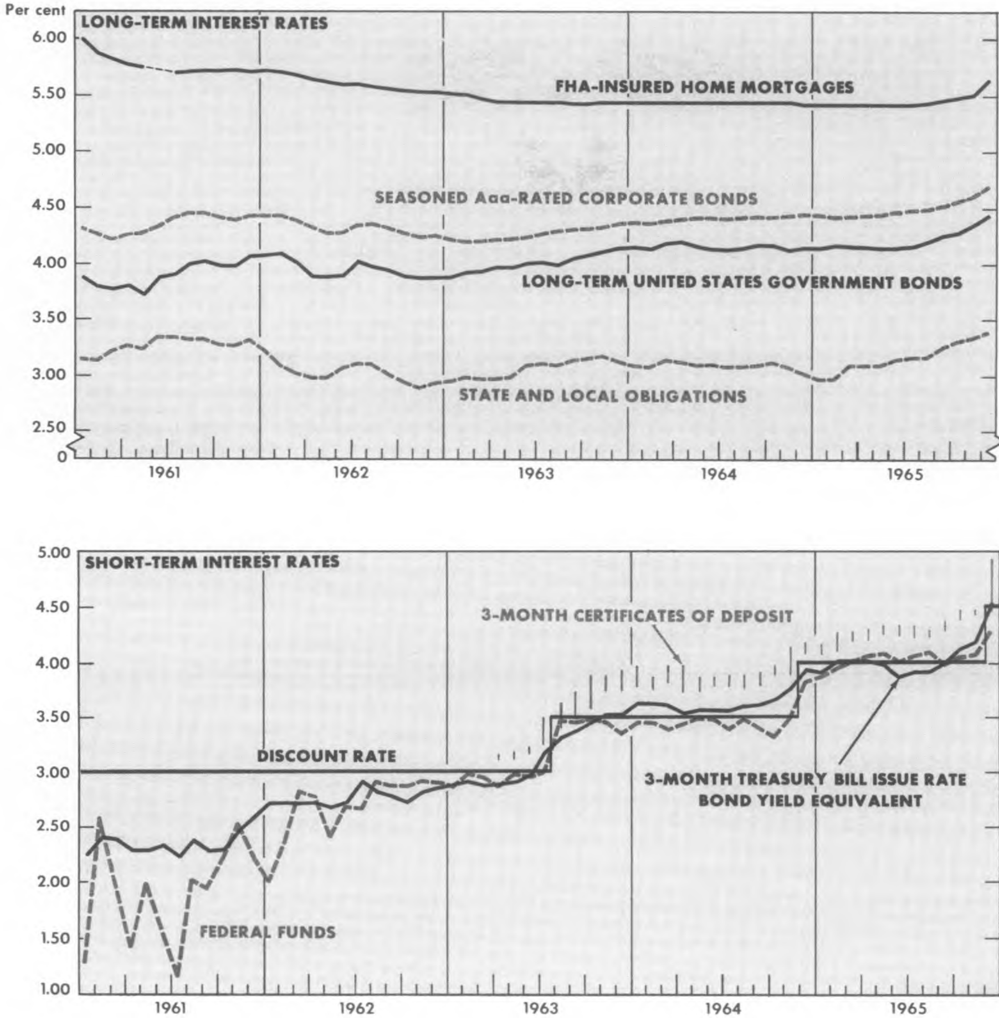
Chart 4. LONG-TERM AND SHORT-TERM INTEREST RATES: Partly reflecting heavy credit demands, long-term interest rates in the last half of 1965 moved up significantly. Yields on state and local government securities showed the largest increase. The influence of firmer monetary policy was first felt in short-term markets, where rates continued the rising trend that has prevailed since 1961.



Data are monthly averages except for certificates of deposit. For this series, the approximate monthly range of rates is indicated, beginning with April 1963, at which time a representative number of secondary market rates were first collected.

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cash balances at commercial banks through May. Rising Treasury balances were accompanied by a temporary slackening in the growth of the privately held money supply.

Despite the downward trend of rates in the Treasury bill market, money market conditions in the first half of the year remained firm. Bank demand for reserves to meet an expanding loan demand—especially from business concerns—continued strong, and Federal funds consistently traded at 4 per cent and 4⅛ per cent. Indeed, to satisfy the unusually strong loan demand, commercial banks again permitted their loan-deposit ratios to rise further, to near-record highs, and reduced their holdings of Government securities. On the other hand, banks continued to add to their holdings of state and local government securities. (This trend continued throughout the year, and the banks' total investments remained about unchanged for the year as a whole). Competition among banks for loanable funds was reflected in aggressive bidding for time deposits. The rates on 90-day negotiable time certificates of deposit remained well above the discount rate throughout the first half of the year, with the result that the yield spread between Treasury bills and certificates of deposit widened substantially. In addition, a number of banks moved up rates paid on savings deposits.

Around midyear, the climate in the money and credit markets began to reflect new elements in the fiscal and economic outlook, and expectations that demand pressures might ease a bit over the second half of the year rapidly disappeared. The visible supply of future new corporate securities issues was increasing—evidence that rising business spending on plant and equipment would probably require a greater degree of external financing than previously, despite the continued growth of internally generated corporate funds. Moreover, Federal expenditures both for defense and for expanded domestic social programs began to move upward, and it became apparent to market participants that Treasury financing needs were likely to increase.

By the third quarter of 1965, this outlook began to affect the longer term credit markets. All long-term securities yields—with the notable exception of mortgage rates—moved up sharply, and the reoffering yields on new corporate bond issues for the first time in several years rose considerably above yields available in the secondary market for corporate bonds. Market rates on municipal bonds, after approaching a six-year low earlier in the year, began to increase more rapidly than other long-term yields. Bank credit terms were also stiffening somewhat, although most loan demands continued to be accommodated readily.

In November 1965, the strength of the economic advance and the reality of

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inflationary pressures gave impetus to firmer anticipations of impending interest rate adjustments in the money and credit markets. Money market rates, including the Treasury bill rate, by that time were uniformly above the discount rate, and offering yields on new 90-day time certificates of deposit issued by even the largest money market banks were firmly at the maximum allowable under Regulation Q. Against this background, it became apparent to the Federal Reserve System that interest rate adjustments in the banking sector were imperative. The discount rate and the prime rate were clearly out of line with prevailing market conditions, and the potential for abrupt shifts of funds and a further tightening in the money market arising from an impending loss of relative competitiveness of banks clouded the financial outlook.

In meeting the problem, the Federal Reserve had two alternatives—either it could supply additional reserves in greater volume, and thus maintain the existing rate structure at the cost of further acceleration of credit expansion, or it could raise the discount rate and liberalize again the maximum rates banks could pay on time deposits. In the light of current and projected economic and fiscal trends, the first of these two alternatives seemed inappropriate. The margin of unemployed manpower and productive capacity had already been reduced to the lowest level in many years, military operations in Vietnam were placing ever greater demands on the budget and the economy, and the outlook for 1966 included the results of surveys pointing to another large rise in business capital outlays. The additions to money and credit availability required to validate the existing discount and time deposit rates would clearly have added to inflationary pressures. Indeed, such pressures were already being reflected in key price indexes. While restraint was being applied successfully against price increases in selected commodities, the isolated cases in which substantial Government stockpiles and moral suasion would hold the line could not be counted upon as a firm defense against broad inflationary forces.

Furthermore, the economy was supplied with ample liquidity, which could have been mobilized in a burst of anticipatory buying. As Federal spending increased in the second half of the year, the high Treasury cash balances accumulated in the first six months were steadily reduced. The privately held money supply expanded rapidly, offsetting the relatively slow growth in the first half of the year, while time deposits and total liquid assets were continuing to advance at high rates. For the year as a whole, the money supply—which is a narrow measure of liquidity—increased 4.8 per cent, more than in any other year of the prolonged economic expansion. However, since GNP in current dollars grew

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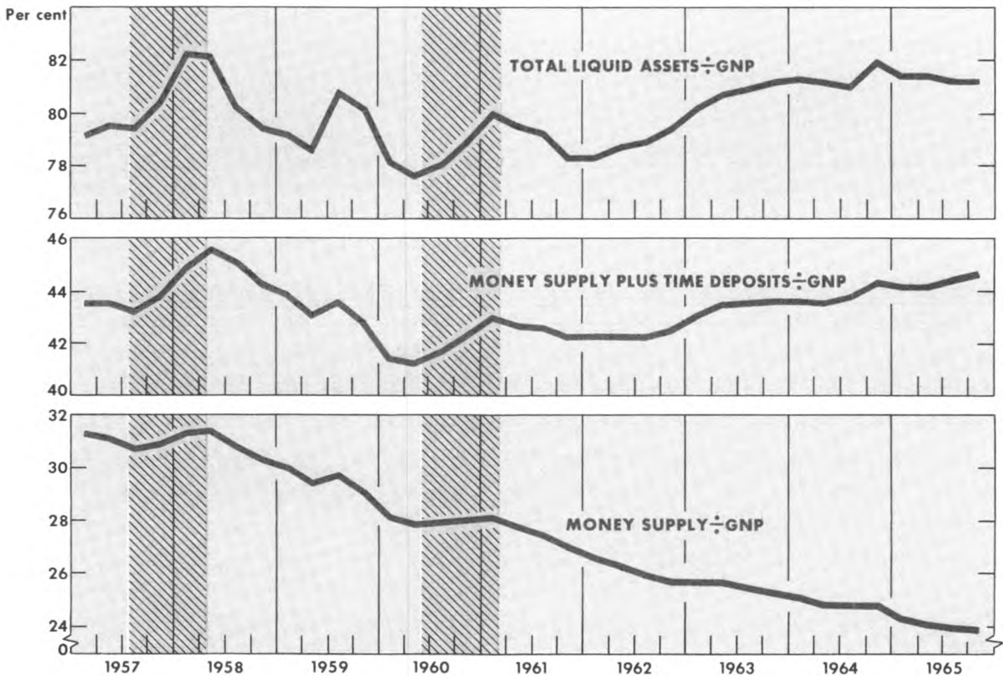
even more rapidly, the ratio of money supply to GNP continued to decline in 1965 (and the income velocity of money continued to increase) about in line with the trend of recent years. In contrast, the money supply plus time deposits at commercial banks as a ratio to GNP increased rather steadily, moving to record

Chart 5. THE LIQUIDITY POSITION OF THE PUBLIC: The public's total holdings of liquid assets relative to aggregate economic activity remained ample in 1965. The ratio of money supply plus time deposits to GNP continued to increase, reflecting in part strong growth in commercial bank certificates of deposit. However, the ratio of money supply to GNP maintained its long downtrend in 1965, as the public continued to economize on cash holdings.



Total liquid assets held outside the banking system, which include the money supply, time deposits, savings deposits and shares, and United States Government savings bonds and marketable securities due in less than one year, are averages of the figures for the end of the month preceding, and of the three months in, each quarter. The money supply--demand deposits and currency in the hands of the nonbank public--and the money supply plus time deposits at commercial banks are quarterly averages of daily figures. All data are seasonally adjusted. Shaded areas denote periods of recession.

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levels for the current expansion. Moreover, total liquid assets in the hands of the nonbank public—the broadest available measure of liquidity—advanced sufficiently to keep the ratio of these assets to GNP at the high 1964 level when the two years as a whole are compared, although the ratio did decline slightly from the last quarter of 1964 when GNP growth was depressed by strikes (see Chart 5). Growth in liquid asset holdings, however, was not shared by all sectors of the economy, as businesses as a group, under the pressure of strong capital spending, were only able to keep such holdings roughly unchanged.

Against this background of a strong and generally liquid economy, the directors of this Bank and the directors of the Federal Reserve Bank of Chicago voted, subject to review and determination of the Board of Governors of the Federal Reserve System, to raise their discount rates from 4 per cent to 4½ per cent, and the Board of Governors approved the increases effective December 6. (The discount rates at the other Federal Reserve Banks were raised within the next week.) Simultaneously the Board increased to 5½ per cent the maximum rate payable on member bank time deposits and certificates of deposit with a maturity of 30 days or more. The previous maximum time deposit rates had been 4 per cent for maturities of 30 to 89 days, and 4½ per cent on maturities of 90 days or more. The Board made no change in the 4 per cent maximum rate payable on savings deposits.

The timing of these Federal Reserve actions caught the market somewhat by surprise, and interest rates reacted quickly. Commercial banks immediately raised their prime lending rate from 4½ per cent to 5 per cent, and auction rates on 90-day Treasury bills advanced beyond 4½ per cent within two weeks, while rates on new certificates of deposit rose by 25 to 30 basis points over the same period. To ease these market adjustments and seasonal pressures, the System provided for ample reserve availability during the weeks immediately following the discount rate increase, and Federal funds frequently traded well below the discount rate. The longer term markets probed for higher yield levels, but investment demand quickly reappeared, and yield advances in these markets were fairly modest. Furthermore, credit availability remained ample and credit demand strong in December. The close of 1965 found the money and credit markets in the process of adjusting to the discount rate and Regulation Q changes.

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The Credit and Capital Markets: Rising Demands Met on Firmer Terms

The capital markets, as noted earlier, tended to tighten in 1965—particularly in the second half—under the influence of rising credit demands, changing expectations regarding interest rates and monetary policy, and stronger prospects for further economic growth. As the year closed, interest rates were up significantly in all sectors of the bond market; moreover, mortgage rates were showing signs of firming after years of either marked decline or stability. Nevertheless, the economy was amply supplied with the funds needed to finance rapid growth in real economic activity. Indeed, total funds (net of repayments) raised by consumers, business, and state and local governments (shown in Chart 6) increased by $10.6 billion in 1965, to $66.4 billion, a gain far in excess of the 1964 rise of $5.9 billion. Within the increased 1965 total, the specific sources and uses of funds reflected shifts in the demand for credit among user sectors as well as changes in the pattern of financial intermediation. For example, relatively heavier business borrowing tended to increase the role of commercial banks in 1965.

One of the significant developments during 1965 was the growth of corporate bond issues as the year progressed. For the year as a whole, the outstanding volume of such issues advanced by 7 per cent, and in the last six months of 1965 it grew at an annual rate of about 8½ per cent. Retained earnings—a key source of corporate investment financing—expanded sharply as corporate profits increased, while dividend payments remained at about the 1964 level. Nevertheless, the high rate of corporate spending on plant and equipment and on inventories necessitated increased recourse by business to outside sources of funds. In the first half of 1965, the need for external finance was reflected most strongly in borrowing from banks as business accumulated inventories, including especially steel stockpiles, at a rapid pace. But in the second half of the year, corporations turned to the bond market for the more permanent investment funds needed to finance growing capital expenditures, and their demand for bank loans eased somewhat.

Total corporate holdings of cash, time deposits, and short-term Government securities remained about unchanged over the year despite the rising level of sales and hence of working capital needs. Within the total of corporate liquidity, time deposits at banks increased substantially. Holdings of Government securities, however, declined markedly. Quite possibly, the acceleration of corporate

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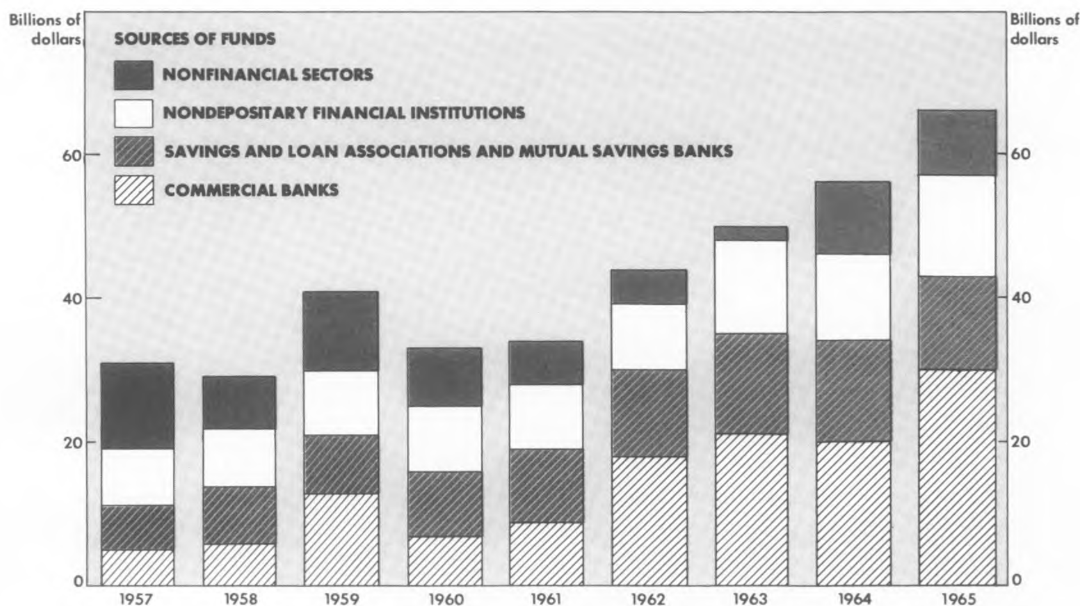
Chart 6. NET FUNDS RAISED BY PRIVATE DOMESTIC NONFINANCIAL SECTORS: Funds raised through new borrowing and through issuing of securities (both net of repayments) by households, business, and state and local governments advanced strongly in 1965. The bulk of the increase was supplied by commercial banks. Funds provided directly by nonfinancial and nondepositary financial sectors of the economy also advanced, reflecting in part an increase in public flotations of corporate securities.



Funds supplied comprise the total (net of repayment) of the additional obligations of business, consumers, and state and local governments acquired during a period by (a) nonfinancial sectors (mainly individuals and nonprofit institutions); (b) nondepositary financial institutions (primarily insurance companies, pension funds, and finance companies); (c) savings and loan associations and mutual savings banks; and (d) commercial banks.

tax payments under the 1964 tax law—designed to bring payments into closer alignment with tax accruals—was a factor of some importance in contributing to this reduction.

American consumers also relied more heavily on borrowed funds in 1965 than they had in the past few years. Consumer credit outstanding grew more rapidly in 1965 than at any time in the current expansion as consumer expenditures on durables, which are heavily financed on instalments, advanced sharply. However, consumers as a group again added substantially to savings, and the

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growth in their holdings of liquid assets more than matched the increase in consumer indebtedness.

Demands in the credit markets by state and local governments continued to expand in 1965, as they have done steadily over the postwar period. In 1965, the emphasis in state and local expenditures was especially on capital projects such as schools, water and sewerage facilities, and highways—which typically are debt financed. Heavy flotations of municipal securities gradually put downward pressure on market prices, and at the year-end yields on municipals were almost ½ of a percentage point higher than at the beginning of the year.

The single most important source of funds for the nonfinancial sectors of the economy in 1965 was the commercial banks. In fact, within a rising total of credit flows the year witnessed a marked shift from nonbank financial institutions toward the banks as a source of finance. Bank credit showed its strongest year-to-year gain of the current expansion, increasing over the year by 10 per cent in contrast to an average for the current expansion of around 8 per cent per year. This strong growth in bank credit, however, was accompanied by a slight decline in the rate of growth of total credit extended by nonbank depositary institutions, reflecting primarily a marked slowdown in the rate of growth of savings shares at savings and loan associations. These institutions are, of course, in fairly close competition with commercial banks. The slowdown in savings institution credit may in part have reflected the virtual stability in residential construction. Given the relatively moderate demand for the type of loans which savings and loan associations traditionally make, these institutions were under less pressure to raise rates or undertake promotional efforts in order to attract funds. A second reason for a slowdown in the credit growth at nonbank depositary institutions was probably the continued aggressive bidding by commercial banks for consumers' savings deposits. It should be noted that the reduced rate of growth of the mortgage-oriented savings institutions has not resulted in a scarcity of mortgage funds, since commercial banks have been increasingly active in the real estate loan field.

Loans to business accounted for almost half of the increase in total commercial bank credit in 1965 and for most of the margin of increase in bank credit growth over the 1964 pace. As in the case of total credit flows, however, lending to business by banks also reflected in part a shifting pattern of financing. While the bulk of the enlarged business borrowing resulted from rising credit needs, some of the increase also appears to have reflected substitution of bank borrowing for funds usually obtained by issuing directly placed com-

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mercial paper. This shift—encouraged by the high rates on money market instruments relative to the banks' prime rate during virtually all of 1965—was most marked in the first quarter of the year. In the face of generally rising rates on money market instruments following the discount rate and Regulation Q increases of November 1964, prime risk borrowers, who had access to both the commercial paper market and bank loans, chose to borrow from banks which were then maintaining their lending terms relatively unchanged from the previous year. The volume of commercial paper outstanding declined in the first quarter after advancing strongly in 1964, while bank loans to commercial and industrial borrowers advanced at an annual rate in excess of 25 per cent in the first quarter. Moreover, while bank loans to business increased more moderately over the remainder of the year, they continued to advance more strongly throughout 1965 than earlier in the expansion. Meanwhile, commercial paper outstanding resumed its upward trend after the first quarter in spite of its fairly high relative cost to borrowers.

In addition to strong demands on the capital markets by the private nonfinancial sectors of the economy, the year 1965 also saw a marked increase in securities flotations by financial institutions, and particularly by commercial banks. To help meet the loan demands of their customers and capital needs, banks augmented deposit inflows by raising about $1.5 billion through issues of new debentures and equities. The banks also raised several hundred million dollars of short-term funds through sale of promissory notes or "acknowledgments of advance".

In summary, the capital markets during 1965 reflected the strength of the economic expansion. The demand for funds of all maturities rose as individuals, business, and state and local governments and other official entities all sought additional financial resources needed to support larger spending. Monetary policy facilitated bank credit growth and associated credit growth from other sources at a rate sufficient to finance enlarged outlays without a major strain on the liquidity of the nonfinancial sectors of the economy, but interest rates were permitted to rise and exercise some moderating influence on credit demands.

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THE UNITED STATES AND THE WORLD ECONOMY

The United States Payments Balance: Distinct but Insufficient improvement

The United States balance of payments in 1965 showed a distinct but still insufficient improvement (see Chart 7, and note on concepts on pages 32-33). Much of the progress may be traced to the President's balance of payments program which was first announced on February 10, 1965. United States determination to take the steps necessary to correct the persistent imbalance in its international payments was underscored toward the year-end by a tightening of the President's program, which was further supported through the increase in the Federal Reserve discount rates and in the ceilings on time deposit rates.

The reduction of the deficit from $2.8 billion in 1964 to $1.3 billion in 1965 was spread unevenly over the year and over the major components of our international transactions. A substantial deficit in the first quarter, partly reflecting large capital outflows, was followed by a second-quarter surplus—as the President's program became effective—and by relatively moderate deficits in the third and fourth quarters. For the year as a whole, the United States private capital outflow was reduced considerably and the surplus on services was increased, but these favorable changes were accompanied by a marked decline in the merchandise trade surplus and a contraction of foreign (primarily official British) portfolio investments in this country.

Outflows of United States private capital had risen from $4.5 billion in 1963 to $6.5 billion in 1964 and were especially high in late 1964 and early 1965. The interest equalization tax on United States purchases of foreign securities proposed in mid-1963 and monetary and debt management techniques held back some outflows, but others accelerated. In order to achieve a decisive improvement, the President's balance of payments program placed special emphasis on reducing the capital outflow through voluntary restraint—financial institutions and business concerns were requested to limit their foreign lending and investment activities. Voluntary credit restraint was conceived as, and continues to be considered, a temporary measure to remain effective only until

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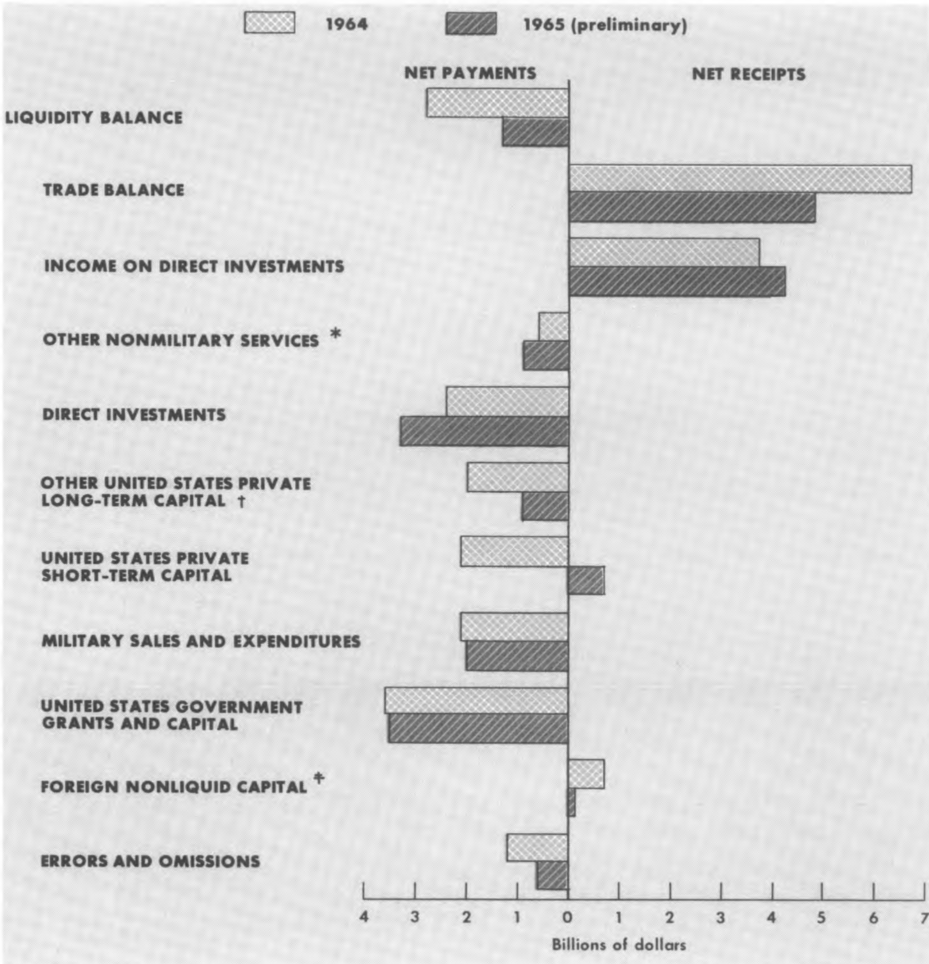
Chart 7. THE UNITED STATES BALANCE OF PAYMENTS AND ITS MAJOR COMPONENTS: The United States international payments deficit (as measured by the liquidity balance) remained large in 1965, although there was a distinct improvement. Most of this improvement reflected a reduced outflow of private capital. A smaller trade surplus and less net foreign nonliquid investments in the United States were important adverse factors.



* Includes transportation, travel, income on investments (other than direct investments), pensions, and transfers.

† Net United States purchases of foreign securities, United States bank term loans, and long-term commercial credits.

‡ Foreign investments in this country, prepayments for military shipments, and purchases of nonmarketable nonconvertible United States Treasury securities.

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BALANCE OF PAYMENTS CONCEPTS

The United States balance of payments is an accounting record of all residents' payments to, and receipts from, foreigners. A surplus or deficit is struck by taking the net sum of certain types of transactions. This sum is commonly referred to as the "above-the-line" balance. The remaining transactions are the "below-the-line" counterpart of this sum.

The *"balance on liquidity basis"* is the net sum of identifiable transactions in merchandise trade, services and transfers, United States private capital, United States Government grants and capital, and foreign nonliquid capital, as well as transactions that cannot be identified. This sum gives rise to a change in the United States international liquidity position. A change in this position is measured by changes in United States monetary reserves and its liquid liabilities to all foreigners. A deficit worsens this position by reducing monetary reserves, or by increasing liquid liabilities, or both; a surplus has the opposite effects. The liquidity balance is currently one main measure of the United States international payments accounts published quarterly by the Department of Commerce in the *Survey of Current Business*. (A variant of this balance often used in the past few years, that of the *"balance on regular transactions"*, differs from the liquidity balance by treating net receipts from certain special United States Government transactions "below the line". These special receipts amounted net to \$0.3 billion in 1964 and \$0.6 billion in 1965. The deficit on this basis thus was \$3.1 billion in 1964 and \$1.9 billion in 1965.)

An alternative measure published in the *Survey*, the *"balance on basis of official reserve transactions"*, is a preliminary Department of Commerce adaptation of a concept recommended by the Government-appointed Review Committee on Balance of Payments Statistics which submitted its report in 1965. In this concept, changes in reserve assets of monetary authorities in this country and abroad are considered as settling the balance arising from all other transactions. It therefore differs from the liquidity balance primarily by including changes in *private* foreigners' liquid claims on this country as part of the "above-the-line" balance. (A second difference

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relates to the dissimilar treatment, in the two balances, of certain United States nonliquid liabilities to foreign monetary authorities.) By this official transactions measure, the deficit totaled $1.2 billion in 1964 and $1.4 billion in 1965. Because private foreigners increased their liquid claims on this country substantially in 1964, the official transactions balance shows a much smaller deficit than the liquidity balance for that year.

The proper interpretation of the official transactions balance, however, depends largely upon the factors underlying the change in private foreigners' liquid dollar holdings. If increases in such holdings reflect primarily strengthened confidence in the dollar or private market incentives rather than official action, they may represent a genuinely favorable factor in the United States payments position. On numerous occasions, however, private foreigners have been induced by official exchange operations—undertaken by United States as well as by foreign monetary authorities—to enlarge or to contract their dollar holdings, as the counterpart of opposite movements in official dollar holdings. Such official operations may serve the domestic monetary policy objectives of foreign authorities, or may be a part of the techniques of international financial cooperation. In either case, such variations would be misinterpreted if viewed primarily as reflecting greater or less attractiveness to private foreigners of liquid dollar claims as an investment or financing medium. Furthermore, the total of these operations varies greatly from period to period. It is also true that strong speculative attacks on a currency may lead to large but strictly temporary shifts of dollar holdings out of private foreign into official foreign hands. These and similar variations heavily influence the official transactions measure of the United States balance of payments over many accounting periods. The liquidity balance is not similarly affected by such transfers, for under that concept the net change in United States liquid liabilities to *all* foreigners, private and official, falls "below the line". On the other hand, the liquidity balance, by failing to treat part of the growth of private foreign dollar holdings as a capital inflow, does not take into account the favorable effect that arises from the desire of private foreigners to increase over the years their dollar holdings for the purposes of investment or financing international trade.

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underlying forces bring our international payments into balance. A voluntary approach was deemed preferable to legislative measures, which often have too sweeping an effect, are subject to delay before coming into force, and may remain on the books longer than absolutely necessary. The program also included implementation of the Gore Amendment—which provided for the extension of the interest equalization tax to most bank loans with a maturity of one year or more to developed countries—and a request for legislation (with which Congress subsequently complied) to prolong this tax and to broaden its coverage to nonbank credits of one to three years. The program was supported by a move toward monetary restraint early in the year, as already noted.

These measures helped limit the 1965 outflow of United States private capital to about $3.5 billion, or $3.0 billion less than in 1964. Long-term outflows were reduced from $4.4 billion in 1964 to $4.2 billion, and the $2.1 billion short-term capital outflow of 1964 was replaced by a return flow of $0.7 billion. The reduction in the rate of long-term outflow reflected primarily a decline in term lending by banks, for net purchases of foreign securities issues by United States residents were approximately the same as in 1964, while corporate direct investment abroad was actually higher. The reversal of short-term capital flows took the form mainly of a sharply reduced outflow of short-term bank loans and acceptances, and of a repatriation of short-term balances held abroad by business corporations and by nonbank financial institutions.

Administration of the voluntary restraint program was shared between the Federal Reserve System and the United States Department of Commerce. The System, in cooperation with the United States Treasury, was made responsible for working with financial institutions. The Commerce Department, also in cooperation with the Treasury, was given the task of working with nonfinancial corporations.

In administering its part of the program, the System issued guidelines to the commercial banks requesting them to limit the increase in their foreign claims during 1965 to no more than 5 per cent of the amount outstanding at year-end 1964. Within this ceiling, banks were to give priority to the financing of United States exports and to loans to less developed countries and were to avoid placing an undue burden on the balance of payments of Canada, Japan, and the United Kingdom. While in early 1965, before announcement of the voluntary program, the outflow of bank credit to foreigners had been heavy, commercial banks as a group subsequently reduced their outstanding credits so that by year-end 1965 these credits were less than 2 per cent above the end-1964 base. Factors

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other than the restraint program of course also affected the amount of bank credit extended to foreigners. Some foreign borrowers had already exhausted the credit lines United States banks were prepared to grant them when the program was announced. Furthermore, considerably stronger domestic demand for bank loans and the further reduction of the banks' liquidity positions may have made foreign lending less attractive, while the firming of interest rates here—plus the interest equalization tax—and slower growth of economic activity in some foreign countries may have moderated foreign credit requests.

Most of the bank credit extended to foreigners in 1965 prior to the President's program was in the form of term loans. Subsequently, term loans were reduced—principally in the second quarter when several large banks sold a portion of their loans to branch offices abroad. On balance, outstanding short-term and long-term bank credit to foreigners rose only moderately for the year, although term lending to less developed countries approached the same amount as during 1964, a record year for such loans.

The guidelines established for nonbank financial institutions were broadly similar to those for banks and also met with a favorable response. The 1965 increase in foreign credits maturing in ten years or less was to be kept within 5 per cent of the amount outstanding at year-end 1964, and short-term investments in foreign money markets were to be reduced to the year-end level of either 1963 or 1964, whichever was lower.

The main change in System guidelines for 1966, announced on December 6, was a boost in the credit ceiling for banks and nonbanks to 109 per cent of the year-end 1964 base (more precisely, the ceiling rises by 1 percentage point per quarter). Special allowances for banks with small base-date credits to foreigners are expected to add about 1 percentage point to the over-all ceiling for 1966, making possible foreign credit expansion for the banking system as a whole about equal to that provided for 1965. Also, an additional ceiling was established for nonbank financial institutions, applicable to credits and investments of more than ten years' maturity to developed countries.

In administering its part of the 1965 program, the United States Department of Commerce asked United States firms with substantial business abroad to improve by 15 to 20 per cent the aggregate of selected components of their individual balance of payments. The choice of means to achieve this target was left to the cooperating corporations, which could increase their exports, accelerate repatriation of income from their direct investments abroad, or decrease their direct investments financed from this country by postponing or canceling marginal

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direct investment in developed countries and by relying more on foreign financing. In addition to the targeted improvement, cooperating firms were requested to reduce their short-term investments held abroad to a level no higher than the amount outstanding at the end of 1963. The actual results for 1965 included a substantial reduction of short-term investments held abroad, some export gains, a further increase in the repatriation of direct investment income, and substantially larger borrowing in foreign markets. On the other hand, direct investment outflows—which had reached the very high level of $2.4 billion in 1964—continued to mount, especially in early 1965, and in the first three quarters alone surpassed the 1964 total. Estimates for 1966 of projected plant and equipment expenditures abroad by United States firms indicated the prospect of continued heavy outflows. In order to moderate the unfavorable impact of these expenditures on the 1966 payments balance, the Department of Commerce strengthened the applicable guidelines late in 1965, mainly by enlarging the number of cooperating firms and by suggesting a ceiling on the sum of direct investment and earnings retained abroad, less financing obtained from foreigners by domestic firms, applicable to a broad group of foreign countries.

United States residents made net purchases of about $0.7 billion in foreign securities in each of the years 1964 and 1965. Canada floated the bulk of the new issues in both years. This type of outflow from the United States would undoubtedly have been higher in 1965 had not a number of Canadian new issues been postponed from the fourth quarter until the first quarter of 1966 in accordance with an intergovernmental understanding. Foreigners reduced their holdings of United States corporate securities by $500 million during the second and third quarters. A large part of this decline reflected British Government sales from its portfolio of such securities and the conversion of these funds into more liquid dollar assets. (These holdings serve as a secondary line of defense for the pound and do not show up in the figures on official British gold and foreign currency reserves.) An increase in other foreign nonliquid holdings, however, including substantial prepayments for military shipments, resulted in a small net inflow for this component of the balance.

The net change from 1964 to 1965 in United States Government military sales and expenditures was small, as was the change in official grants and net capital outflows. Some increases in military expenditures and in foreign aid were offset by larger military sales and increased foreign repayments of Government loans.

A major adverse factor in the 1965 payments performance was a decrease

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in the trade surplus from $6.7 billion in 1964 to $4.8 billion in 1965—a level slightly below the 1960-63 average. The decline from 1964 was the result of a slower advance in exports and a more rapid rise in imports than in the preceding year.

Exports in 1965 rose only 4 per cent above the 1964 level, following a 15 per cent advance the previous year. (About the same amount of our exports as in 1964 represented shipments under Government-aid programs.) Much of the slower rise in commercial exports can be explained by cyclical and policy developments abroad. Some slowing-down of the rate of growth in economic activity in a number of European and Latin American countries and in Japan retarded these countries' purchases from the United States (as well as from other areas). There was no repetition of the large Eastern European wheat purchases. But developments in the United States also limited the 1965 export rise. Anticipation of the dock strike in the first months of the year caused the shift forward of some exports to late 1964, and strike-caused delays may have led some customers to place orders elsewhere. In addition, buoyant domestic demand may, in some cases at least, have interfered with prompt delivery. It is noteworthy, however, that the United States export performance tended to improve in the second half of the year when exports ran about 10 per cent above the average for the year 1964.

Imports, on the other hand, rose 15 per cent as against an increase of 10 per cent in 1964. The import increase in both years was much faster than the growth in gross national product. An exceptional rise in steel imports—partly for stock-building in anticipation of a possible steel strike—accounted for some of the 1965 increase. But there was also a rapid rise in other manufactured imports which are directly competitive with similar goods produced in the United States. The 1965 record thus strongly reaffirms the need for price stability in the United States and for competitiveness of American industry and agriculture. For the longer term, an enlarged trade and services surplus is essential for ending our payments deficits.

The services account was worsened in 1965 by a rise in United States residents' net payments to foreigners for transportation and travel. The growth in recent years of United States tourist expenditures abroad led to inclusion in the President's program of a "See the U.S.A." campaign and a further limitation on duty-free exemptions for returning tourists. The loss of freight earnings stemming from the summer maritime strike also contributed to the rise in net transportation payments.

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The counterpart of our payments deficit was a worsening of the United States liquidity position—i.e., total monetary reserves less liquid liabilities to all foreigners. United States monetary reserves fell by $1.2 billion in 1965—almost the amount of the deficit. Gold reserves declined $1.7 billion, as against a loss of $125 million in the preceding year. About half the 1965 gold sales occurred during the first quarter. France, with a persistent payments surplus and a policy of converting dollars into gold, accounted for more than half the first-quarter gold loss and was the largest single purchaser for the year as a whole. The heavy 1965 gold loss is a clear reminder that sizable United States balance of payments deficits cannot be allowed to continue.

The gold losses were partially offset by an improvement in the United States reserve position with the International Monetary Fund (IMF) and a rise in convertible foreign currency holdings. The United States transferred $259 million in gold to the IMF in June in payment for the gold portion of our quota increase, thereby raising our automatic drawing rights with the Fund. The dollar component of Britain's Fund drawing in May ($200 million) also added to the United States reserve position with the Fund, but three United States drawings (in March, July, and September), totaling $435 million equivalent, reduced it. These and other transactions resulted in a net improvement in the United States position at the Fund of $94 million. Another factor tending to increase United States monetary reserves was a $349 million rise in holdings of convertible foreign currencies, due largely to an expanded foreign use of swap arrangements with the Federal Reserve System. Liquid liabilities to all foreigners rose only slightly in 1965. Foreign authorities reduced their holdings by about $50 million, while private foreigners and nonmonetary international institutions increased their holdings by about $130 million.

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International Monetary Cooperation: A Year of Progress and Study

In 1965, monetary cooperation continued to play a major role in preserving exchange rate stability, and at the end of the year the markets for all the major currencies were calm and orderly. During the year, the monetary authorities made further progress in strengthening the international financial system. International resources available to meet temporary payments imbalances were increased, United States authorities made additional use of International Monetary Fund drawing rights and paid off substantial short-term commitments previously incurred through international monetary operations. Furthermore, ways to assure an adequate supply of reserves and credit facilities for the world economy in the future were explored.

International monetary cooperation again aided in the defense of sterling. The pound came under renewed selling pressure early in 1965, and doubts arose as to whether the measures taken by the British Government late in 1964 to curb excessive domestic demand and to restrain the inflationary trend of wage settlements would be sufficient to eliminate the balance of payments deficit. Despite a $1.4 billion British drawing from the IMF in May (which permitted repayment of previously received short-term central bank credits), market sentiment regarding sterling remained skeptical and the British authorities made further use of credit facilities in resisting exchange market pressures. New financial arrangements to support the pound, announced on September 10, were made by the Bank of England with the monetary authorities of ten countries (including the United States) and the Bank for International Settlements (BIS). Improved British balance of payments figures and operations conducted under the new arrangements brought about a sustained improvement in sterling rates during the fall and winter. The Bank of England was able to recoup a part of its earlier reserve losses, and its official gold and foreign currency reserves expanded even after substantial repayments of central bank assistance and liquidation of maturing forward exchange market commitments.

International monetary cooperation also played an important role in dealing with the large Italian balance of payments surplus that emerged in 1964 and continued through 1965. The Italian authorities minimized the impact of this surplus on the exchange markets and on United States reserves by channeling a large part of their dollar accruals to Italian banks, which in turn placed significant amounts in the Euro-dollar market. The renewed flow of funds into the

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Euro-dollar market eased the tightness that had developed in that market when voluntary credit restraint in the United States led to withdrawals of dollar deposits from London. The United States shared in official Italian contracts to purchase forward dollars from Italian commercial banks, as had previously been done from January 1962 through March 1964. In addition, the United States purchased dollars from the Italian authorities with lire which were acquired by drawings under the Federal Reserve System lira swap arrangement, the sale of a lira-denominated bond to the Bank of Italy, a drawing on the IMF, and purchases from third countries. The financing of Italy's balance of payments surplus through cooperative action, following as it did a period of Italian deficits and international support for the lira, again demonstrated the reciprocal nature of existing international credit and currency arrangements.

The access to credit under the Federal Reserve swap network was enlarged to a total of $2.8 billion in 1965 through increases in swap facilities with the Bank of Italy (from $250 million to $450 million), the Bank of Japan (from $150 million to $250 million), and the BIS (from $150 million to $300 million). Six of the twelve currencies available through reciprocal credit arrangements were actually used during the year; the United States drew five currencies, while one country—the United Kingdom—drew on its facilities with the Federal Reserve. These transactions were supplemented with substantial foreign exchange market operations undertaken by the System and by the United States Treasury. The Treasury also issued $123 million (net) of convertible foreign currency bonds, raising the amount of outstanding nonmarketable foreign currency bonds to $1,208 million at the year-end. The reversible nature of these borrowings was illustrated in 1965 when—during a period of German payments deficits—the United States Treasury was able to acquire Deutsche marks and to repay $75 million equivalent of mark-denominated bonds previously issued to the German Federal Bank. Other Treasury transactions in securities denominated in foreign currencies included new issues to Italy ($125 million), Austria ($50 million), and the BIS ($23 million).

A major step toward augmenting the resources available for coping with international payments disequilibria was taken early in 1965 when the governors of the IMF approved a 25 per cent increase in the quotas of all member countries, with additional special increases for sixteen members. As a result, total quotas in the Fund will be raised from about $16 billion to possibly as much as $21 billion. By the end of the year, members accounting for more than 60 per cent of the total quotas—almost the necessary two thirds—had ratified the in-

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crease. Since 1962, Fund resources have been supplemented by a $6.0 billion standby credit with ten major industrial members, the Group of Ten, subscribing to the General Arrangements to Borrow. These arrangements were renewed in September and now run to October 1970.

Much of the increase in foreign official monetary reserves in recent years has consisted of dollars accumulated by foreign central banks as a result of United States payments deficits. United States determination to end these large deficits means that other countries can no longer count on such deficits as a regular source of reserves. In this new situation, the problem of what ought to be done should the present adequate supply of liquidity not suffice at some point in the future requires thorough exploration. Secretary of the Treasury Fowler announced in July that this country was ready to participate in an international monetary conference on this subject and appointed an advisory committee headed by former Secretary of the Treasury Douglas Dillon to help prepare for future discussions.

Major differences of view, however, have emerged around the world on the question of how much international liquidity will be required to support growth in world trade and investment. Other differences concern the proper approach to any future creation of additional reserves. Explorations range from means of expanding IMF and other credit facilities, including the further development of automatic drawing rights on multilateral credit facilities, to creation of a new reserve unit. At the September Fund meeting, the ministers and central bank governors of the Ten instructed their deputies to proceed with the work of determining what agreement could be reached on any needed improvements in the monetary system, and urged that consultations proceed with the Fund as to how these recommendations might best be brought up for review in a wider forum. The ministers and governors also noted that the required amount of international reserves depends in large part on the ability of countries to adjust quickly to economic changes, so that major and persistent payments imbalances can be avoided. Thus they requested an early report on the international adjustment process by a study group in the Organization for Economic Cooperation and Development.

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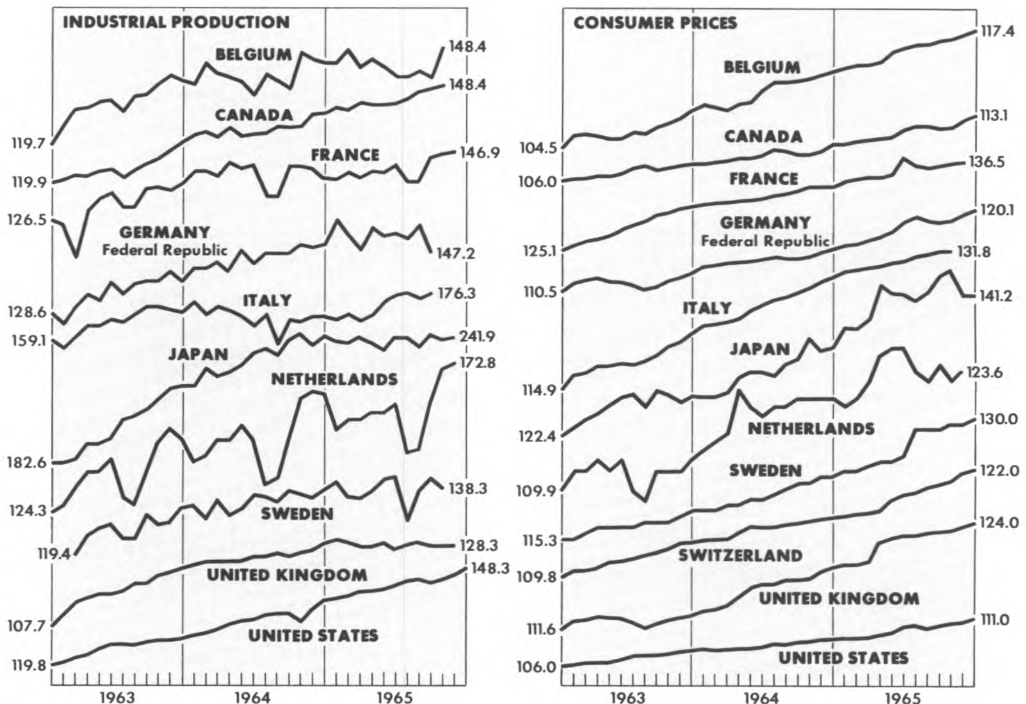
Industrialized Countries: Mixed Trends

In the major industrialized countries abroad, economic growth generally proceeded less rapidly during 1965 than in earlier years, although industrial activity continued at high levels in virtually all countries and price pressures remained strong (see Chart 8). International payments imbalances were on the whole somewhat less severe than in the previous year. However, the broad picture

Chart 8. PRODUCTION AND PRICES IN SELECTED COUNTRIES: In the major foreign developed countries, industrial production generally advanced less rapidly in 1965 than in earlier years. Nevertheless, activity continued at high levels in virtually all countries, and pressures on prices by and large remained strong.



Index numbers based on 1957-59 average=100. Ratio scales on left and right panels are not identical. Industrial production data, except for the Netherlands, are seasonally adjusted. Consumer price data are not seasonally adjusted.

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conceals divergent trends among individual countries. In some countries, including especially Canada, economic growth was swift, and the slack that had remained in employing productive resources was largely eliminated. In a number of other countries, including Germany, industrial production rose at a slower pace than in 1964, and price pressures grew as strains on available resources increased. Elsewhere—especially in France, Japan, and the Netherlands — industrial production leveled off or actually declined temporarily. These variations in the pace of economic activity and in price movements substantially influenced external payments positions abroad, as did the decline in the United States payments deficit. In some countries, the external accounts improved—the United Kingdom's deficit declined while Italy's surplus increased. In other countries, including Germany and Sweden, the external positions worsened. A number of the major countries tended to conduct their official policies more with a view toward their external positions than in previous years. At the year-end, the range of central bank discount rates (see Chart 9) and of short-term interest rates appeared to be somewhat narrower than at the end of 1964.

Among the policy measures taken in 1965, the comprehensive restraint program adopted in the United Kingdom commanded the most attention. Beginning in the fall of 1964 and through most of last year, the British Government sought to develop a combination of domestic and foreign economic policies that would be stringent enough to curb excess domestic demand, retard the increase of costs and prices, and diminish the serious external payments gap. This broad attack included tax increases and reforms, tightening of credit, retrenchment in government spending, curbs on imports and on exchange outlays subject to control, improved assistance to exporters, and a firmer policy limiting wage increases. Cumulatively, the British program came to represent a substantial restraint package, and its effect was being felt increasingly as 1965 drew to a close.

A number of countries besides the United Kingdom found it necessary to introduce or maintain some degree of restraint last year. Germany, faced with rising prices, a deteriorating trade balance, and a congested capital market, considerably reinforced restrictive measures. Sweden had somewhat similar problems, and policy remained oriented toward restraint. In Austria, Canada, the Netherlands, and Switzerland, where inflationary pressures were somewhat milder, restraints were generally of less severity.

In several countries in which earlier restrictive measures had been followed by a substantial slowing-down of economic growth—Belgium, France, Italy, and

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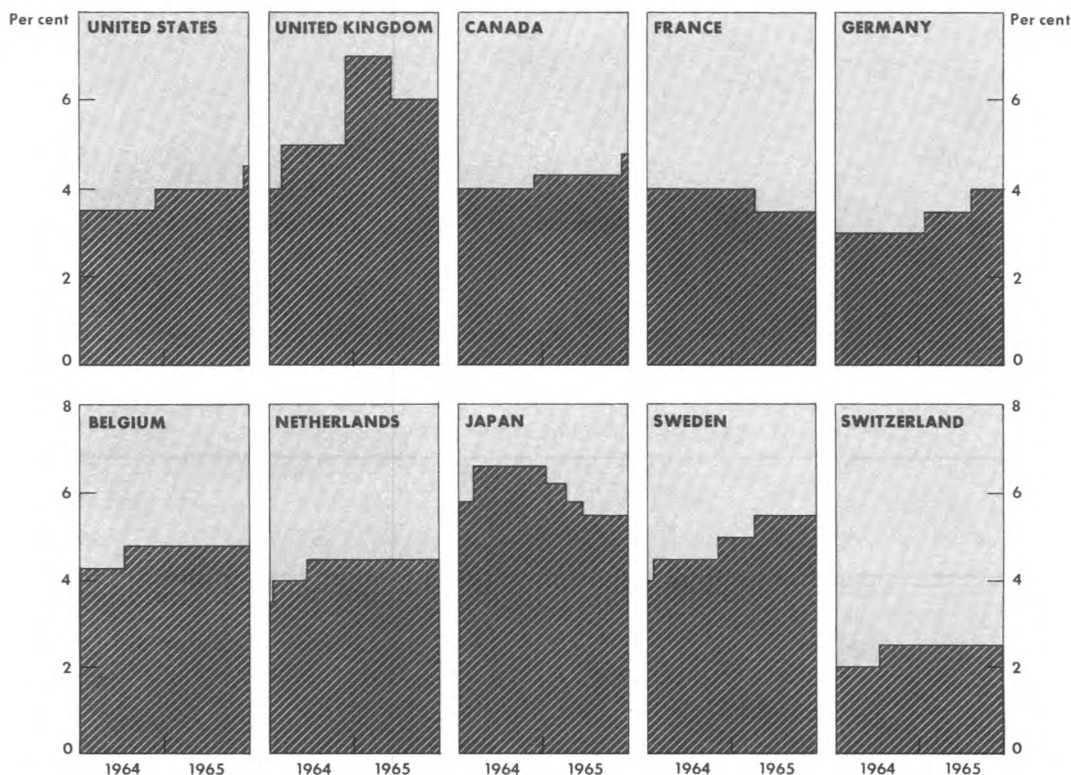
Chart 9. CENTRAL BANK DISCOUNT RATES: The range of central bank discount rates at year-end 1965 was narrower than at year-end 1964. The United Kingdom in 1965 reduced its rate from the 7 per cent "crisis" level instituted late in 1964. France, with a favorable external position, and Japan, with a markedly improved balance, reduced their rates. Among countries with balance of payments deficits, the United States raised its rate, as did Germany.



Japan—stimulative policies were continued or adopted. However, with prices in these countries still rising and the margin of unemployed resources remaining thin in most cases, stimulatory efforts generally were cautious. A noteworthy aspect of foreign official policies, both of restraint and ease, is that the authorities of many countries are increasingly searching for a more balanced mix of monetary and fiscal instruments to deal simultaneously with internal and external imbalances.

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The Less Developed and Eastern European Countries

The need to raise living standards in the less developed countries remained an urgent problem in 1965. In these countries, high rates of population growth continued to limit or prevent a rise in per capita income in spite of production gains, and the need for a greater effort to utilize domestic and foreign resources effectively for economic development was still apparent. Internal and external political strife also was a cause of economic setbacks in a considerable number of such countries. At the same time, the major industrial countries have not significantly raised the level of their development assistance in the last few years, even though a number of underdeveloped countries, according to the World Bank, have the capacity effectively to absorb larger capital inflows than they have been receiving. On the whole, the less developed countries in 1965 probably did not match their 1964 progress.

Progress was made in the establishment of regional development organizations. The African Development Bank, founded in 1964, added to its paid-in capital and plans to begin accepting loan applications in 1966. The Asian Development Bank charter was agreed upon, and commencement of the bank's operations is expected in the near future. Operation of the Latin American Free Trade Association and the Central American Common Market resulted in expanded trade among their respective members.

A number of countries of Eastern Europe continued to make efforts during 1965 to introduce significant reforms for the purposes of raising productivity and achieving a better allocation of resources. In particular, there were additional moves to reduce central administrative controls and to give scope to decisions taken at the industrial management level. Consumer demands and preferences were given increased weight in guiding production decisions; some additional incentives were introduced, both in industry and in agriculture; and some efforts were made to make the price structures more rational and flexible. More generally, the last few years have witnessed noteworthy developments in Eastern Europe, such as considerable experimentation in economic policy and less rigid adherence to received doctrine. East-West trade probably rose again in 1965, but United States trade with Eastern European countries fell below the 1964 level, mainly because the grain purchases made from the United States in 1964 were not repeated. There were, however, large Soviet grain purchases from other Western countries.

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THIS BANK'S OPERATIONS

Volume and Trend of the Bank's Operations

DOMESTIC OPERATIONS. During 1965, the volume of services this Bank performs for the public continued to expand. This steady upward trend basically reflects the expansion of the domestic economy.

Checks processed by the Bank (exclusive of United States Government checks and postal money orders) rose to a new record. The number of checks handled advanced nearly 3 per cent to 722 million and the dollar amount 19 per cent to $528 billion. The comparable increases in 1964 over 1963 were 6 per cent in number handled and 17 per cent in dollar amount. Both checks drawn on this Bank and those drawn on commercial banks shared in the gain in dollar volume, rising 25 per cent and 16 per cent, respectively.

The growth in money transfers processed by this Bank through the Federal Reserve System's leased wire network continued. The number of wire transfers effected rose 9 per cent to just over 1 million, while dollar volume advanced 10 per cent to $1,715 billion, about the same rates of increase as in the immediately preceding years. A part of this steady growth is attributable to increased activity in the Federal funds market; the leased wire facilities are used for the bulk of such transactions.

With the installation of two new high-speed check-processing systems in 1965—which brought the total now in operation to eight—the check collection function concluded the transition to fully automated facilities. By December, about 90 per cent of all checks dispatched were processed on the electronic equipment, up from 64 per cent a year earlier. The remaining 10 per cent either were high-speed rejects or were not compatible with high-speed operations. The percentage of checks preprinted with Magnetic Ink Character Recognition (MICR) symbols flowing into the Bank rose to about 97 per cent from 94 per cent in 1964. To increase efficiency and lower costs, the Bank in 1966 will replace six of the existing systems with new ones of greater capacity.

The enactment on July 23 of the Coinage Act of 1965 marked an important shift in coinage policy in the United States. Burgeoning demand for silver over the past few years had placed a severe drain on Government stocks of silver

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SOME MEASURES OF THE VOLUME OF OPERATIONS OF THE FEDERAL RESERVE BANK OF NEW YORK (Including Buffalo Branch)

Number of pieces handled (in thousands)★	**1965**	**1964**
Currency received	1,455,219	1,426,131
Coin received†	678,248	556,807
Gold bars and bags of gold coin handled	430	203
Checks handled:		
United States Government checks	63,259	60,937
All other	722,005	703,430
Postal money orders handled	31,533	33,233
Collection items handled:		
United States Government coupons paid	3,581	4,007
Credits for direct sendings of collection items	339	325
All other	18,689	19,022
Issues, redemptions, exchanges by fiscal agency departments:		
United States savings bonds	30,814	29,719
All other obligations of the United States and Federal agencies	8,565	8,510
Obligations of the International Bank for Reconstruction and Development	122	98
Obligations of the Inter-American Development Bank	13	59
Participation certificates of the Federal National Mortgage Association	50	14
Safekeeping of securities:		
Pieces received and delivered	8,521	8,135
Coupons detached	5,767	6,193§
Wire transfers of funds‡	1,011	924
Amounts handled (in millions of dollars)		
Discounts and advances‖	24,327	11,686
Currency received	9,968	9,582
Coin received†	48	65
Gold bars and bags of gold coin handled	5,994	2,901
Checks handled:		
United States Government checks	22,897	23,629
All other	527,745	443,195
Postal money orders handled	613	618
Collection items handled:		
United States Government coupons paid	2,834	2,925
Credits for direct sendings of collection items	820	724
All other	3,841	3,656
Issues, redemptions, exchanges by fiscal agency departments:		
United States savings bonds	1,750	1,727
All other obligations of the United States and Federal agencies	589,451	590,742
Obligations of the International Bank for Reconstruction and Development	893	630
Obligations of the Inter-American Development Bank	46	209
Participation certificates of the Federal National Mortgage Association	2,635	786
Safekeeping of securities:		
Par value pieces received and delivered	724,282	717,402
Wire transfers of funds‡	1,715,001	1,554,372

★ Two or more checks, coupons, etc., handled as a single item are counted as one "piece".

† Excludes shipments of new coin from the Mint.

‡ Excludes Treasury transfers between Federal Reserve Districts.

§ Revised.

‖ The number of discounts and advances handled in 1965 was 1,555, compared with 1,248 in 1964.

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bullion. The act authorized the minting of new dimes and quarters containing no silver, and of half-dollars with a greatly reduced silver content. Late in the year, the new quarters began to be released for circulation. They consist of a copper core sandwiched between two cupro-nickel layers. In 1966, similar dimes and silver-copper half-dollars are scheduled for release.

The Coinage Act and stepped-up Mint production in 1964 and 1965 helped greatly in easing the national coin shortage as 1965 progressed. While coin rationing continued throughout the year, record shipments of $91 million of new coin from the Mint enabled the Bank to expand total coin payments to member banks in 1965 to $133 million, 24 per cent above 1964. The dollar volume of coin received from member banks during the second half of 1965 exceeded receipts in the comparable period of 1964 but, reflecting the low first-half figure, the total for 1965 remained below the 1964 volume. The number of coins received, however, exceeded the 1964 level. Higher Mint production of cents and nickels helped especially to relieve the shortage of these minor coins.

Operations performed by the Bank during the past year as agent of the Treasury were virtually unchanged from 1964. The dollar amount of all Government obligations (excluding United States savings bonds) processed by this Bank in 1965 declined by less than 1 per cent to $589 billion, while the number of such items handled edged up 1 per cent to 8.6 million. The volume of operations in United States savings bonds advanced slightly.

Second District member banks borrowed more than $24 billion from this Bank in 1965, the highest dollar volume since 1957 and twice the amount borrowed in 1964. While the number of discounts and advances increased 25 per cent, from 1,248 to 1,555, the proportion of banks borrowing at least once declined to 40 per cent from 42 per cent in 1964. On the one hand, utilization of the "discount window" by the large money market banks increased. On the other hand, many smaller banks made greater use of their correspondents' services and of the Federal funds market for reserve adjustments.

This Bank is a popular source of information on the Federal Reserve System. During 1965, 13,077 visitors were received for tours, the staff delivered 251 speeches to various business and educational groups, and 502,149 copies of a wide variety of Bank publications were distributed.

Despite a significantly higher volume of work, average employment at the Bank declined by 1 per cent in 1965. This decline followed a similar reduction in 1964 over 1963 and in both years reflected largely the expanded application

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of electronic check-processing equipment. At the year-end, this Bank's officers and staff numbered 3,965, including 233 at the Buffalo Branch.

FOREIGN AND INTERNATIONAL OPERATIONS. Foreign exchange activities of this Bank reached record levels in 1965 as a result of active participation in the defense of the pound and extensive operations for System and Treasury accounts, centering on repayments and consolidation of United States short-term foreign indebtedness. At the same time, this Bank participated actively in broadening and refining the practical applications of international monetary cooperation. As already noted, the System's reciprocal swap arrangements with the monetary authorities of eleven countries and the Bank for International Settlements were increased during the year by $450 million to $2.8 billion, while issues and redemptions of United States Treasury foreign currency bonds placed with foreign authorities left outstanding at the year-end the equivalent of $1,208 million.

Over-all holdings of gold, dollar balances, and other assets for foreign and international accounts on December 31 amounted to $28.9 billion, down somewhat from the peak level of $29.0 billion in October but $634 million higher than at the end of 1964. Holdings for international institutions increased $690 million, while those for foreign accounts fell $56 million—the second decline in the last two years, although much smaller than in 1964. Declines in foreign accounts' combined holdings of United States Government securities and dollar balances slightly exceeded gains in holdings of gold and miscellaneous securities (including commercial paper and bankers' acceptances).

Significantly larger purchases of gold from the Treasury and a further increase in exports accounted for a marked increase in gold operations. Demand for loans against gold under earmark was fairly substantial. Credit facilities were made available during 1965 to banks in five countries in order to assist them in meeting seasonal and other temporary dollar requirements. Each bank made use of the facilities, and at the year-end $41 million of drawings was outstanding.

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Financial Statements

STATEMENT OF CONDITION
(In thousands of dollars)

Assets	DEC. 31, 1965	DEC. 31, 1964
Gold certificate account	2,478,306	3,072,781
Redemption fund for Federal Reserve notes	409,153	355,066
Federal Reserve notes of other Banks	151,311	183,441
Other cash	16,507	32,083
Total cash	3,055,277	3,643,371
Discounts and advances	30,627	40,980
Acceptances	186,434	93,768
United States Government securities	10,034,131	9,285,737
Total loans and securities	10,251,192	9,420,485
Other assets:		
Cash items in process of collection	1,676,821	1,833,246
Bank premises	8,667	7,804
All other★	276,390	139,526
Total other assets	1,961,878	1,980,576
Total Assets	**15,268,347**	**15,044,432**

★ Includes assets denominated in foreign currencies and IMF gold deposited.

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STATEMENT OF CONDITION
(In thousands of dollars)

Liabilities	**DEC. 31, 1965**	**DEC. 31, 1964**
Federal Reserve notes	8,600,326	8,253,863
Deposits:		
Member bank reserve accounts	4,803,963	4,829,799
United States Treasurer — general account	159,647	152,505
Foreign★	39,581	67,430
Other†	184,729	180,824
Total deposits	5,187,920	5,230,558
Other liabilities:		
Deferred availability cash items	1,141,912	1,113,473
All other	49,263	172,110
Total other liabilities	1,191,175	1,285,583
Total Liabilities	**14,979,421**	**14,770,004**
Capital Accounts		
Capital paid in	144,463	137,214
Surplus	144,463	137,214
Total Capital Accounts	**288,926**	**274,428**
Total Liabilities and Capital Accounts	**15,268,347**	**15,044,432**
Contingent liability on acceptances purchased for foreign correspondents‡	37,546	32,311
Ratio of gold certificate reserves to Federal Reserve note liability	33.6%	41.5%

★ After deducting participations of other Federal Reserve Banks amounting to	110,700	161,480
† Includes IMF gold deposit.		
‡ After deducting participations of other Federal Reserve Banks amounting to	105,977	90,135

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STATEMENT OF EARNINGS AND EXPENSES FOR THE CALENDAR YEARS 1965 AND 1964 (In thousands of dollars)

	1965	1964
Total current earnings	391,856	335,357
Net expenses	41,716	40,956
Current net earnings	350,140	294,401
Additions to current net earnings:		
Profit on sales of United States Government securities (net)	0	151
All other	264	76
Total additions	264	227
Deductions from current net earnings:		
Loss on sales of United States Government securities (net)	2	0
All other	4	6
Total deductions	6	6
Net additions	258	221
Net earnings available for distribution	**350,398**	**294,622**
Dividends paid	8,501	8,138
Payments to United States Treasury (interest on Federal Reserve notes)	334,648	412,485
Transferred to surplus	7,249	— 126,001

SURPLUS ACCOUNT

	1965	1964
Surplus — beginning of year	137,214	263,215
Transferred from net earnings for year	7,249	0
Payments to United States Treasury (interest on Federal Reserve notes)	0	126,001
Surplus—end of year	**144,463**	**137,214**

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Changes in Membership

During 1965, the total number of commercial banks in this District that are members of the Federal Reserve System declined from 418 to 409. The net decrease of banks was the result of the mergers of fourteen member banks and the organization of five new national banks. The 409 banks constitute 84 per cent of all national banks, state banks, and trust companies in this District and hold 96 per cent of the total assets of all such institutions in this District.

NUMBER OF OPERATING MEMBER AND NONMEMBER BANKS IN SECOND FEDERAL RESERVE DISTRICT AT THE YEAR-END

(Exclusive of savings banks, private banks, and industrial banks)

	DECEMBER 31, 1965			DECEMBER 31, 1964		
Type of Bank	Members	Non-members	Per cent members	Members	Non-members	Per cent members
National banks★	288	0	100	294	0	100
State banks and trust companies	121	80	60	124	82	60
Total	**409**	**80**	**84**	**418**	**82**	**84**

★ Includes one national bank located in the Virgin Islands.

CHANGES IN FEDERAL RESERVE MEMBERSHIP IN SECOND DISTRICT DURING 1965

Total membership beginning of year	**418**
Increases:	
New national banks	5
Decreases:	
Member banks combined with other members	13
Member bank combined with nonmember	1
Total membership at the year-end	**409**

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Changes in Directors and Officers

CHANGES IN DIRECTORS. In November, the Board of Governors of the Federal Reserve System designated Everett N. Case *Chairman* of the Board of Directors of the Federal Reserve Bank of New York and *Federal Reserve Agent* for the year 1966. Mr. Case, President of the Alfred P. Sloan Foundation, New York, N. Y., has been a Class C director since January 1961 and served as *Deputy Chairman* in 1965. He succeeded Philip D. Reed, former Chairman of the Board of the General Electric Company, New York, N. Y., whose term as a Class C director expired December 31, 1965. Mr. Reed had served as a Class B director in 1959 and as a Class C director and *Chairman* and *Federal Reserve Agent* since January 1960.

Also in November, the Board of Governors appointed Kenneth H. Hannan a Class C director for the three-year term beginning January 1, 1966, and *Deputy Chairman* for the year 1966. Mr. Hannan, Executive Vice President of the Union Carbide Corporation, New York, N. Y., had served as a Class B director since January 1960.

In December, member banks in Group 2 elected Robert G. Cowan a Class A director and Milton C. Mumford a Class B director, each for the three-year term beginning January 1, 1966. Mr. Cowan, Chairman of the Board of the National Newark & Essex Bank, Newark, N. J., succeeded Ralph H. Rue, Chairman of the Board of The Schenectady Trust Company, Schenectady, N. Y., who served for the three-year term that ended December 31, 1965; Mr. Rue died on January 6, 1966. Mr. Mumford, Chairman of the Board of the Lever Brothers Company, New York, N. Y., succeeded Mr. Hannan.

At the Buffalo Branch, the Board of Governors in November reappointed Maurice R. Forman a director of the Branch for the three-year term beginning January 1, 1966. Mr. Forman, President of the B. Forman Co., Rochester, N. Y., has been a director of the Branch since January 1963 and served as *Chairman* of the Branch Board of Directors for the year 1965. In December, the Board of Directors of this Bank reappointed Arthur S. Hamlin a director of the Branch for the three-year term beginning January 1, 1966. Mr. Hamlin, President of The Canandaigua National Bank and Trust Company, Canandaigua, N. Y., has been a Branch director since May 1963. At the same time, the

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Bank's Board of Directors designated Thomas E. LaMont *Chairman* of the Branch Board for the year 1966. Mr. LaMont, who is engaged in farming in Orleans County, N. Y., has been a Branch director since November 1959 and served as *Chairman* of the Branch Board in 1963.

CHANGES IN OFFICERS. Since March 1, 1965, four officers have resigned and two have retired:

Robert W. Stone, Vice President, resigned effective May 15, 1965 to become a Vice President of the National Bank of Detroit. Mr. Stone had also resigned as Manager of the System Open Market Account effective at the close of business March 23. His assignment as Vice President in charge of Open Market Operations and Treasury Issues was terminated effective March 24; from then until he left the Bank, Mr. Stone advised the President and senior officers on economic matters. Mr. Stone had joined the Bank's staff in May 1953 and had become an officer in January 1958.

George J. Doll, Assistant Vice President and Cashier of the Buffalo Branch, retired effective July 1, 1965. Mr. Doll had joined the Branch's staff in July 1919 and had become an officer of the Branch in January 1942.

Howard D. Crosse, Vice President in charge of Bank Supervision and Relations, resigned effective July 31, 1965 to become Deputy Chairman of the Board of the Franklin National Bank. Mr. Crosse had joined the Bank's staff in July 1932 and had become an officer in July 1947.

John P. Ringen, Manager, Bank Examinations Department, retired effective October 1, 1965. Mr. Ringen had joined the Bank's staff in February 1951 and had become an officer in January 1959.

Peter D. Sternlight, Assistant Vice President assigned to Open Market Operations and Treasury Issues, resigned effective November 15, 1965 to become Deputy Under Secretary of the Treasury for Monetary Affairs. Mr. Sternlight had joined the Bank's staff in June 1950 and had become an officer in January 1962.

Ernest E. Blanchette, Manager, formerly assigned to the Bank Relations Department, was assigned to the Accounting Department effective October 1, 1965. Effective the same date, he was also appointed Assistant Secretary. Mr. Blanchette resigned from the Bank effective December 31 to accept a position with an accounting firm in New York City. He had joined the Bank's staff in September 1955 and had become an officer in September 1962.

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The following additional changes in official staff, including the appointment of seven new officers, have been made since March 1, 1965:

Alan R. Holmes, Vice President, formerly assigned to Research and Statistics, was assigned to Open Market Operations and Treasury Issues effective March 24, 1965. Effective the same date, Mr. Holmes was selected by the Federal Open Market Committee, with the agreement of this Bank, as Manager of the System Open Market Account, to succeed Mr. Stone.

Robert G. Link, formerly Adviser, Research and Statistics, was appointed Vice President effective March 24, 1965 and assigned to Research and Statistics.

Peter Fousek, Assistant Vice President, formerly assigned to Foreign, was assigned to Research and Statistics effective April 1, 1965.

David E. Bodner, formerly Special Assistant, Foreign Department, was appointed an officer with the title of Manager effective April 1, 1965 and assigned to the Foreign Department.

Fred W. Piderit, Jr., formerly Assistant Vice President, Bank Supervision and Relations, was appointed Vice President effective July 1, 1965 and assigned to Bank Supervision and Relations.

John T. Keane, formerly Assistant Cashier, Buffalo Branch, was appointed Cashier of the Branch effective July 1, 1965.

Gerald E. Beach, Manager, formerly assigned to the Security Custody Department, was assigned to the Government Bond and Safekeeping Department effective July 1, 1965.

Leonard I. Bennetts, formerly Assistant General Auditor, was appointed Manager effective July 1, 1965 and assigned to the Cash Custody Department. Effective October 1, Mr. Bennetts was assigned to the Bank Relations Department, his assignment to the Cash Custody Department being terminated as of the same date.

Robert J. Crowley, formerly Assistant Counsel, was appointed Manager effective July 1, 1965 and assigned to the Foreign Department.

Harry A. Curth, Jr., formerly Special Representative, Buffalo Branch, was appointed an officer of the Branch with the title of Assistant Cashier effective July 1, 1965.

Richard A. Debs, Assistant Counsel, was also appointed Assistant Secretary, effective July 1, 1965. Effective October 1, Mr. Debs was appointed Secretary, continuing as Assistant Counsel.

Martin French, Manager, formerly assigned to the Cash Custody Department, was assigned to the Security Custody Department effective July 1, 1965.

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William M. Schultz, formerly Manager, Personnel Department, was appointed Assistant General Auditor effective July 1, 1965.

Robert C. Thoman, Manager, formerly assigned to the Government Bond and Safekeeping Department, was assigned to the Personnel Department effective July 1, 1965, his appointment as Assistant Secretary being terminated as of the same date.

Ronald B. Gray, formerly Special Assistant, Planning Department, was appointed an officer of the Buffalo Branch with the title of Assistant Cashier effective August 1, 1965.

Arthur A. Randall, formerly Chief, Personnel Division, Buffalo Branch, was appointed an officer of the Branch with the title of Assistant Cashier effective August 1, 1965.

William H. Braun, Jr., Assistant Vice President, formerly assigned to Accounting and Planning, and to Loans and Credits, was assigned to Bank Supervision and Relations effective October 1, 1965.

Bruce K. MacLaury, formerly Manager, Foreign Department, was appointed Assistant Vice President effective October 1, 1965 and assigned to Foreign.

Thomas M. Timlen, Jr., formerly Secretary, and Assistant Counsel, was appointed Assistant Vice President effective October 1, 1965 and assigned to Accounting and Planning, and to Loans and Credits.

Karl L. Ege, Manager, Collection Department, was also assigned to the Cash Custody Department, effective October 1, 1965.

The assignment of Everett B. Post, Manager, to the Accounting Department was terminated effective October 1, 1965, his assignment to the Planning Department continuing.

Betty Jean Shea, formerly Attorney, Legal Department, was appointed an officer with the title of Assistant Counsel effective October 1, 1965.

Francis H. Schott, formerly Manager, Research Department, was appointed Adviser effective January 6, 1966 and assigned to Research and Statistics.

Richard G. Davis, formerly Senior Economist, was appointed Manager effective January 6, 1966 and assigned to the Domestic Research Department.

Frederick W. Deming, formerly Special Assistant, Securities Department, was appointed an officer with the title of Manager effective January 6, 1966 and assigned to the Securities Department.

Edward J. Geng, Manager, Securities Department, was also appointed Assistant Secretary, effective January 6, 1966.

Fred H. Klopstock, formerly Manager, Research Department, was appointed

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Senior Economist effective January 6, 1966.

Madeline H. McWhinney, Manager, Market Statistics Department, was assigned to the Statistics Department effective January 6, 1966.

Frederick C. Schadrack, Jr., formerly Chief, Foreign Research Division, Research Department, was appointed an officer with the title of Manager effective January 6, 1966 and assigned to the International Research Department.

Aloysius J. Stanton, Manager, formerly assigned to the Check Department, was assigned to the Accounting Department effective January 6, 1966.

MEMBER OF FEDERAL ADVISORY COUNCIL—1966. The Board of Directors of this Bank selected William H. Moore to serve during 1966, for the third successive year, as the member of the Federal Advisory Council representing the Second Federal Reserve District. Mr. Moore is Chairman of the Board of the Bankers Trust Company, New York, N. Y.

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Directors of the Federal Reserve Bank of New York

DIRECTORS	Term expires Dec. 31	Class	Group
GEORGE A. MURPHY Chairman of the Board, Irving Trust Company, New York, N. Y.	1967	A	1
ROBERT G. COWAN Chairman of the Board, National Newark & Essex Bank, Newark, N. J.	1968	A	2
ROBERT H. FEARON President, The Oneida Valley National Bank of Oneida, Oneida, N. Y.	1966	A	3
ARTHUR K. WATSON Chairman of the Board, IBM World Trade Corporation, New York, N. Y., and Vice Chairman of the Board, International Business Machines Corporation, Armonk, N. Y.	1967	B	1
MILTON C. MUMFORD Chairman of the Board, Lever Brothers Company, New York, N. Y.	1968	B	2
ALBERT L. NICKERSON Chairman of the Board, Socony Mobil Oil Company, Inc., New York, N. Y.	1966	B	3
EVERETT N. CASE, *Chairman, and Federal Reserve Agent* President, Alfred P. Sloan Foundation, New York, N. Y.	1966	C	
KENNETH H. HANNAN, *Deputy Chairman* Executive Vice President, Union Carbide Corporation, New York, N. Y.	1968	C	
JAMES M. HESTER President, New York University, New York, N. Y.	1967	C	

DIRECTORS—BUFFALO BRANCH

Director	Term expires Dec. 31
THOMAS E. LAMONT, *Chairman* Farmer, Albion, Orleans County, N. Y.	1966
CHARLES W. MILLARD, JR. Chairman of the Board, Manufacturers and Traders Trust Company, Buffalo, N. Y.	1966
ROBERT S. BENNETT General Manager, Lackawanna Plant, Bethlehem Steel Corporation, Buffalo, N. Y.	1967
J. WALLACE ELY President, Security Trust Company of Rochester, Rochester, N. Y.	1967
JOHN D. HAMILTON Chairman of the Board, Marine Midland Chautauqua National Bank, Jamestown, N. Y.	1967
MAURICE R. FORMAN President, B. Forman Co., Rochester, N. Y.	1968
ARTHUR S. HAMLIN President, The Canandaigua National Bank and Trust Company, Canandaigua, N. Y.	1968

MEMBER OF FEDERAL ADVISORY COUNCIL — 1966

Member	Term
WILLIAM H. MOORE Chairman of the Board, Bankers Trust Company, New York, N. Y.	1966

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Officers of the Federal Reserve Bank of New York

ALFRED HAYES, *President*
WILLIAM F. TREIBER, *First Vice President*

HAROLD A. BILBY, *Vice President*
JOHN J. CLARKE, *Vice President and General Counsel*
CHARLES A. COOMBS, *Vice President*
GEORGE GARVY, *Economic Adviser*
MARCUS A. HARRIS, *Vice President*
ALAN R. HOLMES, *Vice President*
ROBERT G. LINK, *Vice President*
FRED W. PIDERIT, JR., *Vice President*
WALTER H. ROZELL, JR., *Vice President*
HORACE L. SANFORD, *Vice President*
THOMAS O. WAAGE, *Vice President*

EDWARD G. GUY, *Assistant General Counsel*
THOMAS C. SLOANE, *Assistant General Counsel*

WILLIAM H. BRAUN, JR., *Assistant Vice President*
FELIX T. DAVIS, *Assistant Vice President*
PETER FOUSEK, *Assistant Vice President*
PETER P. LANG, *Adviser*
ANGUS A. MACINNES, JR., *Assistant Vice President*
BRUCE K. MACLAURY, *Assistant Vice President*
SPENCER S. MARSH, JR., *Assistant Vice President*
DONALD C. NILES, *Assistant Vice President*
LAWRENCE E. QUACKENBUSH, *Assistant Vice President*
THOMAS J. ROCHE, *Senior Foreign Exchange Officer*
FRANK W. SCHIFF, *Assistant Vice President*
FRANCIS H. SCHOTT, *Adviser*
KENNETH E. SMALL, *Assistant Vice President*
FREDERICK L. SMEDLEY, *Assistant Vice President*
THOMAS M. TIMLEN, JR., *Assistant Vice President*

GERALD E. BEACH, *Manager, Government Bond and Safekeeping Department*
LEONARD I. BENNETTS, *Manager, Bank Relations Department*
MARTIN W. BERGIN, *Manager, Public Information Department*
DAVID E. BODNER, *Manager, Foreign Department*
LOUIS J. BRENDEL, *Manager, Computer Services Department*
A. THOMAS COMBADER, *Manager, Building Operating Department*
ROBERT L. COOPER, *Manager, Acceptance Department*
ROBERT J. CROWLEY, *Manager, Foreign Department*
RICHARD G. DAVIS, *Manager, Domestic Research Department*
RICHARD A. DEBS, *Secretary, and Assistant Counsel*
FREDERICK W. DEMING, *Manager, Securities Department*
KARL L. EGE, *Manager, Cash Custody Department, and Manager, Collection Department*
MARTIN FRENCH, *Manager, Security Custody Department*
EDWARD J. GENG, *Manager, Securities Department, and Assistant Secretary*
FRED H. KLOPSTOCK, *Senior Economist*
LEONARD LAPIDUS, *Manager, Personnel Department*
WILLIAM E. MARPLE, *Manager, Credit and Discount Department*
MADELINE H. MCWHINNEY, *Manager, Statistics Department*
PAUL MEEK, *Manager, Securities Department*
ROBERT MEYER, *Assistant Counsel*
ARTHUR H. NOA, *Manager, Service Department*
JAMES H. OLTMAN, *Manager, Bank Examinations Department*
EVERETT B. POST, *Manager, Planning Department*
CHARLES R. PRICHER, *Manager, Cash Department*
EDWIN S. ROTHMAN, *Manager, Foreign Department*
WALTER S. RUSHMORE, *Manager, Savings Bond Department*
FREDERICK C. SCHADRACK, JR., *Manager, International Research Department*
BETTY JEAN SHEA, *Assistant Counsel*
GEORGE C. SMITH, *Manager, Check Department*
ALOYSIUS J. STANTON, *Manager, Accounting Department*
ROBERT C. THOMAN, *Manager, Personnel Department*
ROBERT YOUNG, JR., *Assistant Counsel*

JOHN P. JENSEN, *General Auditor*
WILLIAM M. SCHULTZ, *Assistant General Auditor*

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OFFICERS — BUFFALO BRANCH

INSLEY B. SMITH, *Vice President*
JOHN T. KEANE, *Cashier*

HARRY A. CURTH, JR., *Assistant Cashier*

RONALD B. GRAY, *Assistant Cashier*

GERALD H. GREENE, *Assistant Cashier*

ARTHUR A. RANDALL, *Assistant Cashier*

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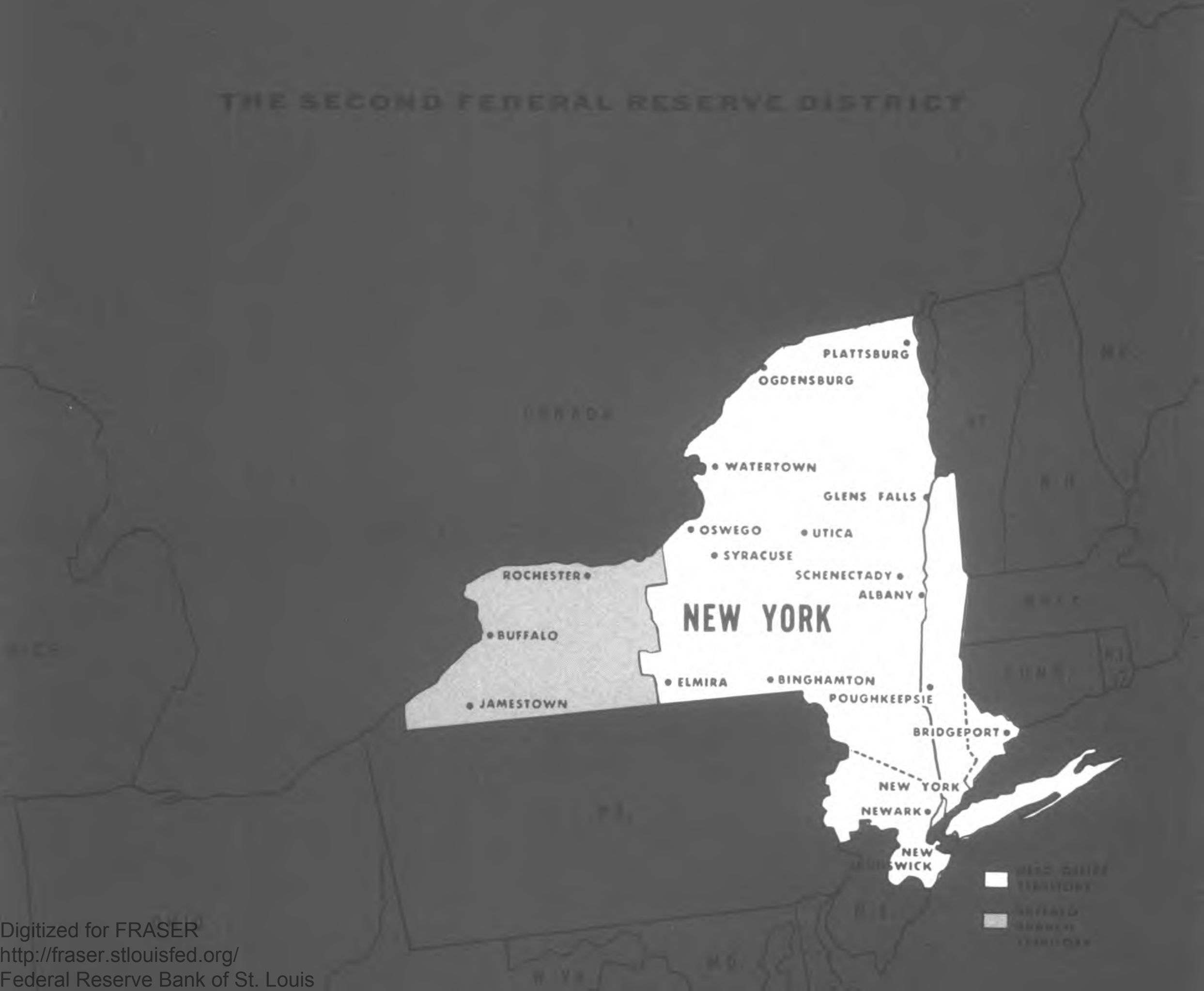

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