SUMMARY

1965, the fifth year of sustained expansion in the U.S. economy, was one of unusually vigorous expansion in demand, output, and employment. Growth was especially marked in the fourth quarter, and at the year-end the economy was operating closer to full potential in terms of manpower and industrial resources than at any other time in nearly a decade. The economy also was in greater danger of damaging inflation than it had been since the current long upswing began in early 1961.

In contrast to the situation at the beginning of 1965, when national economic attention was still being focused on the need to expand employment and to accelerate economic growth, toward the end of 1965 attention was being directed toward the need to contain demand as war in Viet Nam was beginning to add to pressures already evident in the booming civilian economy. By the year-end the downward movement in unemployment had brought the unemployment rate close to the administration's interim target of 4 per cent and to the lowest level since the spring of 1957. Businesses and consumers were highly confident that further rapid expansion in activity, employment, and income was in prospect. Both actual developments and expectations concerning future developments were contributing to expansion of demands for credit.

With the labor market tightening, with over-all demands for goods and services expanding vigorously, and with some industries operating above optimum rates, upward pressure on industrial prices was greater than in earlier phases of the business expansion. Prices of farm products and foods rose sharply during the year, largely because of the sustained increase in consumer demands in the face of reduced meat supplies. Rising demands also produced an increase in U.S. imports. In fact,

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imports rose much more than exports, and the U.S. trade surplus declined appreciably. Nonetheless, with the program of voluntary restraint on capital outflows making an effective contribution, a considerable reduction was achieved in the U.S. balance of payments deficit.

Fiscal developments became stimulative again after midyear when a reduction in Federal excise taxes became effective and the build-up of military strength in Viet Nam increased. In the autumn social security benefit payments were increased considerably, and there were pay increases for both Federal civilian workers and military personnel.

Despite a less expansive stance of monetary policy, the money supply and bank credit grew even faster in 1965 than in 1964, under pressure of exceptionally strong demands for credit, especially business demands for bank loans. Interest rates moved up selectively early in the year and more generally after midsummer, well before Federal Reserve Bank discount rates were raised from 4 to 4½ per cent in early December. Interest rates advanced further after the discount action and the accompanying increase in interest rate ceilings set by the Federal Reserve and by the Federal Deposit Insurance Corporation on time deposits in commercial banks. The sharpest increases were in markets for short- and intermediate-term funds, but rates on long-term funds also rose somewhat.

The expansion in over-all output in 1965 exceeded both official and private projections made at the beginning of the year. This was caused largely by the greater-than-expected increases in Federal spending and by progressive upward revisions of estimates of business spending for inventories and fixed capital; there was also a related strengthening in expectations and in business plans for future fixed investment outlays. In current dollars, the gross national product increased by $47.6 billion—from $628.7 billion to $676.3 billion—or 7.6 per cent from 1964 to 1965. In constant dollars the increase was smaller, 5.5 per cent. Even so, the increase in real output in 1965

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exceeded the unusually large rise of 5 per cent in 1964 and also the average increase of 3.5 per cent for the whole postwar period. Industrial production also showed an exceptionally large growth, with the Board's index rising 8 per cent, from 132 per cent of the 1957-59 average for the year 1964 to 143 per cent for 1965. Some rise in industrial production was registered in every month except September; for several months before that, steel output had been speeded up against the possibility of a strike, but in September it was cut back sharply following agreement early in the month on a new labor contract.

Prospective large increases in the labor force and in industrial capacity, together with a potential for further reduction in unemployment, suggested that the economy would still be able to produce sizable increases in output in 1966. But the pervasive effect on business expectations of prospects for much more defense spending, the sharply reduced supply of unemployed skilled and semiskilled labor, and the increased price pressures in 1965 all indicate the danger that further large increases in output could be accompanied by significant inflationary pressures. In this respect, the economic situation at the end of 1965 differed importantly from conditions earlier in this long expansion period when manpower and industrial capacity were less fully utilized.

The marked improvement in the balance of payments noted for 1965 was aided greatly by the program of voluntary restraint on lending and investing abroad, instituted and administered by the Federal Reserve System and the Department of Commerce, in consultation with the Treasury Department, in accordance with the President's program announced on February 10, 1965. On the "liquidity" basis the deficit for the year declined to $1.3 billion as compared with $2.8 billion in 1964. But the current-account position deteriorated as imports rose strongly, and the outflow of direct investment by U.S. companies into subsidiaries and branches abroad was much larger than in 1964. In our present circumstances, further progress toward balance of payments equilibrium calls for enlargement of the U.S. export surplus, and

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therefore for further strengthening of the U.S. competitive position in international trade. Domestic price stability appears especially important in view of balance of payments needs.

LABOR MARKET

The labor market tightened in 1965. There was a marked growth in the labor force, and the increase in employment was the largest since the current expansion began in early 1961—it was large enough to reduce unemployment significantly. Demands for workers accelerated in the closing months of 1965 as the tempo of economic activity stepped up and as the planned expansion in the strength of the armed forces was beginning to be felt. In the fourth quarter total nonagricultural employment rose to 68.7 million persons from 66.3 million a year earlier, and the over-all rate of unemployment dropped almost to the administration's interim target of 4.0 per cent. It was far below the 7 per cent level of early 1961.

Unemployment declined in 1965 for all major industrial, occupational, and age groupings in the work force. The largest decline was among adult men, who benefited from increased demands for workers in industry. Unemployment among adult women also declined, as a very large rise in their employment exceeded growth in their labor force numbers. Unemployment among nonwhite persons declined substantially, but at the year-end their unemployment rate was still nearly double that for white persons. Long-term unemployment was considerably reduced.

After mid-1965, teenagers entered the labor force in unprecedented numbers, partly in response to expanding job opportunities. Many of the new entrants were readily absorbed, and total teenage employment rose by more than 1.0 million persons during the year. Unemployment rates for teenagers declined, but were still high at the end of the year.

Gains in employment in manufacturing reflected the increases in expenditures by business, government, and consumers.

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Strong demands were also reflected in expanding levels of employment in trade and in services. Employment in construction was relatively stable for most of 1965, but it was moving up as the year closed. With the increase in demands for manpower—for both civilian and military purposes—the supply of adult male labor became more scarce, and shortages of workers were evident in some areas and in some occupations. Needs for skilled manpower were being met more and more by upgrading personnel, by lengthening hours of work per week, and by providing on-the-job training.

PRICES AND COSTS

Productivity continued to rise in 1965, both in manufacturing and in the private economy as a whole, but the gains were somewhat smaller than they had been earlier in the expansion. Increases in average hourly earnings in manufacturing remained about in line with the administration's guideposts, and labor costs per unit of output were little changed. However, in many nonmanufacturing industries—particularly in trades and in services—demands for workers were very strong, and increases in wage rates became larger as the year progressed and were often above the guideposts.

The rise in wholesale prices of industrial commodities that began in the autumn of 1964 continued at about the same pace through 1965. At the year-end the industrial average was up about 1.5 per cent both from the end-of-1964 level and from the cyclical high in early 1960. The rise in prices of metals and machinery, which began in late 1963 and continued in 1964, persisted through 1965 under the influence of strong domestic and foreign demands for nonferrous metals and of rapid expansion in defense spending and in business spending for fixed investment.

As a result of selective increases, average prices of steel mill products rose by about 1 per cent in 1965. The rise in prices of metals was limited by the release of some supplies from Federal stockpiles and by the administration's efforts to encourage adher-

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ence to its wage and price guideposts. Wholesale prices of other industrial materials—such as paper, chemicals, and textiles—generally firmed, and prices of petroleum products rose appreciably, more than recovering the decreases of 1964. Prices of hides and leather soared, mainly because of reductions in supplies from other parts of the world.

Wholesale prices of foodstuffs rose nearly a tenth during 1965, primarily because of strong consumer demands and reduced supplies of meat. Hog raising had been curtailed in response to unfavorable prices in 1963-64; at the end of 1965 there were indications that it was expanding again in response to the very high prices of the summer and autumn of 1965.

In retail markets as in wholesale, meat prices increased sharply, lifting the average price for foods. Reductions in excise taxes helped to lower prices of household appliances and new cars, but with prices of apparel and fuels moving up, the average for nonfood commodities rose by nearly 1 per cent. Prices of consumer services—especially medical care, and auto insurance and other elements of transportation services—increased by more than the average amount for the immediately preceding years. Altogether, the consumer price index rose by 2 per cent during 1965, compared with year-to-year increases between 1.0 and 1.5 per cent in the three preceding years.

PUBLIC AND PRIVATE DEMANDS

Increases in demand in 1965 were widespread. The Federal Government became an expansive influence in the second half, but in contrast to 1964, the fiscal stimulus came more from increased expenditures than from reductions in income tax rates. After 3 years of relatively small net changes, Federal purchases of goods and services began to mount in the spring of 1965. The rise was attributable largely to defense spending, including a pay increase later in the year for the armed services. A large further rise in defense spending was in prospect as the year ended.

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Other Federal expenditures—including social security benefits and grants-in-aid—rose rapidly in the second half of 1965, and wages of civilian workers were raised in the autumn. In the first half of the year the Government had a moderate surplus on the national-income-account basis, but in the second half it had a small deficit. Meanwhile, State and local government purchases of goods and services, including those made with Federal grants, continued to rise by substantial amounts, and for the first time in recent history they exceeded purchases of goods and services by the U.S. Government.

Business increased its spending on fixed investment by 15 per cent to a total of $69.8 billion in 1965. This followed a rise of 11 per cent in 1964 and brought the total rise since 1961 to nearly 50 per cent. In the last quarter of 1965 expenditures by business for fixed investment accounted for 10.5 per cent of GNP, about the same as at the peak of the investment boom of 1956-57. Actual spending in 1964 and 1965 consistently exceeded reported plans. While equipment industries increased their own capital outlays and capacity at rapid rates, they also achieved large gains in output by using their plant and equipment more intensively.

Stimulating business expenditures for fixed capital were the substantial increases in output, a growing confidence in near- and longer-term business prospects, the continuing impact of Government tax measures and depreciation rules designed to stimulate such investment, and growth in profits and internal funds. Corporate profits after taxes rose to $44.5 billion in 1965; this was an increase of about one-fifth and was the largest of this expansion period. Growth in the flow of internal funds, although large, did not equal the rise in capital outlays, and corporate liquidity declined.

In manufacturing, the capacity utilization rate has been rising gradually since 1962. In the second half of 1965 it averaged about 91 per cent, and at the year-end it exceeded that figure, with a number of major industries operating considerably above

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the average. The intensive use of capacity around the year-end developed despite an expansion of manufacturing capacity which was estimated to have amounted to about 6 per cent in 1965, significantly more than the average for 1962-64.

Business inventory accumulation in 1965 was the largest of the expansion period, but sales about kept pace, and the over-all ratio of stocks to sales changed little following an appreciable decline in 1964. In the first half of 1965, accumulation of steel and auto stocks accounted for roughly half of the total inventory build-up. Accumulation of steel continued until a new labor contract was signed in early September, but after that steel output was curtailed and steel stocks were reduced sharply. These changes in steel stocks were more than offset, however, by a high rate of inventory accumulation in other lines (including farm stocks), and the over-all rate of accumulation of inventories was larger in the second half of the year than in the first half.

Expansion in output and employment resulted in another large increase in personal income in 1965. Apart from the sizable increase in the largest component—wages and salaries—there was a sharp rise in farm income, mainly from higher prices for livestock. Also helping to raise personal income, in early autumn, was the rise in social security payments as liberalized benefit payments retroactive to the beginning of the year were made under the old-age and survivors insurance program.

While total personal income increased more rapidly in 1965 than in 1964, disposable income—the portion left after taxes—increased less. In 1964 there had been sharp reductions in Federal withholding rates on personal income; in 1965, when the second stage of that tax cut became effective, payments to cover amounts underwithheld in 1964 exerted a braking effect on the further rise in disposable income. The increase in disposable income over the 2-year period amounted to 15 per cent.

Consumer spending increased by 7.5 per cent in 1965, even more than in 1964. After allowance for the greater rise in con-

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sumer prices in 1965, the increase in purchases—5.9 per cent—was larger than in any other year of this expansion and close to the largest of the postwar period. With total consumption up sharply and the population growing at a slower rate—1.2 per cent in 1965 as compared with nearly 1.7 per cent in 1960—per capita real takings of consumer goods and services rose a sixth in the 5-year period 1961-65.

All major types of consumer purchases contributed to the 1965 advance. Auto sales set another record; the total for the year was 9.3 million units, including nearly 600,000 that were imported. In terms of current dollars, purchases of nondurable goods rose by 6.5 per cent, even more than the exceptional rise of 1964. Expenditures for services also rose at an accelerated rate. Altogether, consumer spending rose faster than disposable income, and personal saving declined to 5.4 per cent of disposable income. In 1964 the saving rate had been 6.0 per cent; in that year spending at first lagged the large tax reduction and later was held down by a temporary shortage of autos. Since 1960 the personal saving rate has ranged between 4.9 and 6.0 per cent of disposable income.

In contrast to vigorous expansion in most areas, residential construction activity changed little during most of 1965, but at the year-end it rose sharply. Private residential starts (including those on farms) totaled 1.5 million for the year, down somewhat further from the recent annual high of 1.6 million reached in 1963. The dollar value of residential construction put in place in 1965 was slightly larger than in the preceding year, but in terms of constant dollars, expenditures were a little lower.

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Period	*Action*
January	Reduced System holdings of U.S. Government securities by about $500 million. Member bank borrowings averaged $300 million.
February	Introduced a program, at the request of the President and in cooperation with the Treasury, under which financial institutions were asked to limit voluntarily their expansion of foreign loans and investments.
February-March	Limited the increase in System holdings of U.S. Government securities to about $1.0 billion, nearly one-fifth of which were securities maturing in over 1 year. Member bank borrowings rose to an average of nearly $500 million in late March.
April-November	Limited the increase in System holdings of U.S. Government securities to about $2.4 billion, nearly one-third of which were securities maturing in over 1 year. Member bank borrowings averaged $500 million.
Early December	(1) Raised the discount rate from 4 to 4½ per cent and (2) raised maximum interest rates payable by member banks on time deposits (other than savings deposits) from 4 to 5½ per cent for maturities of 30-89 days and from 4½ to 5½ per cent for longer maturities.
December	Increased System holdings of U.S. Government securities by about $1.1 billion, one-fifth of which represented securities acquired under repurchase agreements. Member bank borrowings averaged about $450 million.

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Purpose

To absorb seasonal reflow of bank reserves while maintaining about the same firmness in the money market as had prevailed in earlier weeks.

To reduce the outflow of private capital and thus improve the U.S. balance of payments and strengthen the international position of the dollar.

To move toward firmer conditions in the money market, while offsetting a $600 million gold outflow, and to encourage more moderate growth in the reserve base, bank credit, and the money supply—in an effort to reinforce the voluntary foreign credit restraint program and avoid the emergence of inflationary pressures.

To offset a drain on bank reserves from market factors—as outflows of $2.5 billion in currency and $700 million in gold were only partly offset by reserves supplied from other technical factors—while attempting to maintain firm conditions in the money market in a period of rising credit demands and shifting expectations and at the same time accommodating no more than moderate growth in bank reserves, bank credit, and money.

(1) To moderate additional bank reliance on short-term borrowings from the Federal Reserve to meet intensifying loan demand and (2) to enable banks to attract and retain time deposits of businesses and individuals and thus to assure an adequate flow of funds.

To moderate adjustments in money and credit markets following the December discount rate increase and to offset part of the seasonal drain on bank reserves.

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MONETARY POLICY

During 1965, as in earlier years, the Federal Reserve sought to influence credit and monetary conditions in such a way as to foster expansion in the domestic economy at a relatively stable average level of prices and to encourage improvement in the U.S. balance of payments. In the early months of the year the deficit in the balance of payments continued to be large, bank credit expansion was especially rapid, and the voluntary foreign credit restraint program (VFCR) was initiated. Under these circumstances, System open market policy exerted further pressure on the net reserve position of banks, and as a result member bank borrowings rose to levels above their excess reserves.

Toward the end of the year, against the background of a continuing though substantially lessened balance of payments deficit, the expansionary effect on the domestic economy of the military build-up in Viet Nam was intensifying; business spending for fixed investment was moving upward at a pace exceeding earlier expectations; there was a continued rapid growth in demands generally; and market rates of interest were rising further relative to the rates that banks could pay to obtain funds and to the rates they were charging for loans. With unused resources moving nearer to critically low levels and with interest rate relationships threatening a constriction in the flow of funds in credit markets, the Federal Reserve raised the discount rate by one-half of a percentage point to 4½ per cent, effective December 6, and at the same time the Board of Governors raised interest rate ceilings on time deposits under Regulation Q to 5½ per cent. The Federal Deposit Insurance Corporation also approved a similar increase in the interest rate ceilings on time deposits at nonmember insured banks, effective on December 6.

OPEN MARKET AND DISCOUNT POLICY

The rapid expansion of bank credit that occurred in the early months of 1965 was partly in response to exceptionally large

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demands by domestic businesses—primarily for funds with which to finance inventory accumulation—and by foreign borrowers. But it also reflected banks' ability and willingness to attract a large volume of time and savings deposits. Maximum interest rates payable on such deposits had been raised in November 1964, at the same time that the Federal Reserve discount rate had been increased to 4 per cent.

In late 1964 and early 1965, increased foreign lending by banks was an important factor in the U.S. balance of payments deficit. As part of the balance of payments program to reduce this deficit, announced by the President in February and described later in this REPORT, banks and other financial institutions were requested to restrain lending and investment abroad. In March the Board of Governors of the Federal Reserve System issued guidelines for the use of banks and nonbank financial institutions in implementing this program.

With the domestic economy strong, with demands for bank credit very large, and with the need to provide support to the balance of payments program, the Federal Open Market Committee in February and March voted to move toward attaining somewhat firmer conditions in the money market in an effort to moderate the rapid growth of bank reserves and credit. As a result of these actions, member banks found that they had to obtain somewhat more of any additional reserves they needed by borrowing from Federal Reserve Banks.

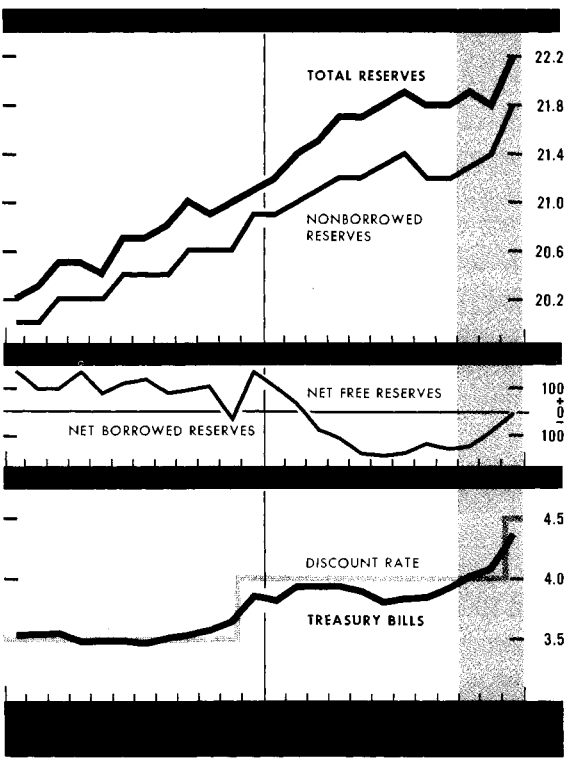
Such borrowings rose to levels above their excess reserves and soon, for the first time in the current expansion, banks found themselves in a sustained net borrowed reserve position, which settled at a level of between $100 million and $200 million. As demand for reserves began to press against the supply, trading in the Federal funds market was most often at, or slightly above, the 4 per cent discount rate. Meanwhile, the 3-month Treasury bill rate moved up closer to the discount rate than it had been.

In the latter part of the spring the 3-month Treasury bill rate fell somewhat as the Government repaid debt on balance and

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as the Federal Reserve, through the System Open Market Account, continued to purchase a sizable amount of bills from the market, partly to offset the reserve-draining effects of gold outflows. But while bill rates were edging lower, rates on U.S. Gov-

AGGREGATE RESERVE EXPANSION accompanied by move to net borrowed reserves and higher discount rate



Monthly averages of daily figures.

ernment long-term securities generally held firm, and yields on corporate and municipal securities began to edge upwards in reflection of the sizable credit demands that were developing in the capital markets.

Growth rates in nonborrowed and in total member bank re-

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serves generally slowed from their winter and early spring pace until late in 1965. The tendency for these aggregate reserve measures to show little net increase in the summer and most of the autumn reflected in part a sharply reduced need for reserves to support U.S. Government deposits, some reduction in loan demand on banks, and also the continued pressure on banks' net reserve positions. After midyear, banks continued to obtain most of their funds through a large growth in time deposits. Expansion in private demand deposits spurted as the U.S. Government drew down its cash balances sharply to finance rising outlays.

Business loan demand on banks lessened from its exceptional first-half level during the July–November period, but it remained strong. Meanwhile, demands in securities markets continued to grow. Not only did the net amount of funds raised through private securities expand, but also the Federal Government raised $6.5 billion in new cash in October and November by selling tax anticipation bills maturing in March and June 1966. These evidences of mounting demands in securities markets buttressed the expectations of higher interest rates that had been developing since July, when the President indicated that our military commitment in the Viet Nam conflict would increase. These expectations, in turn, together with the growth in capital expenditures that was under way, encouraged active borrowing, especially at longer term. Such demands for financing appeared not only in the securities markets but also in demand on banks for term loans.

With credit demands strong, expectations shifting, and growth in bank reserves moderating, interest rates in money and credit markets rose sharply in the summer and autumn. The 3-month Treasury bill rate rose above the discount rate, to a little over 4.10 per cent, and yields on longer-term bills were in a 4.25–4.30 per cent range by early December. With rates at these levels banks found it difficult to compete successfully for funds by offering longer-term time certificates of deposit (CD's),

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given the then-existing 4½ per cent ceiling. At the same time, the rate structure encouraged demands for bank loans, on which rates had not changed significantly despite the considerable rise that had occurred in rates in capital markets. The existing rate structure was thus threatening to constrict the flow of funds through banks, which had very large amounts of CD's maturing in December around the midmonth dividend and tax dates and which were simultaneously facing the prospect of large loan demands.

Under these circumstances, and with evidence of greater than expected actual and prospective domestic spending coming to light, the Federal Reserve took actions that were compatible with the need to resist inflationary pressures at home and to contribute to strengthening of the dollar internationally. Both the discount rate and maximum rates payable on time deposits were raised. Effective December 6, the discount rate at two of the Federal Reserve Banks (the others soon followed) was raised to 4½ per cent, and maximum permissible rates payable on time deposits were raised as shown in the accompanying tabulation.

	Per cent	
	From	To
Time deposits payable in:		
30 to 89 days	4	5½
90 days or more	4½	
Savings deposits	(1)	

[1] The maximum rate remained at 4 per cent.

Following these actions, the prime lending rate—the rate banks charge borrowers with the highest credit rating—rose to 5 per cent from 4½ per cent, where it had been since the summer of 1960; rates on CD's rose; and the 3-month bill rate adjusted upwards and at the year-end was around 4.50 per cent. Long-term interest rates also rose, but by moderate amounts.

Demands at banks for credit, especially for business loans, turned out to be extremely strong in December. Partly as a result of the strengthening in demand for bank loans and partly as a

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result of the efforts of the Federal Open Market Committee, through its open market operations, to avert too sharp an adjustment in credit markets to the new official rate levels, nonborrowed and total reserves of member banks rose substantially over the month while the net reserve position of banks eased to the point where borrowings and excess reserves were about in balance.

Over the year as a whole, including the large bulge in reserves in December, total reserves of member banks increased by 5.0 per cent, about 1 percentage point faster than in 1964. However, nonborrowed reserves supplied to banks as a result of open market operations and of market factors rose by 4.2 per cent, which was slightly less than the year before.

This growth in total reserves supported an expansion of about 10 per cent in bank credit over the year, of almost 5 per cent in the money supply, and of 16 per cent in time and savings deposits—all of these percentages being larger than the year before. Still, interest rates rose as credit demands were large and growing and as open market operations and later the discount rate exerted some restraint through their impact on the availability and cost of reserve funds.

OPERATIONS IN THE GOVERNMENT SECURITIES MARKET

During 1965, as shown in the table on System security transactions on page 158, the Federal Reserve acquired, net, $3.7 billion of U.S. Government securities through open market operations, or slightly more than in 1964. Open market operations of such dimensions were needed to offset the absorption of bank reserves from gold outflows of $1.7 billion and from a continued rise in the public's holdings of currency, while also contributing to growth in aggregate bank reserves.

The bulk of the System's operations were in Treasury bills. Transactions in coupon issues were slightly smaller than in 1964, and net purchases of such issues amounted to only about

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one-fourth of net security acquisitions. Of the coupon issues bought, $500 million had maturities in the 1- to 5-year area, $340 million in the 5- to 10-year area, and $90 million had maturities of more than 10 years.

Purchases of coupon issues in 1965 were largest during the spring, when efforts were made to minimize the downward pressures on Treasury bill rates then tending to emerge. In the summer, as interest rates generally came under pressure from strong credit demands, the Federal Reserve made some further purchases for the Open Market Account of securities maturing in over a year, partly in an effort to temper upward adjustments in market rates.

In the Treasury bill area, the gross volume of outright transactions in the market for the System Open Market Account was slightly less than in 1964—with purchases slightly larger and sales substantially less. Temporary reserve needs were accommodated through increased use of repurchase agreements, the volume of which was about 50 per cent larger in 1965 than in 1964.

A chronological review of Federal Reserve operations in domestic securities for the Federal Open Market Account during the year 1965 appears on pages 157-96.

FOREIGN EXCHANGE OPERATIONS

The Federal Reserve continued in 1965 to engage in foreign exchange operations to help maintain orderly markets for the dollar and for major foreign currencies. As before, these operations were carried out in close cooperation with the U.S. Treasury and with foreign central banks.

Recurrent speculative attacks on the pound sterling continued to be a major source of disturbance in foreign exchange markets during the first 8 months of 1965. A British drawing of $1.4 billion from the International Monetary Fund in May made possible the repayment of short-term assistance previously received from a number of central banks, including the Federal Reserve. But market sentiment about sterling remained skeptical

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through the summer, and the Bank of England made further substantial use of its reciprocal currency (or "swap") arrangements with the Federal Reserve during this period.

Meanwhile the British balance of payments showed some improvement, and in September the Bank of England announced that new arrangements to support the pound had been made with 10 central banks (including the Federal Reserve) and the Bank for International Settlements. After that there was a sustained strengthening in exchange rates for sterling and in British reserves, and the Bank of England was able to make substantial repayments on its swap drawings.

A source of potential disturbance during the year was the persistence of the large surplus in the Italian balance of payments, which had emerged during 1964. The Italian authorities minimized the impact of this surplus on foreign exchange markets and on U.S. reserves by channeling a large part of their dollar accruals through Italian commercial banks into the Eurodollar market. The Federal Reserve helped to facilitate this flow by participating, as the U.S. Treasury had done earlier, in official Italian contracts to purchase forward dollars from Italian commercial banks. Also, it made drawings on its swap facilities with the Bank of Italy in order to reduce the uncovered dollar holdings of that Bank.

The Federal Reserve also operated in Belgian francs, Netherlands guilders, German marks, and Swiss francs, but by the end of the year, outstanding drawings on swap facilities in these currencies had been reduced to very small amounts.

The credit facilities available under the network of swap arrangements between the Federal Reserve and 11 foreign central banks and the BIS were further enlarged during the year, from $2,350 million to $2,800 million. Swap facilities with the Bank of Italy were increased from $250 million to $450 million; with the Bank of Japan, from $150 million to $250 million; and with the Bank for International Settlements, from $150 million to $300 million.

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During 1965, drawings of foreign currencies by the Federal Reserve under reciprocal currency arrangements totaled $605 million, $130 million more than in 1964. By the year-end repayments had reduced outstanding drawings to $135 million. Drawings by foreign central banks, which also involve acquisitions of foreign currencies by the Federal Reserve, totaled $1,765 million during the year, $475 million of which remained outstanding on December 31.

Against the $610 million of foreign exchange commitments arising from swap drawings by the Federal Reserve and by foreign central banks, plus other net forward commitments of $9 million—excluding technical commitments in forward lire—the Federal Reserve held foreign exchange balances of $579 million at the end of 1965. Altogether, therefore, the System had net commitments in foreign exchange arising from its foreign exchange operations of $39 million at the year-end compared with net commitments of $349 million a year earlier.

A detailed review of Federal Reserve operations in foreign currencies during 1965 will be found on pages 197-215.

VOLUNTARY FOREIGN CREDIT RESTRAINT PROGRAM

In February, as a part of the President's program to effect a prompt and substantial reduction in the deficit in the U.S. balance of payments, the Federal Reserve System and the Treasury Department were requested to organize an effort among banks and other financial institutions to reduce their capital outflow from the high levels reached in 1964. In devising an appropriate means for accomplishing this objective, it was necessary to take account of the need to provide the credit essential to finance our exports as well as to ensure that vital national interests, such as economic development in less developed countries, would not be hampered.

In March the Board issued a series of guidelines to commercial banks. These guidelines suggested that the banks restrict the

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increase in their foreign loans and investments in 1965 to 5 per cent of the amount outstanding on December 31, 1964. The banks were requested to give absolute priority to credits needed to finance exports of U.S. goods and services, and in the nonexport category to give highest priority to credits to, and investments in, the less developed countries. It was requested that special consideration be given to Canada and Japan, because of their traditional dependence on the U.S. capital market, and to the United Kingdom, which was having balance of payments difficulties of its own.

At the same time tentative guidelines were issued for financial institutions other than banks. These guidelines were comparable to those for banks, but with allowances for the differences in their methods of operation. It was suggested that liquid funds held abroad, other than working balances, be repatriated and that loans and investments with maturities of 5 years or less be held to 105 per cent of the amount of such loans and investments outstanding on December 31, 1964. No ceiling was established for loans with maturities of more than 5 years, but the priorities suggested to banks were suggested to nonbank financial institutions also.

The guidelines for nonbank financial institutions were revised in June. The principal change was to expand the coverage of the 105 per cent ceiling to loans and investments with maturities up to 10 years and to suggest that substantial restraint be exercised in acquiring long-term assets in developed countries other than Canada, Japan, and the United Kingdom. Also, the 105 per cent ceiling was extended to investment in financial subsidiaries and affiliates abroad, exclusive of retained earnings.

At the end of February, the month in which the program was announced, foreign loans outstanding for the banking system as a whole were just under the suggested target. However, several banks, including some of those with the largest foreign loan portfolios, were considerably over the target as a result of commitments undertaken before the program was announced. At the

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TABLE 1

FOREIGN CREDITS OF U.S. BANKS, 1965

Item	March 31	June 30	Sept. 30	Dec. 31
Number of reporting banks	150	161	160	161
	Millions of dollars			
Total foreign credits subject to 105 per cent ceiling	9,896	9,589	9,503	9,654
Target ceiling (105 per cent of December 1964 base)	9,971	9,981	9,979	9,975
Net expansion of credit since December 1964	398	82	— 2	155
Net leeway for further expansion of credit within target ceiling	75	391	477	320

end of February there were 56 banks with loans in excess of the target ceiling by an aggregate of $265 million.

There was a net inflow of bank credit during both the second and third quarters and in October. A small outflow in November and a larger one in December left the total amount of short-term and long-term bank claims covered by the program about $320 million below the target ceiling—that is, only $155 million above the December 31, 1964 level, as shown in Table 1. The number of banks in excess of the target ceiling had been reduced to 35, and the aggregate excess amount stood at $113 million, as shown in Table 2.

TABLE 2

BANKS WITH FOREIGN CREDITS IN EXCESS OF TARGET CEILING, 1965

Item	Mar. 31	June 30	Sept. 30	Dec. 31
Number of banks	60	56	35	35
Aggregate credit in excess of target (millions of dollars)	274	107	86	113

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Holdings of liquid assets abroad by nonbank financial institutions decreased by $200 million, or 42 per cent, during the first three quarters of 1965. Loans and investments with maturities of 10 years or less, and net financial investments in foreign branches, financial subsidiaries, and affiliates, to which the 105 per cent ceiling applied, rose by 1.4 per cent during the same period. Long-term assets increased by $720 million, or 7 per cent; but more than 90 per cent of the increase was in holdings of Canadian assets, mainly securities issued by Canadian governmental and business borrowers. Long-term assets in developed countries other than Canada and Japan actually declined by 8 per cent during the first three quarters of 1965, while long-term assets in Japan and the less developed countries rose by 14 per cent, as is shown in Table 3.

The success of these voluntary programs for financial institutions played a large part in the improvement in the U.S. balance of payments during 1965, as described later in this REPORT. As a result the administration decided to continue the program in 1966, and appropriate revisions in the bank and nonbank guidelines were announced on December 6, 1965.

The bank guidelines for 1966 allow for about the same expansion as that suggested as a maximum for 1965, with the ceiling rising throughout the year at a rate of 1 per cent per calendar quarter (still based on the amount outstanding on December 31, 1964). Priorities established in the 1965 guidelines have been continued. Banks with small (or no) foreign assets on December 31, 1964, may adopt a special ceiling in consultation with the System. This provision was added in an effort to correct an inequity inherent in the 1965 guidelines and to make doubly sure that adequate credit is available for priority requirements.

Guidelines for nonbank financial institutions were revised at the same time, again with a view to keeping them as consistent as possible with the bank guidelines. With respect to long-term credits—those beyond 10 years—these institutions were requested to limit in 1966 the total of credits and investments in

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developed countries other than Canada and Japan to an amount not in excess of 105 per cent of the amount of such holdings on September 30, 1965. Further, it was suggested that institutions avoid any net increase in long-term investments in the developed countries of continental Western Europe.

TABLE 3

FOREIGN ASSETS OF REPORTING NONBANK FINANCIAL INSTITUTIONS

(Amounts shown in millions of dollars)

Guideline, and area	Amount Sept. 30, 1965	Change from Dec. 31, 1964 Amount	Per cent
All countries			
Guideline 1 (Liquid investments)	271	−199	−42.4
Guideline 2 (Credits with maturities of 10 years or less and net investment in financial subsidiaries)	1,203	16	1.4
Guideline 3 (Credits with maturities of more than 10 years and equity securities)	11,064	722	7.0
Total	12,538	540	4.5
Canada			
Guideline 1	230	−186	−44.8
Guideline 2	711	− 13	− 1.8
Guideline 3	7,853	672	9.4
Total	8,793	472	5.7
Other developed countries [1]			
Guideline 1	19	− 4	−16.0
Guideline 2	189	14	8.3
Guideline 3	1,634	−145	− 8.2
Total	1,842	−134	− 6.8
All other countries [2]			
Guideline 1	23	− 9	−28.9
Guideline 2	303	15	5.2
Guideline 3	1,577	196	14.2
Total	1,902	202	11.9

[1] Excluding Japan.
[2] Japan, less developed countries, and international institutions.

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FINANCING ECONOMIC ACTIVITY

Nonfinancial businesses, consumers, foreigners, and all levels of government raised $72 billion in credit and equity markets in 1965. This total was more than 7 per cent higher than the one for 1964, and the rate of growth was about the same as that in GNP. In 1965 borrowing was especially heavy by consumers and businesses, and these two sectors financed a larger portion of their investment expenditures in credit and equity markets than in 1964. In the final quarter of 1965, after some pause in the third quarter, total credit expansion rose to a new record as both businesses and the Federal Government borrowed heavily. As a result, increases in interest rates became more rapid.

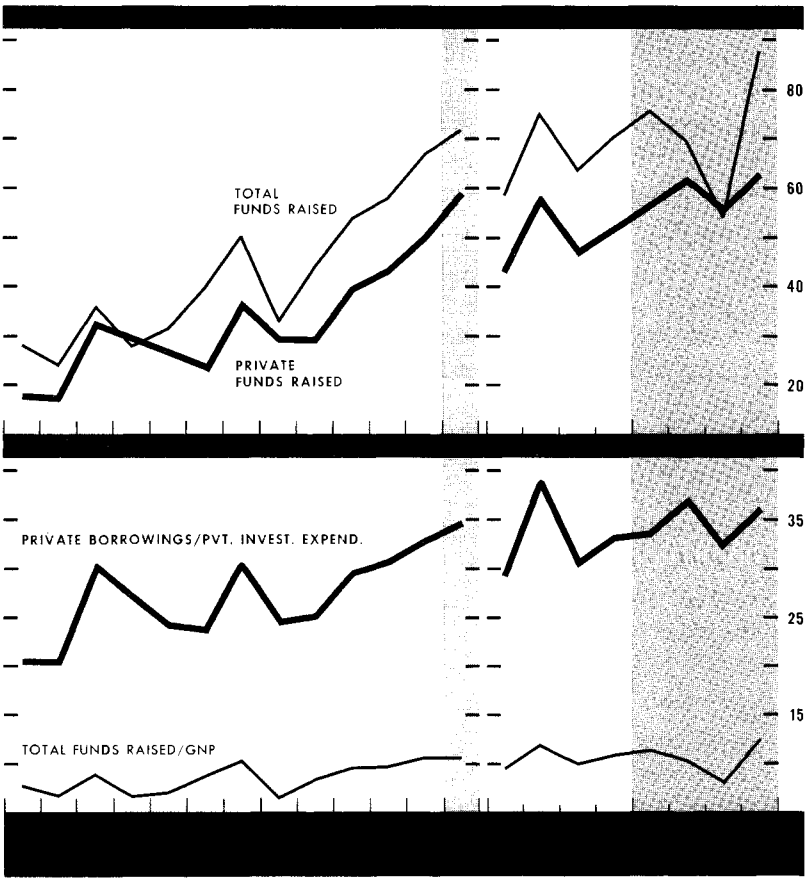
BORROWERS AND LENDERS

During 1965 there were significant shifts in the pattern of credit demands. Consumers expanded their demands for instalment credit to finance purchases of automobiles and other durable goods while reducing their net residential mortgage financing below the total for 1964. Business demands for bank credit swelled in the first half of the year, as a result of labor negotiations and disruptions in operations caused by strikes, and rising levels of capital expenditures increased business demands for funds in capital markets. The Federal Government, after retiring debt at more than the usual rate through the first three quarters, increased its borrowing in financial markets sharply in the closing months of the year. On the other hand, foreign borrowing, after rising at a rapid rate in late 1964 and early 1965, declined later, largely as the result of the introduction of the VFCR program, but also because of the tightening in U.S. financial markets as the year progressed.

Shifting patterns of credit demands were paralleled by shifting patterns of sources of credit. Consumers continued to provide funds to financial markets in 1965, but with an increased emphasis on commercial bank deposits. The Federal Government

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CREDIT EXPANSION accelerates; Govt. financing large in last quarter; businesses and consumers borrow relatively more than other sectors



Flow of funds data; quarterly totals at seasonally adjusted annual rates. Total funds raised consist of borrowings of domestic nonfinancial businesses, households, governments, and foreigners. Private funds raised are for the first two groups; their investment expenditures consist of consumer and business expenditures for durable assets and business outlays for inventory. Borrowings of the consumer sector in credit markets exclude security credit, and purchases of durable assets consist of houses, consumer durable goods, and plant and equipment expenditures of nonprofit organizations. Business borrowings include those of farm businesses and exclude trade debt and miscellaneous liabilities; their expenditures are for fixed investment and inventories.

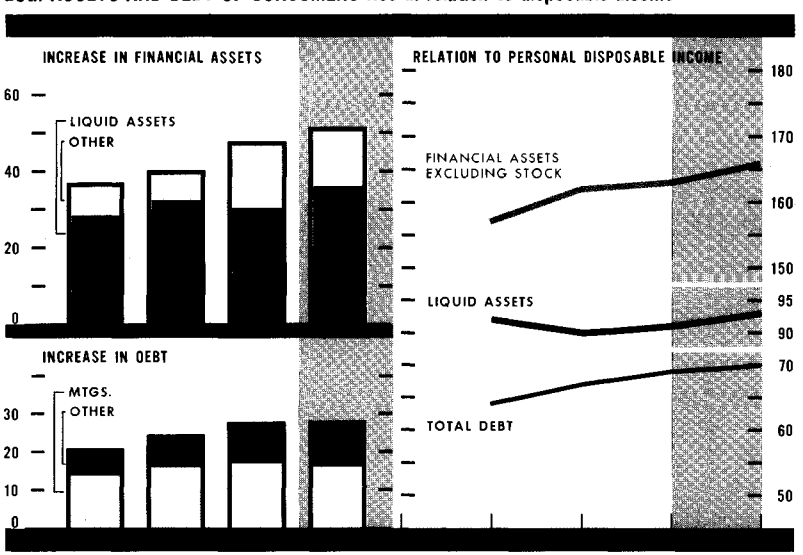
and foreigners, however, reduced their contributions to the supply of loanable funds. Businesses provided somewhat less funds to other domestic sectors than in 1964. In the final months of the year, however, as the pace of economic activity increased,

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businesses stabilized their money holdings; and as yield structures changed, they reduced their acquisitions of time deposits while adding to their Government security holdings.

Consumers. Despite the pick-up in the pace of economic expansion in 1965, disposable income of consumers increased a bit less than in 1964, when a reduction in Federal income tax rates had expanded disposable incomes sharply, as indicated earlier in this REPORT. Nevertheless, consumers added to their financial assets at record rates in 1965, and as in earlier years of the expansion, the proportion of their income channeled into financial assets increased.

Both ASSETS AND DEBT OF CONSUMERS rise in relation to disposable income



Flow of funds data. Increases in liquid and total financial assets are net of security credit. Other financial assets include pension and insurance reserves. Liquid assets are money, savings accounts, U.S. savings bonds, and short-term marketable U.S. Govt. securities.

As in the past, the largest share of the financial assets that consumers acquired in 1965 represented liquid claims on financial institutions. Of their net acquisitions, the proportion held in the form of claims on banks rose relative to claims on other

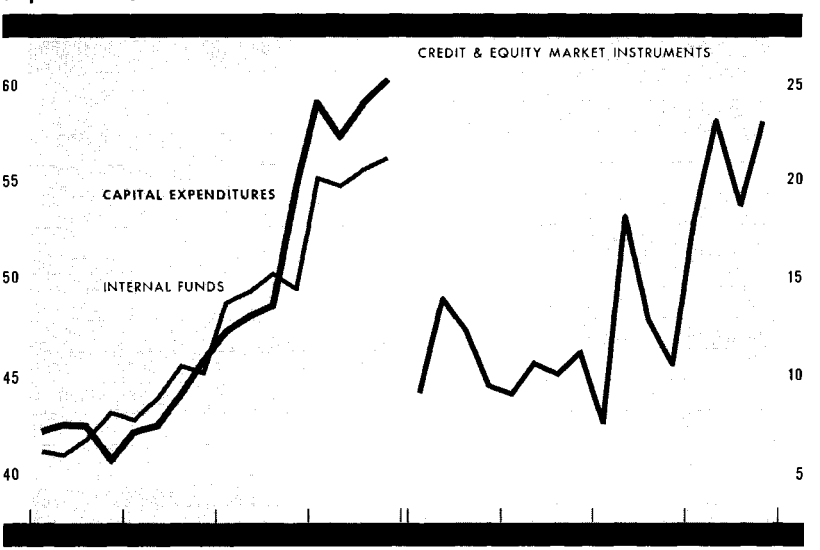
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financial institutions. Meanwhile, their purchases in the market were about as large as in 1964.

Consumers added about as much to their debt too as they had in 1964; their debt-to-income ratio continued to rise, but less sharply than in 1964. While net mortgage borrowing showed some slight decline in 1965, the net increase in such debt continued to account for the larger share of the increase in consumer borrowing. The downward tendency in mortgage borrowing was due in part to the fact that private nonfarm single-family housing starts were no higher than in 1964.

Most other forms of consumer debt rose in 1965. The rise in instalment debt was strong largely because of an upsurge in demand for credit associated with the large volume of automobile sales. While the increase in automobile debt resulted for the most part from the record number of unit sales, it also reflected increases in the proportion of new cars sold on credit, in the

As CAPITAL EXPENDITURES exceed internal funds by wide margins in '65, corporations borrow more and. . . .



Flow of funds data are quarterly totals at seasonally adjusted annual rates. Internal funds are retained earnings plus depreciation and inventory valuation adjustment. Capital expenditures consist of fixed investments and changes in inventories. Credit and equity market instruments consist of bonds, stocks, mortgages, and bank and other loans.

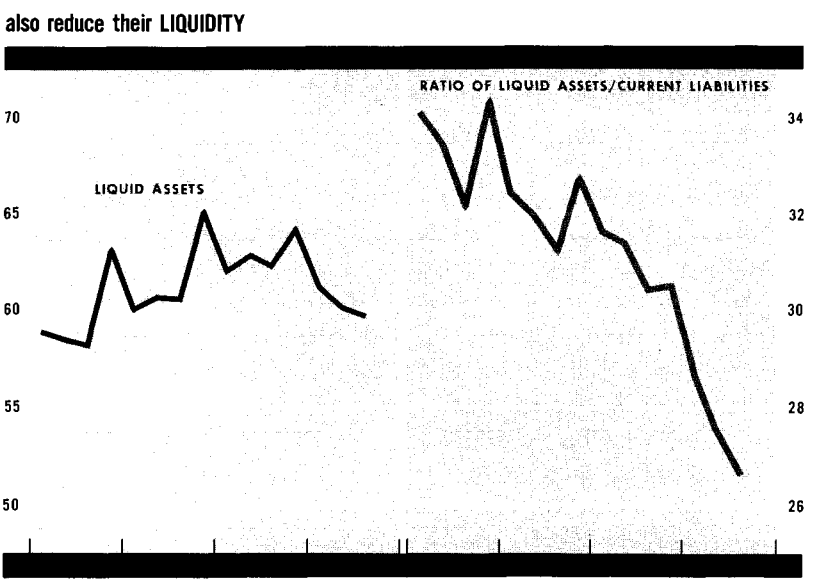
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average size of instalment contracts, and in the average length of contracts.

Increased demand for other consumer durable goods—mainly household appliances, television sets, and furniture—also contributed to the expansion in instalment credit during 1965, as did a rising volume of personal loans made to provide funds for vacations, education, and other purposes. Noninstalment credit, on the other hand, continued to account for a declining proportion of total consumer credit outstanding.

Nonfinancial business. Internal funds generated by all nonfinancial corporate business rose by over 12 per cent in 1965 to about $55 billion. Their outlays for fixed investment and inventories, however, rose even more rapidly than their internal funds. As a result, businesses reduced their liquidity and relied more on external financing during the year.

In addition to making large outlays for physical assets here,



Securities and Exchange Commission data for all U.S. corporations except banks, insurance companies, and savings and loan associations. Data are for end of quarter and are not adjusted for seasonal variation. Liquid assets comprise cash, deposits, and U.S. Govt. securities. Liquidity is measured by the ratio of these assets to total liabilities.

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businesses stepped up their outflows for direct investment abroad in late 1964 and early 1965. Capital outflows were lower after midyear, largely as the result of the President's balance of payments program, but for 1965 as a whole the net outflow was considerably more than in the preceding year.

Nonfinancial businesses provided a moderate volume of funds to other sectors of the domestic economy during the year; most of this flow was in the fourth quarter. Corporations added sharply to their holdings of CD's in the first half of 1965—while reducing their holdings of Treasury securities—and moderately expanded their holdings of private short-term securities and consumer credit. But through the third quarter, these increases were largely offset by reductions in their money holdings. In the fourth quarter their liquid assets probably increased somewhat, after allowances for normal seasonal movement, as firms ceased to reduce their money stocks as they had done in the first three quarters of the year.

With their liquidity reduced and with their expenditures rising, corporate nonfinancial businesses raised more than $20 billion in credit and equity markets during 1965. The increase for the year was $7.0 billion, or more than 50 per cent, larger than that in 1964.

In the first half—especially in the first quarter—strikes and labor negotiations resulted in rapid accumulation of business inventories and a consequent rapid increase in demand for bank loans. Strong demands stemmed from food processors and commodity dealers, who could not ship their products during the dock strike, and from major metals-using groups. But most other major industries also increased their loans from banks during the first half of the year.

Demands by nonfinancial businesses for bank loans moderated in the summer as corporations stepped up their borrowing in capital markets. In the fourth quarter businesses again increased their demands on banks quite sharply. It should be noted that throughout the year companies financed some of their capital expenditures by borrowing at commercial banks, as indicated by

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the large proportion of term loans that these banks made during the year.

In the securities markets, nonfinancial corporations increased their issues—net of retirements—by about 15 per cent to more than $6 billion. Practically all of the financing was in the form of bonds and notes, whereas in 1964 stock issues—primarily two large flotations by communications companies—had accounted for about one-fourth of the increase in outstanding corporate securities. Issues by manufacturing corporations were particularly large in 1965 and for the year as a whole were nearly double the reduced volume sold in 1964.

Federal Government. The accelerating pace of the economic advance in 1965 was reflected in record Federal tax receipts. Even though its expenditures rose moderately in the first half, the Government was able both to repay more debt than it had in the previous year and to increase sharply its operating cash balance. In the second half of the year, however, a sharp jump in Federal expenditures—as defense outlays rose and as the new social security programs went into effect—together with a tempering of receipts from the first phase of the reduction in excise taxes, increased cash financing needs more than seasonally.

The larger cash deficit after midyear was financed in the third quarter by reducing cash operating balances, which had reached $11.5 billion at midyear, and in the fourth quarter by issuing $6.5 billion of tax-anticipation bills.

With expenditures expanding moderately but with tax inflows increasing, the Federal Government found it necessary to borrow only about half as much as in calendar 1964. In financing the deficit, the Government increased its marketable debt by $2.2 billion over the year. However, the impact of these issues on credit markets was more than offset by net acquisitions of marketable issues by the Federal Reserve and by Treasury agencies and trust funds. These purchases for official accounts totaled about $5.0 billion, and consequently marketable debt issues held by the public declined by $2.8 billion over the year as a whole. All of the decline in public holdings was at commercial

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TABLE 4
U.S. TREASURY FINANCE
(In billions of dollars)

Item	1965 I	1965 II	1965 III	1965 IV	1965 Year	1964 I	1964 II	1964 III	1964 IV	1964 Year
Cash receipts	30.7	37.7	29.2	25.8	123.4	30.3	33.4	27.0	24.3	115.0
Cash payments	28.3	32.6	33.1	34.0	127.9	28.7	30.1	30.9	30.6	120.3
Cash surplus (+) or deficit (−)	2.4	5.1	− 3.9	− 8.1	− 4.5	1.6	3.3	− 3.9	− 6.3	− 5.2
Less: Change in cash balance	2.0	3.1	− 4.3	− 2.3	− 1.4	1.5	2.4	− .7	− 2.7	.6
Equals: Net cash borrowing (+) or repayment (−)	− .5	− 2.0	− .4	5.7	2.9	− .2	− .8	3.2	3.6	5.8
Made up of:										
Direct marketable debt	.1	− 3.8	− .3	6.2	2.2	.7	− 1.7	2.5	3.5	4.9
Agency debt	*	1.1	.4	.2	1.8	− .5	.7	.2	.1	.5
Other items [1]	− .6	.7	− .5	.7	− 1.1	− .4	.2	.5	*	.4

* Less than $50 million.

[1] Represents primarily the net change in certain types of nonmarketable debt (mainly foreign series securities, savings bonds, and Investment Series B bonds), and the net investment by Government agencies and trust funds in marketable U.S. Govt. securities.

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banks; the nonbank public added slightly to its holdings of marketable Government securities during the year.

The Treasury achieved some extension of debt maturities early in the year mainly through an advance refunding in January in which the public exchanged $9 billion of shorter-term securities for issues maturing in from 5 to 27 years. In regular refundings during the year the Treasury confined itself mostly to offerings of 15- to 21-month notes, but it sold to the public almost $2 billion of 9-year bonds in May. In the second half of the year an unfavorable market and the existence of the statutory 4¼ per cent interest rate ceiling on Treasury bonds limited the ability of the Treasury to issue longer-term debt. As a result there was some shortening of the average maturity of marketable securities held by the public. At the end of 1965 the average maturity of publicly held marketable debt was 5 years 4 months, about the same as a year earlier. This was the first year in the last four that the average maturity did not increase.

The effects of Federal Government debt operations on financial markets were not limited to the issuance of direct U.S. Government and Federal agency debt. In addition, Government agencies sold assets to private investors both directly, through sales of mortgages by the Federal National Mortgage Association in the secondary market and sales of loans by the Veterans Administration, and indirectly, through the sale of Export-Import Bank and FNMA certificates of participation (in pools of loans and mortgages). Offsetting this absorption of private funds was the continued extension by the Government of new direct loans. Also, a considerable rise in the amount of private loans insured or guaranteed by the Government continued to influence the terms under which much private financing was done.

State and local governments. State and local governments continued to issue large amounts of long-term securities in 1965 to finance a wide variety of public facilities. Sales during the year totaled $11 billion, an increase of about 3 per cent over 1964. The increase in State and local government debt outstanding in

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1965 was $7.5 billion, nearly 20 per cent larger than the increase in 1964. The difference in growth rates between gross sales and the net increase in outstandings reflected an unusually large increase in sales of securities in the final quarter of 1964 that were not delivered until early 1965. Issues for refunding were up slightly from 1964, but rising interest rates kept the volume substantially below the record level of 1963.

Rest of the world. Foreign borrowing at U.S. banks accelerated in late 1964 and early 1965 as expectations arose that the interest equalization tax (IET) would be extended to bank loans. At the same time outflows of direct investment funds were growing rapidly. In February the President extended the IET to bank loans maturing in a year or more and requested, as noted earlier, that programs be undertaken for voluntary restraint of foreign lending by financial institutions, for repatriation of liquid funds held abroad, and for slowing the flow of direct investment. The first two of these programs had immediate, favorable effects. The net outflow of U.S. private capital in all forms in 1965 was $3.5 billion, in contrast to $6.5 billion in 1964 and $4.5 billion in 1963.

Even with this reduction in capital outflow, the rest of the world obtained a much larger volume of investment and credit funds from U.S. sources than was supplied to U.S. financial markets from abroad. In fact, the net supply through short-term investment of foreign official reserve funds and investment of foreign private capital in all forms was negligible in 1965. One reason for this was the conversion of a substantial amount of foreign official claims on the United States into gold.

FINANCIAL INTERMEDIATION

Most of the funds supplied to credit and equity markets in 1965 continued to be channeled through financial intermediaries. And as in previous years of the current expansion, commercial banks —by offering more competitive yields on their time and savings deposits and by aggressively using newer types of time deposits

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—continued to attract a larger share of funds relative to the volume supplied to other financial institutions and directly to borrowers by the public.

Nonbank financial institutions. In 1965 nonbank financial institutions added almost $36.5 billion to their holdings of financial assets, slightly less than in 1963 and 1964. Even though their acquisitions of assets were down only slightly, the share of these institutions in total credit expansion declined sharply, and they accounted for only slightly more than half of the funds supplied to the nonfinancial sector of the economy. As recently as 1963 they had accounted for 62 per cent. All of the decline in their share occurred in the nonbank depository group, which continued to face increasing competition from the higher interest rates paid by commercial banks and from higher yields on open market securities. At insurance companies and pension funds, on the other hand, the total inflow of funds continued to rise, as did their investments. At finance companies consumer demands for credit increased during the year, and these companies raised a record amount of funds from sales of securities and commercial paper, as well as by borrowing from banks.

In addition to yield relationships and commercial bank competition, two other factors—lack of growth in demand for mortgage credit and the rulings of the Federal Home Loan Bank Board restricting rate increases on savings and loan associations' share capital—limited expansion of nonbank depository institutions. The net increase in share capital of savings and loan associations, after expanding by $11 billion in 1963, rose by less than that amount in 1964 and by less than $8 billion, or about 8 per cent, in 1965. In view of the decreased inflow in 1965, these institutions again increased their borrowing—by $0.7 billion—from the Federal home loan banks to supplement their lending resources, and at the year-end their total loans outstanding from this source were at a new high of $6.0 billion. In the closing weeks of 1965, with market rates rising and the Federal Reserve permitting member banks to pay more on time deposits, the Fed-

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eral Home Loan Bank Board relaxed its rulings somewhat and permitted increases in rates on shares; some associations raised such rates effective at the beginning of 1966.

Mutual savings banks fared considerably better than savings and loan associations in the competition for funds in 1965. These institutions experienced a record savings inflow of $4.2 billion in 1964, after they had raised the rates on such deposits, and in 1965 the expansion in their deposits was $3.1 billion or 7.6 per cent; this was the second largest dollar inflow in the postwar period. In reaction to the December increase in the maximum permissible rates that commercial banks could pay on time deposits, several large mutual savings banks increased their deposit rates, effective at the beginning of 1966, in an effort to maintain their competitive position.

The reduced inflows to nonbank depository institutions and the changes in credit demands and yield structures were reflected in the contribution of financial institutions to the various financial markets. Savings and loan associations continued to reduce their net acquisitions of home mortgages, while insurance companies and pension funds increased their share of such mortgages. Commercial banks, though faced by increasing demands for other types of loans, also continued to increase their share of financing in both the home and other mortgage markets. In the third quarter the FNMA began to provide support to the mortgage market. As offerings from private investors accelerated, the FNMA expanded its purchases sharply and its holdings registered a net increase for the first time in more than 3 years.

Even though the shares of the mortgage market accounted for by the major lenders shifted on balance over 1965—and the inflow of funds to the specialized mortgage lenders declined —the total mortgage flow was well maintained in face of the relatively low housing demand.

In 1965, as in previous years, insurance companies were the dominant buyers of bonds, and pension funds bought the most

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stocks, but pension funds also increased their purchases of bonds. Greater yield advantages elsewhere led these types of institutional investors to liquidate holdings of State and local government bonds; as a result commercial banks continued their recent dominance of this market.

Finance companies—even with the large absolute increase in their loans outstanding—did not hold their own in consumer credit markets during 1965. Both bank and nonbank depository institutions—mainly credit unions—increased their share of the market during the year. Sales finance companies in particular have undergone a substantial decline in the share of total automobile credit granted, but they have been increasing their share of personal loans outstanding.

Commercial banks. During 1965 commercial banks provided about $27 billion, or 38 per cent, of the funds supplied to borrowers in credit and equity markets. The banks' share was the largest of any expansion year in the postwar period and was more than twice as large as the annual average during the periods of economic expansion in the 1950's. As in earlier years of this decade, the higher proportion of credit expansion accounted for by banks reflected the greater public demand for bank time and savings deposits. The greater expansion of such deposits in turn reflected both higher rates permitted and offered on such deposits; the issuance of attractive new instruments; and the continued provision of substantial amounts of reserves by the Federal Reserve.

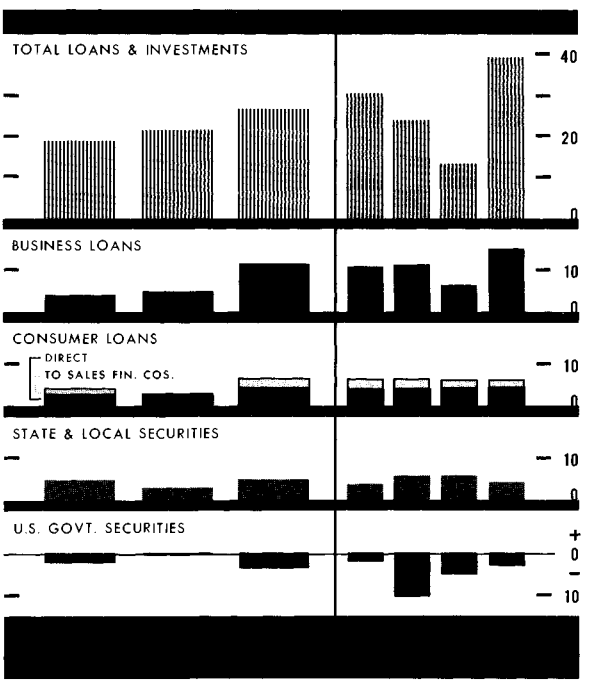
While bank loans and investments increased by a postwar record of 10 per cent in 1965, the rate of expansion was uneven because of shifting patterns in loan demand and in Treasury financing. Demand for credit by domestic businesses was strong all year, but was particularly strong in the first half when strikes and labor negotiations affected their need for external financing. Foreign demands were also heavy early in 1965, but the volume of credit extended to foreigners was sharply reduced after the VFCR program was announced and the IET was

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extended in mid-February to bank loans with maturities in excess of 1 year. Demands by domestic businesses for bank loans moderated for a time during the summer as a result of the end of special factors related to the threatened steel strike and with the shifting of some demand to the capital markets. In the final month of 1965, however, business loans of banks increased sharply as the pace of economic expansion accelerated.

Treasury financing also influenced the pattern of bank credit growth in 1965. After building up its cash balances at banks to much larger than seasonal levels in the first half of the year, the Treasury financed its seasonal deficit in the third quarter by

More rapid BANK CREDIT EXPANSION in '65 concentrated in business and consumer loans



Flow of funds data. Quarterly totals are at seasonally adjusted annual rates, U.S. Govt. securities include nonguaranteed debt of the U.S. Govt. Business loans are to domestic nonfinancial corporate and noncorporate business and include commercial paper and domestic acceptances. Consumer loans include indirect lending in the form of loans to, and purchases of commercial paper issued by, finance companies.

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sharply reducing its balances. While part of this decline in the Treasury cash balance at banks was offset by accelerated growth in private deposits, growth in total deposits slowed in the third quarter, and this retarded the expansion of funds available to banks for lending and investing.

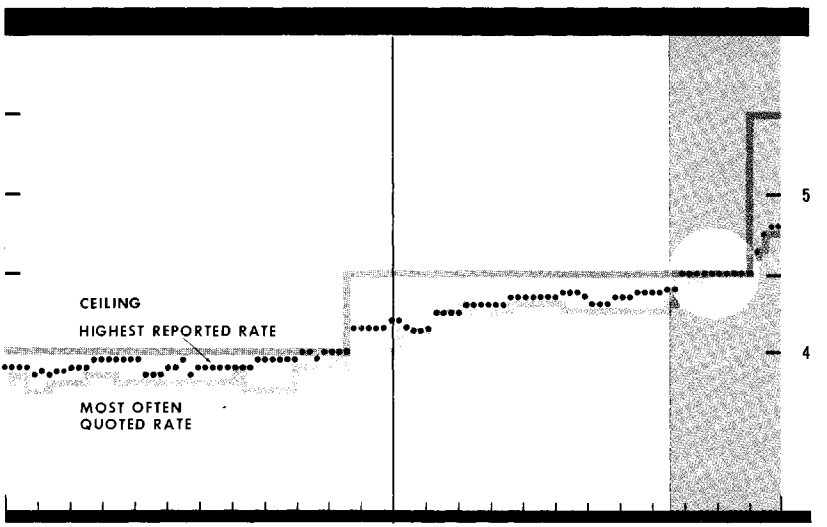
Despite all the demands on them from other sources in 1965, banks provided much more credit to consumers than in 1964—not only directly but also indirectly through loans to and purchases of open market paper issued by finance companies. As in other recent years, commercial banks were the biggest single source of consumer instalment credit in 1965. They accounted directly for one-half of the $8.1 billion increase in consumer instalment credit during the year. And when loans to finance companies are included, they accounted for around three-fourths of the increase.

Even with accelerated loan expansion, banks continued to add to their holdings of municipal securities and mortgages throughout most of 1965. In the final months of the year, however, three factors—the cumulative expansion in business loans, the erosion of liquidity, and purchases of new U.S. Government issues—caused banks to reduce their acquisitions of State and local government securities. Some banks did not replace maturing obligations, and other banks liquidated some of their holdings.

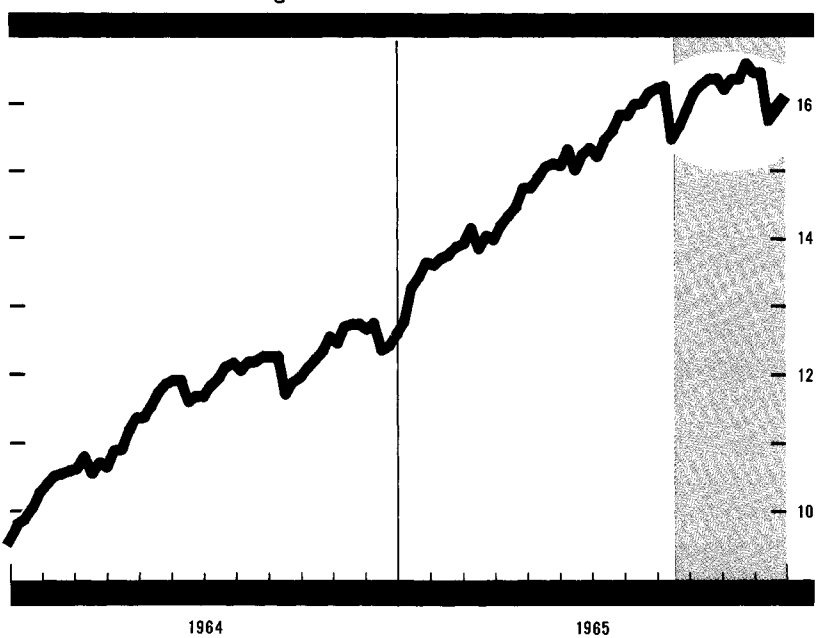
In order to increase both their loans and investments in 1965, banks reduced their liquidity further. While total reserves expanded faster than in 1964, the Federal Reserve supplied less of the increase through open market operations, thus impelling member banks to increase their borrowing at Federal Reserve Banks in order to meet credit demands placed upon them. In addition, the over-all ratio of loans to deposits at commercial banks climbed to a postwar high in the second half of the year, after increasing very sharply in the first half. Moreover, until the Treasury issued $6.5 billion of tax-anticipation bills in the fourth quarter—payable by banks with full tax-and-loan-account credit—banks were steadily reducing their holdings of Govern-

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As INTEREST RATES ON CD's approach Regulation Q ceiling



GROWTH in CD's outstanding moderates



Wednesday figures. Rates are for 90- to 179-day issues of major New York City banks. Outstandings are for CD's of $100,000 or more reported by weekly reporting member banks.

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ment securities. For the year as a whole, their holdings of such securities declined by more than $3 billion.

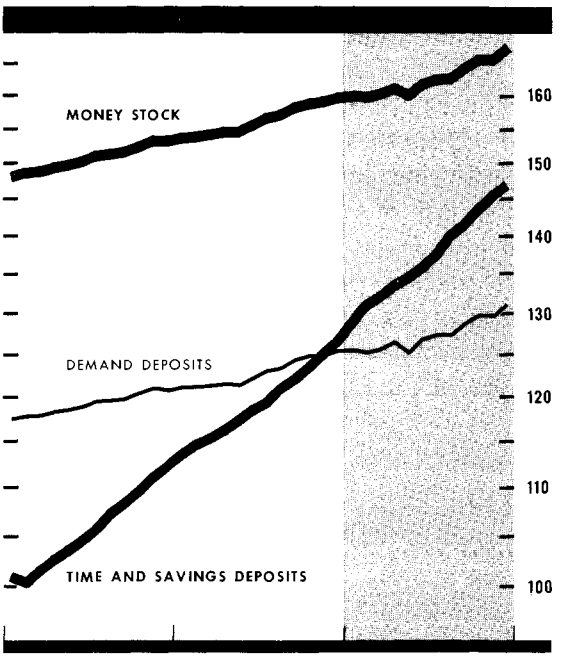
Bank liquidity was brought under further pressure in the autumn as Regulation Q ceilings, higher market rates of interest, and strained corporate liquidity associated with increased capital expenditures limited the ability of banks to issue CD's. In this period weekly reporting member banks increased their issues of CD's of $100,000 or more only slightly, and they suffered larger run-offs of these deposits around the tax and dividend dates in December than in the comparable period of 1964. Even though they had considerable leeway to raise interest rates after the new Regulation Q ceilings became effective in early December, banks found it more difficult—as well as more expensive—to tap short-term money markets with CD's. With liquidity reduced and with both the cost of deposits and the volume of loan demand higher, most commercial banks raised the prime loan rate following the December changes in the discount rate and in the Regulation Q ceiling.

Despite the slower rate of expansion of CD's in the autumn of 1965, growth in total time and savings deposits accelerated over the year. Data for weekly reporting member banks suggest that passbook savings deposits accounted for a larger share of the expansion in interest-bearing deposits at banks in 1965 than in 1964. Moreover, as the year progressed, a greater proportion of the growth of time and savings deposits occurred at banks outside New York and Chicago. This reflected not only the increasing difficulty of selling CD's but also the increased aggressiveness of banks throughout the country in seeking both time and savings deposits to meet increased loan demand. Underscoring the shift in bank liabilities that has developed in recent years, time and savings deposits have exceeded adjusted private demand deposits since late in 1964. By contrast, at the end of 1960 time and savings deposits were less than two-thirds of demand deposits.

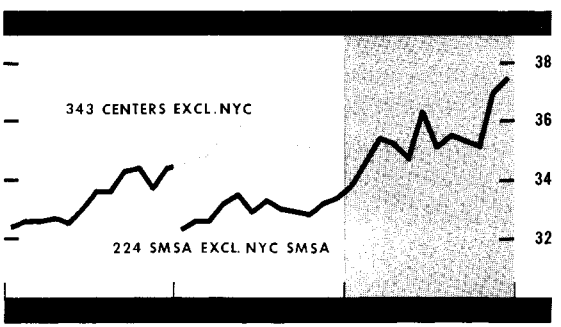
Demand deposit growth also increased as the year progressed, reflecting the higher demand for money concomitant with the

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MONEY STOCK and bank time deposits grow rapidly



TURNOVER of demand deposits accelerates



Seasonally adjusted monthly averages of daily figures. Money stock consists of demand deposits and currency outside the Treasury, the F.R. System, and the vaults of commercial banks. Demand deposit component excludes deposits due to domestic commercial banks and the U.S. Govt., cash items in process of collection, and F.R. float, but includes foreign demand balances at F.R. Banks. Time deposits exclude those due to domestic commercial banks and the U.S. Govt. Debits are to demand deposit accounts, except interbank and U.S. Govt., as reported by banks in (1) 343 reporting centers and (2) 224 Standard Metropolitan Statistical Areas (SMSA's) beginning with January 1964.

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accelerating pace of the economy. The money stock expanded by $7.7 billion, or 4.8 per cent, the largest increase of the current cycle. The higher level of economic activity was also reflected in an average annual rate of turnover of demand deposits at banks outside of New York City that was 7.6 per cent higher than in 1964.

CREDIT MARKETS AND INTEREST RATES

Early in 1965 financial markets were still reflecting forces set in motion by the November 1964 changes in the Federal Reserve discount rate and in Regulation Q. In the municipal bond market in particular, the combination of buying by banks, which were trying to balance attractive after-tax yields against the rising costs of time and savings deposits, and of the usual turn-of-the-year increase in demand for securities depressed yields on State and local government issues. At the same time, yields on corporate bonds edged lower as seasonal demands pressed on a market in which new publicly offered issues had been in small supply for nearly 5 months. With bond markets in a technically strong position in January, the Treasury carried out the largest advance refunding on record.

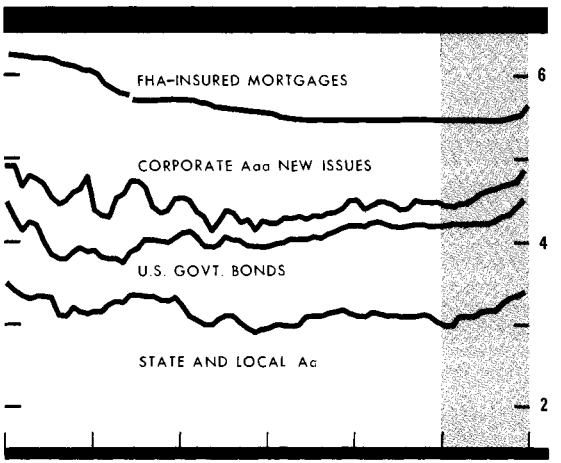
After declining seasonally in January, yields on short-term Government securities rose in February in response to a reduction in reserve availability. But subsequently, as the large Federal cash surplus permitted repayment of short-term debt, as demand for bills by corporations and public funds strengthened, and as the Federal Reserve bought bills in the open market to offset gold outflows, bill rates edged down from their February peak and declined during the remainder of the first half of the year.

Yields on corporate and municipal bonds, on the other hand, began to rise in the late winter and early spring when the volume of new issues expanded sharply. During the second quarter publicly offered corporate bonds—including offerings of nonfinancial firms, banks, and other financial institutions—reached a rec-

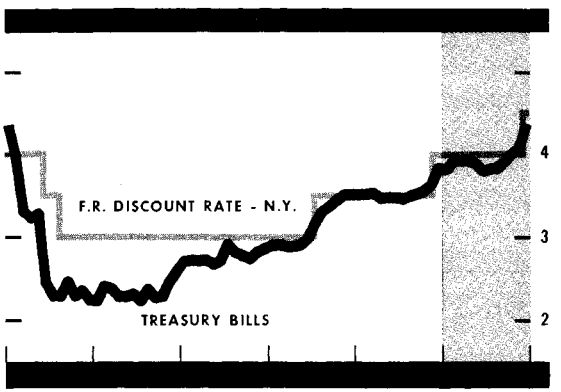
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ord volume. The spring upturn in yields on corporate and municipal bonds was not matched in yields on U.S. Government

RISE IN INTEREST RATES accelerates in last half of '65 for both LONG-TERM



and SHORT-TERM securities



Monthly averages except for FHA (based on quotation for 1 day each month). Yields: FHA-insured mortgages, weighted averages of private secondary market prices of certain new-house mortgages converted to annual yield; State and local govt. Aaa bonds, from Moody's Investors Service; corporate bonds, weighted averages of new publicly offered bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis; U.S. Govt. bonds, market yields at constant maturity; and U.S. Treasury bills, market yields on 3-month issues.

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bonds, however. The continued stability of yields on long-term Government bonds reflected not only the Treasury's large cash surplus and the expectation that no new long-term issues would be forthcoming in the second half of 1965 but also the feeling on the part of market participants that the general level of interest rates was not likely to move much over the remainder of the year.

In July escalation of the war in Viet Nam, coming as it did on top of the unexpectedly favorable performance of the economy, suddenly reversed these midyear expectations as to interest rates. Bond yields rose generally—particularly for U.S. Government securities, which had previously lagged behind other yields.

With corporate and State and local government bond offerings remaining unseasonally large through the summer, bond yields rose further. Moreover, as the dimensions of the economic expansion and the plans for future capital spending by business became evident, estimates of external financing requirements of corporations into 1966 were revised upward, reinforcing the changed expectations for interest rates and producing further upward adjustments in yields. Similarly, with Federal outlays on military items running larger than previously projected, estimates of what the Treasury's cash needs were likely to be in early 1966 were increased.

Yields on short-term Treasury securities turned up at the end of the third quarter in response to tax date pressures and the large and concentrated borrowing by the Treasury in the bill area that was in prospect for the fourth quarter. With rates on short-term marketable securities advancing, rates on CD's at banks began to rise and were soon pressing against the Regulation Q ceiling.

As the spread between rates on CD's and other money market instruments narrowed, questions began to be raised as to whether banks would be able to replace the large volume of CD's maturing in December without an increase in the Regulation Q ceiling. To help relieve this further strain on their liquid-

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ity positions, banks cut back on takings of new municipal securities and in a few cases sold substantial blocks of outstanding municipals in the secondary market. Their actions, which represented a distinct change from earlier months, were quickly reflected in rising market yields.

The mortgage market was another area in which increasing signs of reduced credit availability appeared during the fourth quarter. In the first 8 months of the year interest rates in home mortgage markets had changed little from the levels that had prevailed for the preceding 2½ years. But as the year progressed, increasingly attractive rates on other financial assets began to divert funds from the mortgage market, and after August, rates in this market also turned up.

In view of cumulating pressures from business credit demands and the threatened constriction in the volume of funds flowing through banks, the Federal Reserve raised the discount rate and Regulation Q ceilings in early December, as noted earlier. Interest rate adjustments to these actions were more pervasive than at the time of the previous official rate increases in November 1964. Over the month the prime loan rate charged by banks rose by one-half of a percentage point; short-term market yields, by over 30 basis points; and capital market rates, by almost 10 basis points.

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U.S. BALANCE OF PAYMENTS

Restoration of reasonable equilibrium in U.S. transactions with the rest of the world continued to be an important goal of policy in 1965. The difficulties the United States faced in dealing with this problem were highlighted by the rapid rise in imports, which accompanied brisk growth of domestic demand, and by the exceptionally large volume of funds that corporations sent abroad in 1965 to supply capital to their subsidiaries or to acquire new interests in businesses abroad.

In response to requests by the Government for voluntary restraint and in reaction to growing domestic credit demands, U.S. banks greatly slowed the pace at which they extended new credits to foreign customers, and both business corporations and financial institutions pulled back funds from interest-bearing deposits and other liquid investments abroad. In contrast to an outflow of $3 billion the year before, there was a net reflux in 1965 totaling more than $0.5 billion from banks' and nonbanks' outstanding short-term claims on foreigners and from the longer-term claims of banks.

As a result of this sharp curtailment and reversal of outflows of bank credit and other short-term capital, one measure of the deficit in the balance of payments registered substantial improvement. The net decline in all U.S. official reserve assets plus the net increase in all U.S. liquid liabilities to foreigners was only $1.3 billion, as compared with $2.8 billion the year before. Thus the deficit on the liquidity basis was cut by $1.5 billion.

Another measure of the deficit, official reserve transactions, showed little change from the level to which it had fallen the year before. The U.S. reserve loss plus the increase in liabilities to foreign reserve holders was $1.3 billion, unchanged from the net amount of such official reserve transactions in 1964.

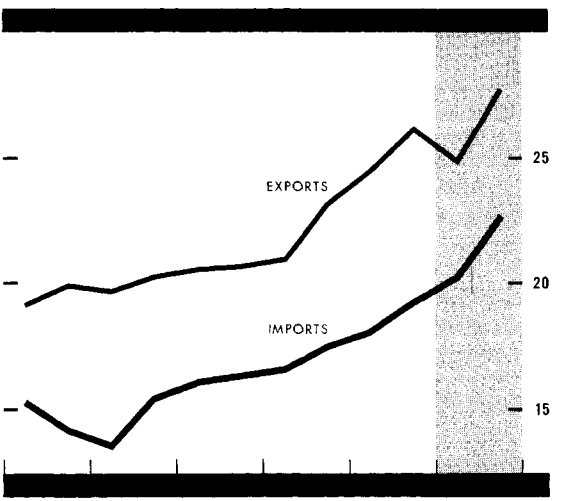
Despite improvement or little change in the deficit—depending on the measure used—the drain on U.S. gold reserves was much larger than it had been in 1964, for reasons touched on below; in 1965 it was $1.7 billion; in 1964, $0.1 billion.

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TRANSACTIONS IN GOODS AND SERVICES; AND AID LOANS AND GRANTS

The rise in merchandise imports, already brisk in 1964, accelerated sharply in 1965. Rising domestic purchases of consumer goods and of capital equipment were reflected in a more than proportionate increase in imports of finished manufactures. Large imports of materials supplemented domestic supplies in meeting the strong domestic demands for additions to inventories as well as for current use. Demand for imported steel was heavy, especially before a wage settlement was reached in the steel industry. Total imports were 15 per cent greater than in 1964.

MERCHANDISE IMPORTS rise sharply in '65, narrowing the trade surplus



Seasonally adjusted balance of payments data.

Exports of goods, which had shown an unusually rapid rise from early 1963 to late 1964, eased off in the first half of 1965. Later in the year they picked up again. In the second half, exports of agricultural and of nonagricultural goods were above their year-earlier levels by 4 and 6 per cent, respectively.

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For the year as a whole, the merchandise trade surplus was smaller than in 1964 by nearly $2 billion. Shrinkage in the balance on goods and services was not so great, mainly because receipts of investment income continued to grow rapidly. Unlike earlier years, 1965 saw no improvement in the military segment of the balance of payments accounts.

The flow of grants and loans by the U.S. Government for economic aid, much of which is closely related to U.S. exports, continued on about the same scale as in the two preceding years.

PRIVATE CAPITAL MOVEMENTS

The outflow of U.S. direct investment capital began to build up rapidly toward the end of 1964 and became exceptionally large in the first half of 1965. The underlying forces making for year-to-year increases in the flow of such capital to Europe did not seem to have altered significantly. However, uncertainties about the Government's program for improving the balance of payments may have led to some transfers of funds in advance of immediate needs. The administration's program announced in February had as one of its components a cooperative effort by several hundred large corporations to expand their exports of U.S. products and to reduce the pace at which they were supplying capital to their affiliates in industrial countries.

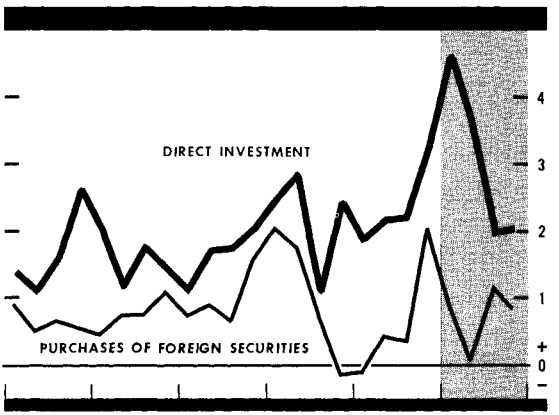
In the second half of the year outflows of funds for direct investment did decline sharply. Among the factors that made this possible was the flotation of a considerable number of bond issues in European capital markets by subsidiaries of U.S. companies, at higher costs than borrowing in the United States would have entailed. Nevertheless, for the year as a whole, the outflow of direct investment funds from the United States exceeded $3 billion, compared with $2.4 billion in 1964.

Other parts of the President's program, involving voluntary restraint on foreign lending and investing by banks and other financial institutions and repatriation of liquid funds from abroad, were successful in 1965 beyond expectations. Short-term

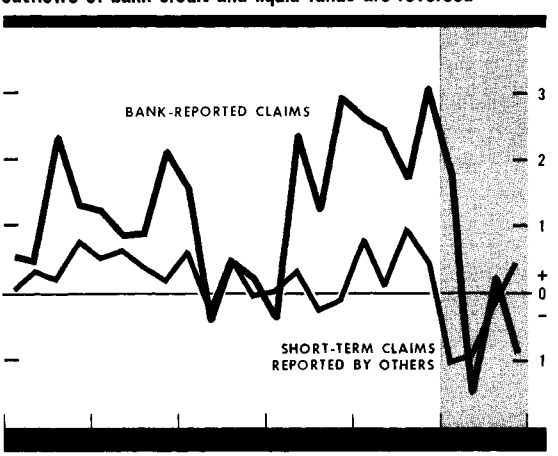
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claims on foreigners reported by others than banks—that is, by nonbank financial institutions and by nonfinancial corporations —were reduced by about $0.5 billion, in contrast to a reported

U.S. CAPITAL OUTFLOWS for direct investment fall in second half, and



outflows of bank credit and liquid funds are reversed



Seasonally adjusted balance of payments data. Direct investment outflow as given in Dept. of Commerce basic statistics is here adjusted by deducting the amount of bond issues sold abroad by U.S.-incorporated subsidiaries; such issues in the fourth quarter of 1965 were at an annual rate of $0.7 billion. Bank-reported claims include some liquid assets and commercial claims of the banks' domestic customers; bank loans maturing in more than 1 year are included.

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outflow of $0.6 billion in 1964. Outstanding term loans of U.S. banks to foreign borrowers, though sharply enlarged in the first few weeks of the year, ended 1965 with a net rise of only $0.2 billion, compared with more than $0.9 billion in 1964. Most term loans made after February 11, 1965, to borrowers in industrial countries were subject to the IET—though loans to finance U.S. exports were exempt—and the outflow of term loans to such countries after that date was very small. Short-term claims on foreigners reported by banks—including both the banks' own claims subject to the VFCR program and also customers' claims and certain bank claims exempted under the program—declined by $0.3 billion, after rising by $1.5 billion in 1964. Growing pressure of demand for funds by domestic borrowers helped to restrain the outflow of bank credit.

Net purchases of foreign securities produced a capital outflow of $0.7 billion in 1965, about the same as in 1964. There was a substantial volume of new issues by Canadian governmental and business borrowers and by borrowers in other countries whose obligations are not subject to the IET. A few taxable issues were placed by borrowers willing to pay the tax. Purchases of outstanding foreign securities by U.S. investors continued to be held down by the IET and were less than U.S. sales of such securities.

In sum, the net outflow of U.S. private capital in all forms was $3.5 billion in 1965.

Foreigners were substantial net sellers of U.S. corporate securities in 1965. A considerable amount of corporate stocks were sold by the U.K. Treasury for reinvestment in more liquid forms.

Restraint of outflow of U.S. bank credit and U.S. liquid funds appears to have had little unfavorable repercussion upon the growth of liquid funds in the United States for the account of private foreigners other than banks. The net inflow of such funds amounted to $0.3 billion, not much less than the yearly inflow in the two preceding years. Liquid assets of international organizations other than the IMF declined by $0.3 billion, slightly more than in 1964 or 1963.

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Balances held in this country by commercial banks located abroad (including branches of U.S. banks) showed a net increase over the year of only $0.1 billion. After increasing by $0.5 billion in the final quarter of 1964, they rose $0.6 billion more in the first three quarters of 1965 and then declined nearly that much in the fourth quarter.

From January through September the foreign branches of U.S. banks placed about $0.5 billion of additional funds with their head offices. Canadian banks, which paid off $0.5 billion of U.S.-dollar deposits to U.S. residents, were able to do so without much of a decrease in their liquid assets in the United States during this period. In both these cases the immediate source of the funds that banks channeled to the United States was the Euro-dollar market, centered in London. Short-term interest rates in that market varied widely during 1965, and though the average relation of Euro-dollar rates to U.S. money market rates was not very different from what it had been in the latter half of 1964, a relatively easy position developed in the Euro-dollar market during the summer of 1965. Net transfers of funds from that market to the United States through the operations of commercial banks were especially large in August. In that one month the net increase in short-term claims on the United States for account of commercial banks in all foreign countries exceeded $400 million.

At some other times in 1965 conditions in the Euro-dollar market were exceptionally tight. Rates in this market were influenced to some extent by conditions in the financial markets of particular countries; while the Italian authorities, for example, took action to ease their market, German authorities pursued a very tight monetary policy. Other factors making for tightness in the Euro-dollar market included, in the spring, the curtailment of previously large flows of bank credit from the United States to Europe, and later the borrowing operations of U.S. subsidiary companies in Europe. In December some European commercial banks withdrew funds from the market to strengthen their domestic cash positions at the year-end.

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Additions to the supply of funds in the Euro-dollar market came from various sources. Italian commercial banks put large amounts into the market during the first 10 months of the year; these funds came, indirectly, from official reserves accruing to Italy as the results of its balance of payments surplus. Also, funds were supplied to the Euro-dollar market by holders shifting from sterling to dollars, but after early September this source of supply dried up as confidence in sterling revived. During the period of tightness that developed near the year-end, funds were returned to the market by branches of U.S. banks and by Canadian banks; as already noted, total balances in the United States of these and other banks located abroad declined by about $0.5 billion in the fourth quarter.

FINANCING THE DEFICIT

The decrease in U.S. reserve assets plus the increase in liabilities to foreign reserve holders was $1.3 billion in 1965. Net gold sales were unusually large, amounting to about $1.4 billion (including net sales of $0.1 billion to industry). In addition, the United States transferred $259 million of gold to the IMF in connection with a quota increase, which added to our drawing rights when it came into effect early in 1966.

Several continental European countries added more to their official gold holdings in 1965 than they had in 1964. In doing this, some of them indicated that they considered that the balance of payments deficits of the United States in recent years had added excessively to the supply of dollars in the hands of monetary authorities. Purchases of gold by the United States were comparatively small; of the two countries that had been large sellers in 1964, Britain sold much less than it had in 1964, and Italy repurchased from us part of what it had sold.

U.S. reserve assets other than gold increased somewhat. The U.S. gold tranche position in the IMF, even with inclusion of the gold subscription made in 1965, increased only a little—by $0.1 billion. This was because drawings of foreign currencies by the United States exceeded other countries' net drawings of dollars

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from the Fund. But U.S. holdings of convertible currencies increased by about $350 million, largely through swaps for sterling with the Bank of England by means of which the Federal Reserve provided dollars to assist in the defense of sterling.

U.S. liabilities, liquid and other, to foreign reserve holders increased by $0.1 billion in 1965. Liabilities to monetary authorities in Latin America, Asia, and Africa increased, but those to European central banks and exchange funds dropped sharply. Declines in the holdings of claims against the United States were in some cases associated with deficits in the countries' international payments. In other countries declines occurred because their purchases of gold exceeded the surpluses in their balance of payments. In still other countries—most notably in Italy—the authorities encouraged commercial banks to hold dollar claims in the form of deposits in the Euro-dollar market. To the extent that this led to a growth in balances placed in the United States by banks operating in the Euro-dollar market, it restrained the growth of official claims against the United States.

The net increase in total liquid claims against the United States of commercial banks, other private foreigners, and international organizations other than the IMF amounted to only $0.1 billion in 1965. As there was also little net change in foreign official holdings of short-term assets in the United States and of marketable U.S. Government bonds and notes, most of the financing of the $1.3 billion deficit in the U.S. balance of payments on the liquidity basis was provided by the net shrinkage of $1.2 billion in U.S. reserve assets (gold, convertible currencies, and IMF gold tranche).

To guard against further dissipation of U.S. reserve assets and to strengthen the dollar in its role as a pivotal part of the international monetary system, further improvement in the balance of payments was needed. To restore a stable equilibrium that would not be dependent on voluntary restraint programs, such as were used so effectively in 1965, it seemed more essential than ever as the year ended that inflation be avoided in the United States.

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PART II

Records, Operations, and Organization

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RECORD OF POLICY ACTIONS OF THE BOARD OF GOVERNORS

February 26, 1965

Amendment to Regulation M, Foreign Branches of National Banks.

Effective March 1, 1965, Regulation M was amended by adding the following new paragraph (g) to Section 213.4: "Pay to any officer or employee of the branch a greater rate of interest on deposits than that paid to other depositors on similar deposits with the branch."

Votes for this action: Messrs. Balderston, Robertson, Shepardson, Mitchell, and Daane. Votes against this action: None.

This amendment made it possible, so far as Federal law or regulations were concerned, for overseas branches of member banks to pay rates of interest on deposits of their officers and employees higher than those paid on other deposits, if the branches were located in countries where such a procedure was consistent with local law and practice. In the absence of this permission, banks had been precluded from paying such rates by the terms of Section 22(e) of the Federal Reserve Act and had thereby been placed in an unfavorable competitive position in the operation of many of their foreign branches. Authority to grant the permission was provided by the Act of August 15, 1962, under which the Board was empowered to authorize foreign branches of member banks to exercise such powers as were usual in connection with the business of banking in the places where the branches were located.

March 3, 1965

Voluntary foreign credit restraint.

The Board adopted guidelines for the use of banks and nonbank financial institutions in limiting foreign credits voluntarily as part of the President's balance of payments program.

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Votes for this action: Messrs. Martin, Robertson, Shepardson, Mitchell, and Daane. Votes against this action: None.

On February 10, 1965, the President sent to the Congress a message in which he presented a program aimed at achieving quickly a substantial improvement in the U.S. balance of payments position. The central focus of this program was on measures that would reduce the outflow of U.S. capital, which had been heavy in recent years and particularly so in recent months. One part of the President's program included a call upon the Federal Reserve System, in cooperation with the Treasury, to work with financial institutions in limiting their foreign lending and investing on a voluntary basis.

On the same date the Federal Reserve System solicited the cooperation of the nation's banks in limiting credits to foreigners that were not clearly and directly for the purpose of financing exports of U.S. goods and services. The over-all objective was to hold outstanding credits (including export credits) to foreigners during 1965 to a level not more than 5 per cent above the volume on December 31, 1964, although it was recognized that within the aggregate limit certain countries might need to be given preferential treatment. On February 18, Chairman Martin and Governor Robertson, the latter having been designated by the Board of Governors to coordinate the System's activities in this matter, discussed the request in detail with representatives of the banking and financial community following a meeting of those representatives with the President.

On March 3, 1965, the Board adopted sets of guidelines to be followed by banks and by nonbank financial institutions in their foreign lending activities. While these guidelines were to be in effect until modified or supplemented, the Board indicated that they might be changed from time to time in the light of new circumstances and in the light of experience gained as the program went forward. Two of the guidelines for banks were later

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amended (in April and July, respectively), and amended guidelines for nonbank financial institutions were issued in June. In early December revised guidelines were issued for both banks and nonbank financial institutions, these guidelines to be applicable to their participation in the voluntary foreign credit restraint effort in 1966.

April 19, 1965

Amendment to Regulation T, Credit by Brokers, Dealers, and Members of National Securities Exchanges.

Effective May 15, 1965, the Board amended Section 220.4(c)(3) of Regulation T, relating to special cash accounts, to provide that the maximum time for payment of a new security issued to accomplish a total or partial refunding of an outstanding security would be 7 days after the maturity, redemption, or prepayment date of such outstanding security, if the period from the time the new security was actually available for delivery to the purchasers until such maturity, redemption, or prepayment did not exceed 35 days.

Votes for this action: Messrs. Martin, Balderston, Robertson, Shepardson, and Daane. Votes against this action: None.

The reason for this departure from the ordinary rules of payment was to enable investors to continue an investment in an enterprise, without undue hardship through advancing new funds, by allowing the application of the proceeds of the redemption to the purchase of the new security within a reasonable period.

August 5, 1965

Amendment to Regulation Q, Payment of Interest on Deposits.

Effective August 5, 1965, Section 217.3(a) of Regulation Q was amended so as to continue from October 15, 1965, to October 15, 1968,

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the exemption of foreign governments and certain foreign or international institutions from regulation by the Board as to the maximum rates of interest permitted to be paid by member banks on time deposits.

Votes for this action: Messrs. Martin, Balderston, Shepardson, Mitchell, and Maisel. Votes against this action: None.

By Act of Congress approved July 21, 1965 (Public Law 89-79), Section 19 of the Federal Reserve Act was amended so as to continue from October 15, 1965, to October 15, 1968, the exemption of foreign governments, monetary and financial authorities of foreign governments when acting as such, and international institutions of which the United States is a member from regulations of the Board of Governors as to maximum rates of interest permitted to be paid by member banks on time deposits. (The law contained a similar amendment to the Federal Deposit Insurance Act with respect to deposits in nonmember insured banks.) The amendment to Regulation Q was made in order to conform the regulation to the provisions of the amended law.

November 17, 1965

Amendment to Regulation R, Relationships with Dealers in Securities under Section 32 of the Banking Act of 1933.

Effective November 17, 1965, the Board amended Regulation R so as to broaden the list of obligations named in a section of the regulation that exempts from the general prohibitions of the regulation relationships of officers, directors, or employees of member banks with firms dealing only in such obligations.

Votes for this action: Messrs. Martin, Balderston, Robertson, Shepardson, Mitchell, Daane, and Maisel. Votes against this action: None.

Section 32 of the Banking Act of 1933 provides that no officer, director, or employee of any corporation or unincor-

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porated association, no partner or employee of any partnership, and no individual primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve at the same time as an officer, director, or employee of any member bank of the Federal Reserve System. However, the statute authorizes the Board of Governors, by general regulations, to except limited classes of relationships from the prohibitions of the statute.

Pursuant to such authority, the Board had heretofore permitted officers, directors, or employees of member banks to serve at the same time as officers, directors, or employees of securities firms dealing only in U.S. Government securities, obligations fully guaranteed both as to principal and interest by the United States, obligations of Federal intermediate credit banks, Federal land banks, Central Bank for Cooperatives, Federal home loan banks, and the Federal National Mortgage Association, and general obligations of territories, dependencies, and insular possessions of the United States.

The current amendment to Regulation R added to this list obligations of the Tennessee Valley Authority, and, subject to specifications contained in paragraph Seventh of Section 5136 of the U.S. Revised Statutes, obligations of the International Bank for Reconstruction and Development, the Inter-American Development Bank, or any local public agency, and obligations insured by the Federal Housing Administrator. This action was taken because it appeared to the Board that these obligations had generally the same characteristics as the obligations previously listed.

Governor Maisel would have preferred to expand the action to include in the list of exceptions all obligations that member banks are authorized to deal in or underwrite pursuant to paragraph Seventh, including general obligations of States and political subdivisions.

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December 3, 1965

1. Increase in rates on discounts and advances by Federal Reserve Banks.

Effective December 6, 1965, the Board approved actions taken by the Boards of Directors of the Federal Reserve Banks of New York and Chicago establishing a rate of 4½ per cent (an increase from 4 per cent) on discounts and advances to member banks under Sections 13 and 13a of the Federal Reserve Act.

Votes for this action: Messrs. Martin, Balderston, Shepardson, and Daane. Votes against this action: Messrs. Robertson, Mitchell, and Maisel.

Pursuant to the policy established by this action, the Board subsequently approved the same rate for the remaining Federal Reserve Banks effective on the following dates:

Boston	December 8, 1965
Atlanta	December 8, 1965
Philadelphia	December 10, 1965
Cleveland	December 10, 1965
Richmond	December 10, 1965
St. Louis	December 10, 1965
Minneapolis	December 10, 1965
Dallas	December 10, 1965
San Francisco	December 10, 1965
Kansas City	December 13, 1965

Effective the same dates the Board approved for the respective Federal Reserve Banks a rate of 5 per cent on advances to member banks under Section 10(b) of the Federal Reserve Act. In addition the Board approved increases at most of the Banks in rates on advances to individuals, partnerships, and corporations other than member banks under the last paragraph of Section 13 of the Act.

(In accordance with provisions of the Federal Reserve Act, the Federal Reserve Banks establish rates on discounts for and advances to member banks at least every 14 days and submit such rates to the Board for review and determination. Prior to this date no changes had been made in these rates since those referred to on pages 44-45 of the Board's ANNUAL REPORT for 1964.)

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2. Amendment to Regulation Q, Payment of Interest on Deposits.

Effective December 6, 1965, the Board approved an amendment of the Supplement to Regulation Q to increase to 5½ per cent the maximum rate of interest permitted to be paid by member banks on time deposits and certificates of deposit. (Since November 1964, member banks had been permitted to pay a maximum rate of 4½ per cent on time deposits and certificates with maturities of 90 days or more and a maximum rate of 4 per cent on those with maturities of less than 90 days.) No change was made in the maximum rate of interest of 4 per cent permitted to be paid by member banks on savings deposits.

Votes for this action: Messrs. Martin, Balderston, Shepardson, Mitchell, Daane, and Maisel. Vote against this action: Mr. Robertson.

The discount rate action was designed to reinforce efforts being made to maintain price stability, and thus to foster balance in the economy's continued growth and strength in the dollar's international standing. Its purpose was not to cut back the pace of credit flows but to dampen mounting demands on banks for still further credit extensions that might add to inflationary pressures.

While the discount rate increase was intended to moderate additional bank reliance on short-term borrowings from the Federal Reserve to meet intensifying loan demands, the action contemplated a continued provision of additional reserves to the banking system, in amounts sufficient to meet seasonal pressures as well as the credit needs of an expanding economy, primarily through Federal Reserve purchases of U.S. Government securities in the open market.

The increase in the rates permitted to be paid by member banks on time deposits was intended to enable the banks to attract and retain deposits of businesses and individuals, and thereby to make more effective use of savings funds already available in the economy to finance their loan expansion.

Since November 1964, when the discount rate and maximum time deposit rates were last increased, total borrowing by con-

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sumers, businesses, and State and local governments had risen sharply, and interest rates throughout the maturity range had been rising under demand pressures. If all demands for borrowed money at existing rates were to be satisfied, the Federal Reserve would have been forced to increase bank reserves at an accelerated pace. With the slack in manpower and production capacity reduced to narrow proportions, with the economy closer to full potential than at any time in nearly a decade, and with military demands on output and manpower increasing, it was felt that excessive additions to money and credit availabilities in an effort to hold present interest rate levels would spill over into further price increases in goods and services, which increases would endanger the sustainability of the business expansion. Moreover, increases in costs and prices would make it more difficult for American goods to compete in markets at home and abroad. In addition, a pattern of interest rates that was accepted by borrowers and lenders as fully reflecting market forces should, it was thought, add assurance of a smooth flow of funds to all sectors of the economy.

Several additional specific considerations strengthened the Board's judgment on the appropriateness of its actions and their timing. As indicated, the acceleration already evidenced in the pace of Government expenditures, reflecting Viet Nam developments, foreshadowed even heavier than previously expected Federal procurement over the coming months. There was also a very real risk, already becoming apparent, of overstimulating an investment boom in process and prospect, both adding further to price pressures and permitting a distortion between the rate of growth of capital expenditures and the general growth rate of the economy. An additional consideration was the judgment that postponement of action until January would involve a conflict with the Treasury financing schedule, probably necessitating still further postponement. Finally, the Board felt that advantage should be taken of the flexibility of the monetary policy instrument to move promptly against undue and inflationary

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credit expansion, in consonance with the statutory responsibilities imposed upon the Board.

In summary, it was believed that the actions taken by the Board would have the effect of backing up the Government's efforts to prevent inflationary excesses from damaging an economy carrying the added burden of military operations in Viet Nam, of bolstering the Government's program to overcome persistent deficits in the U.S. balance of international payments, and of demonstrating anew the determination of the United States to maintain the international strength of the dollar.

Governor Robertson, in dissenting from the discount rate action, commented that changes in monetary policy should not be triggered by fear of prosperity. A prosperous and growing economy had been the goal of public policies, and substantial achievement in that direction in the 1960's should be a cause of gratification rather than concern. It was not inevitable that inflation, boom, and bust must follow from the kind of prosperous performance the U.S. economy had been giving, and consequently he saw no valid grounds for arguing that a tightening of monetary policy was needed to forestall inflationary developments that were sure to come later. This was not to deny the need for careful scrutiny of the progress of economic events and a willingness to restrain credit further if and as excessive demand pressures actually emerged, but he conceived of the present as a time of delicate balance in the economy. Supply and demand forces seemed so tentatively poised that abrupt action to change monetary conditions could tip the scales significantly—toward inflation if policy was actively eased, or toward recession if credit availability was tightened sharply.

Governor Robertson observed that financial markets had only recently calmed somewhat after being buffeted by rumors of an impending discount rate change, and that a rate increase would now come as a distinct surprise, with reactions aggravated by the impending seasonal peak of money market pressures. Such action would insure undoubtedly that the heavy volume of Treas-

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ury cash borrowing to be done in January would have to be undertaken at substantially higher interest costs to the Government.

If, for whatever reasons, a tightening action was to be initiated, Governor Robertson felt that an appropriately mild and indirect line of action might be to (1) dampen bank issuance of promissory notes by defining them as deposits; (2) hold the ceilings on time deposit interest rates at existing levels for the time being; and (3) take no action on the discount rate, expecting that banks would have to cover some portion of their net December loss of certificates of deposit by substantial temporary resort to the Federal Reserve discount window. This combination of steps should serve to moderate somewhat the rate of advance in bank credit while not triggering immediate expectations of higher interest rates in the market. At the same time, it would place banks in a position of dependence on the discount window that could lead fairly naturally to a more overt tightening of monetary policy should inflationary developments begin to appear.

Since it could not be predicted whether or not a breakout of inflationary pressures would in fact occur, Governor Robertson believed that the best practical course would be to adopt a policy of "watchful waiting," meanwhile continuing to supply a reasonable flow of reserves to finance economic growth. Despite large and sustained expansion since 1961, a small but significant margin of human and real capital resources remained unutilized, and further orderly expansion in aggregate demand could effectively employ some of those resources. Continued orderly credit expansion was needed if the economy was to move on up to the goal of sustainable full employment of available resources.

Price pressures to date had been small and selective, Governor Robertson pointed out, and they were not the types appropriately dealt with by a dampening of aggregate domestic demand. Neither did he regard the U.S. balance of payments performance as supplying reasonable grounds for further monetary tightening.

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The allegedly interest-sensitive components were already performing very well under the discipline of the voluntary foreign credit restraint program, and he saw no sign that this program was weakening in so far as its influence on financial institutions was concerned. Corporate direct investment aboard, the category of capital flow that had been least reduced to date, was notoriously insensitive to changing general credit conditions in the United States.

U.S. interest rates were already high by historical standards, Governor Robertson observed, and he believed they were generating all the credit restraint that ought to be attempted in the current delicate situation. The Federal fiscal position would be shifting to a somewhat less stimulative policy for a time after the turn of the year, and he felt that the Federal Reserve should be wary of imposing a coincident restraining influence from additional monetary tightening at this juncture. The appropriate monetary policy for later in 1966 could best be judged in light of the budget message in January and the public reaction thereto.

Governor Mitchell dissented from the discount rate action because he believed that it could have been delayed to await coordination with other Government policies. His willingness to delay was based on the fact that monetary policy already had tightened, on lack of evidence that inflationary pressures were strong or accumulating, and on a belief that high standards should continue to be set for the performance of the economy, and especially for the reduction of unemployment.

Governor Maisel dissented from the discount rate action because he believed it was premature and posed a net threat to long-run price stability. He concluded that a delay of a month or so to await information on the Federal budget could do little harm and that the availability of such knowledge would enable a sounder decision. He also felt that it was wrong to act without the exertion of more effort to obtain agreement on a coordinated monetary, fiscal, and wage-price policy. In his opinion the

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method and timing of the discount rate increase was likely to decrease its hoped-for effect and threatened to introduce undesired, inflationary side effects. It made the future development of sound full employment policies more difficult, and unilateral action of this kind could weaken the President's leadership in a critical period.

Two major arguments cited in favor of immediate discount rate action were, in Governor Maisel's judgment, based on faulty reasoning. These were (1) the continuing use of higher interest rates in the U.S. economy for balance of payments purposes; and (2) the concept that action in advance of changes in demand was warranted on the theory that once demand started to grow it could be contained only with much greater sacrifice. As to the balance of payments argument, he felt that the United States was doing extremely well in restraining interest-sensitive items through existing programs, that further interest rate increases might simply be matched overseas, and that such increases might in fact have a perverse effect. U.S. interest payments abroad would rise, higher financing costs would make American exports less competitive, and slower economic growth in this country might make direct investments abroad more inviting. As to the argument against delay of action until additional information about demand, prices, and credit became available, he understood it was based on an assumption that further small infusions of additional credit were dangerous and could lead to magnified inflationary conditions in the future because the use of credit would gain momentum and run away after some critical point. However, he had been unable to find support for this doctrine among monetary historians or theorists.

Governor Maisel also expressed the view that the Board, in departing from a policy of not making discount rate moves in advance of the market, was investing its current decision with an urgency that was unwarranted.

Governor Robertson dissented from the action to increase the time deposit interest rate ceiling generally for the same rea-

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sons that he dissented from the action to raise the discount rate. The latter action, he assumed, was designed to tighten credit, in view of the rapid expansion of bank credit; it surely was not designed simply to raise interest rates. However, in his view, the raising of the ceilings on interest rates payable on time deposits would—in virtually the same breath—enable banks to acquire more funds to expand their lending, but at higher rates. Thus, it would not serve to reduce bank credit expansion—if that were the aim. In addition, he felt that the larger banks would be able to attract funds away from smaller financial institutions which did not actively engage in the issuance of time deposits but relied on inflows of savings and demand deposits with which to meet loan demands, or, alternatively, to force those smaller banks to engage in the risky business of bidding competitively for highly interest-sensitive short-term funds with which to make long-term loans.

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RECORD OF POLICY ACTIONS FEDERAL OPEN MARKET COMMITTEE

The record of policy actions of the Federal Open Market Committee is presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of Section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each such action, and that it shall include in its ANNUAL REPORT to the Congress a full account of such actions.

In the pages that follow, there are entries with respect to the policy actions taken at the meetings of the Federal Open Market Committee held during the calendar year 1965, including the votes on the policy decisions made at those meetings as well as a résumé of the basis for the decisions, as reflected by the minutes of the Committee.

It will be noted from the record of policy actions that in some cases the decisions were by unanimous vote, and that in other cases dissents were recorded. The fact that a decision in favor of a general policy was by a large majority, or even that it was by unanimous vote, does not necessarily mean that all members of the Committee were equally agreed as to the reasons for the particular decision or as to the precise operations in the open market that were called for to implement the general policy.

The policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. Both the Manager of the System Open Market Account and the Special Manager of the Account for foreign currency operations attend the meetings of

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the Committee. In the area of domestic open market activities the Bank operates under two separate policy directives from the Open Market Committee—a continuing authority directive and a current economic policy directive. At the beginning of the calendar year the continuing authority directive in effect was as follows:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell United States Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing United States Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $1.5 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed $125 million or 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York;

(c) To buy United States Government securities with maturities of 24 months or less at the time of purchase, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve

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

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate ¼ of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $500 million.

This directive was amended on two occasions during the year, as noted in the entries for March 2 and December 14.

The current economic policy directive was changed frequently during the year, as shown in the respective policy record entries. The current economic policy directive that was in effect at the beginning of 1965 instructed the Federal Reserve Bank of New York as follows:

In light of the economic and financial developments reviewed at this meeting, it remains the Federal Open Market Committee's current policy to facilitate continued expansion of the economy by accommodating moderate growth in the reserve base, bank credit, and the money supply, while seeking to avoid the emergence of inflationary pressures and to strengthen the international position of the dollar.

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To implement this policy, and recognizing that international uncertainties and year-end seasonal pressures continue to require a larger than usual degree of flexibility in operations, System open market operations shall be conducted with a view to maintaining about the same conditions in the money market as currently prevail.

In the foreign currency area, the Federal Reserve Bank of New York operates under (1) an authorization regarding open market transactions in foreign currencies, (2) a statement of guidelines for System foreign currency operations, and (3) a continuing authority directive on System foreign currency operations.

The authorization regarding open market transactions in foreign currencies in effect at the beginning of and throughout the year read as follows:

Authorization Regarding Open Market Transactions In Foreign Currencies

Pursuant to Section 12A of the Federal Reserve Act and in accordance with Section 214.5 of Regulation N (as amended) of the Board of Governors of the Federal Reserve System, the Federal Open Market Committee takes the following action governing open market operations incident to the opening and maintenance by the Federal Reserve Bank of New York (hereafter sometimes referred to as the New York Bank) of accounts with foreign central banks.

I. Role of Federal Reserve Bank of New York

The New York Bank shall execute all transactions pursuant to this authorization (hereafter sometimes referred to as transactions in foreign currencies) for the System Open Market Account, as defined in the Regulation of the Federal Open Market Committee.

II. Basic Purposes of Operations

The basic purposes of System operations in and holdings of foreign currencies are:

(1) To help safeguard the value of the dollar in international exchange markets;

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(2) To aid in making the existing system of international payments more efficient and in avoiding disorderly conditions in exchange markets;

(3) To further monetary cooperation with central banks of other countries maintaining convertible currencies, with the International Monetary Fund, and with other international payments institutions;

(4) Together with these banks and institutions, to help moderate temporary imbalances in international payments that may adversely affect monetary reserve positions; and

(5) In the long run, to make possible growth in the liquid assets available to international money markets in accordance with the needs of an expanding world economy.

III. Specific Aims of Operations

Within the basic purposes set forth in Section II, the transactions shall be conducted with a view to the following specific aims:

(1) To offset or compensate, when appropriate, the effects on U.S. gold reserves or dollar liabilities of disequilibrating fluctuations in the international flow of payments to or from the United States, and especially those that are deemed to reflect temporary forces or transitional market unsettlement;

(2) To temper and smooth out abrupt changes in spot exchange rates and moderate forward premiums and discounts judged to be disequilibrating;

(3) To supplement international exchange arrangements such as those made through the International Monetary Fund; and

(4) In the long run, to provide a means whereby reciprocal holdings of foreign currencies may contribute to meeting needs for international liquidity as required in terms of an expanding world economy.

IV. Arrangements with Foreign Central Banks

In making operating arrangements with foreign central banks on System holdings of foreign currencies, the New York Bank shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee.

The Bank shall instruct foreign central banks regarding the investment of such holdings in excess of minimum working balances in accordance with Section 14(e) of the Federal Reserve Act.

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The Bank shall consult with foreign central banks on coordination of exchange operations.

Any agreements or understandings concerning the administration of the accounts maintained by the New York Bank with the central banks designated by the Board of Governors under Section 214.5 of Regulation N (as amended) are to be referred for review and approval to the Committee, subject to the provision of Section VIII, paragraph 1, below.

V. Authorized Currencies

The New York Bank is authorized to conduct transactions for System Account in such currencies and within the limits that the Federal Open Market Committee may from time to time specify.

VI. Methods of Acquiring and Selling Foreign Currencies

The New York Bank is authorized to purchase and sell foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the Stabilization Fund of the Secretary of the Treasury established by Section 10 of the Gold Reserve Act of 1934 and with foreign monetary authorities.

Unless the Bank is otherwise authorized, all transactions shall be at prevailing market rates.

VII. Participation of Federal Reserve Banks

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

VIII. Administrative Procedures

The Federal Open Market Committee authorizes a Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) to give instructions to the Special Manager, within the guidelines issued by the Committee, in cases in which it is necessary to reach a decision on operations before the Committee can be consulted.

All actions authorized under the preceding paragraph shall be promptly reported to the Committee.

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The Committee authorizes the Chairman, and in his absence the Vice Chairman of the Committee, and in the absence of both, the Vice Chairman of the Board of Governors:

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

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

(3) From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Problems.

IX. Special Manager of the System Open Market Account

A Special Manager of the Open Market Account for foreign currency operations shall be selected in accordance with the established procedures of the Federal Open Market Committee for the selection of the Manager of the System Open Market Account.

The Special Manager shall direct that all transactions in foreign currencies and the amounts of all holdings in each authorized foreign currency be reported daily to designated staff officials of the Committee, and shall regularly consult with the designated staff officials of the Committee on current tendencies in the flow of international payments and on current developments in foreign exchange markets.

The Special Manager and the designated staff officials of the Committee shall arrange for the prompt transmittal to the Committee of all statistical and other information relating to the transactions in and the amounts of holdings of foreign currencies for review by the Committee as to conformity with its instructions.

The Special Manager shall include in his reports to the Committee a statement of bank balances and investments payable in foreign currencies, a statement of net profit or loss on transactions to date, and a summary of outstanding unmatured contracts in foreign currencies.

X. Transmittal of Information to Treasury Department

The staff officials of the Federal Open Market Committee shall transmit all pertinent information on System foreign currency transactions to designated officials of the Treasury Department.

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XI. Amendment of Authorization

The Federal Open Market Committee may at any time amend or rescind this authorization.

The guidelines for System foreign currency operations in effect at the beginning of the year were as follows:

GUIDELINES FOR SYSTEM FOREIGN CURRENCY OPERATIONS

1. Holdings of Foreign Currencies

Until otherwise authorized, the System will limit its holdings of foreign currencies to that amount necessary to enable its operations to exert a market influence. Holdings of larger amounts will be authorized only when the U.S. balance of international payments attains a sufficient surplus to permit the ready accumulation of holdings of major convertible currencies.

Foreign currency holdings above a certain minimum shall be invested as far as practicable in conformity with Section 14(e) of the Federal Reserve Act.

2. Exchange Transactions

System exchange transactions shall be geared to pressures of payments flows so as to cushion or moderate disequilibrating movements of funds and their destabilizing effects on U.S. and foreign official reserves and on exchange markets.

In general, these transactions shall be geared to pressures connected with movements that are expected to be reversed in the foreseeable future; when expressly authorized by the Federal Open Market Committee, they may also be geared on a short-term basis to pressures connected with other movements.

Subject to express authorization of the Committee, the Federal Reserve Bank of New York may enter into reciprocal arrangements with foreign central banks on exchange transactions ("swap" arrangements), which arrangements may be wholly or in part on a standby basis.

Drawings made by either party under a reciprocal arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

The New York Bank shall, as a usual practice, purchase and sell authorized currencies at prevailing market rates without trying to establish rates that appear to be out of line with underlying market forces.

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If market offers to sell or buy intensify as System holdings increase or decline, this shall be regarded as a clear signal for a review of the System's evaluation of international payments flows. This review might suggest a temporary change in System holdings of a particular convertible currency and possibly direct exchange transactions with the foreign central bank involved to be able to accommodate a larger demand or supply.

Starting operations at a time when the United States is not experiencing a net inflow of any eligible foreign currency may require that initial System holdings (apart from sums that might be acquired from the Stabilization Fund) be purchased directly from foreign central banks.

It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions in order that System transactions do not conflict with those being undertaken by foreign monetary authorities.

3. Transactions in Spot Exchange

The guiding principle for transactions in spot exchange shall be that, in general, market movements in exchange rates, within the limits established in the International Monetary Fund Agreement or by central bank practices, index affirmatively the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public.

Temporary or transitional fluctuations in payments flows may be cushioned or moderated whenever they occasion market anxieties, or undesirable speculative activity in foreign exchange transactions, or excessive leads and lags in international payments.

Special factors making for exchange market instabilities include (i) responses to short-run increases in international political tension, (ii) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, or (iii) market rumors of a character likely to stimulate speculative transactions.

Whenever exchange market instability threatens to produce disorderly conditions, System transactions are appropriate if the Special Manager, in consultation with the Federal Open Market Committee, or in an emergency with the members of the Committee designated for that purpose, reaches a judgment that they may help to re-establish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should

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be modified, curtailed, or eventually discontinued pending a reassessment by the Committee of supply and demand forces.

4. Transactions in Forward Exchange

Occasion to engage in forward transactions will arise mainly when forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to a disequilibrating movement of short-term funds, or when it is deemed appropriate to supplement existing market facilities for forward cover as a means of encouraging the retention or accumulation of dollar holdings abroad.

Proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

For such operations, the New York Bank may, where authorized, take over from the Stabilization Fund outstanding contracts for forward sales or purchases of authorized currencies.

The New York Bank may also, where authorized, purchase currencies through forward transactions for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements.

The New York Bank may further, where authorized, purchase and sell currencies through forward as well as spot transactions for the purpose of settling commitments denominated in one currency by means of utilizing the Bank's holdings of another currency.

5. Exchange Rates

Insofar as practicable, the New York Bank shall purchase a currency through spot transactions at or below its par value, and should lower the rate at which it is prepared to purchase a currency as its holdings of that currency approach the established maximum.

The Bank shall also, where practicable, sell a currency through spot transactions at rates at or above its par value, and should raise the rate at which it is prepared to sell a currency as its holdings of that currency approach zero.

Spot transactions at rates other than those set forth in the preceding paragraphs shall be specially authorized by the members of the Committee designated in Section VIII of the Authorization for Open Market Transactions in Foreign Currencies.

Revisions were made in these guidelines at the meetings of March 2, March 23, and November 23, as noted in the entries for those dates.

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The continuing authority directive with respect to foreign currency operations in effect at the beginning of the year was as follows:

The Federal Reserve Bank of New York is authorized and directed to purchase and sell through spot transactions any or all of the following currencies in accordance with the Guidelines for System Foreign Currency Operations reaffirmed by the Federal Open Market Committee on March 3, 1964, as amended October 20, 1964; provided that the aggregate amount of foreign currencies held under reciprocal currency arrangements shall not exceed $2.35 billion equivalent at any one time, and provided further that the aggregate amount of foreign currencies held as a result of outright purchases shall not exceed $150 million equivalent at any one time:

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

The Federal Reserve Bank of New York is also authorized and directed to operate in any or all of the foregoing currencies in accordance with the Guidelines and up to a combined total of $200 million equivalent, by means of:

(a) purchases through forward transactions, for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements;
(b) purchases and sales through forward as well as spot transactions, for the purpose of utilizing its holdings of one currency for the settlement of commitments denominated in other currencies;
(c) purchases through spot transactions and concurrent sales through forward transactions, for the purpose of restraining short-term

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outflows of funds induced by arbitrage considerations; and

(d) sales through forward transactions, for the purpose of influencing interest arbitrage flows of funds and of minimizing speculative disturbances.

The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing currencies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $100 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

This directive was amended on five occasions during the year, as noted in the entries.

January 12, 1965

1. Authority to effect transactions in System Account.

As 1964 ended, according to reports at this meeting, domestic business activity was recovering vigorously from the effects of the automobile industry strikes in October and November. Industrial production was estimated to have risen to a new record level in December, about 7½ per cent above a year earlier. Automobiles were being produced in exceptionally large volume, and industry schedules called for high output rates to be maintained in the first quarter of 1965. Steel production also was expected to continue large, at least for a time; consumption of steel was high, and users were attempting to accumulate stocks as a precaution against a possible strike in the spring. Manufacturers' inventories, which had risen slowly earlier in the year, increased rapidly in October and November and probably also in December. Retail sales rose sharply in December and may have exceeded the high reached in the summer of 1964.

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Estimates of various statistics for the fourth quarter as a whole reflected the effects of the work stoppages in the automobile industry. Gross national product, according to preliminary indications, rose much less than earlier in the year despite the substantial increase in the rate of inventory investment. Industrial production averaged only slightly higher than in the third quarter, and the increase in consumer spending was the smallest for any quarter in the current business expansion, which now had continued for nearly 4 years.

Nonfarm employment reached a new record high in December and the unemployment rate edged down to 4.9 per cent. In manufacturing, the rise during 1964 in compensation per employee—including fringe benefits, which continued to increase more rapidly than money wages—was on the average close to the administration's guideposts, and unit labor costs remained relatively stable. It was noted that the outcome of the contract negotiations in the steel industry would provide a major test of whether labor costs would continue stable.

Recent price movements did not suggest any significant change in the price situation, although some businessmen reportedly were expecting an inflationary price drift partly because of the nature of the steel industry settlement they anticipated. The industrial commodity price index, which had increased by four-tenths of 1 per cent in October, rose only two-tenths of a per cent further in November and one-tenth of a per cent in December, and average consumer prices in November continued 1.2 per cent above the year-earlier level.

For the year as a whole bank credit had expanded by about 8 per cent, the same as in 1963, and the money supply had increased by 4 per cent compared with 3.8 per cent in the prior year. Bank credit continued to expand in December, but by an amount considerably below the large increase in November as banks sold Treasury securities acquired late in the preceding month and security loans rose less than usually. Growth in the money supply also slowed in December, but time and savings

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deposits expanded at a rate slightly higher than their 12.6 per cent rise in the year as a whole. A large increase in nonborrowed reserves in December facilitated continued expansion in bank credit and deposits as member bank borrowings declined from the average levels prevailing before the late-November increase in the discount rate.

Money market conditions continued firm in late December and early January, a season in which they normally ease, partly as a result of a sharp shift of reserves to country banks and heavy dealer financing needs associated in part with the Treasury's advance refunding operation, announced on December 30. The refunding was accorded a highly favorable reception by investors, and yields on long-term U.S. Government bonds, which had moved up earlier in part because of market discussion of a possible major financing operation, changed little after its announcement. These yields currently were at about the levels that had prevailed at the beginning of 1964 and again shortly after the November discount rate action. Despite the firmness in the money market, the 3-month Treasury bill rate declined from 3.85 per cent in mid-December to 3.77 per cent on the day preceding this meeting, mainly as a result of the refunding and usual seasonal demands for bills.

The deficit in the U.S. balance of payments was estimated to have increased sharply in the fourth quarter, largely because of a marked increase in capital outflows through foreign security issues in the United States and lending by U.S. banks abroad. Indeed, outflows of private capital were at record or near-record levels throughout the year. Short-term capital outflows were heavy in the first half but diminished later as outflows on long-term bank loans and foreign security issues rose. The deficit for the full year, which seemed likely to exceed $2.5 billion, was below the 1963 deficit of $3.3 billion as a result of a marked expansion in net receipts from transactions in goods and services, including income from foreign investment.

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Foreign exchange markets had continued in an unsettled state in recent weeks. Sterling was under intermittent pressure, and the demand for gold on the London market was heavy at times. Among the factors contributing to the market unsettlement were uncertainties on the part of participants about the outlook for sterling and press reports that France would increase its gold purchases from the United States substantially.

The Committee decided that a change in policy was precluded at this time by the Treasury's advance refunding, the settlement date for which was January 19. The members agreed that the problems of the U.S. balance of payments and the international position of the dollar had become increasingly serious recently. Some members indicated that if a Treasury financing had not been in process they would have favored reducing the availability of bank credit somewhat as a means of contributing to a solution of these problems. In their judgment such an action would not adversely affect the domestic economy; and it was noted that, if specific measures also were adopted to curtail the volume of bank lending abroad, the availability of credit to domestic borrowers could be affected less than total supply. Other members indicated that they favored no change in policy at present, even apart from the Treasury financing, on the grounds that under current domestic circumstances it was preferable to use selective measures for dealing with the international financial problems.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> In light of the economic and financial developments reviewed at this meeting, and taking the current Treasury refunding into account, it remains the Federal Open Market Committee's current policy to facilitate continued expansion of the economy by accommodating moderate growth in the reserve base, bank credit, and the money supply, while seeking to avoid the emergence of inflationary pressures and to strengthen the international position of the dollar, particularly in view of the current unsettlement in financial markets abroad.

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To implement this policy, and recognizing that international uncertainties and shifting seasonal pressures require a larger than usual degree of flexibility in operations, System open market operations over the next 3 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Hickman, Mitchell, Robertson, Shepardson, Shuford, Swan, and Wayne. Votes against this action: None.

2. Authority to purchase and sell foreign currencies.

On recommendation of the Special Manager of the System Open Market Account, the Committee amended the second paragraph of its continuing authority directive for System foreign currency operations to increase the combined dollar limit on forward transactions of the several authorized types by $75 million to $275 million. With this amendment, the paragraph read as follows:

The Federal Reserve Bank of New York is also authorized and directed to operate in any or all of the foregoing currencies in accordance with the Guidelines and up to a combined total of $275 million equivalent, by means of:

(a) purchases through forward transactions, for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements;

(b) purchases and sales through forward as well as spot transactions, for the purpose of utilizing its holdings of one currency for the settlement of commitments denominated in other currencies;

(c) purchases through spot transactions and concurrent sales through forward transactions, for the purpose of restraining short-term outflows of funds induced by arbitrage considerations; and

(d) sales through forward transactions, for the purpose of influencing interest arbitrage flows

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of funds and of minimizing speculative disturbances.

Votes for this action: Messrs. Martin, Hayes, Balderston, Hickman, Mitchell, Robertson, Shepardson, Shuford, Swan, and Wayne. Votes against this action: None.

This amendment was made after the Special Manager indicated that a substantial part of the $200 million authorized earlier for forward transactions currently was committed and that he might have occasion to engage in further useful operations of these types in the near future.

February 2, 1965

Authority to effect transactions in System Account.

Information presented at this meeting indicated that domestic business activity was continuing to expand, while the U.S. international payments position had worsened in late 1964.

Employment increased substantially in December, although the unemployment rate was little changed. Industrial production and retail sales reached new record levels in December, and it appeared that both were rising somewhat further in early January. New orders for durable goods increased in December despite a decline in defense orders. Upward pressures on some commodity prices were evident, but improvement in supplies had reduced pressure in markets for certain nonferrous metals, where the largest price advances had occurred in 1964. At the end of January average prices of common stocks were at record highs.

Much of the support for recent advanced levels of industrial activity was contributed by increased inventory accumulation; for the fourth quarter as a whole business inventories rose at a rate twice that earlier in the year. Record sales of automobiles were limiting replenishment of dealer stocks depleted during

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the strike period, but steel users were continuing to increase stocks in anticipation of a possible spring strike in that industry. Inventories of other goods also were expanding, including consumer durable goods other than automobiles.

The administration's budget message, recently transmitted to the Congress, suggested that fiscal policy would be more stimulative in the second half of the calendar year 1965 than in the first half. The projected patterns of expenditures and receipts implied a larger-than-usual swing in the cash budget from a first-half surplus to a second-half deficit. The additional fiscal stimulus expected after midyear stemmed mainly from proposed increases in social security benefit payments and grants to State and local governments and reductions in excise taxes.

The money supply, which had risen more slowly in December than earlier, increased substantially in early January but was estimated to have declined later in the month. Commercial bank time and savings deposits were expanding unusually sharply, suggesting that banks were competing successfully for savings flows under the new higher ceilings established under Regulation Q. A marked strengthening in business loans at city banks in early January was related in part to inventory accumulation and may also have reflected increased foreign lending. Free reserves at member banks averaged about $90 million in January, compared with a December average of about $130 million.

Some hesitancy had developed recently in security markets as a result of growing investor concern over possible implications of balance of payments developments for monetary policy. Since mid-January the 3-month Treasury bill rate had risen about 10 basis points to a level of 3.88 per cent. In the latter part of January yields on long-term Treasury issues also advanced somewhat as dealers continued to distribute securities acquired in the January advance refunding. Subscription books were open on the day preceding this meeting for the Treasury's regular February refunding, which involved a cash sale of a

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21-month note to refinance the $2.2 billion of securities maturing at midmonth that remained outstanding.

The U.S. balance of payments deficit in 1964 was now estimated at $3 billion, well above earlier expectations. Half of the 1964 deficit was incurred in the fourth quarter alone; loans to foreigners by domestic banks rose sharply, and a large volume of foreign security issues was sold in the United States. Outflows of short-term bank loans and liquid funds were particularly heavy in December, although fragmentary data suggested that some of these flows were reversed in January. It was expected that an administration message on special measures to deal with the balance of payments problem would be transmitted to the Congress shortly.

The Committee decided to modify its policy at this time by moving gradually toward slightly firmer money market conditions. In view of the moderate size of the Treasury's current financing and the relatively short maturity of the security to be issued, the Committee agreed that as strict an adherence to an "even keel" policy as was usual during Treasury operations was not required at present. Because of this financing, however, and because distribution of the securities issued in the January advance refunding was still in process, it was decided that the policy change should be implemented cautiously. The objectives sought included some reduction in growth rates of bank credit and the money supply and moderately higher short-term interest rates, all of which would require moderately lower reserve availability.

This action was taken primarily because of the persistence of the deficit in the U.S. balance of payments and the recent sharp increase in capital outflows, and it was hoped that it would buttress the administration's expected program of special measures to strengthen the international position of the dollar. The Committee concluded that the action would not have injurious domestic effects in light of the strength of the economy. Some

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members thought that a slight reduction in monetary ease also was appropriate on domestic grounds in view of the latent inflationary pressures they saw, and some expressed the view that it would tend to sustain the current expansion by helping to avoid speculative excesses.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> In light of the economic and financial developments reviewed at this meeting, including the generally strong and continuing expansion of the domestic economy and the continuing adverse position of our international balance of payments, it remains the Federal Open Market Committee's current policy to accommodate growth in the reserve base, bank credit, and the money supply but at a more moderate pace than in recent months. This policy seeks to avoid the emergence of inflationary pressures and to support other measures that may be taken to strengthen the international position of the dollar.
>
> To implement this policy, while taking into account Treasury financing, System open market operations over the next 4 weeks shall be conducted with a view to moving toward slightly firmer conditions in the money market than have prevailed in recent weeks.
>
> Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Hickman, Mills, Shepardson, Shuford, Swan, and Wayne. Votes against this action: Messrs. Mitchell and Robertson.

Messrs. Mitchell and Robertson dissented from this action because they believed that additional monetary restraint was not warranted either by present domestic conditions or by the balance of payments situation. They noted that the present high levels of demand for steel and automobiles were likely to be only temporary, and that any expansive effects of the Federal fiscal program would not be felt until the second half of the year. As to the balance of payments, they thought that—in view of the large differentials existing between interest rates in the United States and abroad—a policy change large enough to reduce capital outflows significantly would have severe deflationary effects on the economy. For this reason, Mr. Robert-

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son felt that the appropriate remedy for the international payments problem lay elsewhere than in the area of monetary policy, and Mr. Mitchell thought it lay in specific measures to remove the disequilibrating effect of international interest rate differentials. Mr. Robertson added that in his judgment Treasury financing operations and the recent weakness in security markets also argued for keeping policy on a steady course at present.

March 2, 1965

1. Authority to effect transactions in System Account.

Economic activity was continuing to advance after four consecutive years of expansion. In January, steel and automobile production remained at high levels, and output gains in a broad variety of other industries carried total industrial production to a new peak. Retail sales continued strong in January and early February; sales of new domestic cars were at a record annual rate of 9.7 million units in the first month of the year. Although stock-sales ratios remained low, rough estimates suggested that the rate of inventory accumulation continued high in early 1965 after turning up sharply in the closing months of 1964. Much of the accumulation still was related to strikes—both the possible strike in steel and the earlier strike in automobiles—but stocks of other commodities apparently also were growing rapidly. Labor markets were strong in January: nonfarm employment increased further; the average manufacturing workweek was extended to the longest period since World War II; and the unemployment rate declined to 4.8 per cent from 5 per cent in December.

Average industrial commodity prices, which had risen six-tenths of 1 per cent in the fourth quarter of 1964, edged up one-tenth of a per cent in January. Weekly estimates through mid-February suggested no further change, and the average remained within the broad range of recent years.

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Growth in commercial bank credit accelerated in January and early February, and banks reduced their holdings of Government securities to help accommodate record demands for business loans. Part of the exceptional rise in business loan volume reflected various temporary factors, but part was due to the general strength of business activity. Time and savings deposits at commercial banks continued to expand rapidly in response to the higher interest rates now being paid on such deposits. The money supply rose at a reduced rate in both December and January and declined in the first half of February. Recent money supply performance no doubt was affected by some transfers of funds from demand into time and savings deposits and, in early February, by a larger than usual rise in U.S. Government deposits. Member bank borrowings rose in February, and free reserves were estimated to have averaged about $30 million compared with a revised figure of $114 million in January.

Yields on U.S. Government securities had advanced recently, partly as a result of the somewhat reduced level of reserve availability and of market interpretations of that development as reflecting a mild shift in monetary policy. Rates on 3-month Treasury bills rose about 10 basis points in February to about the 4 per cent discount rate, and Government bond yields also increased slightly. Average prices of common stocks declined in early February but more recently returned to levels near their earlier highs.

In a message to the Congress on February 10, the President had set forth a program to improve the nation's balance of payments position. Steps subsequently were taken by the Federal Reserve System and the Department of Commerce, in cooperation with the Treasury Department, to implement the part of the program that called for voluntary efforts by banks, other financial institutions, and nonfinancial businesses to restrain foreign lending and investment. In January and early February, prior

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to the Presidential message, the U.S. payments deficit had continued large, according to tentative data. Long-term bank loans to foreigners were particularly heavy, perhaps partly because of expectations that the interest equalization tax soon would be extended to such loans.

In the Committee's discussion of prospective business conditions, it was noted that the current high output rates for steel and automobiles probably were unsustainable—declines appeared likely in steel if and when the threat of a strike was removed and in automobiles after previous strike losses were made up—and that downturns in those industries might check the rate of over-all expansion. On the other hand, some members thought that the widespread nature of recent production gains suggested sufficient underlying strength in the economy to cushion the expected readjustments in steel and autos, and that prospects for sustained growth now appeared brighter than earlier.

The Committee concluded that over the next 3 weeks, while the President's balance of payments program was getting underway, it would be appropriate to maintain the slightly firmer money market conditions that had been achieved under the policy adopted at the meeting a month earlier. Some members, although not advocating a policy change at present, expressed concern about the recent high rate of growth in bank credit and indicated that a somewhat more restrictive policy might be necessary in coming months to achieve a reduction in that rate.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

In light of the economic and financial developments reviewed at this meeting, including the generally strong and continuing expansion of the domestic economy and the continuing adverse position of our international balance of payments, it remains the Federal Open Market Committee's current policy to accommodate growth in the reserve base, bank credit, and the money supply but at a more moderate pace than in recent months. This policy seeks to support fully the national program to

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strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures.

To implement this policy, System open market operations over the next 3 weeks shall be conducted with a view to maintaining the slightly firmer conditions in the money market that have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Hayes, Bryan, Daane, Mitchell, Robertson, Scanlon, and Clay. Votes against this action: Messrs. Balderston, Ellis, and Shepardson.

Messrs. Balderston, Ellis, and Shepardson dissented from this action because they favored a further slight firming of money market conditions. Mr. Balderston noted that bank credit had expanded at a considerably higher rate than GNP throughout the current business expansion. This, in his judgment, had added to the volume of funds seeking investment abroad and might have created potentially inflationary pools of liquidity. Messrs. Ellis and Shepardson observed that if the program to restrain foreign lending by U.S. banks was effective, more funds presumably would be available for domestic loans, thus adding to what they considered to be an undesirably high rate of domestic bank lending. Mr. Ellis thought that a firmer monetary policy might result, beneficially, in the deferral of some current domestic demands and indicated that he also favored such a policy for balance of payments reasons.

2. Amendment of continuing authority directive.

The Committee amended Section 1(c) of the continuing authority directive to the Federal Reserve Bank of New York relating to transactions in U.S. Government securities and bankers' acceptances to remove the maturity limitation on Government securities that might be held under repurchase agreements with nonbank dealers during Treasury refunding operations. The directive previously in effect, as set forth in the preface to this record of Federal Open Market Committee policy actions for 1965, limited Government securities acquired under repur-

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chase agreements to those having maturities of 24 months or less at the time of purchase. The new directive authorized repurchase agreements involving Government securities of any maturity during any period beginning the day after the Treasury had announced a refunding operation and ending on the settlement date for the exchange. As amended, Section 1(c) of the continuing authority directive read as follows:

To buy U.S. Government securities with maturities as indicated below, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market. U.S. Government securities bought under the provisions of this section shall have maturities of 24 months or less at the time of purchase, except that, during any period beginning with the day after the Treasury has announced a refunding operation and ending on the day designated as the settlement date for the exchange, the U.S. Government securities bought may be of any maturity.

Except for the change resulting from this amendment the directive was renewed in its existing form.

Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Scanlon, Shepardson, and Clay. Votes against this action: None.

Under the provisions of the previous directive it had been the practice of the Account Management to terminate any repurchase agreements against "rights" (securities eligible for ex-

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change in a Treasury refunding) when the dealer by whom they were to be repurchased entered a subscription to exchange the rights in question for new securities offered by the Treasury with maturities of 24 months or more. During some Treasury refundings such terminations had proved to be inconvenient from the point of view of efficient market operations. Accordingly, the Committee decided to amend the directive so that they would no longer be required.

3. Authority to purchase and sell foreign currencies.

The Committee approved a number of revisions in the guidelines for System foreign currency operations, the purposes of which were (1) to delete passages relating to the original launching of operations in foreign currencies in 1962 and passages that had been found by experience to be unnecessarily detailed; (2) to consolidate certain provisions that had been incorporated into the guidelines at different times into a form that lent itself more readily to operational requirements; and (3) to clarify the language at a number of points. The guidelines previously in effect are shown in the preface to this record of policy actions. As amended, the guidelines read as follows:

1. Holdings of Foreign Currencies

Until otherwise authorized, the System will limit its holdings of foreign currencies to that amount necessary to enable its operations to exert a market influence. Holdings of larger amounts will be authorized only when the U.S. balance of international payments attains a sufficient surplus to permit the ready accumulation of holdings of major convertible currencies.

Foreign currency holdings shall be invested as far as practicable in conformity with Section 14(e) of the Federal Reserve Act.

2. Exchange Transactions

System exchange transactions shall be geared to pressures of payments flows so as to cushion or moderate disequilibrating movements of funds and their destabilizing effects on U.S. and foreign official reserves and on exchange markets.

In general, these transactions shall be geared to pressures connected with movements that are expected to be reversed in the foreseeable future;

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when expressly authorized by the Federal Open Market Committee, they may also be geared on a short-term basis to pressures connected with other movements.

Subject to express authorization of the Committee, the Federal Reserve Bank of New York may enter into reciprocal arrangements with foreign central banks on exchange transactions ("swap" arrangements), which arrangements may be wholly or in part on a standby basis.

Drawings made by either party under a reciprocal arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

The New York Bank shall, as a usual practice, purchase and sell authorized currencies at prevailing market rates without trying to establish rates that appear to be out of line with underlying market forces.

If market offers to sell or buy intensify as System holdings increase or decline, this shall be regarded as a clear signal for a review of the System's evaluation of international payments flows.

It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions in order that System transactions do not conflict with those being undertaken by foreign monetary authorities.

3. Transactions in Spot Exchange

The guiding principle for transactions in spot exchange shall be that, in general, market movements in exchange rates, within the limits established in the International Monetary Fund Agreement or by central bank practices, index affirmatively the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public.

Temporary or transitional fluctuations in payments flows may be cushioned or moderated whenever they occasion market anxieties, or undesirable speculative activity in foreign exchange transactions, or excessive leads and lags in international payments.

Special factors making for exchange market instabilities include (i) responses to short-run increases in international political tension, (ii) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, or (iii) market rumors of a character likely to stimulate speculative transactions.

Whenever exchange market instability threatens to produce disorderly conditions, System transactions are appropriate if the Special Manager,

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in consultation with the Federal Open Market Committee, or in an emergency with the members of the Committee designated for that purpose, reaches a judgment that they may help to re-establish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified, curtailed, or eventually discontinued pending a reassessment by the Committee of supply and demand forces.

Insofar as is practicable, the New York Bank shall purchase a currency through spot transactions at or below its par value, and sell a currency through spot transactions at rates at or above its par value.

Spot transactions at rates other than those set forth in the preceding paragraph shall be specially authorized by the Committee or by the members of the Committee designated in Section VIII of the Authorization for Open Market Transactions in Foreign Currencies, except that purchases of exchange to meet System commitments may be executed without special authorization at rates above par when necessary.

4. Transactions in Forward Exchange

Transactions in forward exchange, either outright or in conjunction with spot transactions, may prove desirable:

(1) When forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to disequilibrating movements of short-term funds;

(2) When it is deemed appropriate to supplement existing market supplies of forward cover, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders;

(3) To allow greater flexibility in covering System commitments, including those under swap arrangements;

(4) To facilitate the use of holdings of one currency for the settlement of commitments denominated in other currencies.

Forward sales of authorized currencies to the U.S. Stabilization Fund out of existing System holdings or in conjunction with spot purchases of such currencies may also prove desirable in order to allow greater flexibility in covering commitments of the U.S. Treasury.

In all other cases, proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

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Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Scanlon, Shepardson, and Clay. Votes against this action: None.

4. Review of continuing authorizations.

This being the first meeting of the Federal Open Market Committee following the election of new members from the Federal Reserve Banks to serve for the year beginning March 1, 1965, and their assumption of duties, the Committee followed its customary practice of reviewing all of its continuing authorizations and directives. The actions taken with respect to the continuing authority directive for domestic open market operations and the guidelines for System foreign currency operations have been described in the preceding portions of the entry for this date.

The Committee reaffirmed its authorization regarding open market transactions in foreign currencies and its continuing authority directive on foreign currency operations, in the form in which they were outstanding at the beginning of the year 1965, as set forth in the preface to this record of policy actions.

Votes for these actions: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Scanlon, Shepardson, and Clay. Votes against these actions: None.

March 23, 1965

1. Authority to effect transactions in System Account.

The domestic business situation continued strong, according to reports at this meeting. Industrial production, retail sales, and nonfarm employment all rose to new record levels in February, although the unemployment rate returned to 5.0 per cent after dipping to 4.8 per cent in January. Weekly estimates suggested that average industrial commodity prices remained stable from mid-January through early March at a level less

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than 1 per cent above that prevailing in the first 9 months of 1964.

The near-term outlook appeared generally favorable despite uncertainties related to labor negotiations in the steel industry and to apparently unsustainable rates of activity in steel and automobiles. As to the latter, it seemed doubtful that sales of new cars would maintain the exceptionally high rate set in the first 2 months of 1965, which was about one-fifth above the year-earlier level. On the other hand, a survey by the U.S. Department of Commerce and the Securities and Exchange Commission of business plans for plant and equipment expenditures, taken in February, implied that capital outlays would grow throughout 1965, and for the year as a whole would average about 12 per cent above their 1964 level.

Bank credit expanded at an annual rate of about 11½ per cent in the first 2 months of the year, considerably above the 8 per cent rise in 1964, and time and savings deposits continued to increase rapidly. In addition to meeting strong loan demands, banks added to their holdings of municipal issues, while substantially reducing their holdings of Treasury bills. Credit growth continued rapid in early March, according to data for city banks, but the rate of increase in time and savings deposits moderated. The money supply, which had declined in February, advanced sharply in the first half of March. Aggregate borrowings of member banks from the Reserve Banks were greater than their excess reserves in the first 3 weeks of March, with net borrowed reserves averaging about $40 million; in February excess reserves had exceeded borrowings by about $30 million.

Interest rates on most money market instruments continued firm or rose in recent weeks against the background of seasonally heavy liquidity needs associated with the March corporate dividend and tax dates, but the 3-month Treasury bill yield had declined about 5 basis points since early March to 3.92 per cent. The disparate behavior of bill yields apparently partly

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reflected temporary investments in bills of corporate funds being repatriated under the administration's program calling for voluntary efforts to restrain foreign lending and investment; any concomitant liquidation of dollar assets by foreign holders may have involved a broader variety of instruments. Treasury bond yields also declined, and yields on corporate and municipal bonds, which had advanced from late January to early March, stabilized at about the levels prevailing in the autumn of 1964.

The Treasury's gold stock declined by $825 million in the first 11 weeks of 1965, after decreasing by only $125 million in all of 1964. Although little firm statistical information was available as yet on the impact of the administration's balance of payments program, announced February 10, incomplete weekly figures suggested a surplus in the over-all U.S. payments balance in the most recent 4 weeks, following substantial deficits in the preceding 6 weeks. Outflows on long-term bank loans to borrowers in developed countries apparently dropped abruptly after mid-February from their high rate earlier in the year. Consistent with this development and also with larger than seasonal withdrawals of U.S. corporate funds from the Euro-dollar market, interest rates advanced in that market, and the dollar strengthened in markets for foreign exchange.

The Committee decided that a further slight firming of money market conditions was desirable at this time. The object, in part, was to reinforce the program of voluntary efforts to restrain foreign lending and investment, but the action also was considered appropriate in view of the strength of the domestic economy and the potential threat to general price stability that might be posed by a continuation of recent high rates of bank credit expansion. Other reasons cited by some members for a slight firming in policy were the recent decline in Treasury bill rates —considered undesirable on balance of payments grounds—and the fact that repatriation of funds formerly invested abroad added to the availability of credit to domestic borrowers.

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The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy and the continuing need to improve our international balance of payments, as highlighted by heavy gold outflows in recent months. In this situation, it is the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next 3 weeks shall be conducted with a view to attaining slightly firmer conditions in the money market.

Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Scanlon, and Shepardson. Votes against this action: Messrs. Mitchell, Robertson, and Clay.

Messrs. Mitchell, Robertson, and Clay dissented from this action on both domestic and balance of payments grounds. In their judgment the likely pace of the advance in business activity did not call for a firmer policy, particularly in view of the declines expected before long in the steel and automobile industries. In connection with the balance of payments, Messrs. Robertson and Clay felt that the recently launched administration program also provided grounds for not changing policy at this time. None of the dissenting members thought a change in policy was called for by the recent decline in Treasury bill rates relative to other money market rates. Mr. Robertson did not consider international bill rate differentials to be a good measure of rate incentives to capital flows; moreover, there appeared to be a reflux of short-term funds, rather than an outflow, at present. In Mr. Mitchell's judgment, higher Euro-dollar interest rates could give foreign central banks a desirable incentive to dispose of some of their dollar holdings to their own nationals

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to relieve pressures in that market, and it would be a mistake to offset any such tendency by higher U.S. interest rates.

2. Authority to purchase and sell foreign currencies.

On March 2, 1965, the Committee had approved a number of revisions in the guidelines for System foreign currency operations. At this meeting the Committee approved further revisions, affecting the first and second paragraphs of Section 4 of the guidelines, for the purpose of language clarification. The revisions in both paragraphs involved replacing the words, "may prove desirable" with the words, "may be undertaken." As amended, Section 4 of the guidelines read as follows:

4. Transactions in Forward Exchange

Transactions in forward exchange, either outright or in conjunction with spot transaction, may be undertaken:

(1) When forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to disequilibrating movements of short-term funds;

(2) When it is deemed appropriate to supplement existing market supplies of forward cover, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders;

(3) To allow greater flexibility in covering System commitments, including those under swap arrangements;

(4) To facilitate the use of holdings of one currency for the settlement of commitments denominated in other currencies.

Forward sales of authorized currencies to the U.S. Stabilization Fund out of existing System holdings or in conjunction with spot purchases of such currencies also may be undertaken in order to allow greater flexibility in covering commitments of the U.S. Treasury.

In all other cases, proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Robertson, Scanlon, Shepardson, and Clay. Votes against this action: None.

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The Committee also amended the continuing authority directive for foreign currency transactions to increase, from $2.35 billion to $2.65 billion, the dollar limit specified in the first paragraph on the aggregate amount of foreign currencies held under reciprocal currency arrangements. It had been the Committee's practice to set this limit at the sum of the amounts currently specified by the Committee for all individually authorized reciprocal currency arrangements, which represented the maximum of System covered holdings of foreign currencies under these arrangements in the remote possibility that they might all simultaneously be fully drawn on. This revision reflected authorization earlier in the present meeting to increase the sizes of the reciprocal currency arrangements with the Bank of Italy from $250 million to $450 million, and with the Bank of Japan from $150 million to $250 million.

Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Robertson, Scanlon, Shepardson, and Clay. Votes against this action: None.

April 13, 1965

Authority to effect transactions in System Account.

Reports at this meeting indicated that the business expansion was vigorous and broadly based. Nonfarm employment advanced in March to a level more than 2 million higher than a year earlier, and the unemployment rate dropped to 4.7 per cent, the lowest figure in more than 7 years. Industrial production also rose to a new high, with gains widespread among materials and finished products. Tentative weekly data suggested that retail sales had declined moderately in March after allowance for usual seasonal influences, as consumer purchases of automobiles and other durables rose less than seasonally. Retail sales figures

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for January and February had been revised upward, however, and first-quarter sales were at a record level.

Output in the steel and automobile industries continued at extraordinarily high rates. Although auto production currently exceeded consumer purchases, it was expected to remain large at least for a few more months as dealers increased inventories. The prospects for steel depended on the outcome of current wage negotiations, since users were continuing to accumulate stocks against the possibility of a strike. The present labor contract in the steel industry was scheduled to expire on May 1.

Some sensitive commodity prices, particularly of nonferrous metals and products, recently had begun to advance again, but average industrial prices had been essentially stable thus far in 1965 following a rise of three-fourths of 1 per cent during the preceding autumn. The consumer price index was unchanged in February at a level 1.2 per cent above a year earlier.

The demand for business loans at commercial banks continued unusually strong in March, and bank credit rose at an even faster rate than in the first 2 months of the year. At the same time the earlier rapid expansion in time and savings deposits slackened markedly, while the money supply increased by the amount it had declined in February. In the first quarter as a whole, bank credit expanded at a 13 per cent annual rate, compared with about 7 per cent in the fourth quarter of 1964; time and savings deposits and the money supply combined advanced at a rate of about 9 per cent, little changed from the preceding quarter.

Net borrowed reserves of member banks averaged about $130 million in the last week of March and the first week of April, compared with an average of $30 million earlier in March. The tone of the money market was somewhat firmer, with Federal funds frequently trading at rates about the 4 per cent discount rate. However, yields on Treasury securities and corporate and municipal bonds had shown little net change since the preced-

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ing meeting of the Committee. Bond markets exhibited some hesitancy in the early part of the interval as a result of continued concern over the position of sterling, evidences of strength in the domestic economy, and attempts to appraise the prospects for monetary policy. The market atmosphere improved subsequently, however, following budget proposals by the British Government and a reduction in the discount rate of the Bank of France. An announcement of the terms on which the Treasury would refund securities maturing on May 15, of which $4.1 billion were held by the public, was expected near the end of April.

Tentative estimates of the U.S. balance of payments in the first quarter suggested that the deficit was at a seasonally adjusted annual rate of roughly $2.5 billion, somewhat below the $3.1 billion deficit of 1964 and well below the fourth-quarter deficit of $6.0 billion, annual rate. There were encouraging additional indications that net outflows of U.S. private capital had diminished sharply after announcement of the administration's balance of payments program in the middle of the quarter. It was still too early to determine, however, how substantial and enduring an improvement was being achieved under the program.

The Committee concluded that no change should be made in its policy at this time, and that open market operations over the next 4 weeks should be conducted with a view to maintaining the firmer money market conditions that had prevailed recently. While this decision took into account the forthcoming Treasury financing operation, in the judgment of most members such a policy was appropriate in the light of current domestic and international conditions. At the same time, a considerable degree of concern was expressed about the acceleration in the rate of bank credit expansion of recent months; and some members indicated that they would welcome a slightly higher level of domestic short-term interest rates if market forces worked in that direction.

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The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy and the continuing need to improve our international balance of payments, as highlighted by heavy gold outflows in recent months. In this situation, it is the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, while taking into account the forthcoming Treasury financing, System open market operations over the next 4 weeks shall be conducted with a view to maintaining the firmer conditions in the money market that have recently prevailed.

Votes for this action: Messrs. Martin, Balderston, Bryan, Daane, Ellis, Mitchell, Robertson, Scanlon, Shepardson, Clay, and Treiber. Votes against this action: None.

May 11, 1965

Authority to effect transactions in System Account.

The business situation remained strong and, while some information for April suggested that the pace of the advance had moderated from the very high first-quarter rate, prospects for further expansion in coming months were strengthened by two recent developments. First, an interim labor agreement reached in the steel industry postponed the possibility of a strike at least until September 1 and offered an opportunity for a more orderly adjustment of steel production to final consumption rates. Secondly, businesses apparently had increased their anticipated capital expenditures in 1965 from levels reported earlier in the year. According to a private survey taken in March and early April, outlays on new plant and equipment in 1965 would be 15 per cent larger than in 1964. This compared with an expected

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rise of 12 per cent indicated in the Commerce–SEC survey, employing somewhat different methods, that had been conducted in February.

Industrial production evidently increased less in April than in other recent months; output gains in a variety of industries were partly offset by a reduction of 5 per cent in automobile assemblies from their record March level. Nonagricultural employment was about unchanged, and the seasonally adjusted unemployment rate rose to 4.9 per cent from 4.7 per cent in March because of a larger than usual increase in teenagers seeking work. Retail sales, which had declined 2 per cent in March from the February peak, eased slightly further in April, according to preliminary data, but remained high.

Recent information confirmed that businesses had continued to accumulate inventories at a rapid rate in the first quarter. Most of the rise was at distributors, particularly wholesalers and retail automobile dealers. Manufacturers' stocks, which had increased by a large amount in the fourth quarter, subsequently rose only moderately although steel stockpiling continued at a substantial pace.

Average industrial prices edged up in April as further advances occurred in some sensitive commodity prices. The consumer price index increased slightly in March but continued 1.2 per cent above its level a year earlier. Common stock prices reached a record high in early May.

Some of the temporary factors that earlier had stimulated business loan demand at commercial banks abated in April, and bank credit expansion moderated from the near-record first-quarter rate to about the average rate of 1964. Loan demand remained vigorous, however, and a further sharp increase in business loans occurred at city banks in early May. The money supply rose at a 5.3 per cent annual rate in April, as it had in March, but growth in time and savings deposits slackened further.

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Average net borrowed reserves of member banks increased to about $130 million in April from $50 million in the preceding month, and money market conditions remained generally firm. Bond yields moved up slightly or held close to earlier highs, and the tone in corporate and municipal bond markets was generally cautious in the face of large May calendars of public offerings. However, yields on 3-month Treasury bills declined several basis points recently, to 3.88 per cent, under pressure of strong demands, including demands from sellers of "rights" in the Treasury's May refunding, and substantial official purchases. In the refunding, holders of maturing issues were offered a choice of a 15-month, 4 per cent note (priced to yield about 4.12 per cent) or a 9 year, 4¼ per cent bond (priced to yield about 4.22 per cent) with settlement scheduled for May 17. The refunding was well received by the market and public subscriptions to the 4¼ per cent bonds were somewhat larger than most market participants had expected.

Surpluses were recorded in U.S. international payments in March and April, according to early indications, in contrast to large deficits in the first 2 months of the year. The improvement reflected a significant decline in outflows on domestic bank loans to foreigners and a substantial reflux of U.S. liquid funds from abroad, as well as a sharp rise in exports resulting from the end of an earlier longshoremen's strike. Further sales of gold by the Treasury to foreign monetary authorities brought the total reduction in the U.S. gold stock thus far in 1965 to nearly $1 billion.

The Committee agreed that in view of the current Treasury financing it was appropriate to maintain an "even keel" in money markets for the next 2 weeks. Recent signs of moderation in the pace of the business advance and in bank loan demand also were offered as reasons for continuing policy unchanged. On the other hand, several members indicated that they thought it would be desirable to consider seeking somewhat firmer money market conditions and slower growth in member bank reserves

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in the near future on the ground that recent rates of expansion in bank credit were excessive, particularly in view of the inflationary pressures they believed were latent in the economy.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy and some improvement in our international balance of payments, but with gold outflows continuing. In this situation, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, while taking into account the current Treasury financing, System open market operations over the next 2 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Galusha, Maisel, Robertson, Scanlon, and Shepardson. Votes against this action: None.

May 25, 1965

Authority to effect transactions in System Account.

Earlier indications that expansion in domestic economic activity had slowed in April from its advanced first-quarter pace were confirmed by reports at this meeting. As preliminary estimates had suggested, the rise in industrial production was small and retail sales edged down further; and in addition to the lack of advance in nonagricultural employment reported earlier, the average length of the workweek in manufacturing was reduced. There were a number of favorable factors in the outlook, including the recent results of a private survey suggesting a step-up in business plans for capital spending, other evidences of continuing business optimism, and administration proposals for reduc-

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tions in excise taxes. It appeared, however, that GNP would increase by considerably less in the second quarter than in the first, when an unusually large rise of $14 billion (seasonally adjusted annual rate) had been recorded under the combined stimuli of recovery from earlier automobile strikes and anticipations of a possible steel strike.

According to weekly data, average prices of industrial commodities advanced slightly further in May to a level fractionally higher than the 1960 peak and 1 per cent above a year earlier, mainly as a result of increases in metals and machinery. The total wholesale price index had risen somewhat more in the past year—1.5 per cent—as prices of meats and fruits and vegetables also moved up.

Data for city banks indicated that loan demand remained strong in the first part of May, but total bank credit was expanding at the slower rate evident in April as banks reduced security holdings. The money supply, which increased rapidly in March and April, dropped sharply in the first half of May as Treasury deposits rose substantially, and time deposits continued to grow at the reduced rate of the previous 2 months.

Although net borrowed reserves of member banks averaged about $155 million in the first 3 weeks of May, somewhat higher than the April average of about $130 million, conditions in money markets were little changed. Rates on 3-month Treasury bills fluctuated in a narrow range near 3.90 per cent. Yields on Treasury notes and bonds also continued generally stable, although they were under some upward pressure stemming in part from the slow progress by Government securities dealers in distributing issues acquired in the recent Treasury refunding. Corporate bond yields moved to new highs for the year—reflecting the heavy volume of public offerings in May—and prices of common stocks eased somewhat from the record level reached at midmonth.

More detailed data on U.S. balance of payments developments in March and April confirmed previous estimates of surpluses

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in those months, and tentative figures suggested that the nation's international payments were roughly in balance in early May. The improvement that had occurred appeared to reflect largely the initial success of the voluntary foreign credit restraint program and the aftereffects of the dock strike rather than basic adjustments of longer-run consequence. Additional gold sales by the Treasury to foreign monetary authorities were reported.

The Committee concluded that no change in current money market conditions was required at this time on either domestic or international grounds, although a minority favored a shift toward firmer conditions on one or both bases. While the members differed somewhat in their assessments of the prospects for domestic business activity and prices, it was generally agreed that the recent slowing in the pace of the expansion was not surprising in view of the special factors making for extremely rapid growth earlier. A number of members—including some who favored no change in policy at present—thought that the economic outlook remained highly favorable, but others were less certain about prospects. With respect to prices, some members thought that upward pressures might pose a serious problem. The view also was expressed, however, that recent price increases had been moderate in size and limited in scope, particularly when the unusual strength of demand pressures in the first quarter was considered. The reduction in the growth rate of bank credit in April and early May and the recent decline in the money supply were noted by some members as reasons for not seeking firmer money market conditions, as was the possibility that such conditions might lead to a significant rise in longer-term interest rates under present circumstances.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy, although at a somewhat slower pace, and some improvement in our international balance of payments, but with gold outflows continuing.

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In this situation, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next 3 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Bryan, Daane, Galusha, Maisel, Mitchell, Robertson, and Scanlon. Votes against this action: Messrs. Hayes, Balderston, Ellis, and Shepardson.

Mr. Balderston dissented from this action because he believed that the progress being made in effecting improvement in the U.S. balance of payments would be undermined unless it was supported by some reduction in domestic credit availability. Mr. Hayes shared this view, and also felt that the domestic business and price outlook now permitted and might even require a somewhat firmer policy. Mr. Ellis, who described the Committee's actions on February 2 and March 23 as "cautious probing toward modest credit restraint," thought that a continuation of such probing would be desirable on both domestic and international grounds. Mr. Shepardson concurred in these judgments.

June 15, 1965

Authority to effect transactions in System Account.

Domestic economic activity expanded in May but, as in April, the advance was slower than earlier in the year. Industrial production and total employment rose moderately and, with the labor force little changed, the unemployment rate dropped to 4.6 per cent from 4.9 per cent in the previous month. Retail sales, which were now indicated by revised data to have increased in April, rose further in May to a level slightly above the February peak.

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Prices of common stocks continued to decline in recent weeks, apparently reflecting as well as contributing to some increase in uncertainty about business prospects. At the time of this meeting average prices of common stocks had fallen about 6 per cent from their mid-May high.

Reports at this meeting suggested that the current pace of the business advance was likely to be maintained over the near term. It was noted that consumer spending would be bolstered in coming months by prospective reductions in Federal excise taxes and increases in social security payments. The decline in sales of new automobiles, to which much of the recent slowdown was attributable, apparently had halted; sales of domestic cars in May, at an annual rate of 8.1 million units, were little changed from April although well below the exceptionally high poststrike rate of 9.3 million units recorded in the first quarter. The numbers of consumers planning to buy cars and other durable goods remained large, according to a Census Bureau survey taken in April, and sales of nondurable goods in May were high and rising.

As to business spending, the May Commerce–SEC survey of plans for fixed investment outlays failed to support the step-up implied by a recent private survey. However, it did confirm the indications of the February official survey that capital expenditures would rise by about 12 per cent in 1965 and would advance more rapidly in the second half of the year than in the first two quarters. The evidence available on business inventories in the second quarter suggested that accumulation was continuing close to the high first-quarter rate and that steel users were adding further to their stocks of that metal.

Average wholesale prices were estimated to have increased about 1 per cent since the end of March. The rise was due mainly to sharply higher prices of foodstuffs as a result of reduced supplies and to a continued upward drift in prices of nonferrous metals and machinery. Higher food prices also contributed to the advance of the consumer price index in April

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to a level 1.4 per cent above a year earlier. Further increases in food prices, particularly for meats, were in prospect, but their effects on the consumer index were expected to be offset in part by reductions in excise taxes.

Bank credit expanded at an annual rate of 8 per cent in May, about the same as in April and considerably below the first-quarter rate of over 12 per cent. Growth in time and savings deposits slackened slightly further, and the money supply declined to the January level. The reduction in the money supply was associated with a large increase in Treasury deposits at commercial banks after mid-April, when tax payments were greater than usual. Net borrowed reserves of member banks averaged about $160 million in May and the first 2 weeks of June, compared with an April average of about $130 million.

Despite continued firmness in money market conditions, rates on 3-month Treasury bills declined to about 3.80 per cent in early June from the levels near 3.90 per cent that had prevailed through most of May. In part, the bill rate decline reflected a change in market expectations following a reduction, on June 3, in the discount rate of the Bank of England from 7 to 6 per cent. In addition, continued investor demands for Treasury bills may have been augmented by funds awaiting placement in the capital markets and by shifts in preferences away from common stocks. Meanwhile, supplies of short-term Treasury securities available to the public had been reduced, and were expected to be further reduced, by sizable debt repayments by the Treasury and by Federal Reserve purchases in supplying bank reserves.

In markets for longer-term securities, average yields on new corporate bonds rose about 10 basis points to their highest levels since early 1962 in the face of relatively heavy flotations. Yields on State and local bonds, the markets for which also were somewhat congested, advanced about the same amount to a new 1965 high, but Treasury note and bond yields changed little.

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Preliminary data for U.S. international payments in May and early June showed a continued small surplus, reflecting the administration's balance of payments program and further progress in clearing merchandise trade shipments held up by the earlier dock strike. Present indications were that a surplus would be recorded for the second quarter as a whole, in contrast with the large first-quarter deficit, now estimated to have been at a seasonally adjusted annual rate of $2.8 billion. Abroad, the combined external payments of major continental European countries moved from surplus to near-balance in March and April, and Japan's international payments concurrently shifted from surplus to deficit. There had been no marked improvement as yet in Britain's external position, and sterling continued under intermittent pressure in foreign exchange markets.

The Committee agreed that no change should be made in policy at this time. Considerations underlying this decision included the prevailing uncertainties in business and financial markets, the more moderate recent rates of expansion in economic activity and of growth in bank credit, and the maintenance of improvement in the U.S. balance of payments.

Although the Committee's conclusion was unanimous, in their initial expressions of views some members leaned toward a slightly firmer policy or noted that they found the choice between no change and slight firming to be close. These members, along with certain others, were concerned about the implications of upward price movements, both for the domestic economy and for the longer-run position of the U.S. balance of payments. They were not convinced that the pace of bank credit growth, although lower recently than earlier, had fallen to an appropriate level, and they noted the lack of evidence that the more basic forces were working toward improvement in the nation's international payments.

Some members thought, however, that recent and prospective price pressures were not of a character to call for further monetary restraint, and that the possibility of declines in rates of re-

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source utilization later in the year warranted close watching by the Committee. The lack of growth in the money supply thus far in 1965 was noted, and the view was expressed that a firmer policy at this juncture would not make the recent balance of payments improvement more lasting.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate continuing expansion of the domestic economy, although at a somewhat slower pace than in the first quarter, and maintenance of earlier improvement in our international balance of payments, but with gold outflows continuing. In this situation, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next 4 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Hayes, Bryan, Daane, Ellis, Galusha, Maisel, Mitchell, Robertson, Scanlon, and Shephardson. Votes against this action: None.

July 13, 1965

Authority to effect transactions in System Account.

The economic advance continued in June, according to reports at this meeting. Employment rose moderately and the unemployment rate—at 4.7 per cent—was little changed from the 4.6 per cent recorded in May. Tentative estimates suggested that both industrial production and retail sales maintained, or possibly bettered, their record May levels. Unit sales of new domestic automobiles rose sharply to an annual rate of 8.8 million units, perhaps partly as a result of purchases that had been postponed earlier because of uncertainty about excise taxes.

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Prices of common stocks, which had declined further in late June to a level about 10 per cent below their mid-May peak, subsequently recovered about half of that loss. The continued strength in retail sales, and the fact that no important reappraisals of business plans for fixed capital expenditures had been reported, suggested that the earlier stock market decline had had little effect on spending.

Although the rate of business inventory accumulation decreased in May, according to preliminary data, automobile dealers added further to their relatively large inventories of new cars, and stocks of steel continued to rise rapidly. There was some evidence suggesting that growth in aggregate inventories thus far in 1965 might have been greater than indicated by official figures.

The consumer and wholesale price indexes advanced in May, to levels 1.7 and 2.0 per cent, respectively, above a year earlier, and average wholesale prices rose further in June. Higher prices for foods continued to account for most of the increases. However, wholesale prices of industrial commodities were estimated to have risen by about three-fourths of 1 per cent in the first half of the year, following a rise of a similar amount in the fourth quarter of 1964.

Bank credit expanded substantially more in June than in April or May, as strong underlying demands for loans were augmented by various temporary factors, including heavy borrowing for corporate tax and dividend payments at midmonth. The money supply also increased sharply in June, bringing the annual rate of growth for the first half of 1965 to about 2.5 per cent, and time deposit expansion accelerated from its reduced May pace. Net borrowed reserves of member banks averaged about $180 million in June and the first week of July, as compared with an average of $160 million in May.

Money market conditions remained generally firm in recent weeks. On most days the effective rate on Federal funds was

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4⅛ per cent, and a few transactions in such funds reportedly were executed at one-fourth of a percentage point above the 4 per cent discount rate. Yields on 3-month Treasury bills continued to drift down in the latter part of June, but subsequently they rose about 10 basis points to levels above 3.85 per cent. The rise in bill rates was attributable in part to light investor demand and higher borrowing costs to dealers. Also important, however, was the fact that the Federal Reserve met the substantial reserve needs of the period mainly by purchases of longer-term Treasury securities, acquisitions of bills in direct transactions with foreign accounts, and other means, rather than—as many traders had expected—by sizable purchases of Treasury bills in the market.

In long-term security markets yields on new corporate bonds receded slightly from their mid-June peaks but were still about one-quarter of a percentage point above their levels early in the year; State and local bond yields continued under upward pressure; and yields on Treasury notes and bonds showed little net change. It was expected that late in July the Treasury would announce the terms on which securities maturing in mid-August would be refunded. About $3.2 billion of these securities were held by the public.

Tentative estimates indicated a surplus in U.S. international payments in the second quarter of about $200 million, seasonally adjusted. Much of the marked improvement from the large deficit of the first quarter reflected the initial impact of the administration's balance of payments program, particularly on bank credit flows; in contrast to the large first-quarter outflows of bank credit, there were inflows in the form of net repayments in April and May. Also, the trade surplus increased in the second quarter, because delays in shipments caused by the earlier dock strike were greater for exports than for imports.

It did not appear likely that all of the second-quarter improvement in the payments balance would be sustained, and the reap-

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pearance in the second half of 1965 of at least a moderate deficit seemed probable. By the end of May aggregate foreign loans of U.S. banks were below the target levels established under the voluntary foreign credit restraint program, thus leaving room for a resumption of net outflows later in the year. Also, recent trends in U.S. merchandise trade, while partly obscured by distortions due to the dock strike, suggested that the gain in U.S. exports from 1964 to 1965 would not be large and might well be substantially less than the rise in imports, with a consequent reduction in the trade surplus.

In the course of the discussion some members of the Committee characterized the domestic business outlook as strong and expressed concern about recent and prospective price developments, the renewed rapid increase in bank credit, and the longer-term outlook for the balance of payments. These considerations, they thought, offered some grounds for seeking a firmer tone in the money market. At the same time certain of these members, as well as others, doubted that a modest policy change would have significantly useful effects under prevailing conditions, and they felt that a larger change was undesirable partly because of the expected Treasury financing. Also, some members noted that an overt change in money market conditions might require an increase in the Federal Reserve discount rate, a step they did not favor at present. However, the view also was expressed that a discount rate increase would be appropriate if bank credit continued to expand at a rapid pace, and that a modest firming of policy now would provide a better basis for such action later.

Other members—noting the possibility of inventory adjustments later in the year and indications that final demands were not likely to expand as rapidly as productive capacity—were less confident about prospects for the economy. In their judgment neither domestic price and bank credit developments nor the balance of payments situation warranted a firmer policy;

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indeed, they believed that the Committee shortly might find it necessary to move in the direction of greater ease. Still other members found little basis in current domestic and international circumstances for either firmer or easier money market conditions.

While their reasons differed, at the conclusion of the discussion all but one member of the Committee agreed that no change should be made in policy at this time. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The economic and financial developments reviewed at this meeting indicate continuing expansion of the domestic economy, although at a slower pace than in the first quarter. Reflecting the large initial impact of the administration's balance of payments program, there was a surplus in our international payments in the second quarter. In this situation, and with gold outflows continuing, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.
>
> To implement this policy, and taking into account the forthcoming Treasury financing, System open market operations over the next 4 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.
>
> Votes for this action: Messrs. Martin, Balderston, Bryan, Daane, Galusha, Maisel, Mitchell, Robertson, Scanlon, Shepardson, and Treiber. Vote against this action: Mr. Ellis.

Mr. Ellis dissented from this action because he favored a further slight step toward less ease similar to the several such actions the Committee had taken during the past 12 months. In his judgment this would help to hold any autumn credit surge within bounds; and, if credit demands should weaken, it would have established a base from which a policy move toward ease would have greater impact.

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August 10, 1965

1. Authority to effect transactions in System Account.

Business activity expanded further in July, and the outlook for coming months was affected by a number of developments, including a Presidential announcement on July 28 of a planned enlargement of U.S. military efforts in Viet Nam. The additional defense spending presently planned did not appear large enough in itself to result in excessive levels of aggregate demand or in widespread production bottlenecks, but the volume of expenditures that might ultimately prove necessary was, of course, impossible to foresee. Amendments to the Social Security Act signed into law on July 30 provided, among other things, for increases in benefit payments retroactive to the first of the year, which appeared likely to add to consumer spending. On the other hand, it was expected that production for inventory would abate later in the year from its current rate. In particular, steel output was likely to decline after September 1—when the 4-month interim labor agreement was scheduled to expire—even if a settlement was reached, as users worked off stocks accumulated as a precaution against a strike.

In July the rate of unemployment declined to 4.5 per cent, the lowest monthly rate since October 1957, despite a sharp rise in the labor force. Early indications were that industrial production rose further to a new peak, and retail sales, which had edged down in June, were tentatively estimated to have exceeded their previous high. These July gains followed a second quarter in which, according to preliminary Department of Commerce estimates, GNP rose at a seasonally adjusted annual rate of about $9 billion—less than the unusual first-quarter advance of $14 billion, but more than had been generally expected.

Average wholesale prices of industrial commodities apparently changed little in July. Increases for some basic commodities,

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related to developments in Viet Nam, proved—with the exception of copper—to be largely temporary. The consumer price index advanced one-half of 1 per cent in June as prices of foods rose further.

At commercial banks business loans continued to grow rapidly in July. Total bank credit probably declined a little during the month, however, as a result of repayments of various kinds of temporary credits that had contributed to the large increase in June and of further reductions in bank holdings of Government securities. Growth in the money supply was less rapid than in June, but time deposits expanded at the highest rate since February. Average net borrowed reserves of member banks, at about $180 million, were unchanged from June.

Securities markets were characterized by a cautious tone in recent weeks as a result of uncertainties relating both to developments in Viet Nam and to continued intermittent pressures on sterling in markets for foreign exchange. Treasury note and bond yields edged up in late July and early August, and the 3-month Treasury bill rate, after declining in the latter part of July, advanced somewhat in early August to levels in the neighborhood of 3.85 per cent. Despite such market weakness, the Treasury's mid-August refunding, which involved slightly more than $3 billion in publicly held maturing securities, was well received.

The U.S. balance of payments continued in surplus in July, according to tentative estimates. Available data for June, however, provided further indications of a deterioration in the trade surplus; exports were about unchanged from the level of the previous autumn but imports were sharply higher.

On July 27 Britain announced further measures designed to improve its external position. There was no substantial abatement of exchange market pressures on sterling, however, partly because of uncertainties arising from published figures indicating further reductions in Britain's international reserves

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in July. Most recently, publication of British foreign trade figures for July revealed a substantial increase in that country's exports.

Members of the Committee differed somewhat in their assessment of the forces affecting the outlook for the domestic economy. They agreed, however, that no change should be made in policy at this time, particularly in light of the various uncertainties presently existing at home and abroad. The current Treasury financing, although moderate in size and about to be completed, also was advanced as providing some ground for maintaining present policy.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further, but at a slower pace than early in the year, and that the improvement in our international payments that occurred in the second quarter has been maintained for the time being, although gold outflows have continued and international developments are creating uncertainties in securities and foreign exchange markets. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next 3 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account the Treasury financing about to be completed and the unsettled conditions in securities and foreign exchange markets.

Votes for this action: Messrs. Martin, Balderston, Galusha, Maisel, Mitchell, Robertson, Scanlon, Shephardson, Bopp, Irons, and Treiber. Votes against this action: None.

2. Authority to purchase and sell foreign currencies.

At this meeting the Committee revised its continuing authority directive for transactions in foreign currencies in two respects.

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One revision involved a change, from $2.65 billion to $2.8 billion, in the dollar limit specified in the first paragraph of the directive on the aggregate amount of foreign currencies held under reciprocal currency arrangements. As indicated in Section 2 of the entry for March 23, 1965, it had been the Committee's practice to set this limit at the sum of the amounts currently specified by the Committee for all individual authorized reciprocal currency arrangements. Today's revision was made because earlier in the present meeting the Committee had ratified an increase in the size of the reciprocal currency arrangement with the Bank for International Settlements from $150 million to $300 million. The second revision involved the addition of a new final paragraph to the directive authorizing purchases of sterling by the Federal Reserve Bank of New York on a covered or guaranteed basis up to a total of $50 million equivalent, in addition to the foreign currency purchases authorized in preceding paragraphs. This supplementary authorization provided a further potential for cushioning or moderating disequilibrating movements of funds in foreign exchange markets.

Reflecting these revisions, the continuing authority directive for transactions in foreign currencies read as follows:

The Federal Reserve Bank of New York is authorized and directed to purchase and sell through spot transactions any or all of the following currencies in accordance with the Guidelines for System Foreign Currency Operations as amended March 23, 1965; provided that the aggregate amount of foreign currencies held under reciprocal currency arrangements shall not exceed $2.8 billion equivalent at any one time, and provided further that the aggregate amount of foreign currencies held as a result of outright purchases shall not exceed $150 million equivalent at any one time:

Pounds sterling
French francs
German marks
Italian lire
Netherlands guilders
Swiss francs

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Belgian francs
Canadian dollars
Austrian schillings
Swedish kronor
Japanese yen

The Federal Reserve Bank of New York is also authorized and directed to operate in any or all of the foregoing currencies in accordance with the Guidelines and up to a combined total of $275 million equivalent, by means of:

(a) purchases through forward transactions, for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements;

(b) purchases and sales through forward as well as spot transactions, for the purpose of utilizing its holdings of one currency for the settlement of commitments denominated in other currencies;

(c) purchases through spot transactions and concurrent sales through forward transactions, for the purpose of restraining short-term outflows of funds induced by arbitrage considerations; and

(d) sales through forward transactions, for the purpose of influencing interest arbitrage flows of funds and of minimizing speculative disturbances.

The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing currencies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $100 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

The Federal Reserve Bank of New York is also authorized and directed to make purchases of sterling on a covered or guaranteed basis in terms of the dollar up to a total of $50 million equivalent.

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Votes for this action: Messrs. Martin, Balderston, Daane, Galusha, Maisel, Mitchell, Robertson, Scanlon, Shepardson, Bopp, Irons, and Treiber. Votes against this action: None.

August 31, 1965

Authority to effect transactions in System Account.

Reports at this meeting confirmed earlier estimates that industrial production and retail sales had reached new highs in July. Production gains in both June and July were larger than in most earlier months of the year as a result of further advances in output of business equipment and of materials, including steel; consumer goods output continued to show little change at a level about 5 per cent above a year earlier. Manufacturers' inventories rose considerably in July, following three quarters in which total business inventories had increased at a more rapid rate than earlier in the current business expansion. The unemployment rate, which had declined to 4.5 per cent in July, remained at that level in August.

Business sentiment recently had become more buoyant, as activity continued to expand faster than had been expected and as prospects for further advances were enhanced by expected rises in military outlays in connection with the Viet Nam hostilities. To date, however, developments in Viet Nam did not appear to have given any sharp, direct stimulus to consumer or business spending, and the timing and amount of expected increases in military expenditures remained highly uncertain.

Additional major uncertainties were associated with the situation in the steel industry. Labor negotiations were still in process at the time of this meeting, and the interim agreement, originally scheduled to expire on September 1, had been extended 8 days at the request of the President. It was not clear whether a settlement would be arrived at without a strike, nor what the terms of the settlement would be. Also in doubt were the probable dimensions and timing of the reduction in

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steel inventories expected to follow the conclusion of a labor agreement; it was possible that the amount of liquidation, while still substantial, would be less than anticipated earlier, particularly if it appeared that military needs for steel would rise rapidly or if the terms of the labor agreement made future increases in steel prices more likely.

Average wholesale prices of industrial commodities, which were stable in July, appeared to have edged up in August, but changes continued selective, without any general response to developments in Viet Nam. The total wholesale price index was estimated to have declined slightly in August as a result of some reductions for foods, which had accounted for most of the rise in the index earlier in the year. The consumer price index rose slightly further in July, despite declines for some products resulting from reductions in excise taxes.

The demand for business loans at banks continued strong and commercial bank credit, which had declined in July, was expanding again in August. Growth of time deposits accelerated from the high July rate, but growth in the money supply moderated further. Average net borrowed reserves of member banks continued to show little change.

The latest information on U.S. international payments indicated that a deficit occurred in August and, contrary to earlier reports, that payments probably were in deficit in July also. Gold outflows continued, but at a lower rate than in the first half of the year. In foreign exchange markets, there had been some improvement recently in attitudes with respect to the outlook for sterling, but the situation remained delicate.

Conditions in domestic money markets generally were steady in recent weeks, although yields on 3-month Treasury bills rose several basis points. Bond markets weakened considerably. Treasury bond yields advanced to their highest levels since the spring of 1964, and yields on new issues of high-grade corporate bonds broke through their June peaks to levels not reached since the summer of 1961. To some extent, the rise in corporate

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bond yields stemmed from unseasonally large recent and prospective flotations; and the rise in yields on Treasury bonds reflected the growing attractiveness of corporate yields for institutional investors. Also, dealer holdings of longer-term issues were still sizable, despite recent reductions as a result of official purchases. To a major extent, however, the yield advances reflected a shift in investor expectations regarding the economic outlook and the future course of interest rates. A variety of factors contributed to this shift, including the unexpectedly strong performance of the economy, developments in Viet Nam, uncertainties regarding the probable terms of the steel wage settlement, continued nervousness about the prospects for sterling, and the possibility that a firmer monetary policy might be required for domestic or balance of payments reasons.

The Committee decided that no change should be made in policy at this time, partly because of the various existing uncertainties. Cited in this connection were the uncertainties about the outcome of wage negotiations in the steel industry and about the likely magnitude and duration of the expected subsequent reduction in steel inventories; the lack of reasonably precise information regarding the probable impact of developments in Viet Nam on the economy; the still sensitive position of sterling in foreign exchange markets; and the possibility that, in view of the recent weakening in bond prices, domestic security markets might over-react to any firming of monetary policy, however modest was the intended change.

Some members who agreed that such factors made a policy change inappropriate at present indicated that in the absence of these factors they might have been inclined toward a shift in the direction of firming. Among the grounds for firming mentioned by members in this group were the strength in the business outlook and the prospects for further price advances; the continued rapid growth in business loans at banks; and the recently less favorable balance of payments situation. Other members expressed the view that even apart from the existing

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uncertainties a firmer policy was not warranted at present. In their judgment a reduction in the rate of over-all inventory accumulation was likely to act as an offset to the economic stimulus of developments in Viet Nam, and they saw little ground at the moment for expecting inflationary pressures to develop in the near future.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further, but with markets characterized by uncertainties as to possible developments in steel, sterling, and Viet Nam. Our international payments have reverted to deficit in August, and gold outflows have continued, although at a more moderate rate. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account unsettled conditions in securities and foreign exchange markets.
>
> Votes for this action: Messrs. Martin, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Robertson, Scanlon, Shepardson, and Irons. Vote against this action: Mr. Treiber.

Mr. Treiber dissented because he believed that domestic considerations warranted some restriction in credit availability before inflationary pressures gained momentum, and because in his judgment the need to bring about a fundamental improvement in the international payments of the United States was pressing. While agreeing that, in light of the various existing uncertainties, caution would be required in reducing the degree of credit availability, he felt that moderate action of that kind would not have untoward consequences.

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September 8, 1965

Authority to purchase and sell foreign currencies.

At this meeting, which was held by telephone, the Committee amended the final paragraph of the continuing authority directive for foreign currency transactions to increase the dollar limit specified for purchases of sterling by the Federal Reserve Bank of New York on a covered or guaranteed basis in terms of the dollar to $200 million equivalent from $50 million equivalent.

Votes for this action: Messrs. Martin, Balderston, Daane, Ellis, Maisel, Robertson, Scanlon, Shepardson, Clay, Irons, and Treiber. Votes against this action: None.

For several weeks negotiations had been in process among Britain, the United States, and a number of other countries on a program designed to assist the recovery of sterling, and today's action was taken in connection with that program, on recommendation of the Special Manager of the System Open Market Account. The U.S. Treasury was planning to participate with the Federal Reserve in the package of assistance.

September 28, 1965

Authority to effect transactions in System Account.

Economic activity advanced further against a background of optimistic business sentiment, and most analysts reportedly

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were now expecting the expansion to continue for some time. Conditions in financial markets had become firmer, and average prices of common stocks had recovered to about their spring highs on heavy trading volume.

Some of the major uncertainties existing at the time of the preceding meeting had since been clarified. The position of sterling in foreign exchange markets improved markedly following announcements by the British Government in the early part of September of further measures to restrain wage and price increases and of new international agreements in support of the pound. Domestically, labor negotiations in the steel industry had been concluded with a settlement that appeared to be about in line with the administration's guideposts.

Industrial production and nonfarm employment rose slightly in August, and the unemployment rate continued at the reduced level of 4.5 per cent reached in July. Retail sales declined by 1 per cent from their high July rate but appeared to be rising again in early September, with automobile sales particularly strong. Average prices of industrial commodities edged up in August but, according to preliminary estimates, had changed little further by mid-September.

Business inventory investment, which had been tending down from the exceptionally high rate reached in the first quarter, was expected to moderate further following the settlement of wage negotiations in the steel industry. Nevertheless, further gains seemed likely in final purchases by businesses as well as by government and consumers. The latest Commerce–SEC survey of business plans for fixed capital outlays indicated that such outlays in 1965 would be about 13.5 per cent above 1964, in contrast to rises of about 12 and 12.5 per cent shown in the February and May surveys, respectively. Moreover, sharply advanced capital appropriations reported by large manufacturing companies in a private survey suggested that the momentum of the expansion in capital spending was likely to

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carry forward into 1966. Although the dimensions of the expected increase in Federal expenditures as a result of the hostilities in Viet Nam were still in doubt, Federal spending—for both defense and nondefense purposes—was rising, and spending by State and local governments was continuing to grow. Personal incomes were expected to show an unusually large increase in September because of higher social security benefit payments retroactive to the first of the year and increased military pay rates. According to a Census Bureau survey taken in July, consumers were optimistic about their income prospects, and more of them reported plans to buy new automobiles and houses than a year earlier.

The money supply expanded substantially in September as Treasury deposits were drawn down sharply, but the rate of growth in time and savings deposits fell off somewhat. According to data for city banks, the rate of increase in commercial bank credit, which was high in August as a whole, moderated late in that month and early in September. Among the factors accounting for the more moderate recent growth were the reduction in Treasury deposits, some liquidation of inventory loans by metal-using companies following the steel settlement, slackened growth in bank holdings of municipal and other securities, and cumulating pressures on bank reserve positions. Renewed heavy borrowing by businesses around the September tax date suggested that underlying demands for business loans remained strong, and there were indications that interest rate and other terms on bank loans were becoming firmer. Average net borrowed reserves of member banks in the first 4 weeks ending in September were estimated at about $120 million, down from the August average of about $170 million.

Interest rates on Treasury and corporate bonds rose further in September, and State and local government bond yields, which had been relatively stable in August, increased sharply.

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Yields on 3-month Treasury bills changed comparatively little over the first 3 weeks of the month, but subsequently the rate moved up about 10 basis points and reached a level of 3.99 per cent on the day preceding this meeting. The Treasury had announced that on October 5 it would auction $4 billion of tax anticipation bills, and the rise in bill rates in part reflected the forthcoming additions to supplies. But it also reflected a general heightening of money market pressures following the mid-September tax date that resulted from strong credit demands and a distribution of bank reserves away from the central money markets. In addition to bill yields, other short-term rates advanced, including the effective rate on Federal funds and rates offered by New York banks on negotiable certificates of deposit with maturities of less than 6 months.

In July and August the deficit in the U.S. balance of payments on the "regular transactions" basis now appeared to have been at an annual rate slightly higher than the $1¼ billion rate recorded in the first half of the year. The trade balance apparently improved somewhat after midyear, but net U.S. private capital outflows increased more as reflows of liquid funds and bank credit appeared to be tapering off. In the second quarter, according to newly available data, outflows of direct investment capital were much larger than most analysts had expected.

Prior to reaching a decision on the appropriate objective of monetary policy at this juncture, the Committee explored several possible alternatives. These included maintaining approximately the current conditions in the money market; supplying reserves in sufficient quantity that the money market rates that had prevailed before the recent increase in pressures would again be approached; and reinforcing the recent trend in the market toward firmer conditions, or at least not offsetting a furtherance of this trend if produced by market forces. The

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conclusion of the majority was that it would be desirable to maintain about the current conditions, while a minority favored fostering a return to the general market conditions that had prevailed earlier. Some members of the majority felt that neither domestic nor international considerations warranted further firming at this time, although they did not consider it desirable to pursue the course recommended by the minority. Other members of the majority thought that the main reason for maintaining the status quo, as contrasted with a further firming, was the forthcoming Treasury financing, with Britain's continuing effort to restore the position of sterling mentioned as another consideration. Otherwise, they indicated, factors such as the inflationary pressures they thought were inherent in the strong business outlook and the continuing balance of payments problem might have been persuasive influences to them.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further in a climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit since midyear. Some of the uncertainties previously affecting foreign exchange markets have diminished. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, and taking into account the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current conditions in the money market.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Ellis, Galusha, Scanlon, Shepardson, and Irons. Votes against this action: Messrs. Maisel, Mitchell, and Robertson.

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Messrs. Maisel, Mitchell, and Robertson dissented from the action taken by the Committee on two grounds. First, they felt that the recent sharp increases in both short- and long-term interest rates were partly the result of the fact that nonborrowed reserves were not being supplied at the rate required by the growing economy. They anticipated that there would be still further increases in interest rates and tightening of credit availability in longer-term financial markets if reserve growth continued to be held below the economy's needs. In their judgment evidence was lacking that inflation either existed or was just around the corner and, accordingly, their preference was to see no greater credit restraint develop at this time. To assure such an outcome they favored open market operations designed to move conditions in the central money markets back to around their averages for the month of September. Second, the dissenting members felt that the language in the directive referring to "maintaining about the current conditions in the money market" was vague and open to misinterpretation, especially in the light of the sharp tightening in market conditions that actually had taken place over the past month when open market operations were being conducted under a similar "no change" directive. In particular, they were concerned that the wording of the directive would permit further tightening of credit conditions, even though couched in terms which could be otherwise construed.

October 12, 1965

Authority to effect transactions in System Account.

Information that had become available in the 2-week period since the previous Committee meeting lent further confirmation

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to the view that domestic economic activity was generally strong and was continuing to expand.

Industrial production appeared to have declined slightly in September, principally because excess steel inventories were beginning to be reduced. The labor market remained strong, however, and the unemployment rate dropped to 4.4 per cent, the lowest level in many years. Retail sales remained at a high level.

According to weekly estimates, the industrial commodity price index had edged up since mid-August, bringing the total rise to 1.5 per cent since the summer of 1964, but foodstuffs continued to decline from their July peak and the total wholesale price index remained at the June-August level. The consumer price index, after rising more than 1 per cent from March to July, declined two-tenths of 1 per cent in August due to the drop in average food prices.

Sales of new domestic automobiles in September remained at the 8.9 million annual rate of the previous 3 months, and prices for the 1966 models—most of which had now been introduced—appeared close to those for the 1965 models. The growth of consumer instalment credit slowed in August, on a seasonally adjusted basis, but early reports for September suggested a return of the rate of net borrowing to levels somewhat above August.

New orders for durable goods showed somewhat less decline in August than preliminary figures had indicated, due mainly to an upward revision in new orders for defense production. Business inventory accumulation in August was not as large as in July; but for the 2 months combined accumulation exceeded the second-quarter rate and approached the high rate of the first quarter. Construction expenditures during the third quarter were unchanged from their second quarter level as higher outlays for business, other private nonresidential, and public con-

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struction offset a downdrift in residential construction activity.

In financial markets there was a slackening in the pace of bank credit expansion in September. The annual rate of growth in the third quarter was estimated at 5.5 per cent compared with approximately 12.5 per cent and 10 per cent in the first and second quarters, respectively. However, when security loans were excluded, total loans rose at an annual rate of about 13 per cent in the third quarter, which was 1 percentage point above the 1964 rate. The demand for business loans had been strong recently after moderating somewhat in late August and early September; for the month of September as a whole such loans expanded at an annual rate of almost 13 per cent.

Following a slowdown in August, the money supply rose in September at a seasonally adjusted annual rate of almost 12 per cent; this reflected in part an unusually sharp reduction of U.S. Government deposits. For the year to date the money supply had grown at an annual rate of 3.8 per cent, a little below the rate for 1964. Time and savings deposit growth in September was at an annual rate of 12 per cent, considerably below the rates of the previous 2 months. While savings deposit inflows remained strong, run-offs of negotiable certificates of deposit were heavy during the September tax and dividend period and only about half had been replaced by the end of the month. Certain major banks had recently pushed their offering rates on certificates to, or close to, the ceiling of 4.5 per cent.

Money market conditions had eased slightly since the period of considerable pressure toward the end of September, with bill rates and other interest rates dropping back somewhat. The supply situation as to Treasury bills had been eased considerably by the System's large purchases of bills to supply needed reserves during the late September period. This abatement of market pressures enabled the Treasury to auction $4 billion of tax anticipation bills at somewhat lower rates than earlier anticipated, and the demand for these bills in the secondary market

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proved to be better than many had expected earlier. The Treasury was expected to announce in late October the terms of its November refunding; $3.3 billion of maturing securities were held by the public. Trading activity in the stock market remained heavy, although the volume was somewhat below the high daily average for the month of September. Prices continued to move in a rather narrow range at about the highs reached in the spring of the year.

U.S. foreign trade showed some improvement in July and August. The trade surplus exceeded a $6½ billion annual rate in those months as exports rose by about 4 per cent in July and again in August while the growth in imports appeared to have tapered off. Nevertheless, preliminary data for the third quarter suggested a payments deficit on the "regular transactions" basis at an annual rate in the order of magnitude of $1¼ billion, and it appeared that in September the "official settlements" balance may have reverted to deficit on a seasonally adjusted basis. In foreign exchange markets the outstanding recent development had been the further recovery of sterling, which was now trading at a spot rate above par.

In the Committee's discussion of the course of monetary policy, some members noted that any significant move toward further firming would almost inevitably soon require consideration of changes in the discount rate and in the maximum rates of interest permitted to be paid on time and savings deposits. It was the predominant view that such changes would not be advisable at this particular time. Accordingly, the discussion focused on a relatively narrow range of policy objectives during the forthcoming 3-week period. Most members of the Committee believed that the best short-run alternative would be to maintain about the existing degree of money market firmness, recognizing that objectives expressed in terms such as bill rates, net borrowed reserves, and Federal funds rates might not prove to be mutually compatible. In this regard, there was some dis-

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position to feel that the level of net borrowed reserves, one of the indicators of market conditions, should be assigned a less prominent role than usual in the current context. Other members of the Committee, who expressed concern about potential inflationary pressures against a background of large cumulative increases in bank credit and the international payments problem, thought that any doubts in the conduct of open market operations should be resolved on the side of a firmer market tone. On the other hand, some members felt that in the absence of clear evidence of a break-out of inflationary conditions care should be exercised against basing actions on expectations, and that any doubts therefore should be resolved on the side of easing bank reserve positions slightly.

At the conclusion of the discussion, the following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity has expanded further in a continuing climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit on the "regular transactions" basis since midyear. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, and taking into account the Treasury financing schedule, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining a firm tone in the money market.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Robertson, Scanlon, Shepardson, and Irons. Votes against this action: None.

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November 2, 1965

Authority to effect transactions in System Account.

Gross national product advanced at an annual rate of $11 billion in the third quarter of 1965, according to preliminary estimates, compared with an increase of $9.5 billion in the preceding quarter. Although the adjustment of steel inventories was producing a considerable drop in the rate of business inventory accumulation and a leveling off in industrial production in the fourth quarter, another substantial rise in GNP appeared likely as marked further gains were expected in outlays for business fixed investment, in Federal defense outlays, and in consumer incomes and spending.

Contrary to earlier indications, average prices of industrial commodities were stable from mid-August to mid-September, and weekly estimates showed little change through late October. The consumer price index rose by two-tenths of 1 per cent in September, the amount by which it had declined in August, with seasonal increases in apparel and fuels accounting for much of the rise.

Partial data for October suggested that industrial production might have been maintained at about the September level, 1 per cent below the previous month, despite a further decline in steel output. In September, strikes in a number of industries and the impact of "Hurricane Betsy" on crude oil output had served to reinforce the effects of the steel contraction on total output; subsequently, however, settlement of the strikes and recovery of oil production had acted to offset the further contraction.

Growth in the money supply was rapid in early October—although less so than during September—partly because U.S. Government deposits were reduced further. Loan demand at commercial banks continued strong and seemed likely to remain vigorous over the final months of the year despite reduced needs for funds by firms that had been stockpiling steel. Net borrowed

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reserves of member banks averaged about $130 million in October, compared with about $140 million in September and $170 million in August.

Interest rates on short- and long-term Treasury securities, which had declined in the first half of October, subsequently edged up again. The general tone of security markets was cautious in the face of good business prospects and heavy actual and anticipated demands for funds. Average prices of common stocks rose to new highs on very heavy trading volume. On the day preceding this meeting the Treasury offered a 4¼ per cent 18-month note for cash, to refund issues maturing on November 15. It was expected that the Treasury also would auction between $2 billion and $2.5 billion of tax anticipation bills within the next few weeks.

The U.S. trade surplus improved substantially in the third quarter, according to preliminary estimates, to an annual rate somewhat over $6 billion. The latest information on the over-all balance of payments in the quarter, however, indicated that the deficit on the "regular transactions" basis was considerably larger than had been estimated earlier—at an annual rate about double that of the first half—and that the surplus on the "official settlements" basis was smaller than had been anticipated. In September, taken alone, the accounts were in deficit on both bases of calculation.

The Committee agreed that the Treasury financing now in process precluded a change in monetary policy at this time. The possibility was noted that market forces might exert upward pressure on interest rates over coming weeks, and divergent views were expressed regarding the appropriate response in such an eventuality. Some members advocated active resistance to any such forces, while others favored permitting rates to rise in response to them.

Views also differed with respect to the type of policy that was likely to be required following completion of the Treasury

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financing. Some members felt that it would prove desirable then for the System to adopt a firmer policy stance, and a possible increase in the discount rate was mentioned in this connection. These members thought a firmer policy, by reducing the rate of bank credit expansion and damping incipient inflationary pressures, would prove helpful both in promoting the sustainability of the domestic expansion and in ameliorating the balance of payments problem. Other members were of the opinion that current domestic and international conditions did not warrant a firmer policy on the part of the Committee nor an increase in the discount rate. They disagreed with the view that such actions would help to maintain the domestic expansion, and they did not consider general instruments of monetary policy to be the appropriate means for dealing with the balance of payments problem under present circumstances.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity has expanded further in a continuing climate of optimistic business sentiment and firmer financial conditions, and that our international payments have remained in deficit. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, and taking into account the Treasury financing schedule, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market that have prevailed since the last meeting of the Committee.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Patterson, Robertson, Scanlon, and Shepardson. Votes against this action: None.

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November 23, 1965

1. Authority to effect transactions in System Account.

Prospects for continued substantial gains in business activity in the current quarter and in early 1966 were firmer than 3 weeks earlier, according to reports at this meeting. It now appeared that the fourth-quarter reduction in the rate of business inventory accumulation might be somewhat smaller than anticipated earlier, and the outlook was strong for all major categories of final demand except residential construction, which had declined slightly in the third quarter.

Industrial production increased somewhat in October as another large monthly decline in steel output was more than offset by production gains in business equipment, defense, and some consumer goods industries. Retail sales rose appreciably in the month to a new record level. The demand for labor continued strong, and the unemployment rate edged down further to 4.3 per cent from 4.4 per cent in September.

According to a private survey taken in October, businesses planned to spend about 8 per cent more on new plant and equipment in 1966 than they had in 1965. It was possible that the actual gain in capital spending would be larger than these plans implied; in each of the past 4 years expenditures rose substantially more than indicated by this survey in the preceding autumn.

The index of industrial prices edged up in October, and weekly estimates suggested a further slight rise in November. Since midyear the average of these prices had advanced at an annual rate of about 1 per cent, compared with a rate of about 2 per cent in the preceding 9 months.

The money supply increased substantially in October; for the first 10 months of the year growth was at a 4.4 per cent annual rate, about the same as in the year 1964. Time and savings deposits continued to expand at the third-quarter annual rate of nearly 17 per cent. In late October and early November

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interest rates on negotiable certificates of deposit at New York banks generally were at the maximums permissible under the Board's Regulation Q.

Bank credit grew at a rapid pace in October, with much of the expansion accounted for by acquisitions of U.S. Government issues and loans to Government security dealers reflecting Treasury financing activity. Business loan expansion moderated, partly because of liquidation of inventory borrowings by metals-using firms but also, perhaps, because of increased capital market financing. Corporate bond issues were large in recent weeks, and the calendar of forthcoming issues was heavy.

Rates on 3-month Treasury bills fluctuated in a 4.04-4.10 per cent range recently, on balance rising somewhat. Yields on corporate and municipal bonds and on Treasury notes and bonds advanced further in early November. The initial reception to the Treasury's November refunding, involving sale of an 18-month 4¼ per cent note for cash, was less favorable than expected. This introduced a new element of uncertainty in the Government securities market, although the reaction was moderated by purchases of the new security on a "when issued" basis for Treasury investment accounts. In a telephone conference meeting held on November 4 to review the situation, the Committee agreed that the Manager should make similar purchases for the System Account if he judged that circumstances warranted them. Such purchases, however, did not prove necessary. Subsequently, yields on Treasury notes and bonds retreated somewhat from their peaks and the tone in the corporate market improved, although municipal yields continued to move up. A Treasury auction on November 17 of $2.5 billion of tax anticipation bills due in June proceeded uneventfully. The Treasury was expected to announce, before the end of the year, another cash financing to be held in January.

Starting with preliminary data for the third quarter, the Department of Commerce began summarizing the U.S. international payments position in a new way, involving "liquidity"

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and "official settlements" balances.[1] On the previously used "regular transactions" basis of calculation, the deficit (seasonally adjusted) was $615 million in the third quarter and $1.3 billion in the first 3 quarters. On the "liquidity" basis, the third-quarter deficit was $485 million and that for the first 3 quarters $940 million. The alternative "official settlements" balance showed a surplus in the third quarter of $260 million, and a deficit in the first 3 quarters of $160 million. The outlook, based partly on available data for October, appeared to be for a deficit on the "regular transactions" basis in the fourth quarter at about the same rate as in the year to date, but a shift in the "official settlements" balance from surplus in the third quarter to deficit in the fourth.

In the course of the Committee's discussion some members expressed the opinion that an overt move to a firmer monetary policy, in the form of an increase in the Federal Reserve discount rate, would be in order in the very near future, assuming economic conditions continued as at present. To facilitate orderly market adjustments in the event such an action was taken, they advocated open market operations directed toward maintaining the present, or if necessary a somewhat greater, degree of reserve availability. In the judgment of these members a discount rate increase would contribute to more balanced and sustainable economic growth domestically and to a stronger dollar internationally, by countering the inflationary pressures inherent in the prospects for rising aggregate demands, augmented by increasing Federal defense expenditures, and declining margins

[1] The "liquidity" balance reflects changes in U.S. reserves and in liquid U.S. liabilities to all foreigners; it differs from the "regular transactions" balance by including debt prepayments and military prepayments as receipts that reduce the deficit instead of helping to finance it. The "official settlements" balance reflects changes in U.S. reserves and in liquid and certain nonliquid U.S. liabilities to foreign official accounts, mainly monetary authorities. It differs from the "liquidity" balance by (1) treating changes in U.S. liabilities to foreigners other than official agencies as ordinary capital flows, and (2) treating changes in certain nonliquid liabilities to foreign monetary authorities as financing items rather than capital flows.

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of unutilized resources. The view also was expressed that a discount rate increase and a concurrent upward adjustment in the maximum rates permitted to be paid by member banks on time deposits would help eliminate obstacles to the efficient flow of funds in credit markets that had resulted from recent changes in the interest rate structure. The members of this group thought that postponement of these steps might pose a serious problem of deposit run-offs for banks if market rates rose further at a time when the rates being paid for time certificates of deposit were pressing against current regulatory ceilings. Also, if these actions were not taken shortly, Treasury financing operations might preclude their being taken for some time.

Other members of the Committee, while sympathetic with the need for some firming of policy, expressed a preference for initially restraining growth in bank credit by a slight reduction in net reserve availability, and for considering an increase in the discount rate if and when market rates rose further. The possibility was noted that, in the present sensitive state of financial markets, discount rate action might lead to undesirably large market reactions. It also was suggested that if higher market rates, confirming the need for a discount rate increase, were to eventuate, they should reflect the pressure of rising credit demands against a steadily growing reserve base. The members of this group believed that a course of action such as they favored could be accommodated under a current economic policy directive similar to the one issued by the Committee at its meeting on November 2, 1965.

Still other members thought that neither a reduction in reserve availability nor a higher discount rate was warranted at this time; in their judgment a continuation of present System policies was best calculated to maintain the current strong performance of the economy. They noted that the rate of increase in industrial commodity prices had slackened recently, and they saw no present evidence of pervasive inflationary pressures. Also, they felt that it would be desirable to await

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the detailed information on Federal budget prospects that would be available in January before considering an increase in the discount rate.

At the conclusion of the discussion the following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing a rate of expansion comparable to that of the third quarter despite the contractive effect of a reduction in steel inventories. Business sentiment continues optimistic and financial conditions are firmer. Meanwhile, our international payments have remained in deficit. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market that have prevailed since the last meeting of the Committee.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Patterson, Robertson, Scanlon, and Shepardson. Votes against this action: None.

2. Authority to purchase and sell foreign currencies.

At this meeting the Committee amended its continuing authority directive for foreign currency operations by adding a new final paragraph reading as follows:

The Federal Reserve Bank of New York is also authorized and directed to assume commitments for forward sales of lire up to $500 million equivalent as a means of facilitating the retention of dollar holdings by private foreign holders.

Concurrently, the Committee amended Section 4(2) of its guidelines for System foreign currency operations by adding the phrase, "directly or indirectly" after the first clause. As amended, Section 4 read as follows:

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4. Transactions in Forward Exchange

Transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken:

(1) When forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to disequilibrating movements of short-term funds;

(2) When it is deemed appropriate to supplement existing market supplies of forward cover, directly or indirectly, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders;

(3) To allow greater flexibility in covering System commitments, including those under swap arrangements;

(4) To facilitate the use of holdings of one currency for the settlement of commitments denominated in other currencies.

Forward sales of authorized currencies to the U.S. Stabilization Fund out of existing System holdings or in conjunction with spot purchases of such currencies also may be undertaken in order to allow greater flexibility in covering commitments of the U.S. Treasury.

In all other cases, proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

Votes for these actions: Messrs. Martin, Hayes, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Patterson, Robertson, Scanlon, and Shepardson. Votes against these actions: None.

In 1964 and 1965 the Italian authorities had dealt with large international payments surpluses in the same manner they had employed in 1961 and 1962; namely, channeling back into private hands dollars that otherwise would have added to their official reserves, by providing commercial banks in that country with forward cover into lire without cost. In 1965, as in 1962, the U.S. Treasury had facilitated such operations by acquiring some of the technical commitments to Italian commercial banks for forward sales of lire. The contracts acquired by the Treasury in 1962 ultimately were all reacquired by the Italian authorities when the balance of payments of that country subsequently shifted to a deficit.

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The Committee noted that the operations that had been undertaken by the Italian authorities were beneficial in reducing strains on the international payments structure and that the assumption by the U.S. Treasury of some of the forward commitments reduced the pressure on the Bank of Italy to convert part of its total dollar holdings—spot and forward—into gold. The Committee concluded that it was desirable for the System to participate along with the U.S. Treasury in this cooperative undertaking with the Italian authorities, consistent with the System's general policy of operating parallel with the Treasury whenever appropriate.

December 14, 1965

1. Authority to effect transactions in System Account.

Reports at this meeting indicated that economic activity was increasing vigorously and that the outlook appeared more expansive than previously. Recent developments in financial markets reflected the actions by the Board of Governors, effective December 6, approving increases in Federal Reserve discount rates from 4 to 4½ per cent and increasing to 5½ per cent the maximum rate member banks were permitted to pay on time deposits other than savings deposits.[2]

With respect to business activity, in November the rise in nonfarm employment was the largest for any month in 1965, and the unemployment rate again declined, to 4.2 per cent. Retail sales were maintained at their record October volume. Despite further reductions in output of steel mill products, industrial production rose substantially from an October level that itself had been revised upward.

[2] These actions are described in the entry for December 3, 1965, in the Record of Policy Actions of the Board of Governors (see pp. 63-70).

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Estimates of the recent pace of business investment also had been raised. Inventory accumulation was larger in the third quarter than previously indicated and the rate of accumulation showed an unexpectedly small decline in October. A Commerce–SEC survey of business expenditures on plant and equipment revealed that outlays in the second half of 1965 were running above earlier projections and that for the year as a whole they would exceed 1964 outlays by over 15 per cent.

As to the outlook, the new Commerce–SEC survey also indicated that businesses planned to increase capital expenditures further in the first half of 1966 at a rate about as rapid as in 1965 and considerably higher than that implied by a recent private survey reporting plans for all of 1966. According to a Census Bureau survey taken in mid-October, consumers intended to buy new cars and major household durable goods at a high rate over the following 6 months. Federal expenditures, particularly outlays for defense, had been rising rapidly since midyear on a national-income-account basis, and a further substantial increase in the first half of 1966 was implied by tentative new administration estimates of Government expenditures in the current fiscal year.

Average prices of industrial commodities continued to edge up in November, but the total wholesale price index increased more as a result of a renewed rise in food prices. The consumer price index advanced by two-tenths of 1 per cent in October, to a level 1.8 per cent above a year earlier.

At commercial banks, growth in business loans in November was moderately above the reduced October pace. Total bank credit continued to expand at a rapid rate, partly because of further Treasury financing activity. The money supply rose by only a small amount, but time and savings deposits continued to grow at an annual rate of nearly 17 per cent despite a relatively modest net increase in negotiable certificates of deposit. Following the Federal Reserve actions of December 6 most large banks raised their prime rate on business loans from 4½ to 5

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per cent and a number of banks increased their offering rates on new certificates of deposit. Excess reserves of member banks, which had averaged about $80 million less than their borrowings in November, were estimated to have exceeded borrowings slightly in the statement week ending December 8; this reflected System open market operations directed to the provision of reserves in order to facilitate market adjustments to the official rate actions.

In security markets initial reactions to the increases in the discount rate and the maximum rate on time deposits were swift but orderly. Short- and long-term security yields, which generally had been under upward pressure prior to the actions, rose sharply on December 6, the day the actions became effective. Yields on long-term Treasury, corporate, and municipal bonds generally moved up about 5-10 basis points, and those on intermediate-term Treasury securities and on Treasury bills advanced 15-20 basis points. For the rest of the week market yields were relatively stable, with the 3-month Treasury bill rate fluctuating in a narrow range around 4.35 per cent and some bond prices showing a slight improvement. On the following Monday (the day preceding this meeting), however, most market rates advanced again, apparently partly because of reports implying further strengthening of the economic outlook. Money market conditions, which had been comfortable in the preceding week, again became firm.

With respect to the U.S. balance of payments, direct investment outflows in the third quarter were now reported to have been substantially smaller than in the first 2 quarters. On the other hand, imports in the 4 months after midyear were larger than previously indicated and were one-sixth greater than in the corresponding period of 1964. Preliminary data for October and November suggested that there would be some improvement in the "regular transactions" balance in the fourth quarter as compared with the third, but thus far a deficit was indicated on this basis of calculation as well as on the "liquidity" and

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"official settlements" bases. Abroad, the Bank of Canada raised its discount rate from 4¼ to 4¾ per cent immediately after the increase in the Federal Reserve discount rate, and rates in Eurodollar markets rose more than seasonally.

The Committee agreed that open market operations in the period until its next meeting should be directed toward moderating any further adjustments that might occur in money and credit markets. Maintaining relatively steady financial market conditions during the next few weeks was deemed particularly desirable because of the large and shifting seasonal pressures typical of this period and because of the likelihood that the Treasury would be engaging in financing operations early in the new year, with the first stage probably under way before the year-end.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that domestic economic expansion is gaining in strength in a climate of optimistic business sentiment, with continuing active demands for credit and some further upward creep in prices. Although there appears to have been some recent improvement in our international payments, the need for further progress remains. In this situation, it is the Federal Open Market Committee's policy to complement other recent measures taken to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

Until the next meeting of the Committee, and taking into account the forthcoming Treasury financing activity and widely fluctuating seasonal pressures at this time of year in addition to the recent increase in Reserve Bank discount rates, System open market operations shall be directed to moderating any further adjustments in money and credit markets that may develop.

Votes for this action: Messrs. Martin, Hayes, Balderston, Ellis, Galusha, Maisel, Mitchell, Patterson, Robertson, Scanlon, and Shepardson. Votes against this action: None.

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2. Ratification of amendment of continuing authority directive.

On the morning of December 6 the Manager of the System Account had reported that the remaining "leeway" at that time for open market purchases, under the limitation established in Section 1(a) of the Committee's continuing authority directive on changes in holdings of U.S. Government securities in the System Open Market Account between meetings of the Committee, was $322 million, and that it was conceivable that purchases in excess of that amount might be necessary before the Committee's next meeting to carry out the intent of the current economic policy directive then in effect. Committee members approved (those outside of Washington by telegram) an amendment to Section 1(a) of the continuing authority directive, raising from $1.5 billion to $2.0 billion the limit on changes in holdings of Government securities between meetings. With this amendment, Section 1(a) read as follows:

(a) To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting.

The December 6 action was ratified at this meeting of the Committee.

Votes for ratification of this action: Messrs. Martin, Hayes, Balderston, Ellis, Galusha, Maisel, Mitchell, Patterson, Robertson, Scanlon, and Shepardson. Votes against ratification of this action: None.

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OPERATIONS OF THE SYSTEM OPEN MARKET ACCOUNT

The following two reports describe the actions taken during 1965 to carry out the policy directives of the Federal Open Market Committee. The first one is a chronological review of operations in domestic securities. In providing the reserve base for rapid expansion in commercial bank credit and for substantial growth in the money supply—and in view of the public's changing preferences for currency, demand deposits, and time deposits—the Federal Reserve acquired during the year $3.7 billion, net, of U.S. Government securities (including repurchase agreements).

The report on operations in domestic securities was prepared by Alan R. Holmes, Manager of the System Open Market Account, who supervises these operations. It is written from the vantage point of the Trading Desk at the Federal Reserve Bank of New York, where operations in these securities are effected to carry out the policy directives of the Federal Open Market Committee. The report stresses the factors—including variations in reserve elements, money market tendencies, and Treasury financings—that the Manager takes into account in the day-to-day provision of bank reserves.

The second report is a review of Federal Reserve operations in foreign currencies. The Federal Reserve has been buying and selling such currencies since early 1962 as part of the efforts to defend the dollar and strengthen the world payments system. During 1965 the volume of Federal Reserve operations in foreign currencies was substantial, and the reciprocal currency, or "swap," network linking the Federal Reserve with foreign central banks and the Bank for International Settlements was enlarged by $450 million.

The report on foreign currency operations was prepared by Charles A. Coombs, Special Manager of the System Open Market Account, who supervises the Federal Reserve's operations in such

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currencies. All these operations for the System Account are carried out, under the authorization of the Federal Open Market Committee, by the Federal Reserve Bank of New York, which also handles foreign currency transactions for the U.S. Treasury. This report begins on page 197.

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REVIEW OF OPEN MARKET OPERATIONS IN DOMESTIC SECURITIES

During most of 1965 the Federal Reserve conducted its operations in domestic securities with a view to accommodating moderate growth in the reserve base, bank credit, and the money supply in an environment marked by (1) rapid growth, diminishing margins of unused resources, and increased price pressures within the domestic economy and (2) a continuing deficit in the U.S. balance of payments that required special measures to defend the dollar.

For the year as a whole, purchases of securities for the System Open Market Account served to offset the reserve drains stemming from the decline of $1.7 billion in the monetary gold stock and from the continued rapid increase in currency in the hands of the public, as well as to provide for an increase of $1 billion in the reserve base. Under the pressures of the demands for credit and with the shift in the composition of bank deposits that occurred, this increase in the reserve base supported a record expansion of bank credit and deposits.

After the Treasury had concluded large-scale financing operations in January, the Federal Reserve provided reserves somewhat less freely than in earlier years. Meanwhile, credit demands became stronger as business activity drew nearer to capacity levels of operation. As a result, generally firm conditions prevailed in the money market during the year, and interest rates gradually came under upward pressure.

By the year-end short-term interest rates were about 75 basis points higher than at the end of 1964, and long-term rates were 50 basis points higher. About two-thirds of these advances had occurred before the Federal Reserve discount rate was raised in early December.

In describing the System's operations in Government securities in 1965 in more detail, it is useful to divide the year into five periods.

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January 4–February 3: "Even keel" during period of large-scale Treasury financing operations. At the beginning of 1965 financial markets were completing the process of adjustment to the November 1964 change in the discount rate and in the Regulation Q ceilings and were emerging from heavy year-end demands on reserve availability. The Treasury had announced a large-scale advance refunding operation to be conducted during the first week of January, involving $22 billion of publicly held issues scheduled to mature over the next 3 years. As this financing proceeded, it was accompanied by the money market "churning" that is often associated with such operations. Further churning developed around mid-January when the Treasury raised $1.75 billion in new cash through the sale of tax-anticipation bills due to mature in June. Market activity increased again toward the end of the month when the Treasury announced a cash financing to refund the remainder of the securities maturing on February 15 that had not been exchanged by holders in the advance refunding.

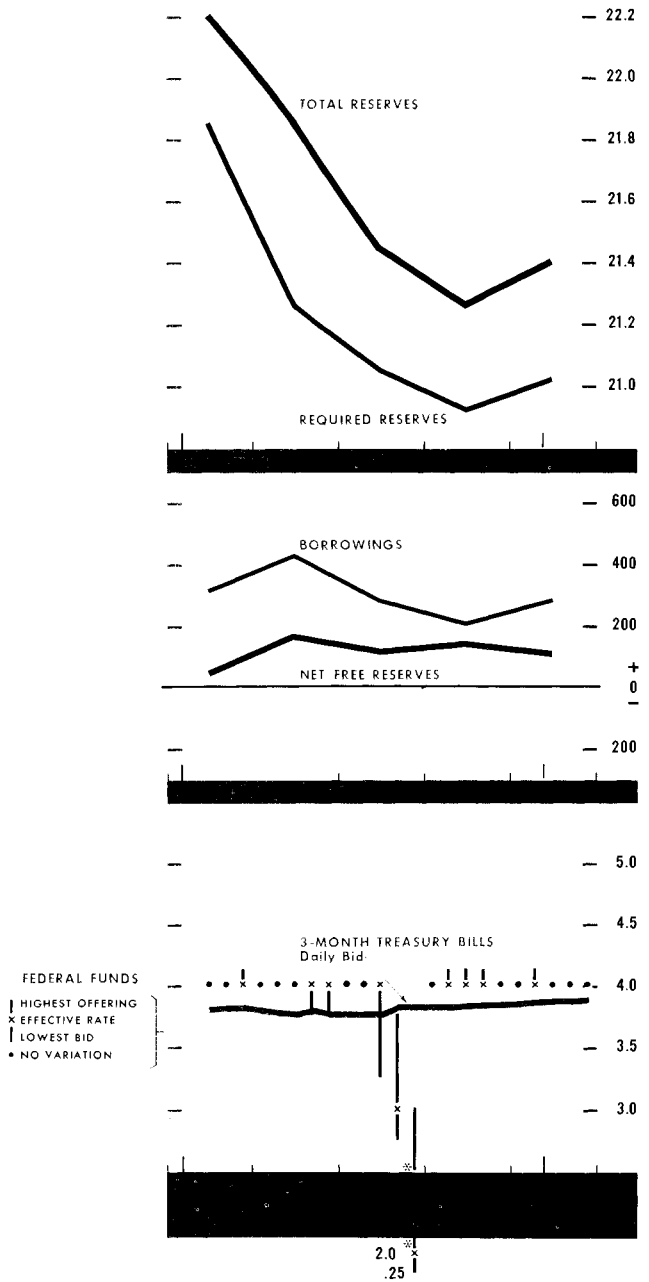
SYSTEM OPERATIONS IN GOVERNMENT SECURITIES DURING 1965
(In millions of dollars)

Type of operation	Jan. 4–Feb. 3	Feb. 4–Mar. 24	Mar. 25–July 28	July 29–Dec. 1	Dec. 2–Dec. 31	Total
Outright purchases:						
Treasury bills:						
From market	567	502	1,119	4,069	606	6,863
From foreign accounts	348	214	879	650	3	2,094
Coupon issues	.....	104	570	257	.....	931
Outright sales:						
Treasury bills:						
To market	201	146	574	1,496	515	2,932
To foreign accounts	60	51	142	941	100	1,294
Coupon issues	.....	.....	.....	.....	.....	.....
Redemptions	12	471	350	560	297	1,690
Repurchase agreements:						
Purchases	1,991	1,096	7,585	2,590	1,661	14,923
Sales	2,290	1,334	7,157	3,018	1,372	15,171
Net change in holdings	+343	−86	+1,930	+1.551	−14	+3,724

NOTE.—All figures are as of date of delivery.

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Member Bank Reserves and Borrowings, and Rates on Treasury Bills and Federal Funds



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To facilitate the financial flows arising out of the Treasury operations—and being mindful of the uncertainties that had been generated in financial markets abroad by concern about the U.S. balance of payments situation—the Federal Reserve conducted its open market operations during January with a view to maintaining generally steady conditions in the domestic money market and accommodating a moderate expansion of bank credit and deposits. At the same time, it allowed the net reserve availability in the banking system to recede somewhat from the high levels that had been provided in December 1964 to ease the special pressures prevailing during that month.

As usual, the task of the Federal Reserve in early January was to absorb the large seasonal reflux of reserves as currency flowed back into the banks after the Christmas and New Year's holidays and as seasonal loans were paid off. This absorption was accomplished in part by the maturity in early January of sizable repurchase agreements against Government securities that had been utilized by the Federal Reserve to supply part of the temporary reserve need at the end of December. During the opening days of the new year, however, net free reserves were consistently less than had been projected, as the seasonal repayment of loans—and the consequent reduction in required reserves—proved to be much smaller than expected. This marked the first of a number of such situations during the year when substantially greater-than-seasonal strength in loan demand absorbed reserves and tended to tighten the money market.

During the first several days of the January 4–February 3 period, when net reserve availability proved to be less than had been expected, the Manager of the System Open Market Account arranged new short-term repurchase agreements against Government securities and bankers' acceptances as earlier agreements were terminated or matured. Later on in January, as movements in required reserves and other market factors worked in combination to release some reserves, the Federal Reserve undertook

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outright sales of Treasury bills. The reserve inflow during the period was markedly smaller than projected, however, and during the period as a whole the System's sales and redemptions of bills totaled only $273 million, compared with sales and redemptions of bills totaling $924 million during the comparable period of 1964. During the last two statement weeks of the interval the System purchased securities, both outright and under repurchase agreements, in sufficient volume to offset the reserve drains stemming from the month-end decline in float and other factors.

For the period as a whole, net free reserves of member banks averaged about $100 million. Only in the first few days of January were there any signs of undue firming in the money market. At that time the financing needs of Government securities dealers were enlarged by their substantial purchases of rights issues involved in the Treasury's advance refunding operation. The System's injection of reserves through repurchase agreements met a portion of the dealers' needs for financing, but there was still a sizable residual need that had to be financed by New York City banks. These banks in turn sought to obtain the reserves required to support their lending operations by bidding strongly for Federal funds at a rate equal to the 4 per cent discount rate. The availability of Federal funds proved limited, however, and consequently the New York City banks found it necessary to meet a portion of their reserve requirements by borrowing at their Reserve Bank.

The availability of Federal funds increased in subsequent weeks. Indeed, these funds traded in volume at a rate below the discount rate late in the statement week ended January 13, as the money-center banks sold the reserve excesses they had accumulated by large borrowings from their Reserve Banks before the preceding weekend. Federal funds again became plentiful at nominal rates at the end of the following week when country banks channeled into the market sizable amounts of the excess reserves that they had accumulated.

There was little demand for these late-in-the-week reserve

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excesses, however, inasmuch as the reserve pressures on New York City banks—which normally buy country banks' excess reserves in volume—had lessened considerably with the reduction in dealers' financing needs after they had settled on January 19 for the securities involved in the Treasury refunding. Even when trading in Federal funds returned to a predominantly 4 per cent rate over the final 2 weeks of the interval, the supply of funds remained ample and member bank borrowing from the Federal Reserve continued at a relatively low level—averaging only about $240 million a day. Over the five statement weeks ended February 3, borrowings averaged just under $300 million a day, about $50 million more than in December 1964.

A favorable atmosphere prevailed in the market for Treasury bills at the start of the year. Although bills with very short maturities were being sold into the market by investors who were reversing year-end window-dressing operations, a fairly active demand emerged for longer-term bills. Some of this demand came from investors who were selling their holdings of the securities serving as rights in the Treasury's refunding operation. As dealers met this demand, their positions in bills declined to just over $1.1 billion by Friday, January 8. Bill rates edged steadily downward, with the rate on the 3-month bill falling to 3.77 per cent (bid) on January 11, compared with a rate averaing about 3.85 per cent in December 1964.

As these lower bill rates emerged, investors became somewhat more cautious. Commercial banks bid strongly, however, for the $1.75 billion of June tax-anticipation bills, auctioned on January 12, in order to obtain the tax-and-loan-account deposits that could be created to pay for 50 per cent of the issue. Yet the auction itself, together with the Treasury's announced decision to add to the regular weekly bill auctions over the coming weeks, was generally interpreted as a mark of official concern over the level to which bill rates had fallen. In these circumstances, the investor interest that remained after the completion of the refunding operation was somewhat selective, and it tended

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to favor longer-term bills, which offered higher yields. Meanwhile, there continued to be some selling of shorter-term bills.

This aura of caution was reinforced toward the end of the period as participants in the market focused on the possible implications for short-term interest rates of the sharp deterioration in the U.S. balance of payments in the fourth quarter of 1964 and of the apparent continuation of substantial amounts of lending abroad by U.S. banks in the early weeks of 1965. As a consequence, bill rates worked upward over the final weeks of the period and by February 3 were as much as 14 basis points above their mid-January lows and 2 to 10 basis points above the levels prevailing at the beginning of the year. The 3-month bill closed the period at a rate of 3.89 per cent (bid), compared with a rate of 3.82 per cent (bid) on December 31.

The dominant factor in the market for Treasury notes and bonds at the start of the period was the Treasury's massive refunding operation. The market adjustment that followed the November 1964 increase in the discount rate had been sufficiently orderly that by the end of the year the Treasury decided to attempt a significant extension of the debt. Accordingly, on December 30, 1964, the Treasury announced that holders of eight issues due from 1965 to 1967—including the February 1965 maturities—would be given the opportunity to exchange their holdings for new 4 per cent bonds maturing in February 1970, new 4⅛ per cent bonds due in February 1974, or additional amounts of the 4¼ per cent bonds due in August 1987-92. Market participants reacted favorably to the offer, and the exchange by the public of $9.1 billion, or 41 per cent of the $22 billion of eligible securities held by the public, exceeded expectations. Interest was particularly strong in the 4¼'s of 1987-92, for which public subscriptions totaled $2.3 billion. Subscriptions to the new 4's of February 1970 totaled $4.4 billion, and those to the new 4⅛ per cent bonds of 1974 totaled $3.1 billion.

The very large size of the combined subscriptions, which

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lengthened the average maturity of the total marketable debt by about 5 months, was viewed by market participants as a reflection of widespread confidence in the current level and structure of interest rates. Thus, despite the increased supply of long-term issues, prices of outstanding long-term bonds remained relatively unchanged following the very mild adjustments that occurred immediately after the announcement of the terms of the refunding. As this increased confidence in the structure of interest rates spread, underwriters began to bid more aggressively for new issues of corporate and tax-exempt bonds. In turn, the successful flotation of a new Aaa-rated corporate bond offering a yield of 4.37 per cent, only 14 basis points more than the yield on the Treasury's new 4¼'s of 1987-92, further reinforced the favorable atmosphere in the Treasury bond market. A report that the British trade deficit had declined in December also encouraged participants in the bond market.

Against this background, investors initially took in stride reports of the fourth-quarter-1964 deterioration in the U.S. balance of payments as well as a sharp rise in the price of gold in the London market. As investor demand for the new Treasury issues remained strong, producing a steady reduction in dealer positions, prices of outstanding Treasury notes and bonds inched higher and by January 22 stood 4/32 to 16/32 of a point above the levels prevailing at the opening of the year.

Subsequently, a technical reaction to these price gains took place. Factors contributing to the downward price adjustments were increased market attention to the underlying U.S. balance of payments deficit, the accompanying declines in the U.S. gold stock, and the increase of one-half percentage point in the discount rate of the German Federal Bank. Demand for the new Treasury issues remained fairly active, however, and price declines were modest. When the Treasury announced on January 27 that it planned to refund the remaining February 15 maturities through a cash offering of about $2.2 billion of new 21-month, 4 per cent notes priced at a discount to yield 4.09 per

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cent, the initial reaction of the market was one of caution. On the subscription date, however, the issue attracted a substantial amount of investor interest, and large subscriptions were subjected to a 15 per cent allotment. At the close of the period prices of most Treasury notes and bonds were unchanged to 18/32 of a point higher than at the end of 1964, and the three issues offered in the advance refunding were bid at a premium compared with their initial offering prices.

February 4–March 24: Shift away from ease in support of measures to defend the dollar. At the beginning of February a large outflow of capital—particularly in the form of U.S. bank loans abroad—was contributing to a very sharp worsening in the U.S. balance of payments deficit. Furthermore, domestic business conditions were strong and domestic demands for credit were unseasonally large. As a result bank credit was expanding at a considerably more rapid pace than it had earlier.

With the need for an "even keel" policy reduced after subscriptions to the Treasury's February financing had closed on February 1, the Federal Open Market Committee at its meeting on February 2 instructed the Manager of the System Open Market Account to move toward slightly firmer conditions in the money market than had prevailed in the early weeks of the year in order to moderate the rate of growth in bank credit and the money supply. The shift in policy served to support the administration's voluntary foreign credit restraint program, announced a few days later on February 10—a program that suggested limits on lending abroad by bank and nonbank financial institutions and requested large nonfinancial corporations to improve their individual balance of payments positions.

Open market operations over succeeding weeks were conducted with a view to providing reserves somewhat less freely in response to expanding demands for reserves and absorbing promptly whatever reserve excesses were generated temporarily by market factors. As a result, reserve availability at member banks was reduced to a net borrowed reserve figure of about

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$20 million in the 7 weeks ended March 24, compared with average net free reserves of about $100 million during January.

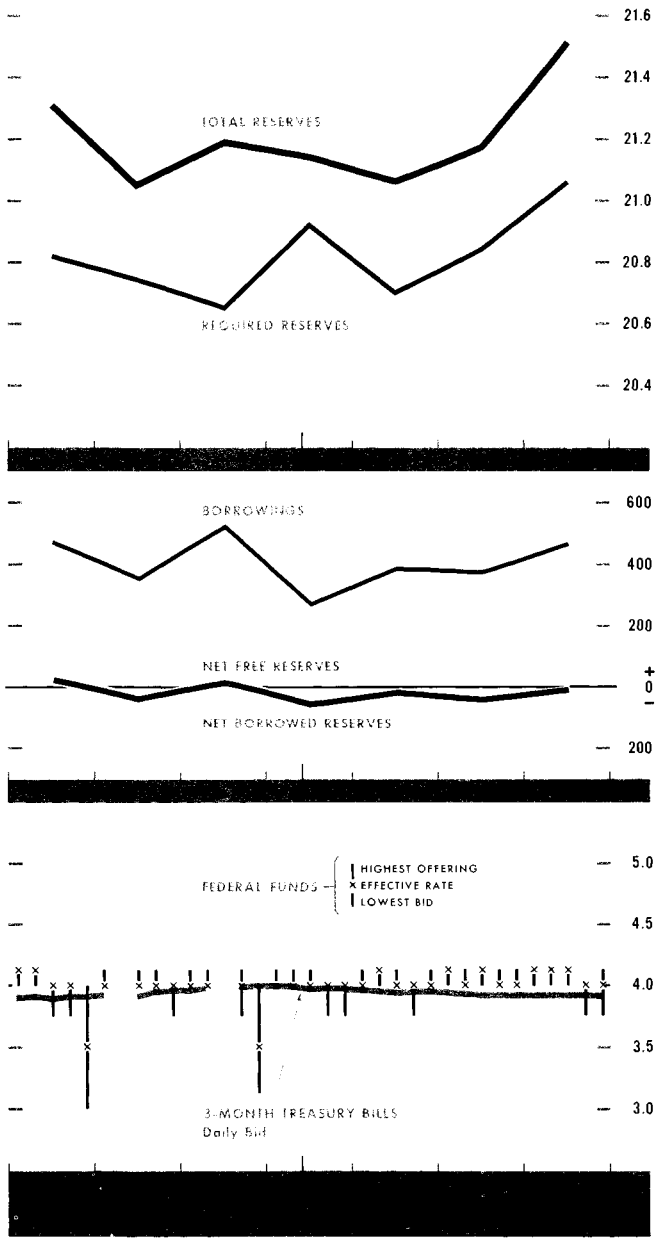
Slightly firmer conditions prevailed in the money market throughout the February 4–March 24 period. Federal funds were quoted at or above the 4 per cent discount rate on most days during this interval. Trading in Federal funds at a premium rate as compared with the discount rate—a market innovation that had first appeared in October 1964—became fairly common, as firmness in the money market continued and as banks with persistent basic deficiencies in their reserve positions sought to avoid resort to the discount window. However, there were a few days at the end of statement weeks when large amounts of Federal funds were traded at rates below the discount rate, chiefly because some banks had built up sizable holdings of excess reserves by borrowing heavily at their Reserve Banks earlier in the week. Borrowings from the Reserve Banks for the period as a whole averaged about $400 million a day, more than $100 million a day higher than in January.

Two considerations that entered into the conduct of operations during this period continued to play a role in subsequent months. One was the introduction, after a period of testing, of a new sampling technique for estimating the current reserve positions of country banks. Prior to the introduction of the new procedure, the reserve estimates initially published each week were constructed without direct current information as to levels of vault cash and required reserves at country banks; as actual data became available in subsequent weeks, the initial estimates were revised, sometimes substantially. The new sampling procedure provided current-week data for country banks promptly enough to enable the Manager to make some corresponding adjustments in open market operations.

The second consideration influencing Federal Reserve open market operations during the second half of the February–March period was a recurrence of a problem that had arisen in earlier years—namely, a persisting downward trend in short-term in-

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terest rates, particularly rates on Treasury bills. In the firmer money market that had characterized most of the winter months, Treasury bill rates had held at levels sufficiently high relative to foreign rates to create no special incentive to liquid capital flows abroad. U.S. bill rates actually rose during most of February, as market participants became more concerned about the war in Viet Nam, the possibility of a firming of monetary policy, and the prospect of a seasonal slackening in demand for bills in March. In these circumstances the rate on the 3-month bill climbed to the 4 per cent discount rate on February 24. In the weeks that followed, however, bill rates edged steadily lower. The expected drying up of demand for bills did not occur; on the contrary, sizable purchases were made by public funds and also by corporations seeking investment outlets for funds being repatriated to the domestic market under the impetus of the VFCR program.

Corporate selling of bills around the mid-March dividend and tax dates was light, and dealers rapidly digested the bills returning to them at that time from maturing corporate repurchase agreements. In addition, toward the end of the period under review, banks in Chicago began their annual large-scale buying of bills in preparation for the April 1 Cook County personal property tax date. As a result, by the end of the period, on March 24, 3-month bills were bid at a rate of 3.91 per cent.

To avoid adding to such downward pressures on bill rates and thereby enhancing the incentive for capital to flow out of the country, the Federal Reserve met the modest reserve needs that emerged around mid-March in large part by purchasing securities under short-term repurchase agreements or directly from foreign accounts. It also injected a small amount of reserves during this period by buying Treasury coupon issues.

An atmosphere of caution dominated the markets for high-grade notes and bonds at the start of the interval. Market participants had become increasingly concerned over the seriousness of the nation's balance of payments problem amid news of cur-

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rent gold outflows and reports that France and some other countries in the Common Market would be making more large-scale purchases of gold in the months to come. The President's balance of payments message on February 10 announcing plans for the new VFCR program tended to steady the securities markets for a time. A hesitant atmosphere reappeared, however, as market participants reassessed prospects for a less stimulative monetary policy in the light of the published reports indicating lower levels of net reserve availability and as renewed concern developed over the war in Viet Nam.

Against this background, prices of Treasury notes and bonds drifted lower at the start of the period; by the middle of February declines ranged from 1/32 to 11/32 of a point. The downward pressures on prices developed mainly in response to offerings from professional and trading sources, while investors generally moved to the sidelines for a time in the cautious market atmosphere. With the increased availability of coupon securities, the System made some reserve injections around the Washington's Birthday holiday by buying Treasury notes and bonds in the market. As note and bond prices reached the lower levels, purchases by investors reappeared, although a cautious undertone remained in the market over the remainder of the month.

By early March, indications of positive results from the VFCR program began to relieve the earlier concern that the U.S. balance of payments deficit might necessitate a sharp rise in domestic interest rates. Market psychology also was buoyed by reports of continued improvement in the British trade position, which generated some discussion of the possibility of a reduction in the discount rate of the Bank of England. Government securities dealers, who had succeeded in reducing their portfolios during February, no longer pressed offerings aggressively. In addition, investment demand continued to expand, particularly for the various 2½ per cent bonds selling at deep discounts. For most Treasury issues, price gains more than offset the February declines, and by the end of the period most issues maturing in more

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than 3 years were priced 2/32 to 10/32 of a point higher than at the beginning of February. Short-term coupon issues recorded small net price declines over the period.

Developments in the corporate and municipal markets during the period generally paralleled those in the market for Government securities. Investors showed little interest in new offerings or seasoned issues during February. Although the volume of new publicly offered corporate issues was modest in that month, a large number of private placements contributed to a hesitant atmosphere in the market. Syndicate price restrictions were removed on large unsold balances of several current offerings, with upward adjustments in yields on these issues generally ranging from 3 to 7 basis points.

On March 3 a new issue of Aa-rated utility bonds was reoffered at 4.51 per cent, 7 basis points above the yield on a similar issue sold a month earlier. A heavy tone in the tax-exempt market during February was magnified by a sizable build-up in the calendar of new offerings and in dealer inventories. Most offerings were accorded only a fair reception at best, and by February 28 dealers' advertised offerings of municipal securities had risen to a record level of over $800 million, despite their aggressive price cutting on older issues, which had raised yields by as much as 10 basis points during the month.

As in the Government securities market, the emergence of higher yields brought about an increase in investor interest in corporate and municipal securities. Dealer inventories of unsold municipal bonds remained quite large in March, but a lighter calendar of future offerings helped to restore dealers' confidence and caused underwriters to bid aggressively for new issues. Investor interest in bonds was temporarily diverted, however, as attention focused on the large volume of secondary stock offerings in March, highlighted by the U.S. Government's offering of almost $350 million of stock of General Aniline and Film Corporation.

The February rise in municipal bond yields was only partially

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offset by declines during March, and by the close of the interval the *Bond Buyer's* index of 20-year seasoned tax-exempt bonds stood at 3.16 per cent, 12 basis points above its February 4 level. Yields on new corporate offerings also rose on balance over the period, while Moody's index of yields on Aaa-rated seasoned corporate bonds—at 4.42 per cent on March 24—was about the same as in early February.

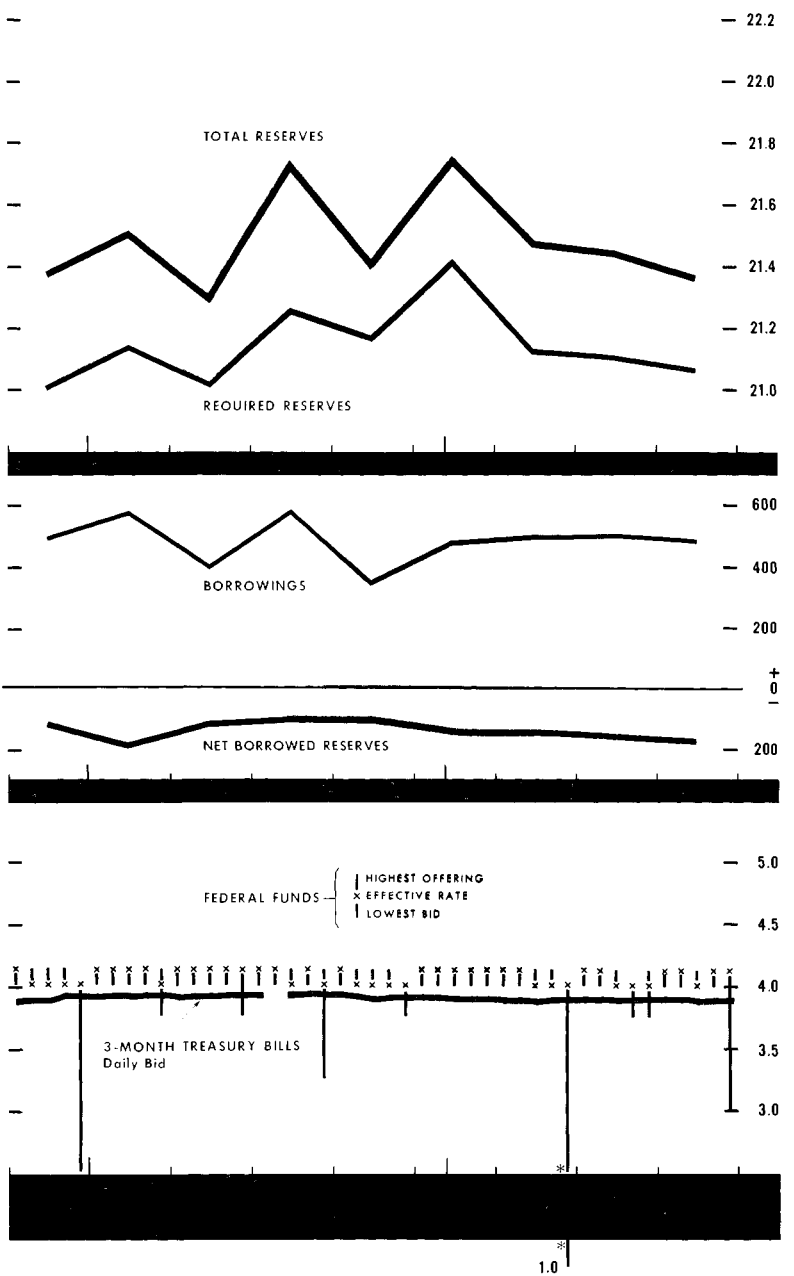
March 25–July 28: Further shift toward mild monetary restraint. Potential inflationary pressures accompanying the vigorous expansion of the domestic economy as well as the need to reinforce the VFCR program led the Federal Open Market Committee at its March 23 meeting to instruct the Manager of the Open Market Account to promote somewhat firmer conditions in the money market while accommodating moderate growth in the reserve base, bank credit, and the money supply.

By early April Federal Reserve open market operations had achieved a firmer tone in the money market. Daily average borrowing by member banks from the Reserve Banks rose to around $500 million in the March 25–July 28 interval, compared with about $400 million in the preceding 7 weeks. Net borrowed reserves generally ranged from $100 million to $200 million on a weekly average basis during the 4-month period, compared with an average of about $20 million for the 7 weeks ending March 24. During these 4 months, Federal funds traded predominantly at 4⅛ per cent.

As the period progressed, economic opinion was concerned about the possibility that the business expansion might slow down in the last half of the year. The pace of both economic and monetary growth—while still strong—was a little slower than the unusually rapid rate of the first quarter. Bank credit expansion fell back to much the same annual rate as in earlier years of the current business expansion. More importantly, there were expectations that liquidation of the steel inventories built up as a strike hedge would exert a dampening influence after the September 1 wage-contract deadline. At the same time, it

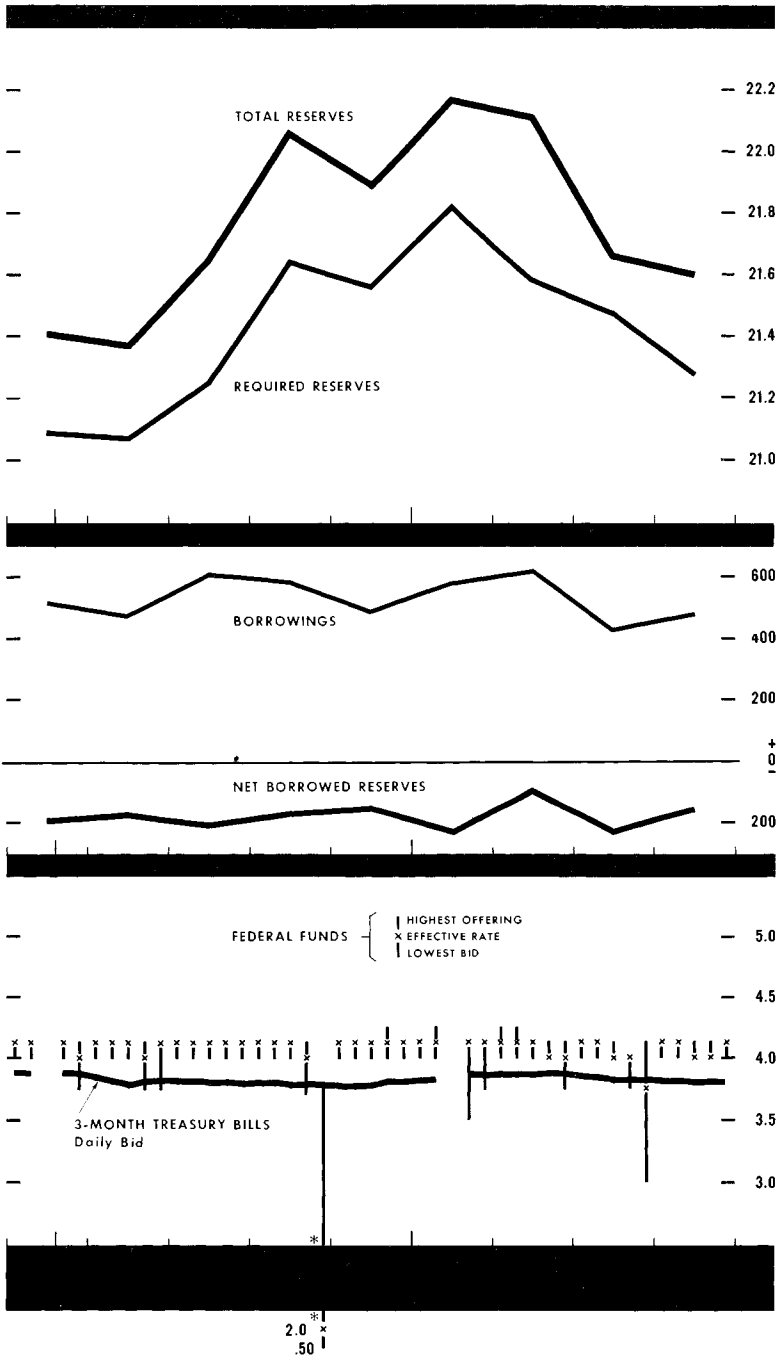
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seemed to many market participants that the evident effectiveness of the VFCR program was reducing the likelihood of further moves toward monetary restraint for balance of payments reasons.

Over the entire period, the Federal Reserve purchased $1.9 billion of Government securities on a net basis. These purchases offset the continued reserve drains stemming from movements in market factors and provided for a growth of $213 million in member bank required reserves. The bulk of this reserve provision was concentrated in the period from mid-June to early July as the banks first provided the credit and deposit expansion required around the corporate dividend and tax payment dates and later supplied the enlarged needs for currency around the July 4 holiday.

As toward the end of the preceding 7-week interval, the conduct of open market operations during the March 25–July 28 period was repeatedly conditioned by the tendency of rates on Treasury bills to drift lower. Since outright purchases of Treasury bills in the market would have added to an already strong investor demand for bills, the Federal Reserve continued to rely heavily on purchases of Treasury coupon securities, repurchase agreements, and purchases directly from foreign accounts, to supply needed reserves. The aim was to smooth the over-all flow of reserves by means that would add least to the already strong downward pressures on bill rates that were evident in the market.

Over the period as a whole purchases of securities under repurchase contracts totaled $7.6 billion and exceeded sales by $428 million. Net purchases of $737 million of Treasury bills from foreign accounts accounted for the major part of the $932 million net increase in outright holdings of bills. The Federal Reserve also bought $570 million of Treasury coupon securities over the interval.

During April and most of May, the Federal Reserve limited its outright transactions in the market largely to sales of a moderate amount of Treasury bills in the latter part of April. It off-

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set large drains on reserves, particularly in early May, by executing substantial new repurchase agreements with dealers on maturing Treasury issues that constituted rights in the Treasury's May refinancing. These rights had to be financed by the dealers until May 15 when delivery was made of the new securities sold to customers on a when-issued basis. Such Federal Reserve repurchase agreements on rights issues represented the first use of a broadened authority granted in the March 2, 1965 revision of the Federal Open Market Committee's continuing directive to remove the maturity limitation on Treasury issues bought under repurchase agreements during periods of Treasury financing.

Large-scale reserve drains appeared again around Memorial Day, and during this period the market was less receptive to short-term repurchase agreements. However, following the Treasury's May refunding operation the Manager of the Account was able to purchase substantial amounts of the Treasury notes and bonds offered freely by dealers at attractive prices. As necessary, the Manager supplemented these purchases with moderate amounts of outright buying of Treasury bills in the market.

The mid-June dividend and tax dates produced a sharp increase in bank credit demands and a spurt of required reserves above projected levels. This was followed in short order by large-scale reserve drains caused by the month-end decline in float and the sizable currency outflow over the Independence Day holiday. However, the Federal Reserve was able to provide all the reserves it regarded as appropriate by means other than purchases of Treasury bills: continued outright purchases of Treasury coupon securities; short-dated repurchase agreements after the tax-date pressure on the money market appeared; and a temporary reduction in the level of Treasury balances at Federal Reserve Banks planned in coordination with the Treasury. A large British drawing on its swap arrangement with the Federal Reserve had the effect of adding to member bank reserves during this interval.

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Despite a moderate reduction in net reserve availability on average during the March 25–July 28 period, the money market experienced periods of greater and lesser firmness as reserves moved away from and then back to money centers. This reflected in part a frequent tendency for some country banks to accumulate more reserves than they needed in the first half of their biweekly reserve periods, and then to sell Federal funds or otherwise transfer the accumulated excess to the money market banks as the second week progressed. This kind of influence was particularly evident around the end of March and again after mid-April.

A more powerful influence producing shifts in reserve distribution and in money market pressure during the second quarter, however, was the flow of Treasury receipts. The April 15 payment date for individual and corporate Federal income taxes placed heavy demands on the money market, and banks in the money centers had to borrow heavily from the Reserve Banks. Toward the end of April, Treasury balances at the Reserve Banks were swelled by the collection of tax checks drawn on banks in all parts of the country, and as the Treasury made large redeposits with the "C" banks, the pressure on banks in the money centers subsided.

While the money market handled smoothly the large flows of funds and securities accompanying the June dividend and tax dates, the money market banks—especially those in New York City—came under increased pressure as the temporarily enlarged demands of corporations and securities dealers for credit focused on them. Collection of funds in Treasury balances at the leading banks temporarily helped to relieve money market pressures in the week ended June 23; but this influence was reversed subsequently as the Treasury made heavy calls on the class "C" bank depositories.

In contrast to the fluctuations in most other money market measures, rates on short-term Treasury bills came under repeated downward pressure throughout the second quarter. The chief

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cause was a vigorous demand for bills from corporations and public funds. In the first few weeks of the March 25–July 28 period 3-month bill rates moved within a narrow range—3.89 to 3.95 per cent—as investor demands were offset by the combined influence of the developing firmness in the money market, the lower level of net borrowed reserves, and an increase in market supplies—the latter stemming from an addition of $200 million of bills to the April 5 weekly auction and from sizable liquidations of bills by the banks in Chicago following the April 1 Cook County tax date.

With the passing of the mid-April Federal tax date, however, rates on Treasury bills started to move lower as investment demand, particularly from public funds, proved unusually strong. The Treasury's May refinancing brought a surge in demand for bills from those who were selling their rights to the new issues offered by the Treasury, and surprisingly strong demand for bills from public funds continued through May and even into June, a time when these funds normally begin to reduce their holdings. A downward drift in bill rates through this period was also encouraged by availability of dealer financing at rates as low as 4¼ per cent from the New York City banks. As noted earlier, these banks were accumulating abnormally high balances in their Treasury deposit accounts at this time, a development that led to a marked easing in the pressures on their reserve positions.

Against this background, bidding for the attractive September and December maturities was aggressive in the weekly bill auction on June 7, and average issuing rates of 3.78 and 3.86 per cent were set on the new 3- and 6-month issues, the lowest levels since November 1964. Very large awards of the new bills to dealers produced an element of caution, reinforced by some subsequent sales of Treasury bills, which the Manager of the Account made for both System and foreign accounts.

But the bill market quickly recovered its affirmative tone, and bills returning to dealers from maturing repurchase agreements

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over the June dividend and tax dates were readily absorbed despite their substantial volume. Additional demand for bills developed later in June out of the funds investors obtained from the redemption of over $1.1 billion of tax-anticipation bills due June 22 that had not been used for tax payments and from the step-up in buying by commercial banks in preparation for the June 30 quarterly statement publishing date. Dealer anticipation that the Federal Reserve would make large-scale purchases of bills to meet midyear and July 4 reserve needs also strengthened market sentiment. By June 24 the 3-month bill rate had declined to 3.77 per cent, 14 basis points below the rate on a comparable maturity at the start of the period.

That the Federal Reserve found it unnecessary to buy bills around the end of June and over the July 4 holiday helped to bring to an end the more or less steady decline in Treasury bill rates. Dealers' portfolios of bills were soon augmented by bank selling for delivery after the June 30 statement date. Large sales of bills by a Government agency and higher dealer financing costs also contributed to a rise in Treasury bill rates. By July 28 the rate on 3-month bills was up to 3.81 per cent (bid), 4 basis points above the June low but still below the level at the start of the period.

In the capital markets, prices of Treasury notes and bonds fluctuated narrowly throughout the March 25–July 28 interval, while yields on corporate and tax-exempt bonds tended to rise somewhat. At the start of the period a hesitant atmosphere dominated all sectors of the capital markets as renewed pressures on the pound sterling generated concern lest the weakness in sterling necessitate firmer monetary policy measures to deal with the deficit in the U.S. balance of payments. In addition, uncertainties over future events in Viet Nam and news that the unemployment rate had fallen to 4.7 per cent in mid-March, the lowest level since 1957, led some observers to think that interest rates might rise. New issues of corporate and municipal securities in late March and early April were accorded luke-

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warm receptions by investors. As reoffering yields rose in late April and early May, investor interest appeared to be moderately good, but it was not enough to reduce the very sizable inventories of dealers in municipal bonds.

On the other hand, sentiment in the market for Treasury notes and bonds tended to improve, helped by two items of foreign news that were regarded favorably: the announcement of a stiffer British budget, and a reduction from 4 to 3½ per cent in the discount rate of the Bank of France.

At the end of April the Treasury announced the terms of its quarterly refinancing, which gave holders of notes maturing on May 15 the right to exchange for either a 4 per cent, 15-month note at a yield of 4.12 per cent or a 4¼ per cent bond due May 1974 at a yield of 4.22 per cent. The terms came to be regarded as attractive, and attrition was small, with $3.6 billion out of $4.1 billion held by the public being exchanged—$1.6 billion for the new notes and $2.0 billion for the 9-year bonds.

Investment activity in the market for Treasury securities tapered off after the Treasury's refunding operation. As dealers became somewhat concerned over the sizable positions they had built up, they increased their efforts to make sales, and prices drifted irregularly lower. Buying interest in corporate and municipal bonds also lagged; this applied even to new Aaa-rated utility bonds reoffered to yield 4.50 per cent. The corporate bond market also began to suffer from the heavy schedule of new financing set for June. In the municipal market several sizable new offerings were quickly taken up by investors at higher yields, but smaller issues were not well received and older issues moved slowly despite price concessions.

In early June advertised dealer inventories of tax-exempt bonds rose to record levels, but these were worked down somewhat in July by some selective commercial bank buying. The corporate bond market, in contrast, readily absorbed at somewhat higher yields the large offerings that came in June—including over $500 million of commercial bank debt issues.

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Investor activity expanded following the very successful marketing of $525 million of participation certificates by the Federal National Mortgage Association on June 15. The volume of scheduled new financing declined significantly, and underwriters made considerable headway in distributing the large supply of earlier offerings.

With the improvement in the market for corporate securities, there also came an improvement in the Treasury bond market in the latter half of June. A fairly steady tone prevailed during July, with some tendency for prices to drift lower—in part reflecting a switching from Treasury issues into corporate bonds, for which the yield advantage had widened. At the close of the period the average yield on long-term Treasury issues stood at 4.15 per cent, compared with 4.13 per cent in late March.

July 29–December 1: Maintaining firm money market conditions as the economy becomes more buoyant. Financial markets were subject to persistent upward pressures and interest rates rose during the July 29–December 1 interval. The steady stream of increasingly optimistic reports on business conditions gradually led to a reassessment of earlier expectations of economic slowdown. Then, as the forces of domestic expansion began to accelerate in the wake of the stepped-up commitment in Viet Nam, market participants began to consider the likely effects of increases in Treasury financing requirements on a market already under pressure from other credit demands. Against this background financial markets were marked by considerable uncertainty during most of the period; Treasury financing operations encountered somewhat greater difficulties; and there was growing skepticism in the market about the viability of prevailing interest rate levels.

Federal Reserve open market operations over these months injected a total of $1.6 billion (net) in reserves through purchases of Government securities. These purchases provided an offset to the continuing gold outflow and the rise in currency in circulation and also supported—to the extent of $600 million—further expansion in member bank required reserves. As the

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demands for credit continued to press on the commercial banks, bank credit grew over the period at an annual rate of more than 10.5 per cent. With interest rates on Government securities rising irregularly over the interval, the Federal Reserve was able to shift the emphasis of its operations toward outright transactions in Treasury securities and to reduce its reliance on repurchase agreements.

Firm conditions prevailed in the money market during the period. Federal funds regularly traded at a premium relative to the Federal Reserve Bank discount rate. On occasion the premium increased to one-quarter of a percentage point. Member bank borrowing from the Federal Reserve averaged about $500 million a day over the period, about the same as in the preceding 4-month interval, and average net borrowed reserves fluctuated for the most part between $100 million and $200 million.

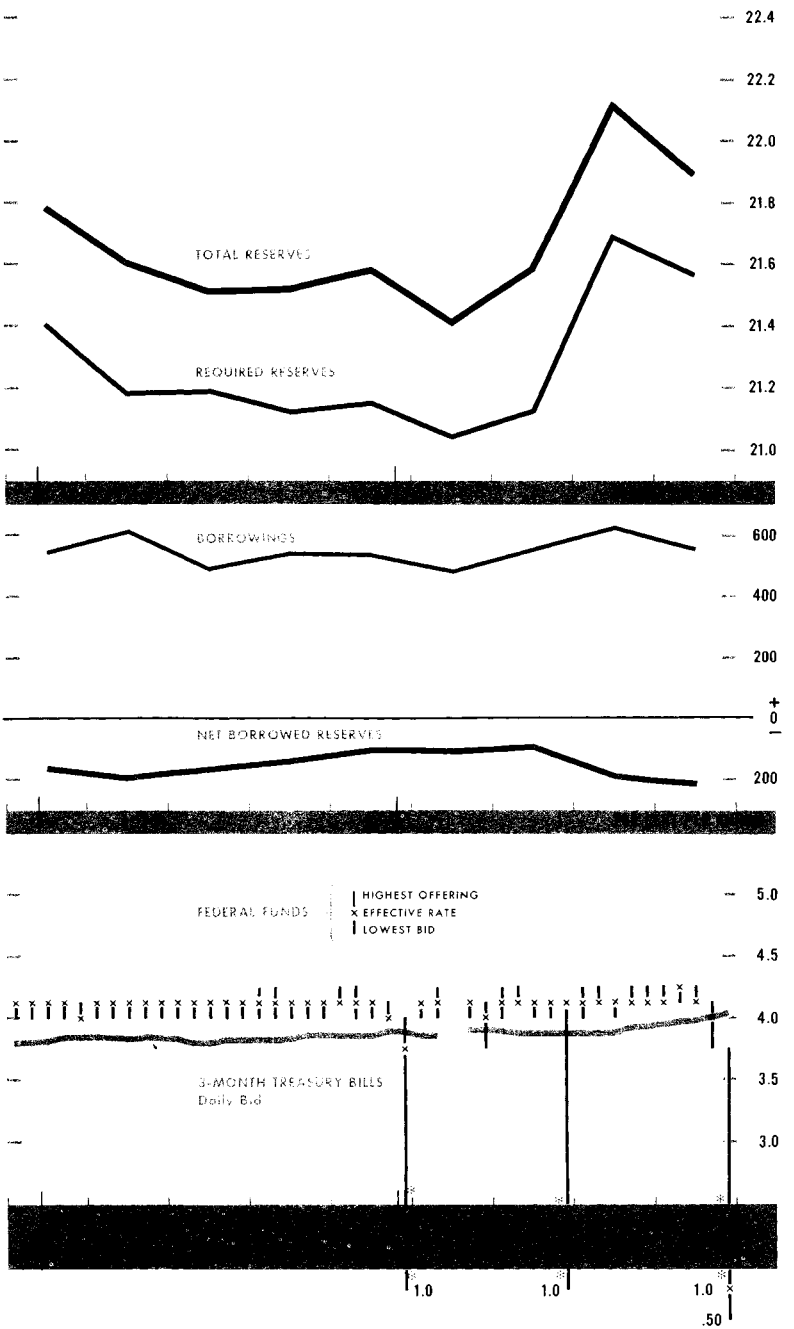
The one period when net borrowed reserves broke significantly out of this range was in the week that ended November 10. On Tuesday, November 9, a massive power failure in the northeastern part of the United States caused havoc in check clearing operations and made it difficult for banks in that area to calculate their reserve positions. The consequent bulge in float pushed net reserve availability at member banks for that week to a daily average of $94 million of free reserves.

Some of this extra reserve availability remained for several days because the Federal Reserve permitted reserve city banks in New York and Boston to carry accumulated reserve excesses over into the following statement week. Subsequently, as operations by the Federal Reserve and movements in market factors absorbed reserves, net reserve availability returned to the preblackout levels.

On a number of occasions during the interval the direction of open market operations had to be reversed rather abruptly to counter sizable unexpected movements in market factors. One was during the Treasury's refinancing of securities maturing in

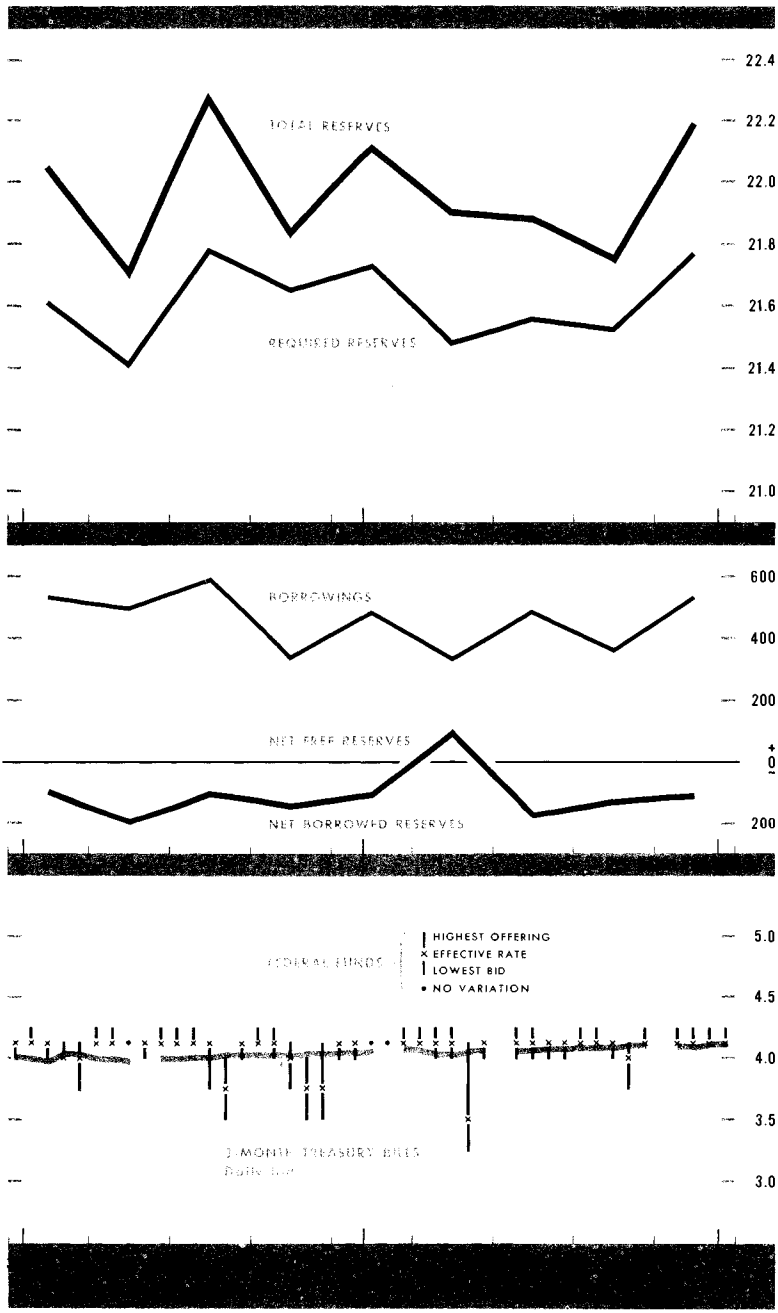
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Member Bank Reserves and Borrowings, and



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Rates on Treasury Bills and Federal Funds



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August, announced at the end of July. The Federal Reserve, as is customary during financings, was seeking to maintain steady conditions in the money market, but net reserve availability tended alternately to fall short of expectations and then to be unexpectedly large. To offset a major part of the unexpected decline in reserves that developed over the last weekend in July, the Federal Reserve purchased a substantial amount of Treasury bills in the market during the first several days of August. At the time of these purchases, bill rates had already come under upward pressure because of the disappointing demand for bills from sellers of rights in the Treasury's refunding.

Subsequently, the Federal Reserve dealt with an emerging over-abundance of reserves by selling Treasury bills that it had tendered for redemption earlier. This served to advance the timing of the already scheduled reserve absorption by a few days. Later on, when pressures built up rapidly in the money market on Friday, August 13, the payment date for the financing, the Federal Reserve replaced maturing repurchase agreements with new contracts extending over the weekend. After the weekend, it absorbed reserves by selling Treasury bills.

In early August a cautious atmosphere developed in the capital markets. While a generally favorable response was accorded the terms of the Treasury's relatively short-term refinancing operation, which included an 18-month note and a reopening of the bonds of February 1969, Government securities dealers soon concluded that the market outlook was uncertain and that they should reduce sharply their sizable inventory positions in Treasury notes and bonds. As prices moved lower, the Federal Reserve sought to carry out open market operations in a way that would cushion the adjustments in the market for coupon issues.

Thus, as market offerings of notes and bonds increased after the Treasury refunding had been completed, the Federal Reserve was able to offset part of the pre-Labor Day currency drain on bank reserves by purchasing $257 million of coupon issues over the August 20–September 3 period. It also purchased $350

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million of Treasury bills over this 2-week period, with most of its buying concentrated just before the Labor Day weekend.

A series of developments over the remainder of the year caused the Federal Reserve to remain out of the market for coupon securities after September 3. These included unexpected stresses in the short-term market in late September; first the approach and later the completion of the Treasury's November financing; and the market's upward groping for a viable rate level in November and December.

The mid-September dividend and tax dates passed with no unusual pressures developing in the central money market. Weekly reporting member banks lost $816 million (net) of time certificates of deposit in the week ended September 15, as corporations used these funds to make dividend and tax payments. Corporate sales of Treasury bills were light, however, and there was also a relatively modest return of securities to dealers under maturing repurchase agreements. Dealers' demands for loans from New York City banks thus were lighter than they had been around other recent dividend and tax dates.

After the September tax date, however, the money market became firmer as the reserves shifted away from banks in the money centers. At the same time, Government securities dealers did not experience the normal recovery in the availability of corporate funds for temporary investment in repurchase agreements; this was in part because the relatively late introduction of the new-model automobiles delayed the usual seasonal rise in automobile company liquidity.

Confronted by the need to finance their inventories at the higher rates being charged by the New York City banks and by the prospective offering in late September by the Treasury of tax-anticipation bills due in March and June 1966, dealers became aggressive sellers of Treasury bills, and bill rates rose. Reserve drains during the period were such as to require large-scale purchases of securities by the Federal Reserve; between September 22 and October 1 the System bought $1.4 billion of

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bills. The growing scarcity of bills that gradually developed in the wake of these purchases helped to ease the upward pressure on bill rates, but not before the 3-month bill rate had reached 4.05 per cent on September 29, or 28 basis points above the June low.

A recurring pattern in the money market during the fall of 1965 was the tendency for member banks to overborrow from the Reserve Banks before a weekend. Such developments gave rise to redundant reserves and to an easing of money market conditions toward the end of the statement week. This pattern appeared to be triggered on occasion by some trading in Federal funds at 4¼ per cent, one-quarter percentage point over the discount rate. Some banks that had become regular users of Federal funds to finance growing credit demands were willing to pay a premium on funds in order to avoid borrowing at the Reserve Banks. With a large volume of Federal funds preempted by such heavy borrowing by banks with reserve deficits, other banks were unable to obtain in the Federal funds market the funds they needed to meet temporary reserve shortages and had to borrow at the Reserve Banks.

Federal Reserve operations often sought to head off a pyramiding of such pre-weekend borrowing by providing reserves before the weekend. While this procedure moderated the variations in money market conditions, it was sometimes necessary to reverse direction toward the end of the statement week if reserve availability turned out to be large. In the week ended October 20, for example, the Federal Reserve purchased $145 million of Government securities under 3-day repurchase agreements on Friday, October 15, and then reversed direction through an outright sale of $334 million of Treasury bills on the following Monday and Tuesday. Even so, member bank borrowing over that weekend amounted to $880 million, lifting average borrowing for the week as a whole to nearly $600 million, and Federal funds traded as low as 3½ per cent for a time after the weekend.

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In the Treasury bill market, apprehension over the outlook for interest rates prompted many investors over the period to favor bills with short maturities, while dealers at times were aggressive sellers of bills in an effort to lighten their inventories. Bill rates moved sharply higher in the early part of the period, and again after the September tax date when dealers were unable to locate lower-cost repurchase agreements to finance their positions. The Treasury bill market also reacted in late September to the Treasury's announcement of a $4.0 billion auction of March and June tax-anticipation bills.

By early October some supply scarcities had developed in the bill market, and rates receded from their late September peak. Bidding in weekly auctions became more aggressive as dealers sought to replenish their depleted stocks. A fair investment demand for bills was also present, particularly from corporations seeking the recently issued tax-anticipation bills.

As financing costs remained high in the firm money market, however, dealers were willing sellers in the latter half of October, and this caused rates to creep higher again. The Federal Reserve purchased over $1 billion of Treasury bills in the three business days October 28–November 1 to meet month-end reserve needs. Nevertheless, bill rates continued to inch upward.

The Federal Reserve was again a sizable buyer of Treasury bills around the Thanksgiving Day holiday when large reserve needs arose, and then again at the very end of the period when special strains developed in the money market on December 1 as settlement was made for several large offerings by Government agencies. These Federal Reserve purchases had a somewhat steadying influence on the hesitant bill market, but rates—particularly on longer maturities—still tended to creep higher throughout November. Thus, by the close of the period, rates on most bill issues were about 30 to 40 basis points higher than at the end of July, with the 3-month bill bid at 4.13 per cent compared with 3.81 per cent on July 28.

In the capital markets the cautious atmosphere that dominated

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activity throughout the period first emerged after the Treasury had announced on July 28 the terms of its August refinancing. Heavy pressures on the pound sterling, as well as a growing awareness of the economic implications of stepped-up defense spending for Viet Nam, prompted participants to reappraise the outlook for interest rates. The refunding itself was concluded successfully; but as investment demand failed to respond to the volume of dealer offerings, prices of Treasury notes and bonds moved lower on almost every day from early August to the latter part of September. Yields on long-term Treasury issues moved to their highest levels in about 6 years during this period.

A similar adjustment occurred in the market for corporate bonds. A heavy volume of new corporate financing was scheduled for September, and as offerings attracted only limited interest on the part of investors, syndicate restrictions on prices were removed; significant upward adjustments in yields followed. In the tax-exempt sector a heavy atmosphere did not emerge until late August, but it persisted through September, with flotations of some previously announced new issues being postponed because of market conditions. The cancellation of one tax-exempt offering—the proceeds of which had been scheduled for reinvestment in Treasury securities—added to the pressures in the market for Government issues.

In early October the market atmosphere temporarily strengthened, partly reflecting official comments looking toward steadier interest rates. In this atmosphere two moderately sized Aaa-rated corporate offerings were well received, and they sold quickly at yields below the yield on a recent issue of similar rating. Business demands for credit were expanding rapidly, however, and with yields on new Aaa-rated corporate bonds generally above the 4½ per cent prime rate being charged by commercial banks, some financing that would normally have been carried out in the capital markets was being diverted to the banking system.

The tax-exempt market, in contrast, had some difficulty in

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digesting a heavy volume of new offerings, and renewed caution appeared following the brief rally in early October. Over the period, yields on new tax-exempt bonds generally rose 25 to 30 basis points on issues of comparable quality, while yields on new corporate bond issues adjusted to an Aaa basis rose about 20 basis points. At the end of the period a municipal bond issue rated Aaa was reoffered to yield 3.50 per cent for the longest maturity; by that time yields on new corporate bond issues adjusted to an Aaa basis averaged 4.79 per cent.

In the market for Treasury securities, dealers' offerings abated in the improved atmosphere of early October. Some increases in demand appeared, stemming in part from a step-up in switching among different securities by commercial banks. The rally was short-lived, however, as expanding demands from business for capital and expectations of enlarged Treasury financing needs re-emerged as the focus of attention. Trading activity contracted in the latter part of October amid reports, subsequently confirmed, that the Federal National Mortgage Association was planning to sell several hundred million dollars of participation certificates.

In this cautious atmosphere the Treasury confined its November refinancing of $9.7 billion of maturing issues—$3.3 billion of which were in the hands of the public—to the offering of new 4¼ per cent 18-month notes for cash, priced to yield 4.37 per cent. Although the offering was in line with market expectations, the atmosphere in the securities market continued to deteriorate, and the new issue elicited little enthusiasm. Indeed, larger subscriptions received a 48 per cent allotment, the largest allotment percentage in almost 4 years. This response in turn added further to the already cautious atmosphere. Some switching from Treasury bonds to corporate bonds, on which yields had become relatively attractive, also contributed to the downward pressure on prices of Treasury issues.

In mid-November the rescinding of the increase in aluminum prices and the favorable reception accorded the reduced volume

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of new corporate offerings helped spur a technical rally in prices of Treasury notes and bonds. Subsequently—as attention again focused on the growing Federal budget deficit, the continued rise in prices, the persisting balance of payments problem, and the prospective surge of corporate borrowing—a heavy tone reappeared. Additional official statements urging stable interest rates had little effect on bond prices. Over the July 29–December 1 interval average yields on 3- to 5-year Treasury issues rose by 42 basis points to 4.53 per cent, while yields on long-term bonds increased by 22 basis points to 4.37 per cent. This rise in yields over the 4-month period was almost as great as the total increase in yields on Treasury issues over the preceding 4½ years of the current business expansion.

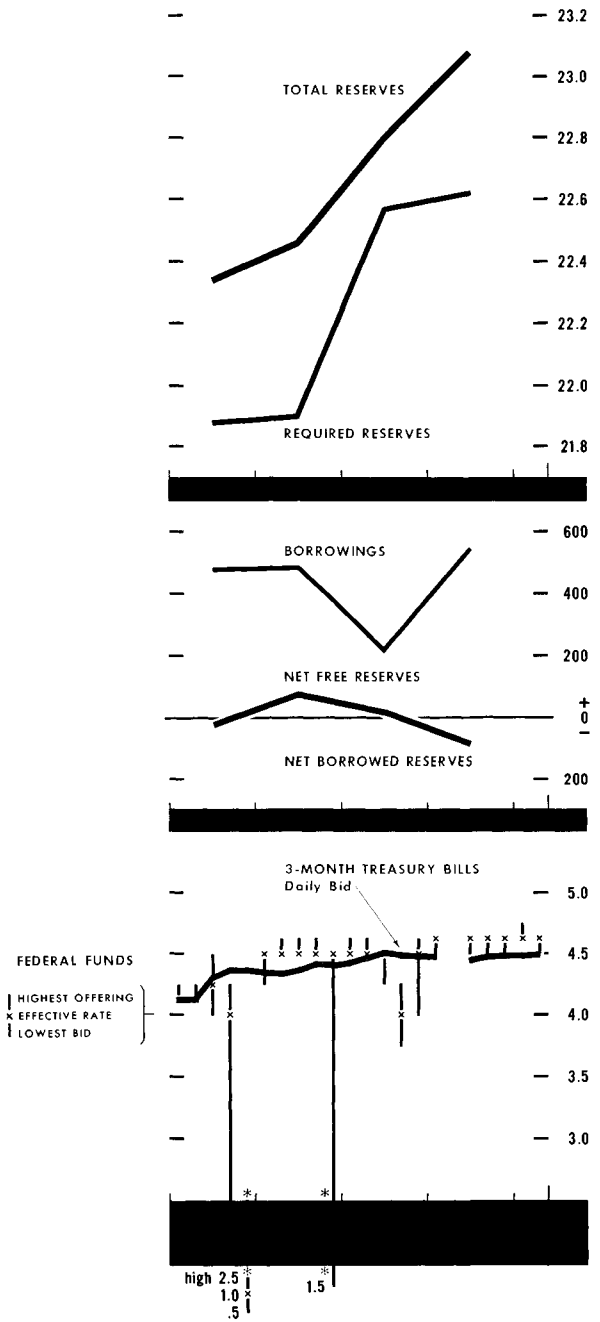
December 2–31: Moderating market adjustments in the wake of official rate actions. On Sunday, December 5, the Board of Governors of the Federal Reserve System announced that it had approved an increase in the discount rates of the Federal Reserve Banks of New York and Chicago from 4 to 4½ per cent and an increase in the maximum permissible interest rates payable on time deposits under Regulation Q to 5½ per cent. The Board's announcement stated that "the action contemplates the continued provision of additional reserves to the banking system, in amounts sufficient to meet seasonal pressures as well as the credit needs of an expanding economy without promoting inflationary excesses, primarily through the Federal Reserve's day-in and day-out purchases of Government securities in the open market." Shortly thereafter the other Federal Reserve Banks also raised their discount rates to 4½ per cent.

The immediate task confronting the Federal Reserve in its open market operations was to facilitate an orderly adjustment of money market rates to the official rate actions. The timing of these actions came as a surprise to market participants, even though skepticism about the viability of existing rate levels had become widespread after Federal officials tentatively had projected an increased budget deficit for the 1966 fiscal year. On

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DECEMBER 2 – DECEMBER 31, 1965

Member Bank Reserves and Borrowings, and Rates on Treasury Bills and Federal Funds



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Monday morning, December 6, the System purchased $272 million of Treasury bills at the market's opening in an endeavor to keep the adjustment process orderly.

The initial adjustments in the market were sharp. Treasury bill rates rose from 15 to 20 basis points, and prices of Treasury notes and bonds declined from one-half point to almost a full point. Declines in prices of corporate and municipal bonds also ranged to about one point, with yields rising by 5 to 10 basis points on actively traded issues. Rates on bankers' acceptances, commercial paper, and certificates of deposit were raised by about one-quarter percentage point, and major banks increased their prime lending rates by one-half percentage point to 5 per cent.

While the initial rate adjustments soon ran their course in the comfortable reserve climate fostered by open market operations, participants in money and credit markets still had to work out their appraisals of the longer-run outlook for interest rates. In this regard, attention was focused on the demands—as yet unclear—of the expanded military effort and of buoyant capital spending plans by business; and there was also increasing concern with the threat of inflationary pressures. At its December 14 meeting the Federal Open Market Committee, taking into account forthcoming Treasury financing activity and widely fluctuating seasonal pressures as well as the recent increase in Reserve Bank discount rates, directed that open market operations continue to be aimed at moderating further adjustments that might develop in money and credit markets.

In accordance with this objective, open market operations continued to provide a climate of ample reserve availability. With the mid-December bulge in float providing over $1 billion of reserves, reserve injections by open market operations were needed on only a small scale. Except for two occasions when he made outright purchases of long-term Treasury bills that were in heavy supply in the market, the Account Manager relied primarily on purchases of Government securities and bankers' acceptances under repurchase agreements.

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The use of repurchase agreements served not only to provide reserves temporarily at times of pressure but also to moderate the upward pull on Treasury bill rates that stemmed from the high dealer loan rates posted by the New York City banks. Over the December 2-31 interval, gross repurchase contracts entered into by the Federal Reserve totaled $1.7 billion, and on a net basis holdings of Treasury securities under repurchase agreements rose by $290 million. At the same time, despite the Federal Reserve purchases of longer-term bills, total outright holdings of Treasury bills fell by $304 million over the period, as short-dated bills were sold or redeemed on those occasions when it was necessary to absorb reserves.

The December dividend and tax dates brought a rapid expansion in bank credit and deposits and an attendant massive redistribution of reserves, but the central money market handled these flows with facility. Federal funds traded in volume at 4½ per cent or below through December 22, and member bank borrowing from the Reserve Banks averaged $394 million in the 3 weeks that ended on that day, well below the average of the preceding 4 months. Average free reserves of $22 million in these 3 weeks compared with net borrowed reserves averaging $138 million in the preceding 3 weeks.

The credit and monetary expansion during December was far greater than seasonal. The loans and investments of weekly reporting member banks rose by $1.7 billion in the week ended December 15 alone, while negotiable CD's at these banks declined by $730 million. The major money market banks in New York City and elsewhere accounted for a large part of the expansion in credit, and these banks came under increased reserve pressure as their assets rose more rapidly than their deposits. In the main, however, they were able to cover their reserve needs by borrowing in the Federal funds market.

A somewhat tauter tone developed in the money market after December 22. Federal Reserve open market operations injected reserves on a day-to-day basis, but these actions did not fully

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offset an unexpectedly large absorption of reserves caused by a decline in Federal Reserve float. Banks in the money centers also experienced a further increase in reserve pressure as the distribution of reserves continued to favor other banks. Strong bidding for Federal funds kept the rate at 4⅝ per cent throughout the week ended December 29, and member bank borrowing from the Reserve Banks rose to $546 million. While the Federal Reserve stood ready to offset any unusual stresses that might develop around the year-end statement publishing date, only a moderate temporary injection of reserves through repurchase agreements proved necessary at that time.

Rates on Treasury bills moved irregularly upward until shortly after mid-December and then fluctuated narrowly over the remainder of the period. After the discount rate was raised, a growing concern over a further military build-up in Viet Nam, high costs of dealer financing, and prospects of large Treasury financing operations in the short-term area added to the upward pressure on bill rates just at a time when large amounts of Treasury bills were being returned to dealers under repurchase contracts with corporations that matured on December 10, the popular dividend rate. Dealers were also apprehensive about the rates that banks might pay on CD's, especially in view of the very heavy demand for bank loans. On December 17 the 3- and 6-month bills were auctioned at average rates of 4.505 and 4.692 per cent, respectively, the highest since early 1960. Subsequently, investor demand for bills expanded, and the bill market steadied.

The Treasury announced on December 22 that it would soon raise in the short-term market $3.8 billion of its estimated $5 billion remaining cash need for the 1966 fiscal year. The package included the addition of $1 billion of tax-anticipation bills (due in June) to be sold December 29; the addition of $100 million to the weekly auction of 3-month bills, probably for 13 weeks; and about $1.5 billion of short-term securities to be sold for cash in January.

Heavy demand by corporations and banks developed for

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Treasury bills, partly for year-end statement purposes. Bidding in the 1-year Treasury bill auction on December 23 was strong at the higher rate levels, and commercial banks bid aggressively on December 29 for the reopened June tax anticipation bill for which payment could be made by crediting Treasury tax and loan accounts. Even so, as the year closed, Treasury bill rates were generally 40 to 50 basis points higher than they had been on December 1, before the discount rate was raised. Rates on 3- and 6-month bills stood at 4.49 and 4.67 per cent (bid), respectively.

The market for Treasury notes and bonds continued to grope for a new trading level following its sharp initial adjustment. With no new consensus about interest rate levels quickly established in the wake of the discount rate change, prices of Treasury coupon issues tended to react in exaggerated fashion to conflicting reports regarding prospects for ending hostilities in Viet Nam, to speculation over the size of the Federal budgetary deficit and the possibility of Federal tax increases, and to further signs of inflationary pressures. The sharpest price declines were registered in the short- and intermediate-term areas, where heavy credit demands of Government and business were expected to be centered in 1966.

Treasury issues due within 5 years closed the year with yields as high as 5.01 per cent, the highest since early 1960. Yields on bonds due in more than 5 years reached their high points for recent years at mid-December, then inched irregularly lower. At the close of the year yields on long-term Treasury bonds averaged about 4.50 per cent. The volume of trading expanded during December despite the sharp price gyrations as commercial banks and others engaged in heavy year-end switching programs for tax purposes.

The markets for corporate and tax-exempt bonds performed quite smoothly following their adjustments to the change in the discount rate. In the week after the Federal Reserve's rate action three major tax-exempt issues, offered at yields 10 to 12

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basis points above those on comparable issues a week earlier, were accorded favorable receptions. One utility company postponed indefinitely a major bond offering in the wake of the rate change, but a corporate issue rated Aa—offered at a yield of 4.95 per cent—was well received by investors.

During the latter part of December, trading in seasoned issues and the pace of new offerings were seasonally slow in both corporate and municipal markets. Offerings of new municipal bonds met with a mixed reception. However, dealers were successful in reducing inventories of older issues during this period, although price concessions were often necessary. At the end of the year the total of dealers' advertised inventories of municipal securities stood at $453 million, the lowest level since January 1964. Yields on seasoned corporate and tax-exempt bonds at the close of the year, as measured respectively by Moody's Aaa series and the *Bond Buyer's* index of 20 bonds, were 4.73 and 3.54 per cent. At these levels they were 30 and 42 basis points, respectively, above such yields a year earlier.

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REVIEW OF OPEN MARKET OPERATIONS IN FOREIGN CURRENCIES

The position of the dollar improved in foreign exchange markets during 1965, and U.S. monetary authorities—the Federal Reserve and the Treasury—were able to reduce significantly foreign exchange commitments undertaken in 1964 and early in 1965. As the year opened, increased capital outflows from the United States were adding heavily to an already large U.S. payments deficit and to continental European countries' official holdings of dollars, which had been swollen by the flight from sterling in 1964. It was against this background that the United States in February 1965 adopted a new series of measures—including the Voluntary Foreign Credit Restraint program—to deal with its balance of payments deficit.

Although the effects of these measures soon began to show up in the exchange markets, U.S. authorities nevertheless faced the necessity of absorbing large amounts of dollars in foreign official accounts. The U.S. payments deficit persisted, although at a reduced rate; Italy and France continued to run very sizable balance of payments surpluses; and other countries received additional flows of funds out of sterling during the first 8 months of the year. Under the circumstances, U.S. authorities relied heavily on exchange operations and international credits, particularly during the early months of the year, to reduce the drain on U.S. gold reserves.

As in the past, official exchange transactions took a variety of forms to meet varying circumstances. The Federal Reserve made extensive use of its swap lines during the year, and these facilities were enlarged by $450 million to a total of $2.8 billion; the increases included $200 million with the Bank of Italy, $100 million with the Bank of Japan, and $150 million with the Bank for International Settlements. In addition, both the Federal Reserve and the Treasury continued to undertake commitments in the forward exchange markets. The Treasury also issued $198

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million equivalent in foreign currency debt obligations denominated in Swiss francs, Austrian schillings, and Italian lire, the proceeds of which were used to purchase excess dollars from the respective central banks.

TABLE 1

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Other party to arrangement	Amount (in millions of dollars)		Term of arrangement (in months)
	Dec. 31, 1964	Dec. 31, 1965	
Austrian National Bank	50	50	12
Bank of Canada	250	250	12
Bank of England	750	750	12
Bank of France	100	100	3
German Federal Bank	250	250	6
Bank for International Settlements	150	[1] 300	6
Bank of Italy	250	450	12
Bank of Japan	150	250	12
National Bank of Belgium	100	100	12
Netherlands Bank	100	100	3
Bank of Sweden	50	50	12
Swiss National Bank	150	150	6
Total	2,350	2,800	

[1] Half is available in Swiss francs and half in other European currencies.

Total foreign exchange commitments of U.S. monetary authorities rose to a new high of $2 billion in April 1965. This total included $585 million equivalent in drawings under the Federal Reserve swap network, $213 million in forward sales to the market, $65 million under third-currency swaps, and $1,137 million equivalent in foreign currency obligations of the Treasury. (Not included are the Treasury's technical commitments in forward lire, nor the U.S. net position in the International Monetary Fund, described below.)

The U.S. Treasury also made further drawings on the Inter-

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national Monetary Fund. In order to avoid selling gold to countries making repayments to the Fund, the Treasury—as it had done in 1964—drew eligible currencies from the Fund for resale to such countries. In March it drew $75 million equivalent in Canadian dollars, German marks, and Italian lire, and in September it drew $60 million equivalent in Canadian dollars. In addition, in July the United States made its first ordinary drawing on the Fund to acquire foreign exchange on a medium-term basis. This drawing totaled $300 million equivalent in five European currencies. Some of the proceeds were sold to the Federal Reserve to enable it to repay swap drawings, and the remainder was used by the Treasury. Although the United States drew a total of $960 million in foreign currencies from the IMF during 1964 and 1965, other operations of the Fund resulted in disbursements of dollars and at the end of 1965 the U.S. repurchase obligation to the Fund was only $427 million.

As 1965 progressed, the position of the dollar improved and the United States was able to reduce its use of international credit and to begin building up balances in foreign exchange. This turnabout reflected not only the successful efforts to reduce our payments deficit but also occasional payments pressures in some foreign countries and the emergence of a substantial payments deficit in Germany. Moreover, during the autumn there was a reversal of previous outflows from sterling, and at the year-end the pressures usually associated with window-dressing by European commercial banks were substantially lessened by various measures of central bank cooperation.

As a result, the Federal Reserve was able to reduce its swap commitments from the $585 million peak in early April to $135 million equivalent at the end of 1965. In addition, all System and Treasury forward commitments to the market (except for technical commitments in lire) were paid off, and $20 million equivalent in third-currency swap commitments were reversed. The Treasury also repaid $75 million equivalent of mark-

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denominated bonds. Thus, from the $2 billion peak in April, the foreign currency commitments of U.S. monetary authorities —exclusive of technical commitments in Italian lire—had been reduced to $1,398 million equivalent by the year-end, while U.S. obligations to the IMF had increased by only $97 million during the same period.

The Italian lira was the only currency in which the United States significantly increased its foreign exchange obligations during 1965. The huge surplus in the Italian balance of payments posed problems for international monetary cooperation, but these were worked out successfully, thanks in large part to the constructive policies of the Italian authorities, who entered into an unprecedented volume of dollar swaps with Italian commercial banks. These operations not only alleviated the need for inter-central-bank settlement of the Italian surplus but also helped to assure that international markets were not unduly squeezed for dollars as a result of the U.S. program to reduce capital outflows. As in 1962 under similar circumstances, U.S. authorities agreed to participate with the Bank of Italy in forward commitments to the Italian banks. First the Treasury, and later the System acting under a new authorization to assume commitments for forward sales of lire up to $500 million equivalent, took part in the arrangements.

The United Kingdom continued to be plagued by a large payments deficit despite substantial progress in reducing it during the year. By late summer the exchange markets had seen a succession of speculative selling waves that had depleted Britain's credit lines—including its swap arrangement with the Federal Reserve. Nevertheless, there was increasing evidence that sterling had become heavily oversold (with a consequent improvement in the technical position of sterling) and that the corrective British measures were gradually taking hold. Therefore, the major central banks agreed in September that the time was right to initiate an operation to put pressure on the accumulated short positions in sterling, and they agreed

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TABLE 2

FOREIGN CURRENCY TRANSACTIONS OF THE FEDERAL RESERVE, 1965

(In millions of dollars equivalent)

Currency	Transactions under swap lines					Third-currency swaps		Other transactions			
	Drawings	Repayments	Disbursements of swap-acquired balances	Acquisitions of funds for repaying swaps				With U.S. Treasury		With others [1]	
				From U.S. Treasury	From others	Purchases and reacquisitions	Sales and repayments	Purchases	Sales	Purchases	Sales
Austrian schilling											
Belgian franc	65.0	75.0	[2] 150.1	[2] 40.0	[2] 120.0						
Canadian dollar											
Pound sterling	[3] 1,765.0	[3] 1,490.0				25.0			7.5	70.1	73.2
French franc											
German mark	15.0	65.0	12.3		62.3	12.5	52.5			72.9	
Italian lira	350.0	250.0	350.0	163.0	86.6						
Japanese yen											
Netherlands guilder	25.0	125.0	25.0		123.1		25.0			126.8	31.7
Swedish krona											
Swiss franc	150.0	250.0	150.0		209.2	[4] 40.0				32.5	11.0
All currencies	2,370.0	2,255.0	687.4	203.0	601.2	77.5	77.5		7.5	302.3	115.9

[1] Includes forward as well as spot transactions; excludes Italian lira forward operations and renewals of forward sales.

[2] Includes disbursements from and reconstitution of $50.0 equivalent portion of the swap line, which remains fully drawn by both parties at all times.

[3] Initiated by the Bank of England.

[4] Used to repay swap drawing.

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to provide assistance to the United Kingdom for this purpose. The Federal Open Market Committee authorized the System to participate to the extent of $200 million in these new arrangements. The U.S. Treasury also stood ready to provide substantial resources. On September 10 the Federal Reserve Bank of New York, acting for the System, initiated market operations. In succeeding months, with Britain's payments deficit narrowing, the position of sterling improved materially.

In the London gold market there was large private demand for gold through most of 1965. This continuing heavy private buying resulted mostly from speculation against sterling, large declines in the U.S. gold stock, publicity given to France's advocacy of a return to the gold standard, and a variety of international political tensions. In addition, Communist China bought a fairly sizable amount of gold. The price of gold in London therefore tended to be somewhat above the levels of the past 2 years, but with renewed Soviet sales of gold to finance purchases of wheat, the Gold Pool registered a small surplus for the year.

The remainder of this report will present a more detailed review of the Federal Reserve System's operations during 1965 in sterling, German marks, Swiss francs, Netherlands guilders, Italian lire, and Belgian francs. There were no Federal Reserve operations in Austrian schillings, Canadian dollars, French francs, Japanese yen, or Swedish kronor.

Sterling. The speculative attack against sterling that developed in the fall of 1964 continued on a diminished scale into early 1965. The Bank of England, which had already drawn a net amount of $200 million under its swap arrangement with the System by the end of 1964, made further use of the $750 million facility with the System in January and also drew on its credit lines with other central banks. By mid-January, however, the spot rate for sterling had firmed as selling abated, and the Bank of England began taking in dollars. During the remainder of the month, it repaid all of the amounts drawn in January,

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and in February it was able to make fairly substantial further net repayments to the System.

In March the market became increasingly apprehensive that the official British pledge to defend the pound's parity might not be matched by effective restraint measures in the April budget. In addition, reduced availabilities of Euro-dollars after the United States had taken measures to curtail its balance of payments deficit helped put an end to inflows of short-term funds to London. Moreover, large forward dollar commitments to the market that the Bank of England had undertaken in late 1964 began to mature. As market pessimism increased, offerings of sterling became sizable, and the Bank of England again had to draw extensively on facilities with the Federal Reserve and with other creditors and also had to extend its forward commitments.

Following the announcement of a restrictive budget in April, and after the Prime Minister categorically denied that sterling would be devalued, the rate firmed again. The reintroduction shortly thereafter of special deposit requirements for London clearing banks and Scottish banks, followed in early May by an official request for a 5 per cent limitation on credit expansion to the private sector during the 12 months ending March 1966, also contributed to renewed buying of sterling. Consequently the Bank of England was able to purchase dollars in the market and to make substantial repayments to the System. Late in May, following a drawing of $1.4 billion from the IMF, the Bank of England made a final payment of $230 million to the System, and the swap line reverted to a standby basis.

Nevertheless the market remained cautious and sensitive to news of changes in Britain's economic performance. As summer approached, trade figures pointed to a widening of the trade deficit in the second quarter as a result of higher imports and sluggish exports. With attention focused on these trade results, unmistakable signs of faltering confidence emerged and the market did not respond to the June 3 reduction in the Bank

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of England's discount rate to 6 per cent from the crisis level of 7 per cent and the simultaneous tightening of cash down payment requirements on hire purchase contracts. Speculative pressures mounted during June, and increasingly large operations were necessary to support sterling. Under the circumstances the Bank of England reactivated its swap facility with the Federal Reserve, drawing a total of $360 million in June and additional amounts in July and August. By the end of August it had not only exhausted the $750 million swap line, as the accompanying tabulation shows, but had also drawn additional amounts of $40 million and $100 million, respectively, from the System and the U.S. Treasury over the end of the month.

End of month	Drawings outstanding (in millions of dollars)
1964—December	200
1965—January	200
February	105
March	320
April	280
May	0
June	360
July	525
August	750
September	750
October	700
November	550
December	475

By mid-August, however, the oversold position of sterling was becoming apparent. In order to capitalize on this technical strength, the Federal Reserve along with the U.S. Treasury and nine other central banks plus the BIS joined forces with the Bank of England in new arrangements designed to force the market to cover its short positions. This agreement was announced on September 10, and the Federal Reserve immediately

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entered the market to start bidding up the rate for sterling. Private covering soon took over, and as buying gained momentum, spot sterling rose above its parity of $2.80 for the first time since the spring of 1964. At the same time the Bank of England began to take in large amounts of dollars from the market, and it continued to improve its over-all position through the year-end.

With dollars flowing back into its reserves during the autumn, the Bank of England made substantial progress in reducing its over-all commitments. In September it repaid the special System and Treasury credits totaling $140 million, and before the end of the year it repaid a total of $275 million under its regular swap commitment to the System. In addition, it made substantial payments on its forward commitments to the market while adding $420 million to its reserves (although deferring some $175 million in debt and interest payments due at the year-end to the United States and Canada). As the year closed the Bank of England's debt under the swap line was down to $475 million.

German mark. In late December 1964 the Federal Reserve had drawn $50 million equivalent under its $250 million swap facility with the German Federal Bank to absorb dollars taken in by that Bank at the time of the sterling crisis. This drawing was reversed in January 1965, as short-term capital outflows from Germany—combined with German military purchases in the United States—enabled the Federal Reserve to acquire $50 million equivalent of marks from the German Federal Bank. A $15 million swap drawing—initiated in February when the System offered marks (and Italian lire) in New York to maintain orderly market conditions immediately following President de Gaulle's endorsement of the gold standard—was reversed in March and April.

In May the mark began to display an increasingly soft tone, as German imports continued to outpace exports. By June the mark was quoted below its par of $0.2500 for the first time since

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February 1963. The easing of the mark prompted the Federal Reserve and the U.S. Treasury to initiate substantial purchases of marks both in the market and from the German Federal Bank, in order to strengthen the official U.S. foreign currency position and begin repayment of U.S. Treasury bonds denominated in marks. Thus, the Federal Reserve purchased $39 million equivalent of marks in June and early July, and on July 8 it swapped $40 million equivalent of marks for Swiss francs with the BIS for use in liquidating the remaining Swiss franc drawing under the swap arrangement with that institution. In July and August additional purchases of marks enabled the System and the U.S. Treasury each to substitute $12.5 million equivalent of marks for sterling under third-currency swaps that had been initiated in the fall of 1964 with the BIS for the purpose of acquiring guilders. Similarly, for Treasury account, $15 million equivalent of marks were substituted for sterling in July under third-currency swap with the BIS against Swiss francs.

Additional purchases of marks enabled the Treasury to redeem a $25 million equivalent mark-denominated bond in July and a $50 million equivalent bond in October. These redemptions represented the first reductions in the Treasury's mark-denominated bonds. Such bonds were initially issued to the German Federal Bank in January 1963, and the total outstanding reached a high of $679 million equivalent in 1964.

Swiss franc. In late 1964 the Swiss National Bank took in a sizable amount of dollars as funds moved into Switzerland during the sterling crisis. These dollars were partially absorbed by a Federal Reserve drawing of $100 million equivalent in Swiss francs in December of that year under the System's swap line with the BIS. Further drawings of Swiss francs, amounting to $60 million equivalent in January and $90 million equivalent on March 1, were made for the same purpose—this time under the swap line with the Swiss National Bank. Thus by March 1 the Federal Reserve had used $250 million of its $300 million credit facilities in Swiss francs. In addition, the Swiss National

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Bank purchased $50 million of gold from the U.S. Treasury during the first 4 months of the year.

These operations were made necessary by the overhang of dollars accumulated by the Swiss National Bank during the latter part of 1964. In fact, the Swiss franc began to ease early in 1965 as Swiss banks once again started to place funds abroad. By March the rate had moved below $0.2300, and the Swiss National Bank sold dollars to the market in support of the rate for the first time since 1962. With the softness in the franc rate persisting through the early summer, and with the Swiss National Bank needing dollars to cover its requirements for European currencies, especially for lira remittances by Italian workers in Switzerland, the U.S. monetary authorities were able to acquire a total of $175 million equivalent in Swiss francs during the period April–July, mainly through direct transactions with the Swiss National Bank.

At the end of March the Federal Reserve began to reduce its liabilities under its swap line with the Swiss National Bank; for this purpose it used $20 million equivalent of francs that it had acquired from the Bank of England in connection with a credit to the latter by the Swiss National Bank. During subsequent months it purchased $82 million equivalent of francs, which it used to reduce its liability to the Swiss National Bank to $48 million equivalent by July 16. Other spot purchases during May and June enabled the System to repay a considerable amount of its $100 million equivalent drawing from the BIS, and on July 8 it made a final repayment with francs acquired through a $40 million equivalent swap of German marks for Swiss francs with the BIS.

U.S. Treasury commitments resulting from forward sales of Swiss francs in the Swiss market were paid down further to $22.5 million equivalent by late June, and forward sales of Swiss francs by the Federal Reserve were completely liquidated. The latter sales, which had been initiated in December 1964 to encourage Swiss banks to invest abroad dollars they might other-

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wise have sold to the Swiss National Bank, reached a peak of $32.5 million equivalent by January 8. The bulk of these contracts were paid off by mid-February—through spot purchases of Swiss francs—and the remainder were liquidated in July. As a result of these various operations, commitments of the Federal Reserve and the Treasury in Swiss francs were reduced by a total of $233 million during the January–July period.

In June the Swiss franc began to firm in conjunction with the approach of midyear balance-sheet positioning by Swiss commercial banks. However, the Swiss authorities acted in both the money and foreign exchange markets to mitigate the seasonal liquidity squeeze. Consequently, the Swiss franc remained below its effective ceiling during June, and U.S. authorities continued to acquire Swiss francs from the Swiss National Bank. Opportunities for further acquisitions diminished considerably after midyear, however, as the unwinding of swaps undertaken by the Swiss National Bank at midyear brought about a tightening in the Swiss money market.

Under the circumstances the Swiss National Bank repurchased from the Swiss commercial banks part of the foreign exchange that it had sold them on a covered basis in January when the market was extremely liquid. Nevertheless, owing to renewed nervousness about sterling, the Swiss franc advanced to its effective ceiling. This made it necessary for the Swiss National Bank to buy additional dollars in its market, part of which the U.S. Treasury absorbed by purchasing dollars from that Bank against Swiss francs obtained by sale to the BIS of a $23 million equivalent U.S. Treasury bond denominated in Swiss francs. This sale raised the Treasury's bond indebtedness in Swiss francs to $350 million equivalent.

In mid-August the Swiss franc began to decline from its ceiling as tensions associated with sterling subsided and as the Swiss money market became easier. Late in October the Swiss National Bank again began to meet some of its dollar requirements by selling Swiss francs to the U.S. authorities. These pur-

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chases enabled the Federal Reserve by early December to liquidate its remaining $48 million equivalent drawing under its swap arrangement with the Swiss National Bank. In addition, the U.S. Treasury paid off $22.5 million equivalent of maturing forward sales of Swiss francs to the market. Thus, at the year-end the only Federal Reserve indebtedness in Swiss francs was a $40 million equivalent swap of German marks for Swiss francs with the BIS. The Treasury had a similar swap of $15 million equivalent outstanding and also $350 million equivalent of medium-term securities denominated in Swiss francs.

Netherlands guilder. Official U.S. commitments in Netherlands guilders reached a peak of $348 million equivalent on January 8 as a result of operations during the period August 1964–January 1965, when the Dutch payments position was strong and when, in addition, funds were moving into the Netherlands as a result of speculation against sterling. As of January 8 the $100 million Federal Reserve swap facility with the Netherlands Bank had been fully utilized, a temporary $35 million swap between the U.S. Treasury and the Netherlands Bank had been arranged, another $50 million of guilders had been acquired through sterling–guilder swaps with the BIS for sale to the Netherlands Bank to absorb dollars, and $163 million equivalent of guilders had been sold forward in the Netherlands market.

Early in January the temporary swap of $35 million between the U.S. Treasury and the Netherlands Bank was liquidated as Federal Reserve and Treasury sales of forward guilders, initiated in mid-December, induced covered investments abroad by Dutch commercial banks and facilitated the acquisition of spot guilders by the U.S. authorities. Commitments on these forward contracts through the market reached a peak of $197 million equivalent on January 19, but by early February $10 million of short-dated contracts had been paid off at maturity with guilders purchased from the Netherlands Bank. Moreover, in the early part of February the Federal Reserve started to repay its drawings under the swap arrangement, and by the end of the month it had

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reduced the amount outstanding to $70 million equivalent. (Half of a $20 million equivalent swap repayment in early February was financed by the sale of $10 million of gold by the U.S. Treasury to the Netherlands Bank.)

A payments deficit began to emerge in the Netherlands in March, and during the spring and early summer U.S. monetary authorities acquired sufficient guilders, mainly through purchases from the Netherlands Bank as it sold dollars in its market, to reduce outstanding commitments by a total of $225 million equivalent by late July. During March and April the Federal Reserve used guilders acquired from the Netherlands Bank to repay $25 million equivalent of its swap drawings. In late May it paid off the remaining $45 million equivalent of drawings with guilders acquired in conjunction with the drawing by the United Kingdom from the IMF. The Federal Reserve and the Treasury also paid off a total of $25 million equivalent of sterling–guilder swaps with the BIS in June as well as a considerable amount of forward market contracts. The remaining System forward contracts were paid off in July.

Toward midsummer, renewed nervousness regarding sterling contributed to flows of funds into the Netherlands. These inflows more or less coincided with the return of seasonal strength in the Netherlands' payments position, and with the guilder in good demand the Netherlands Bank began to buy dollars to prevent too rapid a rise in the guilder rate. Its acquisitions soon raised its total holdings above desired levels. Consequently, the U.S. Treasury purchased $25 million at the end of July with guilders drawn from the IMF under the $300 million equivalent multicurrency drawing referred to elsewhere, and in August the Federal Reserve reactivated its swap arrangement with the Netherlands Bank by drawing $25 million equivalent.

In the autumn the demand in the Netherlands for dollars picked up as Dutch imports accelerated in anticipation of the imposition of new Dutch excise taxes on January 1, 1966. With the Netherlands Bank selling dollars in support of the guilder

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rate, the U.S. Treasury purchased from that Bank guilders totaling $56.9 million equivalent between late September and mid-December and repaid at maturity all of its remaining forward guilder commitments to the market. In late December the U.S. authorities acquired sufficient guilders from the Netherlands Bank to repay all the remaining official U.S. guilder commitments: $25 million equivalent under the System's swap arrangement with the Netherlands Bank and the two $12.5 million German mark–Dutch guilder swaps with the BIS for Federal Reserve and Treasury account.

Italian lira. In 1965 Italy registered a balance of payments surplus of nearly $1.6 billion dollars, attributable to a much reduced trade deficit and record earnings on service transactions. Large U.S. sales of gold to Italy were avoided, however, as U.S. and Italian monetary authorities undertook a variety of measures to offset the flow of dollars to Italy. The most important element in this cooperative effort to insulate official reserves from the potentially disruptive effects of Italy's large payments surplus was the policy adopted by the Italian authorities to encourage investment abroad of dollar inflows by providing forward-lira cover to Italian commercial banks. As indicated below, U.S. authorities participated with the Italian authorities in this program. But in spite of the rechanneling of funds, Italian reserves increased, particularly during the summer months when seasonal factors are favorable to Italy. The United States therefore employed a variety of techniques to reduce official Italian outright holdings of dollars.

The Federal Reserve reactivated its $250 million swap arrangement with the Bank of Italy on January 22 by drawing $50 million equivalent in lire to absorb dollars. In March it made another drawing for the same amount. With $100 million of the $250 million swap line utilized, and with the prospect of further increases in official Italian holdings of dollars during the seasonally strong summer months, it seemed desirable to increase the size of the System's swap facility with the Bank of

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Italy. Effective April 1, the arrangement was expanded to $450 million, and a further $100 million was immediately drawn. (Of the $200 million increase in the swap line, $100 million replaced a standby swap facility for a like amount made available to Italy by the U.S. Treasury in March 1964 as part of a $1 billion credit package.) Additional dollars were absorbed from the Bank of Italy in April by an $80 million sale of gold by the U.S. Treasury—this represented a partial repurchase by Italy of the $200 million of gold sold to the United States in 1964—and in May by a further System swap drawing of $50 million equivalent of lire.

In late May the United Kingdom drew from the IMF $82 million equivalent of lire, which it sold to the Federal Reserve, thus enabling the System to reduce its swap drawings by that amount. A similar operation in connection with a subsequent drawing of lire from the Fund by Ceylon enabled the System to repay an additional $5 million on July 2. However, as the sizable surplus in the Italian balance of payments continued, it seemed appropriate to fund the swap drawings still outstanding. Accordingly, in July the United States drew $180 million equivalent of lire as part of its $300 million multicurrency drawing from the IMF. Of this amount, $163 million equivalent was used to liquidate the remaining Federal Reserve swap drawings, and the balance was used to purchase dollars from the Bank of Italy. Another $125 million was purchased from that Bank with the proceeds from an 18-month lira-denominated bond, which the Treasury issued to the Bank of Italy. In August, inflows of dollars to Italy associated in part with continuing pressures on sterling caused the Federal Reserve to reactivate its swap facility with the Bank of Italy by drawing $100 million of lire in order to absorb an equivalent amount of dollars.

In 1964, as the Italian payments position swung from heavy deficit to substantial surplus, the Italian authorities had begun to sell dollars to Italian commercial banks on a swap basis,

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mainly for investment abroad. By March 1965 these swaps had reached substantial proportions and at that time it was agreed that the U.S. Treasury would begin to participate with the Italian authorities in forward commitments to the Italian banks. (The Treasury had undertaken similar technical commitments beginning in January 1962 and continuing until March 1964; by the latter date, the contracts between the Italian authorities and Italian banks had been fully liquidated as Italy's balance of payments swung into deficit.)

These arrangements not only reduced Italy's potential demand for gold but also helped materially to avoid a potentially disturbing squeeze for dollars that might have arisen in international markets as a result of the U.S. balance of payments program. As Italian banks received dollars from the Bank of Italy under these swaps, they repaid previous borrowings and placed additional funds in the Euro-dollar market, thereby replacing dollars being repatriated through Canada to the United States. Since the Federal Reserve had an interest in assuring orderly flows of short-term funds in this fashion, it was agreed that the Federal Reserve should join with the Treasury in the operation. Thus, in late November the Federal Open Market Committee authorized the Special Manager of the Open Market Account to assume commitments for forward sales of lire up to $500 million equivalent as a means of facilitating the retention of dollar holdings by private foreign holders.

Belgian franc. Belgium continued to run a balance of payments surplus during the greater part of 1965, and with the Belgian franc generally at its ceiling, the Federal Reserve used its swap line to absorb excess dollars from the National Bank of Belgium. Nevertheless, the National Bank of Belgium purchased a total of $83 million of gold from the U.S. Treasury during the first 8 months of 1965.

At the beginning of 1965 Federal Reserve drawings under the $100 million swap arrangement with the National Bank

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of Belgium amounted to $45 million equivalent. Increases in Belgian official holdings of dollars during January and February were absorbed in part through additional drawings of $40 million equivalent, and in early March the Federal Reserve used the remaining $15 million of its Belgian franc facility.

In the latter part of March demand for dollars in Belgium enabled the System to acquire $10 million equivalent of Belgian francs and reduce its drawings by that amount. However, with the Belgian franc again at its ceiling in April, the Federal Reserve drew another $10 million from the National Bank of Belgium. The Federal Reserve was able to make the first major reduction in its Belgian franc commitments in late May, when it purchased $40 million equivalent of Belgian francs from the National Bank of Belgium, after the United Kingdom had converted into dollars Belgian francs that it acquired under its $1.4 billion multicurrency drawing from the IMF.

During July and August there was a succession of disbursements and purchases of Belgian francs under the swap facility; these reflected in part temporary swings in Belgium's balance of payments position and in part special transactions. In early July the Federal Reserve again increased its drawings in Belgian francs—from $60 million to $80 million equivalent—before a temporary demand for dollars in Belgium enabled the Federal Reserve to buy the equivalent of $40 million of Belgian francs from the National Bank of Belgium. In late July the Federal Reserve liquidated its remaining uncovered Belgian franc position by purchasing from the U.S. Treasury $40 million equivalent of Belgian francs, which the Treasury had acquired under its $300 million equivalent multicurrency drawing from the IMF. In August dollars again began to move into the reserves of the National Bank of Belgium on a substantial scale, mainly as a consequence of the U.K. balance of payments difficulties, and the Federal Reserve used Belgian francs available under its swap facility with that Bank to absorb a total of $55 million.

In mid-September, as sterling began to recover, the Belgian

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franc declined from its ceiling, and in early October the Federal Reserve reduced its Belgian franc commitments by $15 million equivalent with francs purchased from the Belgian National Bank following dollar sales by that Bank to meet the requirements of the market. The franc temporarily returned to its ceiling in November, and the System absorbed $10 million from the Belgian National Bank with funds available under the swap facility. But in December the franc eased again, and the National Bank of Belgium sold $15 million equivalent of francs to the System. Thus by the year-end, uncovered System commitments in Belgian francs amounted to $35 million equivalent.

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SPECIAL STUDIES BY THE FEDERAL RESERVE SYSTEM

From time to time the Federal Reserve System has undertaken extensive economic studies to reappraise the workings of its various instruments of monetary and regulatory policy. The broad aim of these studies has been to keep Federal Reserve policy and action adapted to the changing economic and financial scene. Several such studies currently under way are described below.

Member bank borrowing. The study on member bank borrowing involves a comprehensive reevaluation of the lending function of the Federal Reserve Banks. In the decade since the regulations in this field were last revised by the Board of Governors, marked changes have taken place within the financial system. Private debt has been growing much faster than Federal debt, and much of the new private debt has reflected longer-term borrowing needs. In meeting such shifting credit demands, banks have sharply reduced their cushion of liquid assets, and they have come to rely increasingly upon interest-bearing deposits and other liabilities as a means of raising additional loanable funds.

To determine to what extent the Federal Reserve discount mechanism may need to be altered in view of this changing environment, the Federal Reserve has undertaken a wide range of individual studies of relevant theory and experience. Attention is being paid to the past performance of Federal Reserve Bank discount operations as well as to the activities of other Government financial institutions in this country, and of central banks in other major industrial nations.

Among the issues being explored are:

1. Obstacles to borrowing from the Reserve Banks.
2. The changing dimensions of seasonal swings in bank and community needs for funds.
3. The growing needs of agriculture and other industries for intermediate-term external credit.
4. The extent to which reliance ought to be placed upon the discount rate on the one hand, and administrative discipline and the tradition

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against borrowing on the other, as means of regulating member bank borrowing from the Federal Reserve Banks.

5. The extent of member bank reliance upon sources of lending other than the Federal Reserve Banks for assistance in times of stress, and the relation such sources should bear to accommodation by the Reserve Banks.

6. The appropriate degree of emphasis that should be placed upon sales of bank assets instead of borrowing as a means of obtaining funds, and the extent to which such sales should be facilitated by efforts to improve secondary markets for a wider range of bank assets.

7. The relation of any contemplated changes in the functioning of the discount mechanism to the conduct of open market operations, and to considerations of bank liquidity and soundness.

This study is engaging a substantial number of research, examination, legal, and operating personnel in the System, under the direction of a steering committee composed of members of the Board of Governors and the presidents of the Federal Reserve Banks. At appropriate stages, counsel will be sought from academic scholars, bankers, and a number of foreign central banks. The development of this study and of any consequent proposals for regulatory or legislative changes is expected to extend through 1966 and beyond.

U.S. Government securities market. Planning for a joint study of the U.S. Government securities market by the Treasury and the Federal Reserve was undertaken during the year 1965. The broad purpose of the study is to ascertain how the dealer market for U.S. Government securities has performed during the 1960's in light of economic developments during the period, of innovations in the financial environment and their implications for the dealer market, and of operating techniques used by the Treasury and the Federal Reserve. (This study was initiated in the early part of 1966.)

The market environment of the 1960's has changed considerably from that within which the Treasury and the Federal Reserve operated, first during World War II and the early postwar

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years and then in the 1950's following the Treasury-Federal Reserve accord. The functioning of the market was studied by official groups both in the early 1950's and at the end of that decade.

The current study will focus on elements that have tended to differentiate the 1960's from earlier years and may include analyses of the following topics as they bear on the functioning of the U.S. Government securities market:

1. Financial innovations such as the rapid growth of time certificates of deposit and the greatly enlarged Federal funds market.
2. The path of economic expansion, the balance of payments, and other factors influencing interest rate variations and the volume and nature of market transactions in U.S. Government securities.
3. Performance of the U.S. Government securities market in the 1960's, with particular attention to the needs of investors, the Federal Reserve, and the Treasury.
4. Treasury and Federal Reserve operating techniques in the market, including transactions in U.S. Government securities by the Federal Reserve and the development of advance refunding techniques by the Treasury.
5. Structural elements of the market as they affect dealer functioning, including the cost and availability of financing, profitability of operations, and the changing structure of the dealer industry.

It is planned to carry out the study through staff analyses, questionnaires to U.S. Government security dealers and investors in the market, and conferences with active market participants.

Foreign operations of member banks. Among the significant developments in U.S. banking in recent years has been the rapid growth of international lending and of international operations in general. Expansion of these activities has taken place through international and foreign departments of head offices of commercial banks located in this country, through a growing network of branches abroad, and through subsidiary corporations organized under Sections 25 and 25(a) of the Federal Reserve Act (so-called Edge Act and Agreement corporations). New and closer relations between domestic and foreign credit markets

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and new connections between the domestic and foreign banking systems have developed as a result of the enlargement of these operations.

A research study now under way at the Board of Governors is intended to enlarge and extend existing knowledge of the organization and conduct of these operations, the influences bearing on them, and the adaptation of banking facilities and practices that have occurred in response to changes in the international financial environment. The study is also intended to develop new and up-to-date information on the sources and character of foreign demands for bank credit from this country, and the terms and conditions on which it is extended. This information, in turn, will assist appraisal of the current role of U.S. banks in financing foreign trade and in facilitating international flows of capital.

Improved knowledge of these operations will contribute to a fuller understanding of domestic and foreign financial developments and of the broader implications that expansion of these activities holds for the international financial position of the United States. Perspective gained on the growing interconnections between foreign and domestic banks will also assist the Board in the exercise of its special responsibilities in supervising the foreign operations of member banks and their subsidiaries.

Effects of monetary policy on economic activity. The influence of financial factors on demands for goods and services is doubted by few economists. But there is far less agreement as to which financial variables are the most influential, through what channels they exert their influence on spending and saving decisions, the magnitude of their influence, how long it takes for this influence to be effective, and how the magnitude and timing of their influence varies at different stages of the business cycle. Nor is there substantial agreement as to the process by which monetary policy actions of the Federal Reserve affect these financial variables and, indirectly, the real economy.

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To illuminate these problem areas in monetary economics, the Federal Reserve has undertaken a coordinated research effort that is building on the extensive research work already under way in the System and on work previously accomplished by economists within or outside the System. The program has been designed to explore these problems systematically and to use the most advanced analytic techniques available.

There are six major elements in the program. These include studies of:

1. The links between Federal Reserve open market operations in Government securities, short-term interest rates and other indexes of money market conditions, and reserve utilization by the banking system.
2. The links between changes in bank reserves and such other financial variables as the money supply, bank credit, and interest rates and other terms on longer-term securities.
3. The influence of financial variables on decisions to spend or save, that is, the impact of changes in monetary policy on major categories of expenditures.
4. The relationships among the ultimate goals of monetary policy—high employment and production, sustainable economic growth, and reasonable price stability.
5. The relationships between domestic financial conditions and international capital movements.
6. The development of over-all models of economic behavior, with special emphasis on those aspects of behavior and the time pattern of economic processes particularly relevant to the formulation of monetary policy. The models will provide a framework for integrating the relationships developed in the other elements of the study.

Staffs of the Board of Governors and the Reserve Banks are participating in the effort. Collaborating with the System staff are a number of monetary scholars whose contributions are being organized through the Social Science Research Council. Certain papers reporting on the progress in different phases of the program have already been summarized in the *Federal Reserve Bulletin,* and other summaries, and possibly complete papers, will follow from time to time as they become available.

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INTERNATIONAL LIQUIDITY DISCUSSIONS

The Federal Reserve has been participating, with the Treasury Department, in the study and negotiations being carried out within the Group of Ten major trading countries regarding "arrangements for the future creation of reserve assets, as and when needed, so as to permit adequate provision for the reserve needs of the world economy." In launching this effort in September 1965, the finance ministers and the governors of the central banks of the Group of Ten envisaged two stages. In the first, they requested their deputies to determine what basis of agreement can be reached; the second stage would provide an opportunity for broader consideration in a forum that would permit the participation of other members of the International Monetary Fund.

The need to provide machinery for creating reserve assets is closely related to the prospects for restoring the U.S. balance of payments to equilibrium—an objective to which the U.S. Government is firmly committed and toward which significant progress was made in 1965. In recent years the increase in foreign holdings of dollars associated with the U.S. deficit has accounted for a substantial proportion of the growth of reserves in the rest of the world. As the deficit diminishes, there will be a slower growth of foreign reserves, unless other means of reserve creation are put into effect.

At the present time international reserves consist mainly of gold and dollars, with smaller amounts provided by other reserve currencies and by reserve positions of member countries in the IMF. The amount of new gold becoming available is not large enough to be relied upon for adequate growth in reserves and is subject to uncertainty and considerable fluctuation. Reserves created by the IMF, under its existing functions, are in relatively small quantity, comprising about 8 per cent of world monetary reserves at the present time. What will be needed, there-

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fore, is a means of reserve creation that will supplement existing reserves in the form of gold, reserve currencies, and present-type claims on the IMF.

The two major forms of reserve asset under discussion are drawing rights on the IMF that are virtually automatic and a reserve unit that would be directly transferable among participating countries. The United States has put forward for consideration a dual approach involving a combination of these types of reserve asset. Under this approach, all members of the IMF would be eligible for drawing rights, while a more limited group of advanced industrial countries would create reserve units. The approach recognizes that most countries have a need for growth in their reserves over time, while also recognizing the special reserve needs of the more highly developed countries.

The Group of Ten countries are exploring for areas of agreement on questions involving the extent and nature of participation in reserve creation, the role of the IMF, and the means of assuring the acceptability and effective use of new reserve assets. In these discussions, there are several considerations that appear to be especially important from the point of view of the United States.

It is clear that the creation, distribution, and use of a supplementary reserve asset should not have the effect of reducing other forms of reserves. In particular, the world would not gain if procedures governing the use and acceptance of a new reserve asset influenced the attitudes of countries in or out of the Group of Ten toward the composition of their reserves in a way that led to a shrinkage of total reserves. Another consideration is that a new reserve asset, if it is to serve its purpose, must be based on a recognition of the limitations noted above on present and prospective supplies of gold.

More generally, changes in the international monetary system that may be sought need to recognize that the world—and even the Group of Ten—is composed of countries with diverse

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characteristics. Countries differ greatly with respect to their real incomes, industrial development, maturity of financial structure, dependence on foreign trade, and flexibility of fiscal and monetary policies. The international monetary system and the means for adjusting imbalances in international payments must be supple enough to permit countries with these diverse characteristics to grow and prosper together.

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BANK SUPERVISION BY THE FEDERAL RESERVE SYSTEM

Examination of Federal Reserve Banks. The Board's Division of Examinations examined the 12 Federal Reserve Banks and their 24 branches during the year, as required by Section 21 of the Federal Reserve Act. In conjunction with the examination of the Federal Reserve Bank of New York, the Board's examiners also made a comprehensive audit of the accounts and holdings of the System Open Market Account operated at that Bank in accordance with policies formulated by the Federal Open Market Committee, and rendered a report thereon to the Committee. The procedures followed by the Board's examiners were surveyed and appraised by a private firm of certified public accountants, pursuant to the policy of having such reviews made on an annual basis.

Examination of member banks. National banks, all of which are members of the Federal Reserve System, are subject to examination by direction of the Board of Governors or the Federal Reserve Banks. However, as a matter of practice they are not examined by either, because the law charges the Comptroller of the Currency directly with that responsibility. The Comptroller provides reports of examinations of national banks to the Board of Governors upon request, and each Federal Reserve Bank purchases from the Comptroller copies of reports of examination of national banks in its district.

State member banks are subject to examinations made by direction of the Federal Reserve Bank of the district in which they are located by examiners selected or approved by the Board. The established policy is to conduct at least one regular examination of each State member bank, including its trust department, during each calendar year, with additional examinations if considered desirable. Wherever practicable, joint examinations are made in cooperation with the State banking authorities, or alternate independent examinations are made by

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agreement with State authorities. All but 11 of the 1,406 State member banks were examined under the Federal Reserve System's 1965 program.

The Board of Governors makes its reports of examination of State member banks available to the Federal Deposit Insurance Corporation, and the Corporation in turn makes its reports of insured nonmember State banks available to the Board upon request. Also, upon request, reports of examination of State member banks are made available to the Comptroller of the Currency.

In its supervision of State member banks, the Board receives, reviews, and analyzes reports of examination of State member banks and coordinates and evaluates the examination and supervisory functions of the System. In addition, under provisions of the Federal Reserve Act and other statutes, the Board passes on applications for admission of State banks to membership in the System and for permission, among other things, to (1) merge banks, (2) form or expand bank holding companies, (3) establish domestic and foreign branches, (4) exercise expanded powers to create bank acceptances, (5) establish foreign banking and financing corporations, or (6) invest in bank premises in excess of 100 per cent of a bank's capital stock.

By Act of Congress approved August 20, 1964 (Public Law 88-467), the disclosure requirements of the Securities Exchange Act of 1934 (15 U.S.C. 78) were made applicable to equity securities (including bank stocks), and the three Federal bank supervisory agencies were vested with the authority to administer these provisions of the 1934 Act with respect to securities of banks within their respective jurisdictions. Pursuant to the provisions of the Act, the Board issued its Regulation F, effective January 1, 1965. During the year 97 State member banks registered their securities in accordance with Regulation F. Analytical review of registration statements and other material filed by banks is directed toward achieving uniform compliance by the banks, so as to assure comparability of the information

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made public to serve the needs of the banks' security holders and potential investors.

In connection with disclosure regulations relating to new securities, and in its continuing efforts to reduce the incidence of crimes against banking institutions, the Board, in conjunction with the Federal Deposit Insurance Corporation and a special committee of bankers preeminent in the field of bank audit and control, developed during 1965 a list of guidelines or criteria for use by examiners in evaluating a bank's internal audit procedures and other internal safeguards. While many of the principles set forth in the guidelines have been applied by examiners for many years, renewed emphasis should serve to alert banks to any weaknesses in their internal controls and should help to check the increase in internal crimes against banking institutions.

Federal Reserve membership. As of the December call date in 1965, member banks accounted for 45 per cent of the number of all commercial banks in the United States and for 63 per cent of all commercial banking offices, and they held approximately 83 per cent of the total deposits in such banks. State member banks accounted for 16 per cent of the number of all State commercial banks and 30 per cent of the State banking offices, and they held 60 per cent of total deposits in State commercial banks.

Of the 6,221 banks that were members of the Federal Reserve System at the end of 1965, 4,815 were national banks and 1,406 were State banks. There was a net decrease of 4 member banks during the year. This reflected an increase of 42 national banks and a decrease of 46 State members. The increase in national banks reflected the organization of 88 new national banks and the conversion of 13 nonmember banks to national banks, offset by 53 conversions to branches incident to mergers and absorptions and 7 conversions to nonmember banks; and the State member decrease reflected 17 conversions to branches incident to mergers and absorptions, and 23 withdrawals from membership.

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At the end of 1965, member banks were operating 12,063 branches, 848 more than at the close of 1964; this included 788 de novo establishments.

Detailed figures on changes in the banking structure during 1965 are shown in Table 19, page 276.

Bank mergers. Under Section 18(c) of the Federal Deposit Insurance Act, as amended May 13, 1960, the prior written consent of the Board of Governors of the Federal Reserve System must be obtained before a bank may merge, consolidate, acquire the assets or assume the liabilities of another bank if the acquiring, assuming, or resulting bank is to be a State member bank. Before acting on each application the Board must request reports from the Attorney General, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on the competitive factors involved in each transaction, unless it finds that it must act immediately to prevent the probable failure of one of the participating banks. The Board in turn responds to requests by the Comptroller or the Corporation for reports on competitive factors involved when the acquiring, assuming, or resulting bank is to be a national bank or an insured nonmember State bank.

During 1965 the Board approved all 23 applications on which it acted, and it submitted 73 reports on competitive factors to the Comptroller of the Currency and 50 to the Federal Deposit Insurance Corporation. As required by Section 18(c) of the Federal Deposit Insurance Act, a description of each of the 23 applications acted on and approved by the Board, together with other pertinent information, is shown in Table 21 on pages 281-310.

Statements and orders of the Board with respect to all bank merger applications, whether approved or disapproved, are released immediately to the press and the public and are published in the *Federal Reserve Bulletin*. These set forth the factors considered, the conclusions reached, and the vote of each Board member present.

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Bank holding companies. During 1965, pursuant to Section 3(a)(1) of the Bank Holding Company Act of 1956, the Board approved 2 applications for prior approval to become a bank holding company and denied 1 application. Pursuant to Section 3(a)(2) of the Act, the Board approved the acquisition by 9 bank holding companies of voting shares in 12 banks and denied 2 applications. To provide necessary current information, annual reports for 1964 were obtained from all registered bank holding companies under Section 5(c) of the Act.

Statements and orders of the Board with respect to applications to form or to expand bank holding companies, whether approved or disapproved, are released immediately to the press and the public and are published in the *Federal Reserve Bulletin*. These set forth the factors considered, the conclusions reached, and the vote of each Board member present.

During 1965, pursuant to the Banking Act of 1933, the Board authorized the issuance of 5 voting permits for general purposes and 8 for limited purposes to holding company affiliates of member banks. In accordance with established practice, several holding company affiliates were examined by examiners for the Federal Reserve Banks in whose districts the principal offices of the holding companies are located.

Section 301 of the Banking Act of 1935 provides that the term "holding company affiliate" shall not include—except for the purposes of Section 23A of the Federal Reserve Act, which restricts loans to affiliates and loans on, or investments in, the stock or obligations of affiliates—any organization that is determined by the Board not to be engaged, directly or indirectly, as a business in holding the stock of, or managing or controlling, banks, banking associations, savings banks, or trust companies. The Board made such determinations with respect to 32 organizations during 1965 and denied 1 application for such determination.

Foreign branches of member banks. At the end of 1965, 13 member banks had in active operation a total of 211 branches

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in 50 foreign countries and overseas areas of the United States; 7 national banks were operating 197 of these branches, and 6 State member banks were operating 14. The number and location of these foreign branches were as shown in the accompanying tabulation.

Latin America	*88*
Argentina	17
Bahamas	3
Brazil	15
British Guiana	1
Chile	3
Colombia	6
Dominican Republic	4
Ecuador	2
El Salvador	1
Guatemala	2
Jamaica	1
Mexico	5
Nicaragua	1
Panama	12
Paraguay	2
Peru	2
Trinidad	3
Uruguay	2
Venezuela	4
Virgin Islands (British)	2
Continental Europe	*21*
Austria	1
Belgium	4
France	4
Germany	6
Greece	1
Italy	1
Netherlands	3
Switzerland	1
England	*21*
Ireland	*1*
Africa	*2*
Liberia	1
Nigeria	1
Near East	*5*
Dubai	1
Lebanon	3
Saudi Arabia	1
Far East	*50*
Hong Kong	6
India	6
Japan	12
Malaysia	5
Okinawa	2
Pakistan	2
Philippines	5
Singapore	8
Taiwan	2
Thailand	2
U.S. Overseas Areas and Trust Territories	*23*
Canal Zone	2
Guam	1
Puerto Rico	15
Truk Islands	1
Virgin Islands	4
Total	**211**

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Under the provisions of the Federal Reserve Act (Section 25 as to national member banks and Sections 9 and 25 as to State member banks), the Board during 1965 approved 38 applications made by member banks for permission to establish branches in foreign countries and overseas areas of the United States.

During the year member banks opened branches in foreign countries as follows: 1 branch in Buenos Aires, Argentina; Nassau, Bahamas; Georgetown, British Guiana; Concepcion, Chile; Cartagena, Colombia; and Santo Domingo, Dominican Republic; Vienna, Austria; Dublin, Ireland; West Berlin, Frankfurt-am-Main, and Hamburg, Germany; Calcutta, India; Kuala Lampur and Georgetown, Malaysia; Koza, Okinawa; 2 branches in Panama City, Panama; Port of Spain, Trinidad; Antwerp, Belgium; Taipei, Taiwan; 4 branches in London, England, and in Singapore. One member bank sold its branch in Lagos, Nigeria.

Acceptance powers of member banks. During the year the Board approved the application of 1 member bank, pursuant to the provisions of Section 13 of the Federal Reserve Act, for increased acceptance powers. The bank was granted permission to accept drafts or bills of exchange drawn for the purpose of furnishing dollar exchange as required by the usages of trade in such countries, dependencies, or insular possessions of the United States as may have been designated by the Board of Governors.

Foreign banking and financing corporations. At the end of 1965 there were 4 corporations operating under agreements with the Board pursuant to Section 25 of the Federal Reserve Act relating to investment by member banks in the stock of corporations engaged principally in international or foreign banking. Three of these "agreement" corporations with head offices in New York were examined during the year by examiners for the Board of Governors. The fourth "agreement" corporation is a national

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member bank in the Virgin Islands and is owned by a State member bank in Philadelphia.

During 1965, under the provisions of Section 25(a) of the Federal Reserve Act, the Board issued final permits to 4 corporations to engage in international or foreign banking or other international or foreign financial operations. Each of these corporations commenced operations in 1965. At the end of the year there were 37 corporations in active operation under Section 25(a): 20 have home offices in New York City, 1 in Boston, 4 in Philadelphia, 2 in Pittsburgh, 1 in Winston-Salem, 1 in Atlanta, 2 in Chicago, 2 in Detroit, 3 in San Francisco, and 1 in Seattle. The corporation in Seattle has an active branch in Hong Kong. Examiners for the Board of Governors examined 35 of these corporations during 1965.

Bank Examination Schools and other training activities. In 1965 the Bank Examination School conducted two sessions of the School for Examiners, four sessions of the School for Assistant Examiners, and one session of the School for Trust Examiners. The Bank Examination School, established in 1952 by the three Federal bank supervisory agencies, has been conducted jointly by the Federal Reserve System and the Federal Deposit Insurance Corporation since withdrawal of the Office of the Comptroller of the Currency in 1962.

Since the establishment of this program, 2,733 persons have attended the various sessions. This number includes representatives of the Federal bank supervisory agencies; the State Banking Departments of California, Connecticut, Idaho, Indiana, Louisiana, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia, and Washington; the Treasury Department of the Commonwealth of Puerto Rico; and 10 foreign countries.

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During 1965, in cooperation with the Federal Deposit Insurance Corporation, regional training programs in automation for bank examiners were conducted in San Francisco and Minneapolis. Since their inception in 1962, these programs to train examiners in appropriate techniques and procedures for the examination of banks utilizing electronic data-processing systems have been attended by examiners from the Federal bank supervisory agencies and the State Banking Departments of Alabama, Arizona, California, Connecticut, Georgia, Idaho, Maine, Massachusetts, Michigan, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Vermont, and Wisconsin.

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LEGISLATION ENACTED

Elimination of gold reserve required against Federal Reserve Bank deposits. An Act of Congress, approved March 3, 1965 (Public Law 89-3), eliminated the requirement contained in Section 16 of the Federal Reserve Act (12 U.S.C. 413) for the maintenance of reserves in gold certificates of not less than 25 per centum against Federal Reserve bank deposit liabilities.

Exemption of interest on foreign time deposits. An Act of Congress, approved July 21, 1965 (Public Law 89-79), amended Section 19 of the Federal Reserve Act (12 U.S.C. 371b) so as to continue until October 15, 1968, the exemption of deposits of foreign governments and certain foreign institutions from regulation by the Board of Governors as to the rates of interest member banks may pay on time deposits.

Legal tender status of coins and currencies. An Act of Congress, approved July 23, 1965 (Public Law 89-81), known as the Coinage Act of 1965, repealed the provisions of law formerly contained in Section 43(b)(1) of the Act of May 12, 1933, as amended (31 U.S.C. 462), with respect to the legal tender status of coins and currencies of the United States, including Federal Reserve notes, but added a new provision of law to the same effect codified in 31 U.S.C. 392.

Real estate and building construction loans by national banks. An Act of Congress, approved August 10, 1965 (Public Law 89-117), amended the first paragraph of Section 24 of the Federal Reserve Act (12 U.S.C. 371) so as to make certain limitations and restrictions on the making of real estate loans by national banks inapplicable to loans for land development that are secured by mortgages under Title X of the National Housing Act. This Act also amended the third paragraph of Section 24 by substituting "twenty-four months" for "eighteen months," as the maximum maturity for loans to finance the construction of industrial or commercial buildings and residential or farm buildings.

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Antitrust exemptions for voluntary agreements or programs. An Act of Congress, approved September 9, 1965 (Public Law 89-175), enacted pursuant to the President's balance of payments message of February 10, 1965, provided procedures for obtaining exemptions from the antitrust laws to assist in safeguarding the balance of payments position of the United States. As stated in the report of January 1, 1966, to the Congress, required of the Attorney General by Section 3 of the Act, the exemptions provided by this standby legislation have not been put into effect.

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LEGISLATIVE RECOMMENDATIONS

Lending authority of Federal Reserve Banks. Under present law, when member banks of the Federal Reserve System borrow on any collateral other than U.S. Government obligations or limited types of paper that meet certain outmoded "eligibility" requirements, they must pay interest at a rate not less than one-half of 1 per cent higher than their Federal Reserve Bank's normal discount rate. In its ANNUAL REPORTS for 1963 and 1964 the Board of Governors recommended legislation that would permit a member bank to borrow from its Federal Reserve Bank on the security of any sound assets without paying a "penalty" rate of interest.

The Board's recommendation is embodied in S. 1559, 89th Congress, which passed the Senate August 6, 1965. The Board urges enactment of S. 1559 in order to repeal the restrictive provisions of present law and thus to facilitate rather than to penalize efforts by banks to meet the changing credit needs of the economy.

Reserve requirements. Under present law the Board is permitted to establish a system of graduated reserve requirements against demand deposits subject to the maximum and minimum percentages now specified in the law and to certain other statutory restrictions. For the reasons indicated in its ANNUAL REPORT for 1964, the Board continues to believe that serious consideration should be given to changes in present law regarding reserve requirements against deposits and, in particular, to changes that would authorize a graduated reserve system under which the required reserves of a bank would depend upon the amount of its demand deposits rather than its location. Under such a system all member banks of the same size, in terms of deposits, would carry equal reserves against such deposits.

In addition, the present law applies only to banks that are members of the Federal Reserve System. In the Board's opinion, deposits in nonmember banks are no less a part of the country's

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money supply than those in member banks; yet a State bank is presently free, by not becoming a member of the Federal Reserve System, to avoid compliance with reserve requirements established to effectuate national monetary policy. The increase in demand for credit and the corresponding increase in competitive pressures to avoid the burdens of reserve requirements in attempting to meet this demand have resulted in accelerated withdrawals by member banks from the System in recent years. While the problem heretofore has been primarily one of inequity between member and nonmember banks, it is fast reaching the point where System effectiveness in the implementation of monetary and credit policy may be impaired. During the decade 1946-55, an average of 9 banks per year terminated their membership in the System, whereas in the decade 1956-65 average withdrawals jumped to 24 per year. It is even more significant, in this connection, that such withdrawals during the last decade included a number of relatively large banks, with the result that deposits substantially in excess of $2 billion ceased to be subject to reserve requirements imposed in accordance with the Federal Reserve Act.

The Board recommends legislation that would authorize the Board to fix reserve requirements on a graduated basis according to the amount of deposits and that would make such requirements applicable to all insured banks. At the same time, it is recommended that all banks subject to such requirements should be afforded access to Federal Reserve discount facilities.

Bank Holding Company Act of 1956. In a special report submitted to Congress in 1958 and in each of its ANNUAL REPORTS since that time, the Board of Governors has recommended a number of amendments to this statute that would improve the Act's effectiveness and facilitate its administration.

Bills that were introduced during the first session of the 89th Congress would amend the Act by eliminating a number of exemptive provisions that the Board regards as unwarranted. They would also make the statute applicable to holding com-

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panies with one subsidiary bank; at present it applies only to companies with two or more banking subsidiaries. In addition, the pending bills would extend the Act to cover holding company systems that are controlled by trusts of certain types.

One of the pending bills (S. 2353) would also eliminate provisions of the Holding Company Act and of the Banking Act of 1933 that the Board considers to be unnecessarily restrictive or to impose redundant regulatory burdens. The bill that passed the House of Representatives during the first session (H.R. 7371) would not repeal those provisions, and it would expand the bank holding company category to include partnerships, a step that the Board believes would excessively broaden the coverage of the statute.

Enactment of either S. 2353 or H.R. 7371 would result in more effective and more equitable regulation of bank holding companies by extending the coverage of the 1956 Act to "one-bank" situations and eliminating unjustified exemptions. However, the Board recommends enactment of S. 2353, for the reasons indicated in the preceding paragraph.

Loans to executive officers. Under the provisions of Section 22(g) of the Federal Reserve Act, a member bank may not lend more than $2,500 to any of its executive officers. In its ANNUAL REPORT for 1964 the Board recommended that an executive officer of a member bank be permitted to borrow from his own bank up to $5,000, or in the case of home mortgage loans up to $30,000. The Board also suggested (1) amendments in the statute's requirements as to reports by executive officers to their banks with respect to borrowings, as well as (2) a statutory requirement that loans by a bank to its executive officers be made on terms not more favorable than those extended to other borrowers.

These recommendations are embodied in the bill S. 1558, which passed the Senate August 3, 1965, and is now pending in the House of Representatives. The Board urges enactment of S. 1558.

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Purchase of obligations of foreign governments by Federal Reserve Banks. In connection with the System's foreign currency operations, the Reserve Banks acquire balances with foreign central banks. Under present law such balances may be invested in prescribed kinds of bills of exchange and acceptances, but on occasion these investment media have not been available.

To facilitate economic use of Reserve Bank balances with foreign central banks, the bill S. 1557 would amend Section 14(e) of the Federal Reserve Act to permit the investment of such balances in obligations of foreign governments or monetary authorities that will mature within 12 months and are payable in a convertible currency. S. 1557 passed the Senate August 3, 1965, and the Board recommends its enactment.

Underwriting of "revenue bonds." In recent years the Office of the Comptroller of the Currency has informed national banks that (by reason of changes in interpretations of law by that agency) they may underwrite and deal in certain types of "revenue bonds"—that is, obligations issued by a governmental entity that are not supported by general powers of taxation. The Board of Governors, however, believes that the applicable provisions of the Federal banking laws cannot properly be so interpreted. As a consequence, the rules that now govern national banks in this respect differ from those that govern State member banks, despite the intent of Congress that banks of both categories should have equal powers and be subject to the same limitations with respect to underwriting and dealing in securities.

Bills have been introduced in recent years that were designed to eliminate this disparity by permitting member banks (both national and State) to underwrite and deal in revenue bonds to a limited extent. The Board has not favored enactment of these bills. Rather, it has recommended that Congress reaffirm and clarify existing law on the subject, which forbids member banks to underwrite or deal in revenue bonds. This could be effected by adding the following sentence at the end of paragraph Seventh of Section 5136 of the Revised Statutes:

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As used in this paragraph, the term "general obligations of any State or of any political subdivision thereof" means only obligations that are supported by an unconditional promise to pay, directly or indirectly, an aggregate amount which (together with any other funds available for the purpose) will suffice to discharge, when due, all interest on and principal of such obligations, which promise (1) is made by a governmental entity that possesses general powers of taxation, including property taxation, and (2) pledges or otherwise commits the full faith and credit of said promisor; said term does not include obligations not so supported that are to be repaid only from specified sources such as the income from designated facilities or the proceeds of designated taxes.

Because the inequality between national and State member banks becomes increasingly detrimental to the banking system with the passage of time, the Board considers that corrective legislation is imperative to terminate, by one means or the other, a situation in which divergent interpretations of a law result in inequitable differences in the authority of competing banks. Congress should decide whether member banks, national and State, should be permitted to underwrite and deal in revenue bonds and, if so, to what extent.

Delegation of authority. In recent years the responsibilities and tasks of the Board of Governors have substantially increased, both in the determination of monetary and credit policies and in the field of bank supervision. The efficient and expeditious performance of these duties might, at times, be impaired in the absence of authority on the part of the Board to delegate to others the performance of certain of its functions.

The bill S. 1556, which passed the Senate on August 3, 1965, would obviate this possibility by inserting a new subsection (k) in Section 11 of the Federal Reserve Act. The new subsection would authorize, but not require, the Board to delegate its functions (except those relating to rule-making and to monetary and credit policies) to members or employees of the Board or to the Federal Reserve Banks. Assignment of responsibility for the performance of particular delegated functions would be a prerogative of the Chairman of the Board of Governors, as is the case with other Federal agencies that are authorized to delegate functions. A provision requiring, at the instance of any

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one member, Board review of action taken at a delegated level (1) would assure any party adversely affected by such action of a means of administrative appeal and (2) would provide the Board with an effective means for review and control of actions at the delegated level.

The Board recommends enactment of S. 1556.

"Par clearance"; absorption of exchange charges. In some areas of the United States a substantial number of banks impose so-called "exchange charges" for paying checks that are presented for payment through the mails. Such "nonpar banks" exact the exchange charges by deducting, typically, one-tenth of 1 per cent from the face amount of the check.

Deposits in checking accounts constitute the bulk of our country's money supply. Checks and currency are the essential lubricant of our economic machine, and efficient operation requires that checks and currency be interchangeable at their face value. In the Board's opinion, under today's highly developed system of check collections there is no sound reason for any bank to pay less than the face amount of checks drawn upon it, even though that practice provides a source of revenue to the drawee bank. The expense incurred by that bank in performing this service should be borne by the bank's customer—the depositor who drew the check—rather than by the payee or endorsee. This is the practice followed by most banks.

The Board recommends enactment of legislation that would require all insured banks to pay at "par" all checks drawn upon them—that is, without deduction of an exchange charge.

If such legislation is not enacted, the Board of Governors recommends that, at the very least, provisions of the Federal Reserve Act and the Federal Deposit Insurance Act with respect to the payment of interest on deposits by member and nonmember insured banks be amended to state expressly that *absorption* of exchange charges by such banks constitutes a payment of interest for the purposes of such provisions. Such an amendment would resolve a long-standing difference of opinion between the

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Board of Governors and the Federal Deposit Insurance Corporation and would enable competing member and nonmember banks to operate on the same basis in this respect.

Loans to affiliated foreign bank. Under Section 23A of the Federal Reserve Act (12 U.S.C. 371(c)), member banks may not make loans or extend credit to their affiliates except against collateral of 100 to 120 per cent of the amount of the loan or extension of credit, depending on the kind of collateral. These restrictions needlessly interfere with normal commercial banking relations between a member bank and a bank abroad that is a subsidiary of a member bank's Edge corporation or Agreement corporation operating under Section 25 or Section 25(a) of the Federal Reserve Act (12 U.S.C. 601-603, 611 et seq.), unless the foreign subsidiary is wholly owned by such a corporation. The regulatory authority in the Board with respect to Edge and Agreement corporations is sufficient to insure against any practices that would be inconsistent with the purposes of the restrictions contained in Section 23A. Accordingly, there is no reason to continue the applicability of such restrictions in these situations.

This situation could be remedied by adding at the end of the second paragraph of Section 23A a provision that would make the limitations contained in the first sentence of that paragraph inapplicable to any affiliate that is organized under the laws of a foreign country or a dependency or insular possession of the United States and is engaged principally in banking.

Loans to bank examiners; margin requirements for securities transactions. The Board reiterates the recommendations included in its ANNUAL REPORT for 1964 that legislation be enacted that would (1) permit a Federally-insured bank to make a home mortgage loan to a bank examiner in an amount not exceeding $30,000 and (2) modify Section 7 of the Securities Exchange Act of 1934 (15 U.S.C. 78g) to eliminate the difference in the status, for credit purposes, of securities traded on exchanges and securities traded over the counter.

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LITIGATION

Whitney Holding Corporation, New Orleans, Louisiana. The Fifth Circuit Court of Appeals, where the Board's Order of May 3, 1962, approving the Whitney application was pending for review, remanded the matter to the Board for further "consideration in the light of the opinion of the Supreme Court" in the related case of *Whitney* v. *Saxon,* 379 U.S. 411. The Supreme Court, in ruling that the District Court for the District of Columbia lacked jurisdiction to enjoin the Comptroller of the Currency from authorizing the opening for business of a new bank in Jefferson Parish, to be operated as a subsidiary of Whitney's holding company, indicated that questions as to the organization or operation of a new bank by a holding company are to be decided only by the Board, with judicial review exclusively in the Court of Appeals as prescribed by the Bank Holding Company Act. The Supreme Court recommended that the Board should reconsider the Whitney application in the light of the Louisiana anti-bank-holding-company statute enacted after the Board's original Order of May 3, 1962 (See ANNUAL REPORT for 1964, pp. 208-09).

In May of 1965, the Whitney interests filed suit in a Louisiana State court against the Louisiana State Bank Commissioner, seeking to establish that the Louisiana statute was not applicable to the Whitney Holding Corporation and the newly established Whitney National Bank in Jefferson Parish and, if applicable, that it was in violation of the Constitutions of the United States and the State of Louisiana. The State court held the Louisiana statute applicable to the Whitney proposal and constitutional as so applied. That ruling has been appealed to a Louisiana Circuit Court of Appeals.

Whitney, the opposing banks, and the State Bank Commissioner all requested an opportunity to present written briefs and oral argument to the Board in connection with its reconsideration of the matter remanded to it by the Fifth Circuit Court of

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Appeals. The Board granted the requests for submission of briefs by Order dated July 23, 1965. At year-end briefs had been submitted, and the arguments presented therein were under consideration. Also pending was the request by Whitney for oral argument before the Board.

Virginia M. Kirsch, et al. v. Board of Governors. At the end of 1964 there was pending before the U.S. Court of Appeals for the Sixth Circuit (Cincinnati) an appeal by Virginia M. Kirsch, and others, from the Board's Order of July 27, 1964, approving action by Society Corporation, Cleveland, Ohio, to become a bank holding company. (For a statement of Society Corporation's proposal and of the Court of Appeals' preliminary orders pending decision on the appeal, see ANNUAL REPORT for 1964, pp. 209-10.)

On December 8, 1965, the Court of Appeals unanimously affirmed the Board's action approving Society Corporation's proposal to form a bank holding company. The Court held that, contrary to petitioners' position on appeal, the Board neither abused its discretion nor violated any constitutional rights of petitioners in granting Society Corporation's application without a public hearing. Further, the Court found that the Board's decision was supported by clear and convincing evidence.

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RESERVE BANK OPERATIONS

Earnings and expenses. The accompanying table summarizes the earnings, expenses, and distribution of net earnings of the Federal Reserve Banks for 1965 and 1964.

EARNINGS, EXPENSES, AND DISTRIBUTION OF NET EARNINGS OF FEDERAL RESERVE BANKS, 1965 AND 1964
(In thousands of dollars)

Item	1965	1964
Current earnings	1,559,484	1,343,747
Current expenses	204,290	197,396
Current net earnings	1,355,194	1,146,351
Net addition to current net earnings[1]	1,022	726
Net earnings before payments to U.S. Treasury	1,356,215	1,147,077
Statutory dividends paid	32,352	30,782
Payments to U.S. Treasury (interest on F.R. notes)	1,296,810	1,582,119
Transferred to surplus	27,054	−465,823

[1] Includes net losses on sales of U. S. Govt. securities of $9,000 in 1965 and net profits of $616,000 in 1964.

Of the increase in current earnings of $216 million, or 16 per cent, $198 million represented larger earnings on U.S. Government securities, which in turn reflected larger holdings and a somewhat higher average yield, as shown in the table on the following page.

The increase of approximately $7 million in current expenses amounted to about 3 per cent, and the increase of $209 million in current net earnings amounted to about 18 per cent.

Net earnings before payments to the U.S. Treasury were $1,356 million, an increase of 18 per cent from 1964.

Statutory dividends to member banks amounted to $32 million, about $2 million more than in 1964. This rise reflected an increase in the capital and surplus of member banks and a con-

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sequent increase in the paid-in capital stock of the Federal Reserve Banks.

Payments to the Treasury as interest on Federal Reserve notes totaled $1,297 million for the year. This amount consists of all net earnings after dividends and the amount necessary to bring surplus to the level of paid-in capital.

Expenses of the Federal Reserve Banks include costs of $547 for 5 regional meetings incident to the Treasury Department Savings Bond program.

A detailed statement of earnings and expenses of each Federal Reserve Bank during 1965 is shown in Table 7 on pages 264 and 265, and a condensed historical statement in Table 8 on pages 266 and 267.

Holdings of loans and securities. Average daily holdings of loans and securities during 1965 amounted to $39,230 million—an

RESERVE BANK EARNINGS ON LOANS AND SECURITIES, 1963-65

Item and year	Total	Discounts and advances	Accept-ances	U.S. Govt. securities
	In millions of dollars			
Average daily holdings:[1]				
1963	32,085	269	53	31,763
1964	34,985	294	76	34,615
1965	39,230	492	77	38,661
Earnings:				
1963	1,148.8	8.9	1.7	1,138.2
1964	1,337.0	10.5	2.8	1,323.7
1965	1,545.0	19.8	3.2	1,522.0
	In per cent			
Average rate of interest:				
1963	3.58	3.30	3.28	3.58
1964	3.82	3.57	3.67	3.82
1965	3.94	4.03	4.14	3.94

[1] Based on holdings at opening of business.

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increase of $4,245 million over 1964. U.S. Government securities accounted for $4,046 million of the increase, and discounts and advances for $198 million.

The average rate of interest on holdings of U.S. Government securities increased from 3.82 per cent for 1964 to 3.94 per cent for 1965. The average rate of interest on discounts and advances increased from 3.57 per cent to 4.03 per cent. The increased rate of earnings on discounts reflects primarily the full effect of the discount rate increase in November 1964 and, to a slight extent, the increase in December 1965. The preceding table shows holdings, earnings, and average interest rates on loans and securities of the Federal Reserve Banks during the past 3 years.

Volume of operations. Table 10 on page 268 shows the volume of operations in the principal departments of the Federal Reserve Banks for 1962-65. Discounts and advances increased over 1964 in number and particularly in dollar amount, but the number of member banks borrowing declined to 1,157 as compared with 1,244 in 1964. The largest volume of credit outstanding to these banks was $1.67 billion compared with $1.17 billion in 1964, and the average outstanding was $470 million, compared with $289 million in 1964. Most of the credit extended was for such usual purposes as helping banks to meet seasonal needs or to offset temporary fluctuations in loan demand or deposit withdrawals.

In a majority of cases the credit was of an essentially different type; that is, it represented funds supplied by Reserve Banks in an effort to assist member banks that were in difficulty and were endeavoring to work out their problems. In several such cases credit from the Reserve Bank—or some instances the mere availability of the credit—enabled member banks to meet or to forestall immediate needs for cash that they could not have otherwise satisfied. The credit thus provided time in which to bring about necessary adjustments in the banks' affairs, making it possible for them to merge with another institution or to continue

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banking operations on their own—thus avoiding losses to depositors and stockholders, disruption of the money supply, and individual and community hardship. However, such solutions were not always achieved; during the year two national member banks failed despite the substantial amounts of credit that the Reserve Banks supplied to them over extended periods to assist them in solving their problems.

The steady rise in volume of checks handled continued in 1965. At the year-end about three-fourths of these items were being processed on electronic check-handling equipment, which is now in operation at 31 of the 36 Federal Reserve Banks and branches.

The number of pieces of coin received and counted was above the extreme low of 1964, but the dollar volume dropped still further because member banks continued to deposit fewer coins of higher denominations. Currency received and counted rose moderately again in 1965, and transfers of funds continued their upward trend. Fiscal agency transactions in U.S. Government securities reached a new high again in 1965, reflecting a large advance refunding by the Treasury and increased sales and redemptions of savings bonds.

In 1961, as noted in the ANNUAL REPORT for that year, the Reserve Banks began redeeming food stamps issued by the Department of Agriculture. The number of stamps redeemed in 1965 was approximately 82 million, and they amounted to $116 million. Figures for these operations are being shown in the table this year for the first time.

Loan guarantees for defense production. Under the Defense Production Act of 1950, the Departments of the Army, Navy, and Air Force, the Defense Supply Agency of the Department of Defense, the Departments of Commerce, Interior, and Agriculture, the General Services Administration, the National Aeronautics and Space Administration, and the Atomic Energy Commission are authorized to guarantee loans for defense production made by commercial banks and other private financing

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institutions. The Federal Reserve Banks act as fiscal agents of the guaranteeing agencies under the Board's Regulation V.

During 1965 the guaranteeing agencies authorized the issuance of 5 guarantee agreements covering loans totaling $16 million. Loan authorizations outstanding on December 31, 1965, totaled $64 million, of which $55 million represented outstanding loans and $9 million additional credit available to borrowers. Of total loans outstanding, 77 per cent on the average was guaranteed. During the year approximately $108 million was disbursed on guaranteed loans, most of which are revolving credits.

Authority for the V-loan program, unless extended, will terminate on June 30, 1966.

Table 14 (page 270) shows guarantee fees and maximum interest rates applicable to Regulation V loans.

Foreign and international accounts. Assets held for foreign account at the Federal Reserve Banks declined $65 million. At the end of the year they amounted to $20,241 million: $10,906 million of earmarked gold; $8,272 million of U.S. Government securities (including securities payable in foreign currencies); $150 million in dollar deposits; $144 million of bankers' acceptances purchased through Federal Reserve Banks; and $769 million of miscellaneous assets. The latter item includes mainly dollar bonds issued by foreign countries and international organizations. Assets held for international organizations, including an IMF gold deposit, increased by $690 million to $8,753 million.

In 1965 new accounts were opened in the names of the central banks of Jordan, Malawi, Rhodesia, Sierra Leone, and Zambia.

Gold collateral loans totaling $30 million which were outstanding at the beginning of 1965 were repaid. New arrangements—including a standby commitment—amounted to $93 million, of which $41 million was outstanding at the end of the

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year. Loans on gold are made to foreign monetary authorities to help them meet dollar requirements of a temporary nature.

The Federal Reserve Bank of New York continued to act as depositary and fiscal agent for international organizations. As fiscal agent of the United States, the Bank continued to operate the Exchange Stabilization Fund pursuant to authorization and instructions of the Secretary of the Treasury. Also on behalf of the Treasury Department, it administered foreign assets control regulations pertaining to assets in the United States of North Viet Nam, Cuba, Communist China, and North Korea, and their nationals, and to transactions with those countries and their nationals.

Bank premises. During 1965 the Board authorized construction of a new building for the Little Rock Branch.

With the approval of the Board, properties adjacent to the Federal Reserve Bank of Richmond and the new building for the New Orleans Branch were acquired for future expansion, and a site was obtained for a new building for the Cincinnati Branch.

Table 6 on page 263 shows the cost and book value of bank premises owned and occupied by the Federal Reserve Banks and of real estate acquired for banking-house purposes.

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BOARD OF GOVERNORS—INCOME AND EXPENSES

The accounts of the Board for the year 1965 were audited by the public accounting firm of Haskins & Sells.

Accountants' Opinion

Board of Governors of the
Federal Reserve System:

We have examined the balance sheet of the Board of Governors of the Federal Reserve System as of December 31, 1965 and the related statement of assessments and expenditures for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying financial statements present fairly the financial position of the Board of Governors of the Federal Reserve System at December 31, 1965 and its assessments and expenditures for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Haskins & Sells

Washington, D. C.
January 28, 1966

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEET, DECEMBER 31, 1965

ASSETS

OPERATING FUND:		
Cash		$ 610,862
Miscellaneous receivables and travel advances		21,014
Stockroom and cafeteria inventories—at cost		17,470
Total operating fund		649,346
PROPERTY FUND—At cost:		
Land and improvements		792,852
Building		4,113,043
Furniture and equipment		1,247,203
Total property fund		6,153,098
TOTAL		$ 6,802,444

LIABILITIES AND FUND BALANCES

OPERATING FUND:		
Current liabilities:		
Accounts payable and accrued expenses	$ 327,390	
Income taxes withheld	230,539	
Accrued payroll	249,237	$ 807,166
Fund balance:		
Balance, January 1, 1965	264,133	
Excess of expenditures over assessments for the year	(421,953)	(157,820)
Total operating fund		649,346
PROPERTY FUND:		
Fund balance, January 1, 1965	6,121,390	
Expenditures for additions	49,301	
Property adjustments and disposals	(17,593)	
Total property fund		6,153,098
TOTAL		$ 6,802,444

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Board of Governors of the Federal Reserve System

Statement of Assessments and Expenditures for the Year Ended December 31, 1965

Assessments Levied on Federal Reserve Banks:		
For Board expenses and additions to property		$ 8,576,400
For expenditures made on behalf of the Federal Reserve Banks		21,930,445
Total assessments		30,506,845
Expenditures:		
For printing, issue and redemption of Federal Reserve notes, paid on behalf of the Federal Reserve Banks		21,930,445
For expenses of the Board:		
Salaries	$5,716,937	
Retirement and insurance contributions	1,327,927	
Traveling expenses	317,377	
Consumer finances surveys	293,844	
Legal, consultant and audit fees	86,921	
Other contractual services	199,508	
Printing and binding—net	307,722	
Equipment and other rentals	139,060	
Telephone and telegraph	121,718	
Postage and expressage	101,275	
Stationery, office and other supplies	77,107	
Heat, light and power	51,509	
Operation of cafeteria—net	51,441	
Repairs, maintenance and alterations	70,431	
Books and subscriptions	24,596	
Insurance	1,775	
System membership, Center for Latin American Monetary Studies	18,000	
Miscellaneous—net	41,904	8,949,052
For property additions		49,301
Total expenditures		30,928,798
Excess of Expenditures Over Assessments for the Year		$ 421,953

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INTRODUCTION

1966 presented to monetary policy the challenge of coping first with a too-exuberant upsurge in economic activity, and later with a less ebullient economic outlook. The expansionary forces in the economy, which had gathered momentum after mid-1965, accelerated even more rapidly later that year and into 1966—with demands for goods, services, and credit expanding faster than resource availability and financial savings. The convergent pressures on resources resulted in a strong and pervasive rise in costs and prices—a rise that threatened the life of the economic expansion—and in a further larger rise in U.S. imports, which greatly reduced our surplus on international trade transactions.

Before the year ended, however, final demands for goods and services were expanding at a more moderate pace. Monetary policy therefore shifted toward less restraint on bank credit expansion, and interest rates began to decline from the high levels attained during the year.

* * * * * *

In late 1965 and early 1966 total spending had increased at a very rapid pace. An acceleration in defense spending after mid-1965, superimposed on a fast rise in civilian spending—notably by businesses for new investment in plant and equipment—resulted in sharp upward pressures in many markets for goods and labor. Demands for most types of credit soared.

To blunt the inflationary impact of credit-financed spending, the Federal Reserve endeavored to slow the rate of monetary expansion, first, by raising the discount rate in December 1965, and then beginning in February, by reducing the rate at which it supplied reserves to commercial banks through operations of the System Open Market Account. With demands for credit and capital remaining strong, with smaller amounts of nonbor-

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rowed reserves being made available to banks, and with bank credit constituting a smaller component of the total credit supply, interest rates rose sharply.

The rise in interest rates and the related structural shifts in credit and capital markets tended to divert flows of the public's savings from financial intermediaries into direct acquisitions of market securities. In this period mutual savings banks and savings and loan associations were not subject to any fixed Federal ceiling rates on deposits and shareholdings. But because most of their holdings were concentrated in long-term assets acquired when interest rates were at lower levels, they could not increase their returns on investments enough to make it possible for them to pay rates on savings that would meet the competition. Insurance companies also experienced financial pressure; a sharp increase in the demand for policy loans absorbed a larger than normal proportion of their already heavily committed cash flows, and there was a slowing down of prepayments on mortgage loans and other credits.

While all depositary institutions were under strong competitive pressure from more direct types of investment in the first half of 1966, commercial banks were able to maintain inflows of savings better than could other types of financial institutions because the maximum permissible rates payable by banks on time deposits and the more rapid turnover of their assets allowed more prompt compensatory upward adjustment in portfolio yields. Banks also benefited from their ability to offer a variety of deposit instruments geared to the needs of a variety of savers. The continued sizable net inflow of new funds enabled commercial banks to continue to expand their loans to businesses rapidly through midsummer.

On the other hand, the reduced flow of savings to financial institutions other than commercial banks—which invest a major share of their resources in real estate mortgages—resulted not only in an increase in the cost of mortgage funds but also in a sharp dropoff in their availability. Thus, the impact of restraint

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on credit-financed spending during much of 1966 was most evident in residential construction activity and in transfers of existing dwellings.

Other areas of the economy were also affected by restraint on credit and monetary expansion in 1966. Some of the moderation in consumer spending for durable goods—for automobiles in particular—was probably attributable to the higher charges and more stringent lending policies that developed for consumer instalment credit.

State and local government expenditures, too, were affected by monetary restraint. Some units of government postponed bond issues because of higher interest rates and the difficulties they encountered in borrowing, as commercial banks—which as a general rule buy large amounts of municipal issues—became less inclined to buy such securities because of the very heavy demand for loans by nonfinancial businesses and by finance companies.

Through midsummer, the business sector of the economy—considered as a whole—felt the effect of monetary restraint less than other sectors. Although their cost was high and was rising, borrowed funds remained in relatively ample supply to businesses, which in turn furnished some financing to their suppliers and customers. Despite their higher costs, both new corporate security issues and business borrowing from banks rose sharply. As a result, aggregate spending by businesses on plant, equipment, and working capital appeared to be little dampened by financial restraint through the spring and early summer. But by late summer monetary restraint also affected business financing, and total funds raised by corporate borrowers began to decline sharply.

The rapid rise in business spending adversely affected the U.S. balance on international trade. Demands for imported materials rose, and as backlogs of orders of domestic producers of machinery and fabricated products increased, purchases of foreign goods mounted. Although our exports continued to

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rise, imports showed a much sharper increase, and the result was a significant drop in the trade balance.

However, monetary restraint in 1966 served to retard capital outflows and to stimulate inflows. The changes in capital flows were substantial and they served to offset the decline in the U.S. balance on current account. Overseas branches of U.S. banks attracted funds from foreign money markets and provided a substantial volume of funds to their head offices for lending in this country, especially after midyear. There was also a large inflow of foreign long-term capital to the United States—in part through shifts from shorter- to longer-term assets on the part of international institutions and foreign central banks.

In response to the voluntary foreign credit restraint program (VFCR), U.S. commercial banks in 1965 had brought almost to a halt the rise in their outstanding credits to foreign borrowers. The added pressure of financial market conditions in this country resulted in some reduction in these credits in 1966.

During the summer the Federal Reserve took steps to alleviate the uneven effects of financial restraint among the various sectors of the economy by restraining the rapid growth of business loans at banks and also to dampen the escalation of interest rates. The Board of Governors maintained the ceiling rate on time deposits of commercial banks, fixed in December 1965 at 5½ per cent. However, by early summer the intensification of monetary restraint had caused market rates for financial instruments that are competitive with negotiable time certificates of deposit (CD's) to rise to levels above the CD ceiling rate. During the summer the Federal Reserve took several actions to make it more expensive for banks to compete for large time deposits —twice raising reserve requirements on time deposit holdings in amounts of more than $5 million at each member bank. Further, on September 1 a letter was sent to each Federal Reserve member bank urging moderation in business loan expansion in the interest of achieving a more balanced economic and credit expansion. The letter assured banks losing deposits that

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they would be able to borrow from the Federal Reserve Banks for longer periods than normal if their adjustments to the deposit losses were achieved through curtailment of lending activity rather than through the sale of securities.

As a continued high volume of credit demands and increased monetary restraint resulted in rising market rates of interest, commercial banks found themselves less able to accommodate business and other credit demands by competing for the liquid funds of corporations. Because of the great pressure for loanable funds, however, there was still the possibility that these banks would intensify their competition for consumer savings being held in nonbank financial institutions and thereby put further pressure on such institutions and indirectly on the homebuilding industry.

Under existing legislation the Federal Reserve could not base any limitation of rate competition by banks on criteria of type of saver or size of saving. But in late September the Congress enacted broader enabling legislation, and promptly thereafter the Federal Reserve and other regulatory authorities acted to limit further, or to reduce, interest rates payable on certain types of deposits and shareholdings in commercial banks, mutual savings banks, and federally insured savings and loan associations. The purpose of this legislation, to be in effect for a year, was to dampen the rate competition for savings among the various types of financial institutions and to reduce the upward ratcheting of interest rates to which such competition contributed. Over-all pressures on financial markets reached their peaks in August and early September.

By the early fall it became evident that monetary policy, aided by certain fiscal restraints, including the suspension of the investment tax credit and accelerated depreciation privileges, was achieving the objectives of curbing excessive aggregate demand and of damping inflationary pressures. Defense spending did continue to rise sharply in the fall. But the rate of expansion in final takings by the private sectors of the economy declined; indus-

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trial production, retail sales, and new orders for durable goods leveled off; and the rise in industrial prices moderated over this time period.

In this situation Federal Reserve open market operations, while still directed at maintaining firm money market conditions, were modified in light of the lack of growth in bank credit. Then in November the Federal Open Market Committee shifted its policy so as to stimulate a moderate renewed expansion of bank credit and easier conditions in financial markets. And in late December the Federal Reserve terminated the special discount arrangements of the September 1 letter.

By the end of 1966, pressures in financial markets had eased significantly. Most market rates of interest had declined sharply from their late summer peaks; banks were again able to compete successfully for funds with large negotiable CD's and also to obtain consumer-type time deposits; and mutual savings banks and savings and loan associations were beginning to have larger inflows of funds. Bank credit was again expanding at a substantial rate, and the mortgage market began to reflect an easier availability of funds.

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Digest of Principal Federal Reserve Policy Actions in 1966

Period	*Action*	*Purpose*
January	Reduced System holdings of U.S. Government securities, on balance, by about $650 million. Member bank borrowings averaged about $400 million.	To continue to moderate money and credit market adjustments to the December 1965 discount rate increase early in the month, and then to offset seasonal reflow of funds and maintain about the same money market conditions that had prevailed in early January.
February–early June	Limited the increase in System holdings of U.S. Government securities to about $1.5 billion. Average member bank borrowings rose to nearly $600 million.	To effect gradual reduction in net reserve availability and thereby to restrain the growth in the reserve base, bank credit, and the money supply.
June	Raised from 4 to 5 per cent the reserve requirements against time deposits, other than savings deposits, in excess of $5 million at each member bank, effective July 14 and 21 for reserve city and country member banks, respectively, thereby increasing required reserves by about $420 million.	To exercise a tempering influence on the issuance of time certificates of deposit by larger banks and to apply some additional restraint on the expansion of banks' loanable funds, thus reinforcing the operations of other instruments of monetary policy in containing inflationary pressures.
	Made shorter-term bank promissory notes and similar instruments issued after June 26, 1966, subject to regulations governing reserve requirements and payment of interest on deposits, effective September 1, 1966.	To prevent future use of these relatively new instruments as a means of circumventing statutory and regulatory requirements applicable to bank deposits.

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DIGEST OF PRINCIPAL FEDERAL RESERVE POLICY ACTIONS IN 1966—Continued

Period	*Action*	*Purpose*
Early June–September	Limited the increase in System holdings of U.S. Government securities to about $800 million. Average member bank borrowings rose to $750 million.	To continue to restrain bank credit expansion while maintaining about the same state of net reserve availability and/or money market conditions and taking account, at various times, of scheduled financings by the Treasury, any unusual liquidity pressures, and any significant deviations of required reserves or bank credit from current expectations.
July	Lowered from 5½ to 5 per cent the maximum rate payable by member banks on new multiple-maturity time deposits of 90 days or more, and from 5½ to 4 per cent the maximum rate payable on such deposits with maturities of less than 90 days.	To help forestall excessive interest rate competition among financial institutions for consumer-type time deposits.
	Granted temporary authority to the Federal Reserve Banks to provide emergency credit facilities, under certain conditions, to nonmember depositary-type institutions, including mutual savings banks and savings and loan associations. No lending was necessary under this authority.	To assure that funds could be provided to assist in meeting unusual withdrawals that might develop at nonmember depositary institutions and to safeguard against the possibility of additional pressures on mortgage and securities markets resulting from such exceptional withdrawals.
August	Raised reserve requirements from 5 to 6 per cent against time deposits, other than savings deposits, in excess of $5 million at each member bank, effective September 8 and 15 for reserve city and country banks, respectively, thereby increasing required reserves by about $450 million.	To exert a tempering influence on the issuance of certificates of deposit by the larger banks and to apply some additional restraint upon the expansion of bank credit to businesses and other borrowers.

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September	Requested member banks to moderate their rate of expansion of loans, particularly business loans; indicated that bank use of Reserve Bank discount facilities would be expected to be in a manner consistent with this objective; and noted the continuing availability of discount facilities to cushion deposit shrinkages.	To moderate excessive expansion of business loans at banks and at the same time to avoid additional pressure on financial markets resulting from further substantial liquidation by banks of municipal securities and other investments to obtain loanable funds; also to reaffirm availability of Federal Reserve credit assistance in case of deposit shrinkages.
	In exercise of authority given by new temporary legislation, reduced from 5½ to 5 per cent the maximum interest rate payable on any time deposit under $100,000, other than savings deposits, effective September 26.	To limit further escalation of interest rates paid in competition for consumer savings, and to help keep the growth of commercial bank credit to a moderate pace.
October–late November	Increased System holdings of U.S Government securities by nearly $500 million. Average member bank borrowings declined to $680 million.	To permit somewhat less firm conditions in the money market in view of the recent lack of growth in bank credit.
Late November–December	Increased System holdings of U.S. Government securities by about $970 million, including about $660 million in repurchase agreements. Average member bank borrowings declined to $550 million.	To relax monetary restraint somewhat in the light of both the outlook for slower economic growth and persisting lack of expansion in bank credit.
December	Issued new 1967 guidelines for banks and other financial institutions as part of broader governmental program of voluntary foreign credit restraint.	To continue, and in some respects to intensify, the voluntary effort to restrain the outflow of private capital.
	Terminated special discount arrangements announced on September 1 when member banks were asked to curtail their business loan expansion.	To eliminate discount arrangements that were no longer needed, since expansion in business loans had been reduced to a moderate rate and banks were no longer unloading securities in unreceptive markets to obtain loanable funds.

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DEMANDS, RESOURCE USE, AND PRICES

During 1966 the economy extended the expansion in output, employment, and incomes that had been under way since the cyclical low in February 1961. Under the impetus of sharp increases in defense spending and in business expenditures for plant and equipment, the economy approached full use of resources. Unemployment declined to the lowest rate in more than a decade, and industrial capacity was more fully utilized than at any time since 1953.

But the achievement of substantially full employment had its costs. As activity pressed harder on resource availability, a pervasive rise in prices and costs threatened a return to inflationary conditions that had been characteristic of earlier postwar upswings, but that had been avoided in the prolonged and balanced expansion from 1961 to 1965. The expansion in domestic demand stimulated a surge of merchandise imports, which rose half again as much as exports; the U.S. foreign trade surplus, which had declined substantially in 1965, fell even further in 1966. And the pressure of defense and business investment demands preempted financial as well as physical resources—forcing a sharp curtailment in homebuilding.

As the monetary and fiscal restraints took hold, the excessively rapid rate of expansion moderated. Industrial production leveled off after August, and the rate of capacity utilization in manufacturing eased slightly. The pace of price increases diminished—led by lower prices for farm products and for industrial materials. Expansion in over-all economic activity was maintained at a fast pace late in the year by the unusually large proportion of output that went into business inventories; in some industries, such as steel and autos, production schedules were being reduced. The prompt easing of monetary policy, however, was giving evidence before the year-end of laying the groundwork for a revival in the homebuilding industry.

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DEMANDS

Our gross national product totaled $740 billion (in current dollars) in 1966, an increase of $58 billion, or 8.6 per cent, from 1965. This was a larger increase than had been anticipated by most official and private projections early in the year, in part because prices advanced more than expected. The GNP price deflator rose on average by 3.0 per cent, the largest advance since 1957. The rise in GNP in constant dollars amounted to 5.4 per cent, compared with 5.9 per cent in 1965 and 5.3 per cent in 1964.

Expansion was most rapid in the first quarter. After that, the rate of gain was slower, as declines in some important sectors —particularly residential construction and autos—partially offset continued expansion in other key areas of demand. A stepped-up rate of increase in the fourth quarter represented a bulge in inventory accumulation; Government purchases rose less rapidly than in the third quarter, while expansion in final purchases of goods by the private sector virtually halted.

Industrial production also showed a very large increase in 1966, with the Board's index rising by 9 per cent, to 156 per cent of the 1957–59 average, from 143 per cent in 1965. In 1965 the increase had amounted to about 8.5 per cent. By this measure, too, growth was most rapid early in 1966; after August the index showed little net change.

Defense needs associated with the escalation of military activity in Vietnam exerted a substantial expansive influence on over-all economic activity throughout 1966. Federal spending for defense had begun to rise in the spring of 1965, and it accelerated during most of 1966, with an exceptionally sharp rise in the third quarter. New and unfilled orders for defense rose rapidly until late in the year, and the Armed Forces were expanded in substantial numbers. Defense outlays for the calendar year totaled $60 billion, up $10 billion from 1965 and considerably in excess of the rise contemplated early in the year.

Federal expenditures other than for goods and services also

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rose sharply in 1966, reflecting mainly increased social security benefits and grants-in-aid to State and local governments. Payments under the new medicare program increased sharply after the program went into effect at midyear. Altogether, total Federal expenditures on the national-income-accounts basis totaled $142 billion in 1966, up almost $19 billion from 1965.

The Federal Government budget as measured in the national income accounts shifted from a moderate surplus in the first half of the year to a sizable deficit in the fourth quarter. For the calendar year as a whole, despite the very large increase in outlays, there was a slight surplus—$0.3 billion. In the calendar year 1965, the surplus had amounted to $1.6 billion. The virtual balance of receipts and expenditures in 1966 was achieved in part by higher tax receipts from sharply increased incomes. But it also resulted from several policy actions in the fiscal area; these included (1) an increase effective at the beginning of the year in social security tax rates and a rise in the taxable wage base; (2) the withdrawal beginning April 1 of excise tax reductions on automobiles and telephone service, which had gone into effect on January 1; (3) the establishment of a graduated schedule for withholding taxes on individual incomes, effective in May; and (4) the institution of taxes at midyear to cover payments under the medicare program.

State and local government purchases rose by almost $7 billion in 1966, the largest dollar increase on record. The sharp increases in grants from the Federal Government were a significant influence. The large expansion in purchases by these governments placed further pressure on available resources, particularly of manpower.

In the private sector, business spending on fixed capital was a major expansive force in 1966. Such outlays increased by $9.6 billion, or almost 14 per cent, to $79.3 billion. For the year such expenditures accounted for 10.7 per cent of GNP, the highest annual ratio of the postwar period, slightly exceeding

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the previous peak of 10.4 per cent reached in 1948 and again in 1956.

Expenditures on equipment increased sharply throughout the year, but investment in structures declined after the first quarter, as builders of commercial structures—which are more dependent on mortgages than are industrial plants—found increasing difficulty in obtaining credit. Expenditures on fixed capital increased less rapidly in the second half of the year than in the first, and as reported in the Commerce–SEC survey taken in November, nonfarm business concerns significantly scaled down earlier intentions to spend for the first time since 1963. The survey also indicated a marked reduction in the prospective pace of expansion in business spending for fixed capital in the first half of 1967.

Influences contributing to the sharp increase in spending for fixed capital in 1966 included the continued rapid rise in output —particularly in late 1965 and early 1966, when spending plans for the year were largely formulated; the sharp stepup in defense requirements; the high rates of capacity utilization in manufacturing throughout the year; the high levels of profits and flows of internal funds; and the stimulus exerted by the investment tax credit and provisions for accelerated depreciation. Profits both before and after taxes were at record highs in the first half of the year.

But after midyear profits declined, in part because of rising unit labor costs. For the year as a whole, corporate profits after taxes totaled about $48.5 billion, a rise of nearly $4 billion, or 9 per cent, from 1965. This was a distinct slowdown from the 15 per cent rise in 1965. There was some increase for the year in internal funds—that is, chiefly undistributed profits and depreciation allowances—but it was less than the rise in outlays for fixed capital. At the same time, further steps in the transition to a full pay-as-you-go system for corporate income taxes were taken. This speedup in tax payments did not show in the national income accounts (which are on an accrual basis), but it intensified corpo-

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rate needs for external financing. Altogether, business concerns early in the year apparently underestimated the extent to which they would have to resort to external financing and did not foresee the difficulty they would encounter in obtaining that financing.

In the manufacturing sector, growth in output early in the year exceeded, and then until late in the year about matched, the exceptionally large rise in capacity, which amounted to around 7 per cent compared with about 6.5 per cent in 1965 and 4 per cent in 1964. The capacity utilization rate for 1966 averaged 91 per cent, with only the fourth quarter—at 90 per cent—slightly below this. The average for the year was 2 percentage points higher than in 1965 and was the highest since 1953. Utilization rates were particularly high in such industries as nonferrous metals, fabricated metals, instruments, nonelectrical machinery, aircraft, and rubber and plastics.

The pressure of rising demands for defense and for business fixed capital, along with expectations that materials would be scarce and that prices would rise, provoked the largest inventory buildup of the expansion period. Almost one-half of the increase in the book value of inventories at the manufacturing level from late 1965 to late 1966 occurred in the business and defense equipment industries.

For manufacturing and trade as a whole, accumulation tended to exceed the growth in sales, which changed little after mid-year, and the stock/sales ratio rose persistently after the first quarter, particularly for durable goods. This development was in contrast to earlier years of this expansion when the over-all ratio of stocks to sales had tended downward. A sharp upward bulge in the rate of accumulation during the fourth quarter appears to some extent to have been involuntary. For consumer durable goods, with sales lagging late in the year, stocks became excessive at both factory and distributive outlets, and production curtailments were instituted by manufacturers of automobiles and some major appliances. Farm stocks decreased slightly for the year as compared with moderate accumulation in 1965.

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In contrast to expansion in most other sectors, residential construction activity declined sharply. Nonfarm housing starts, which had shown an irregular downtrend during the previous 2 years, dropped to unusually low levels after midyear and in the fourth quarter were at a seasonally adjusted annual rate of less than 1 million units. The total of 1.2 million starts for the year, the lowest since 1957, compared with 1.5 million in 1965 and a recent peak of 1.6 million in 1963.

The steepness of the drop in housing starts reflected for the most part the restrictive conditions that developed in the mortgage market toward the end of 1965 and the further tightening during most of 1966. But there were other contributing factors, such as overbuilding in the West and in some other regions in earlier years and the dampening effects on demand of continuing increases in costs of land, materials, and wages. While the decline was relatively greater for multifamily buildings, it affected all types of structures and all areas of the country.

Residential construction expenditures, which are far less volatile than starts and which tend to lag them, dropped appreciably after April and were still declining at the year-end. However, the decline over the year was not so pronounced as it was in the case of starts, owing to rising unit prices and a further shift in the mix from multifamily structures to the more expensive single-family units. For 1966 as a whole, the total value of nonfarm residential construction activity approximated $25 billion, only moderately below the record 1964 and 1965 totals.

Consumer spending on goods and services is dependent primarily on after-tax income, but other influences also affect consumer propensity to spend and save. During 1966 some significant fluctuations appeared in the allocation of consumer income between spending and saving, although for the year as a whole the saving rate was close to the 5.4 per cent average of the years 1960–65. A slowdown in consumer spending in the second quarter of 1966 was associated with a relatively slow growth in after-tax income. A renewed upsurge in consumer spending in

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the summer reflected both a stepped-up rise in after-tax income and a reduction in the saving rate. In the fourth quarter after-tax income showed a sharp increase, but consumer purchases of goods leveled off and the saving rate rose from 4.8 to 5.9 per cent of income.

In total, consumers increased their spending by almost 8 per cent in 1966, compared with 7.5 per cent in 1965. But with consumer prices rising rapidly, the increase of about 5 per cent in the physical volume of purchases, while large, was somewhat less than in 1965. The increase in constant dollars amounted to only 3 per cent when measured from the fourth quarter of 1965 to the fourth quarter of 1966.

Spending for services increased sharply throughout 1966. In current dollars the increase was about 8.5 per cent and in constant dollars 4.7 per cent, a little more than in 1965. Purchases of nondurable goods showed sizable increases for the first three quarters, but virtually leveled off in the fourth quarter. For the year such purchases were up 8 per cent in current dollars; in constant dollars the rise was 4.2 per cent, about the same as in 1965.

In contrast, purchases of durable goods, particularly automobiles, slumped in the spring quarter, in part because of adverse publicity on auto safety and also because of the relatively slow rise in disposable personal income as large final settlements were made on 1965 tax liabilities and the graduated withholding tax went into effect. Subsequently, total purchases of durable goods, but not automobiles, recovered to a level close to that of the first quarter. For the year as a whole, sales of automobiles totaled 9 million units, including imports, compared with the record 9.3 million units sold in 1965.

Substantial increases in output, employment, and wages resulted in an increase of 8.5 per cent in personal income in 1966, more than in 1965. Wages and salaries, as usual, accounted for the bulk of the rise, but all other major types of income were up for the year as a whole. Farm income peaked in the first quar-

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ter, as prices received by farmers climbed steeply; and then it declined as prices of farm products came down. Transfer payments showed the largest dollar increase of the postwar period.

Disposable personal income (that is, personal income after taxes) also showed a large increase for the year, but when measured from fourth quarter to fourth quarter the relative rise was considerably smaller than it had been during 1965. Personal tax payments rose sharply throughout 1966, in part because of the introduction of graduated withholding rates. With consumer prices up considerably, the rise in constant-dollar disposable income from the fourth quarter of 1965 to the fourth quarter of 1966 amounted to only 3 per cent, compared with about 7 per cent over the preceding year. In fact, it was the smallest increase for such a period since 1960.

LABOR MARKET

Demands in the labor market were strong in 1966. Employment in nonfarm industries expanded vigorously, and the labor market became very tight. Increased Government expenditures for defense, augmenting already strong demands at the end of 1965 for both capital goods and consumer durable goods, generated the largest annual rise in nonfarm employment since early in the Korean war. Meanwhile, unemployment averaged less than 4 per cent for the first time in more than a decade. In the fourth quarter of 1966 nonfarm payroll employment was 2.9 million persons, or 5 per cent, higher than a year earlier, and the unemployment rate was 3.7 per cent, down 0.4 of a percentage point from a year earlier.

The influence of spending for defense and capital goods was reflected in very large gains in employment in durable goods manufacturing, where employment rose by 8 per cent over the year. The impact of military spending was especially strong in the electrical equipment and aircraft industries. In other durable goods industries, however, employment gains were not nearly so impressive, especially after the spring when employment in the

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automobile industry leveled off and manufacturers of construction materials began to feel the effect of the reduction in residential building. Employment in the construction industry dipped after the spring, and by the year's end the number of jobs was 140,000 below the March peak.

Employment in the trade and service industries continued to grow at a rapid pace in 1966. Government needs helped to put increased pressure on the labor supply. Government civilian employment expanded by 800,000, or 8 per cent, the most rapid increase since the Korean war; more than two-thirds of the rise was in the State and local government sector. In addition, in the 12 months ending December, the Armed Forces were expanded by about 500,000 men—drawn largely from those 20 to 24 years old who otherwise would have been in the civilian labor force.

The intense demands for labor put pressure on the available supply of skilled and experienced workers during 1966, and the unemployment rate for adult men was reduced to close to 2 per cent—virtually a frictional level. As a result, employers turned more and more to women and to youths to fill their labor needs. Record numbers of teenagers entered the labor force during the summer, and they found jobs readily available. But large numbers were interested only in vacation-time jobs, and they left the labor force when schools reopened in September. Altogether, teenagers provided less than 300,000 of the 1.6 million increase in the labor force between the fourth quarters of 1965 and 1966. Since so few men were available, either among the unemployed or outside the labor force, women contributed most—almost three-fourths—of the increase in the civilian labor force over the year.

Increased manpower requirements were also met through expansion of on-the-job training, upgrading of workers, and additional overtime. For most of 1966, hours of work in manufacturing were higher than during the Korean war.

The decline of about 250,000 in total unemployment from

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the fourth quarter of 1965 was reflected in lower unemployment rates in a wide range of occupations and industries. But most of the decline occurred early in the year, and after that the unemployment rate remained on a plateau, ranging—with one exception—from 3.7 to 3.9 per cent. Little improvement was evident in the typically high unemployment rates of teenagers. The unemployment rate among nonwhite workers showed virtually no change at an average of 7.3 per cent.

WAGES AND COSTS

Earnings rose substantially during the year in most industries—reflecting upward adjustment of wage rates in a tightened labor market, more overtime work at premium pay, rapid increases in consumer prices, and cost-of-living wage adjustments for some 2 million workers. Many new settlements in the second half of the year provided for annual increases of around 5 per cent. For production workers in manufacturing, average hourly earnings in the fourth quarter of 1966 were 4 per cent higher than a year earlier; the annual increase from 1960 to 1965 had averaged less than 3 per cent. Larger than average increases were reported in construction and trade and in some of the service industries.

In manufacturing, increases in wages exceeded the gains in productivity during 1966, which were smaller than in 1965 and other recent years. As a result unit labor costs, which had been holding steady for several years, rose and toward the end of 1966 averaged 2.6 per cent higher than a year earlier. For the private economy as a whole, gains in productivity were also quite modest; for the year they averaged 2.8 per cent—about equal to the rise in 1965 but substantially below the average of 3.6 per cent for the 5 years from 1960 through 1965.

PRICES

The pressures on resources that had begun to accumulate during the second half of 1965 were followed by an accelerated

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rise in prices of goods and services in 1966. The consumer price index rose by 3.3 per cent over the 12 months ending December 1966, as compared with 2 per cent the year before; in the period 1961–64 the average annual increase had been about 1.5 per cent.

While the rise in the wholesale price index over the 12 months ending December was only half the increase that had occurred in 1965—1.7 per cent versus 3.4 per cent—the moderation reflected an easing of supply pressures in markets for agricultural products and for some sensitive industrial materials that more than offset in the total index the intensified pressures on industrial products. Wholesale prices of foodstuffs, after rising in 1965 and during much of 1966, turned down in the autumn in response to some improvement in supplies and supply prospects. As a result the net increase over the 12 months ending December was considerably less than that for 1965, when market supplies of some foodstuffs were sharply reduced. In contrast, the increase in wholesale prices of industrial commodities was the largest since 1956.

There were several distinctive features of the behavior of prices in 1966. For one thing, consumer services played an unusually important role in the rise. Secondly, supplies of certain agricultural commodities became short in 1965 for the first time in many years and remained short during much of 1966, with a consequent effect on their prices. Thirdly, the rise in industrial commodity prices, although the largest in a decade, was not especially large for an economy that was expanding as fast as the U.S. economy was in 1966; at wholesale, the December-to-December increase was only around 2 per cent as compared with 1.5 per cent during 1965. At the year-end the industrial average was only about 3 per cent higher than in late 1959 and early 1960, prior to the slight decline that occurred in the 1960–61 business recession.

The increase in prices of consumer services in 1966 amounted to 5 per cent. This was more than twice the average increase

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in the preceding 4 years. Services included in the consumer price index are diverse, and the acceleration in the price rise in 1966 reflected more rapidly rising wages and labor costs in response to labor market pressures, in addition to continued expansion in consumer demands.

The rise in costs of medical care, led by hospital services, was especially large; the increase—8 per cent—was double that for 1965 and was equal to the increase in 1946 when war-time price controls were removed. Mortgage interest rates, which have a relatively large weight in the consumer index for services, rose sharply in 1966 as a consequence of monetary policies designed to restrain the excessive expansion in aggregate demands and an associated rise in the general price level. Costs of transportation and other groups of services showed average increases of between 4.0 and 5.5 per cent; and rent rose by 1.6 per cent.

The small net increase in wholesale prices of foods and foodstuffs, following the large rise of 1965, reflected substantially offsetting movements for major commodity groups. Prices of livestock and meats, which had accounted for so much of the over-all rise in 1965, advanced somewhat further in early 1966. Later they declined sharply in response to expansion in supplies, and at the end of the year they were considerably lower than at the beginning. Late in the year, improvement in actual and prospective supplies brought about decreases in prices of grains and soybeans, but prices remained well above their levels at the end of 1965. Prices of milk and dairy products and of bakery products, on the other hand, rose substantially.

Increases in prices of industrial products were fairly widespread in 1966—although they were large in relatively few cases —and seemed to reflect a combination of pressures of demands against resources and some increases in labor and other costs. In a few instances, prices were influenced by special supply problems. Prices of machinery and equipment, for example, rose by 5 per cent compared with less than 2 per cent in 1965; booming demands for both business and defense equipment were

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confronted by the limitations of plant capacity and by shortages of certain labor skills, which resulted in a large buildup of order backlogs and undoubtedly some increases in costs.

Prices of consumer goods other than foods rose by about 2 per cent at both wholesale and retail levels, after rising by about 1 per cent during 1965; increases were more prominent among nondurable goods than among durable goods. Costs and prices of finished goods were subject to some upward pressures because of increases in prices of materials. Reflecting supply problems as well as strong demands, prices of hides, lumber, and copper and copper scrap—and prices of certain intermediate products that embody these materials—rose quite sharply in early 1966. As a result the average for all industrial materials showed a rapid upward trend. Prices of these sensitive or basic materials turned down during the spring and summer—bringing prices of some of the intermediate products down moderately—and the rise in prices of many other materials tapered off. At the year-end average prices of industrial materials were only 1.5 per cent higher than a year earlier; this was the same amount of increase as during 1965.

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MONETARY POLICY

The policy of monetary restraint pursued by the Federal Reserve during most of 1966 was carried out through a wide variety of instruments—including open market operations, discount window administration, reserve requirements, and policy regarding maximum interest rates on time deposits. The intensity of restraint and the mix of monetary policy instruments were adjusted flexibly during the course of the year, as inflationary pressures generated by the business investment boom and expansion in defense spending intensified and then moderated, and as it became necessary to modify the uneven impact of over-all monetary restraint on different sectors of the economy. During the final months of the year, monetary restraint was relaxed as certain additional Federal fiscal actions of a restrictive nature were taken and as evidence of moderating tendencies in economic activity and commodity prices accumulated.

OPEN MARKET OPERATIONS: JANUARY–JUNE 1966

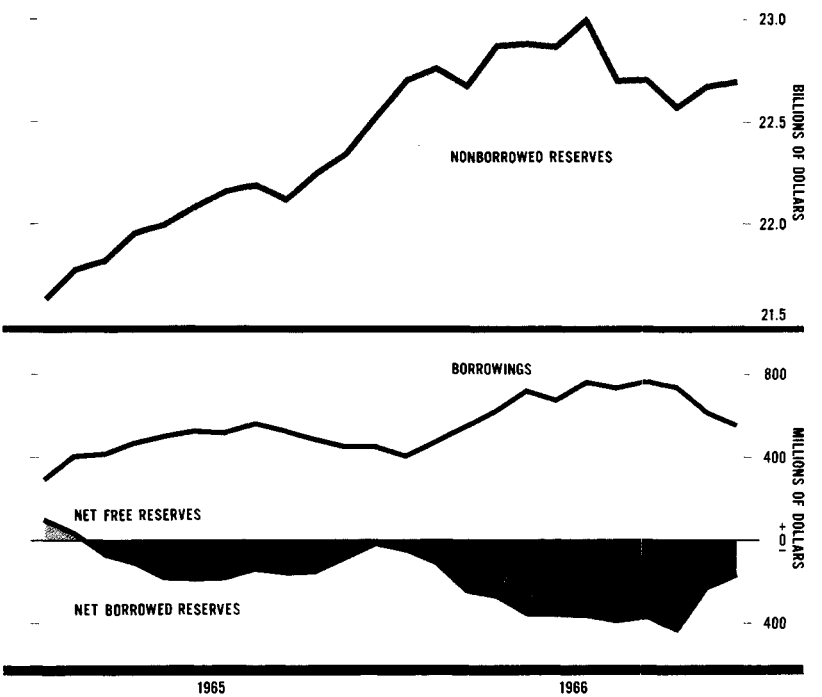
Following the increase in the Federal Reserve discount rate to 4½ per cent and in maximum interest rates payable on time deposits to 5½ per cent in December 1965, short- and long-term market interest rates rose sharply. Credit demands, which had expanded substantially in late 1965, continued to expand in early 1966. Operations for the Federal Open Market Account in that period were conducted so as to smooth the adjustments in credit markets. Because nonborrowed reserves were supplied generously in December 1965 and in January 1966, member banks had no need to increase their borrowings from the Federal Reserve Banks. The 3-month Treasury bill rate, which had closed 1965 at almost 4.50 per cent, generally fluctuated within a range of 4.50–4.65 per cent during the early weeks of 1966.

After the usual year-end ebbs and flows of funds had subsided, and credit markets had adjusted to the new higher level of interest rates, monetary policy gradually exerted further restraint

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through open market operations. With credit demands strong, prices of goods continuing to rise, and the balance of payments still unsatisfactory, the Federal Reserve began to supply reserves less freely to banks. Over the February–June period, nonborrowed reserves rose by only 1.7 per cent (seasonally adjusted annual rate), as compared with a 4.8 per cent rate of rise from mid-1965 through January 1966. However, around the March–April tax period, and again around midyear, the Federal Reserve supplied nonborrowed reserves to banks in substantial volume to

1 | NONBORROWED RESERVES decline after mid-1966 but rise late in the year as monetary policy eases and member bank borrowings decline



Nonborrowed reserves: Seasonally adjusted monthly averages of daily figures for all member banks, adjusted to eliminate effects of changes in reserve requirement ratios. Series reflects current percentage requirements effective Sept. 15, 1966. Borrowings and net borrowed and net free reserves: Monthly averages of daily figures, not seasonally adjusted, for all member banks.

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help moderate the additional money market pressures being generated by the enlarged temporary needs of corporations for funds to meet accelerated tax payments. Banks borrowed increasingly more from the Federal Reserve Banks' discount window as the first half of the year progressed, and these borrowings rose from an average of about $400 million in January to about $675 million by June. With the rise in borrowed reserves, total reserves of banks rose at a rate of about 4 per cent in February–June, little different from the pace of aggregate reserve expansion of the previous 7 months.

Over-all, during the February–June period the increased restraint in the provision of nonborrowed reserves and the continued large demands for credit were reflected in generally rising money market rates—including those on Federal funds, dealer loans, commercial and finance company paper, and short-term Federal agency issues. Banks raised their prime loan rate during this period; and there were marked increases in most long-term interest rates in conjunction with a surge of security issues, especially of corporate bonds and of issues by the Federal Government of participation certificates. Despite the pressure being exerted on financial markets, however, the 3-month Treasury bill rate generally remained within its early-in-the-year range, as market pressure from bank liquidations of U.S. Government securities was offset by a very sizable decline in the volume of Treasury tax bills outstanding.

As a result of the advances in interest rates on a variety of short- and long-term market instruments, both banks and nonbank financial institutions found it difficult to hold and attract funds of individuals and other investors, who increasingly placed their funds directly in relatively high-yielding market instruments. In March, after the prime loan rate was raised, banks bid much more actively to attract funds into time deposits. They sought funds from corporations by raising rates on negotiable CD's toward the ceiling rate of 5½ per cent; they also increased their efforts to attract time deposit money from consumers through the

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issuance of a variety of savings instruments. With increased competition for savings flows not only from market instruments but also from banks, other depositary institutions (savings and loan associations and mutual savings banks) found it especially difficult to attract savings funds, and in consequence the availability of new mortgage commitments from these lenders was severely restricted.

ADAPTATIONS IN THE MIX OF POLICY INSTRUMENTS: JULY–SEPTEMBER 1966

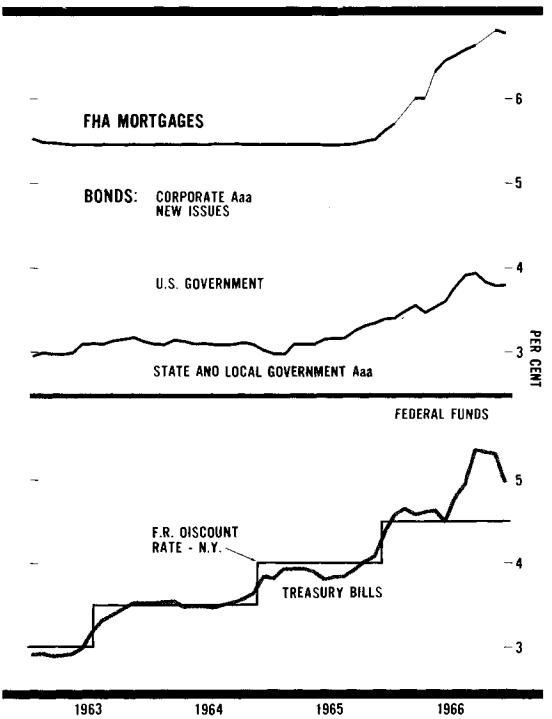
The problem of retaining savings funds was particularly acute for savings and loan associations around the midyear interest-crediting period, and in July savings shares outstanding at these institutions declined, after seasonal adjustment. Bank credit, meanwhile, had expanded fairly fast during the spring, and the pace of expansion accelerated around midyear. Borrowings from banks by businesses grew very rapidly in June and July, in part to finance the large accelerated tax payments that businesses had to make in that period but also to finance their increased capital outlays.

With business loan expansion adding to inflationary pressures and with the impact of tighter credit conditions falling heavily on nonbank institutions and therefore on mortgage markets, the Federal Reserve adapted the mix of policy instruments to help redistribute the impact of financial restraint. On June 27 the Board of Governors announced an increase in reserve requirements from 4 per cent to 5 per cent on time deposits in excess of $5 million to be effective in mid-July. In mid-August it announced another increase in such requirements to 6 per cent, to be effective around mid-September. Also, promissory notes of banks maturing in less than 2 years were made subject to regulations governing reserve requirements and payment of interest on deposits. In addition, in mid-July the Board of Governors had lowered the maximum rate of interest payable on new multiple-maturity time deposits to 5 per cent on such deposits

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maturing in 90 days or more and to 4 per cent on such deposits maturing in less than 90 days in order to help forestall excessive interest rate competition among financial institutions. At the same time the Board supported legislation containing broader authority for itself and for the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board to govern the interest rate practices of banks and savings and loan associations.

2 INTEREST RATES hit new highs in late summer, then decline



Federal funds, effective rate. For other notes see p. 71.

Under a program authorized by the Board of Governors, the Federal Reserve also instituted procedures whereby emergency credit facilities could be provided through the Federal Reserve

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Banks under specified conditions to nonmember depositary-type institutions, including mutual savings banks and savings and loan associations. While no actual use was made of these emergency credit facilities, their availability provided a safeguard against the possibility of additional pressures on mortgage and securities markets resulting from exceptional deposit losses at nonmember financial institutions.

Open market operations during the summer complemented the changes in reserve requirements and in time deposit rates—by limiting the availability of reserve funds to banks to the extent consistent with orderly market conditions. Nonborrowed reserves declined during the third quarter, and banks were forced to rely somewhat more heavily on borrowed reserves and on funds attracted from abroad. With restraints on the supply of funds intensifying and with loan demands still basically strong, banks raised the prime loan rate further to 6 per cent by midsummer, continued to reduce their portfolios of U.S. Government securities, and sharply curtailed their participation in the market for State and local government securities.

As the summer progressed, commercial banks found that negotiable time CD's, with interest rates limited by the 5½ per cent ceiling, were no longer competitive with other short-term market instruments. The rate on 3-month Treasury bills rose to around 5½ per cent and in the third week of September reached its peak for the year of 5.59 per cent (on a discount yield basis). Yields on longer-term bills and other types of money market paper, including Federal agency issues, rose further to levels consistently well above 5.50 per cent. With rates at such levels, banks were unable to roll over all maturing negotiable CD's after mid-August, and their holdings of such deposits began to decline. As this source of funds dried up, large banks sought money elsewhere. They obtained more funds in the Euro-dollar market through their foreign branches; and they bid more aggressively in the Federal funds market—at times paying 6 per cent or more for such 1-day money.

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Upward pressure on money market rates was exerted not only by the cumulative impact of restraint on the banking system but also by the financing needs of the U.S. Government. In addition to a large offering of tax bills in midsummer, there were sizable offerings of Federal agency issues in the 6-month to 2-year maturity range in the late spring and summer. These agency issues included a large amount of funds raised by the Federal home loan banks and the Federal National Mortgage Association to help ease pressures on savings and loan associations and on the mortgage market.

Money market rates were also influenced by a larger volume of commercial and finance company paper offered, as borrowers sought alternatives to bank loans. And finally U.S. Government securities dealers kept their bill positions unusually low, as expectations of rising interest rates intensified and dealers' borrowing costs rose further.

Bond yields also rose markedly in the summer and reached a peak in late August. The new-issue rate on high-grade corporate bonds (with 5-year call protection) briefly touched 6 per cent; 20-year U.S. Government bonds for a few days yielded more than 5 per cent; and seasoned high-grade tax-exempt municipal issues averaged just over 4 per cent. The sharpness of the rise in yields reflected strong demands in capital markets. But it was also influenced by expectational forces generated by the gathering of pressures on banks and other financial institutions, by the high yields that had been required to sell participation certificates mainly in FNMA and Small Business Administration assets, by the prospect of additional issues of certificates, and by uncertainties about the course of the conflict in Vietnam and about Federal fiscal policy.

During the summer the Board of Governors disapproved discount rate increases that had been proposed at various times by several of the Federal Reserve Banks. An attempt to avoid further escalation of interest rates was among the reasons for the Board's decisions.

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The late summer rise of yields in short- and long-term markets was the culmination of financial market pressures during the year; interest rates in the mortgage market, however, continued to rise into the autumn. A number of fiscal and monetary policy developments contributed to the moderation of adverse market expectations and of credit market pressures after late August.

The administration's announcement in early September of a program of fiscal restraint had a tonic effect on market psychology, especially in long-term markets. The program included measures to reduce relatively low-priority Government expenditures, a recommendation for suspension of the investment tax credit and of accelerated depreciation, postponement of sales of participation certificates, and a limitation on Federal agency issues to the public to no more than the amounts that would be needed to roll over maturing debt.

Meanwhile, on September 1 the Board of Governors released a letter that was sent by the Federal Reserve Banks to all member banks. In an attempt to moderate financial pressures on securities markets the letter urged moderation in bank extensions of loans to business. The letter indicated the desirability of banks' reducing business loan expansion and of avoiding further substantial liquidations of municipal securities or other investments. It was recognized that banks that adjusted their positions by tightening lending standards further rather than by selling securities might require accommodation at the discount window for longer periods than usual.

Finally, in late September the Board of Governors reduced to 5 per cent from 5½ per cent the maximum rate of interest member banks might pay on time deposits of less than $100,000. This action was taken under temporary authority granted by the Congress that broadened the basis for setting interest rate ceilings on time and savings deposits. Rate ceilings were also established for insured nonmember banks, mutual savings banks, and savings and loan associations under parallel authority granted to the

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FDIC and to the Federal Home Loan Bank Board. The rate ceilings established by the three agencies had the objective of limiting further escalation of interest rates paid for consumer savings.

MOVE TOWARD LESS MONETARY RESTRAINT: OCTOBER–DECEMBER 1966

Federal Reserve open market operations in the early fall were directed at maintaining orderly and generally steady conditions in the money market. With market interest rates remaining high, though below their peak levels, the decline in bank credit that had begun in late summer continued into the autumn. This was partly the result of reductions in negotiable CD's outstanding, which dropped by $2.7 billion from mid-August through the end of October. Concurrently, the rate of business loan expansion at banks was sharply reduced. This slower expansion was the result in part of restrictive lending policies of banks and in part of a reduction in loan demands, following the very large increase in bank loans related to the speed-ups in tax payments around mid-year. The money stock did not show any tendency to rise following its summer decline.

The behavior of bank credit, money stock, and aggregate reserves was even weaker than might have been expected under the prevailing money market conditions. Under the circumstances, and with excessive credit demand pressures in the economy appearing to abate, open market operations were conducted so as to lessen somewhat the restraint on banks. Member bank borrowings began to decline after reaching a peak of $878 million on the average during the first two statement weeks in October. Treasury bill rates began to decline again, and banks' net losses of CD money in November were only about one-third of the amounts in each of the previous 2 months.

As moderating tendencies in the economy became more widespread, the Federal Open Market Committee moved in late November and December to attain a further easing in money market

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conditions through open market operations. As a result of these actions, member bank borrowings at Federal Reserve Banks declined to an average of $557 million in December; the Federal funds market eased, with most trading in a 5–5½ per cent range; and the 3-month Treasury bill rate dropped to around 4.80 per cent by the year-end.

Long-term interest rates also declined sharply during the final months of the year. Investor receptivity to long-term issues was enhanced by the gradual realization that monetary policy had shifted to a stance of less restraint; by the apparent tapering of the investment boom, as indicated by various surveys of business plans for capital spending; and by various other indications that the economic outlook was no longer so buoyant as earlier in the year. By the year-end yields on U.S. Government, new high-grade corporate, and municipal bonds were 40 to 60 basis points below their late summer peaks, and there were signs of an easing in mortgage market conditions. On December 27, with business loan expansion at banks having moderated substantially and with security markets showing renewed strength, the Board of Governors issued a statement terminating the special discount arrangements announced in the September 1 letter.

Growth in bank credit—as indicated on a weekly basis by data for total member bank deposits—resumed in the latter part of November, and the money supply also rose during the last few weeks of the year. In December banks actually experienced a modest increase in outstanding negotiable CD's, despite record maturities during the month.

Over the year 1966, outstanding bank credit expanded by 6 per cent—reflecting mainly the relatively rapid growth in the first half of the year; such credit had risen by 10 per cent in 1965. With open market operations generally exerting restraint throughout the year, nonborrowed reserves of banks grew by less than 1 per cent, compared with a rise of more than 4 per cent in 1965. Member bank borrowings from the Federal Reserve

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first rose and then fell during the year and were a relatively minor source of reserve funds for the year on balance.

With reserve growth very restrained, the 6 per cent expansion of bank credit was made possible by a rise in time and savings deposits and by the increased use of funds obtained through branches abroad. Time and savings deposits grew by 8 per cent in 1966, while demand deposits expanded by less than 1 per cent. And the money supply—demand deposits and currency in the hands of the public—rose by less than 2 per cent, a rate of growth less than half that in 1965.

OPERATIONS IN FOREIGN CURRENCIES

During 1966 the Federal Reserve—in cooperation with the U.S. Treasury, foreign central banks, and the Bank for International Settlements (BIS)—continued to engage in operations in foreign currencies for the purpose of alleviating temporary strains in foreign exchange markets and curbing speculative developments.

The sterling crisis during the summer provided the main focus of these operations. Early in the year sterling was relatively strong in foreign exchange markets, and the Bank of England repaid the $475 million of drawings that had been outstanding at the end of 1965 under its reciprocal currency arrangement with the Federal Reserve. But during the spring the pound weakened again as Britain's economic problems persisted and were aggravated by a prolonged maritime strike. As confidence in sterling waned during the summer, Britain experienced very large outflows of capital, and the Bank of England drew heavily on its credit facilities with the Federal Reserve and the U.S. Treasury and also borrowed from the central banks of other countries. At the end of September its outstanding drawings from U.S. authorities totaled $575 million.

Some of the funds converted from sterling into dollars flowed to the United States, as foreign branches of U.S. banks bid actively for Euro-dollar deposits and placed them at the disposal

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of their head offices. But there were also substantial flows of dollars into continental European currencies, and the dollar came under pressure in foreign exchange markets. As a result, the United States was called upon to make use of its own credit lines. The Federal Reserve made swap drawings of $570 million during the third quarter—$325 million in lire and the remainder in Swiss francs, Dutch guilders, and Belgian francs. Of the lira drawings, it repaid $225 million in August with the proceeds of a U.S. Treasury drawing of $250 million of lire from the International Monetary Fund (IMF).

The tensions and uncertainties that developed in foreign exchange markets during the spring and summer prompted the Federal Reserve to initiate discussions aimed at increasing its reciprocal currency facilities with partner central banks. In mid-September the Federal Reserve announced a general increase in these swap lines from $2.8 billion to $4.5 billion. At the same time the Bank of England announced an increase in its credit facilities with a number of other central banks as well as with the Federal Reserve.

Meanwhile the sweeping measures adopted in July by the British Government to check inflation and correct the payments deficit began to take effect. Also, financial markets became less strained. As a result of these developments as well as of the announcement of expanded international credit facilities, financial markets and foreign exchange markets began to calm. During the fourth quarter of 1966, the Bank of England was able to make repayments on its outstanding credits. The Federal Reserve, too, reduced its liabilities during this period.

In the closing weeks of the year the System joined in efforts to moderate year-end pressures in the Euro-dollar market that threatened to disturb foreign exchange markets. The System intervened moderately in the New York market for German marks and pounds sterling; and it agreed to drawings by the BIS on its swap line for the purpose of placing funds in the Euro-

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dollar market. At the same time several continental European central banks acted either to reduce commercial bank withdrawals from that market or to rechannel official reserve accruals to that market. Also in December, the Federal Reserve drew $140 million on its reciprocal currency arrangements with the German Federal Bank to absorb some of that bank's large reserve gains.

During 1966, drawings of foreign currencies by the Federal Reserve under reciprocal currency arrangements totaled $710 million, of which $280 million were outstanding at the year-end. Drawings by foreign central banks and the BIS, which also involve acquisitions of foreign currencies by the Federal Reserve, totaled $928 million, $550 million of which remained outstanding on December 31.

A detailed review of Federal Reserve operations in foreign currencies during 1966 is found on pages 269-90.

VOLUNTARY FOREIGN CREDIT RESTRAINT PROGRAM

During 1966 the Federal Reserve System continued to coordinate that part of the President's balance of payments program applicable to banks and other financial institutions in accordance with revised guidelines announced on December 6, 1965.

By December 1965 an increasing scarcity of loanable funds in the face of rapidly rising demands for credit from domestic borrowers clearly had begun to supplant the voluntary program as the dominant factor affecting the foreign lending activity of U.S. financial institutions. At the same time a narrowing of the differences between interest rates in the United States and those abroad, associated with the increasing tightness of the U.S. domestic money market, reduced foreign demand for credit in the U.S. markets. Outstanding foreign credits of the reporting commercial banks trended downward during 1966, as shown by Table 1, to $9,496 million at the year-end. This was $156 million below the total on December 31, 1965, $864 million below the

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TABLE 1

U.S. BANKS: FOREIGN CREDITS SUBJECT TO VOLUNTARY PROGRAMS

Item	1965, Dec. 31	1966				
		Mar. 31	June 30	Sept. 30	Dec. 31, calculated on guidelines for	
					1966[1]	1967[2]
Number of reporting banks	161	161	161	159	[3] 148	[3] 148
	Millions of dollars					
Total foreign credits subject to ceiling	9,652	9,367	9,429	9,142	9,496	9,496
Target ceiling	9,973	10,076	10,179	10,290	10,360	9,640
Net expansion of credit since December 1964	156	−134	−77	−369	−3	−3
Net leeway for expansion within target ceiling up to specified date	319	709	751	1,148	864	144

[1] Target ceiling generally 109 per cent of December 1964 base.
[2] Interim target ceiling generally the amount outstanding on Sept. 30, 1966, plus 40 per cent of the difference between that amount and 109 per cent of the December 1964 base.
[3] Beginning with Dec. 31, 1966, data exclude banks with foreign credits of less than $500,000 on the reporting date.

109 per cent ceiling suggested by the 1966 guidelines, and $144 million below the interim ceiling for the end of 1966 suggested by the 1967 guidelines, described below.

This decline in foreign credits may be compared with the substantial further expansion in total bank loans outstanding during 1966. Total loans of U.S. banks increased by 8.4 per cent in 1966, while their foreign credits declined by 1.6 per cent. At the end of the year credits reported under the voluntary program were equivalent to 4.4 per cent of total commercial bank loans outstanding as compared with 4.9 per cent on December 31, 1965.

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The number of banks having foreign loans in excess of their individual target ceilings and the aggregate amount of such excess continued to decline for the year as a whole, as shown in Table 2, although there was some increase in the last quarter from the low reached on September 30. However, a large number of banks had foreign credits in excess of the interim target calculated in accordance with the 1967 guidelines, owing to the fact that these guidelines were not announced until mid-December 1966.

TABLE 2

BANKS WITH FOREIGN CREDITS IN EXCESS OF TARGET CEILING

Item	1965, Dec. 31	1966				
		Mar. 31	June 30	Sept. 30	Dec. 31, calculated on guidelines for	
					1966[1]	1967[2]
Number of banks.....	35	22	24	13	18	51
Aggregate credit in excess of target (millions of dollars).....	114	18	26	17	31	155

[1] Target ceiling generally 109 per cent of December 1964 base.
[2] Interim target ceiling generally the amount outstanding on Sept. 30, 1966, plus 40 per cent of the difference between that amount and 109 per cent of the December 1964 base.

Foreign assets of nonbank financial institutions declined slightly over the first 9 months of 1966, as shown in Table 3. Liquid assets, which had been reduced substantially during 1965, were reduced by an additional $59 million or 22 per cent. Loans and investments with maturities of 10 years or less and net financial investments in foreign financial branches, subsidiaries, and affiliates rose by 1 per cent, but on September 30, 1966, they were still 3 per cent below the target ceiling that applied to

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TABLE 3

FOREIGN ASSETS OF REPORTING NONBANK FINANCIAL INSTITUTIONS

(Amounts shown in millions of dollars)

Guideline, and area	Amount Sept. 30, 1966	Change from Dec. 31, 1965: Amount	Per cent
All countries—total	**13,049**	**— 72**	**— .5**
Guideline 1 (Liquid investments)	208	— 59	—22.2
Guideline 2 (Credits with maturities of 10 years or less and net investment in financial subsidiaries)	1,280	13	1.0
Guideline 3 (Credits with maturities of more than 10 years and equity securities)—total	11,561	— 25	— .2
By type of asset:			
Bonds of international institutions	842	— 16	— 1.8
Other bonds and credits	8,525	443	5.5
Stocks	2,193	—452	—17.1
By area and type of asset:			
Canada—total	8,561	293	3.5
Bonds and credits	7,284	423	6.2
Stocks	1,277	—130	— 9.3
Other developed countries—total[1]	1,373	—271	—16.5
Bonds and credits	580	— 22	— 3.6
Stocks	794	—250	—23.9
All other countries—total[2]	1,626	— 47	— 2.8
Bonds and credits	1,504	26	1.7
Stocks	122	— 72	—37.2

[1] Excluding Japan.
[2] Japan, less developed countries, and international institutions.

such assets. Investment in longer-term foreign assets was about unchanged, as an increase of $427 million in bonds and other long-term loans—largely to Canadian borrowers—was more than offset by reductions in the reported value of holdings of foreign corporate stocks. Total long-term loans and investments in developed countries other than Canada and Japan declined by $270 million and on September 30, 1966, were 10 per cent below the target ceiling suggested for these assets.

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Despite the reduction in holdings of foreign assets achieved by banks and other financial institutions, the U.S. balance of payments deficit as measured on the liquidity basis remained at about the 1965 level for reasons discussed later in this REPORT. On December 12, 1966, the President, in a memorandum addressed to the Secretary of the Treasury, stated that the nation's objective was to continue to move toward balance of payments equilibrium as fast as the continuing foreign exchange costs of Vietnam would permit. The President accepted the appraisal of the Cabinet Committee on the Balance of Payments that achievement of the objective would require continued restraint of both Government overseas expenditures and private capital outflows, and he accepted the recommendation of the Committee that the voluntary programs be continued in 1967. The Board of Governors issued revised guidelines for banks and nonbank financial institutions on December 13, 1966.

The bank guidelines for 1967 remain substantially in the form in use since 1965. The ceiling for outstanding credits to foreigners remains at 109 per cent of the end-of-1964 base (the same as in the last quarter of 1966); no increase was provided in view of the fact that on October 1, 1966, there existed a potential leeway under the voluntary ceiling for an outflow of bank credit in excess of $1.2 billion. To guard against the possibility of a large-scale outflow of funds in any short period of time, in the event of a shift in international credit conditions and interest rates, the banks were requested to restrain their foreign credits so as to use not more than 40 per cent of the leeway available on October 1, 1966, before April 1, 1967; not more than 60 per cent before July 1, 1967; and not more than 80 per cent before October 1, 1967.

The priorities suggested in the guidelines for 1965 and 1966 were continued for 1967 and were reinforced by a request that banks in the last quarter of 1966 and in 1967 use not more than 10 per cent of the leeway available on October 1, 1966, for nonexport credits to developed countries. This request was made

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to give utmost emphasis to the importance attached to meeting requirements for priority credits—that is, credits to finance exports of U.S. goods and services, and credits to meet the needs of developing countries.

Banks with bases between $500,000 and $10 million were permitted to use the 1964 base plus $900,000 as their ceiling rather than 109 per cent of the 1964 base, and provision was made for banks with bases lower than $500,000, or no base, to discuss with their Federal Reserve Banks the possibility of adopting a special ceiling. These provisions reflected a continuing effort to minimize the inequities inherent in any program based on a state of affairs existing at a particular moment in time, and to insure that these smaller banks would be in a position to meet requirements for priority credits arising in their trade areas.

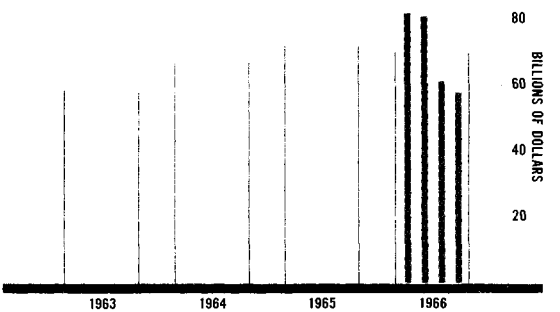
The program for nonbank financial institutions has been considerably simplified for 1967. A single guideline ceiling has replaced the three different ones in effect in 1966, and several types of assets are no longer subject to a ceiling. Under the 1967 program each nonbank institution is requested to limit its total holdings of "covered assets" to not more than 105 per cent of its "base date" holdings. Such base-date holdings are equal to the lesser of (1) covered foreign assets held as of September 30, 1966, or (2) the amount of such assets that could have been held on that date in compliance with the 1966 guideline ceilings.

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FINANCIAL FLOWS IN 1966

Until the final months of 1966, financial markets were placed under pressures by the record volume of credit demands and an increasingly restrictive monetary policy. In the late fall, easing of demands permitted the Federal Reserve to reduce the degree of restraint, and by the year-end a good part of the increase that had occurred in interest rates earlier in the year had been erased.

3 **CREDIT FLOWS rise sharply in first half, decline in second half**



Flow of funds data. Net funds raised by consumers, nonfinancial businesses, foreigners, and all levels of government. Quarterly totals for 1966 are at seasonally adjusted annual rates. Data for fourth quarter of 1966 are preliminary.

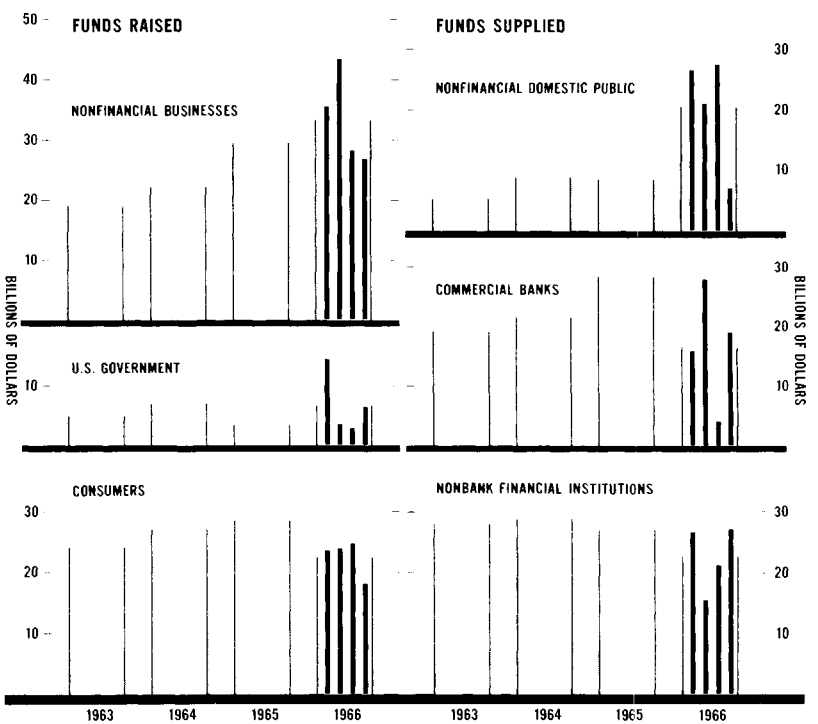
The stresses and strains created by financial market pressures in the first 6 months of 1966 were reflected not only in interest rate movements but also in the composition and volume of credit flows. In the first half of the year the total of funds raised by the nonfinancial public rose to a record rate about one-eighth more than in 1965. All of this increase, however, reflected greater reliance of businesses on external financing and an increased demand for funds by the Federal Government. The expanded credit demands of these sectors—in conjunction with monetary policy—led to rising interest rates on securities. These higher rates induced the public to increase sharply its direct investment in credit and

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equity market instruments and to reduce the rate at which it was acquiring deposits and shares at financial intermediaries.

In the summer and early fall, strains on financial markets became more intense. Deposit inflows to financial institutions slackened further, as market interest rates continued to advance, and the flow of bank credit to businesses contracted.

4 BUSINESSES and U.S. GOVERNMENT raise more funds, and PUBLIC increases sharply its purchases of securities



Flow of funds data. Nonfinancial businesses are corporate and noncorporate concerns, including farm. U.S. Govt. borrowing is net of official purchases by Treasury investment accounts. Consumer borrowing includes that of nonprofit institutions, but excludes security credit. The nonfinancial public is made up of consumers, businesses, and State and local governments; its supply of funds is net of its security credit borrowing. Credit supplied by commercial banks and by nonbank financial institutions is net of their security and other credit market issues. Data for fourth quarter of 1966 are preliminary.

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In the late fall the relaxation of monetary policy that accompanied reduced demand pressures contributed to a sizable reduction in market interest rates and to a sharp increase in deposits at nonbank financial institutions in the fourth quarter. However, efforts of banks and nonbank financial institutions to rebuild their depleted liquidity, as well as reduced demands for credit, held total credit flows to the reduced third-quarter pace. Total funds raised in the second half of the year consequently were only three-fourths as large as in the first half of 1966.

BORROWERS AND LENDERS

For the year as a whole, total funds raised in credit and equity markets by the nonfinancial sectors—businesses, consumers, foreigners, and all levels of government—amounted to $70 billion, somewhat less than in 1965. Businesses and the U.S. Government were the only sectors that increased their borrowing in 1966.

With securities becoming more attractive because of rising market rates of interest, the nonfinancial public supplied directly to the market almost 30 per cent of the total funds raised—well above the average from 1961 through 1965. Financial institutions, on the other hand, with their deposit inflows reduced, contributed a smaller proportion of the total funds supplied.

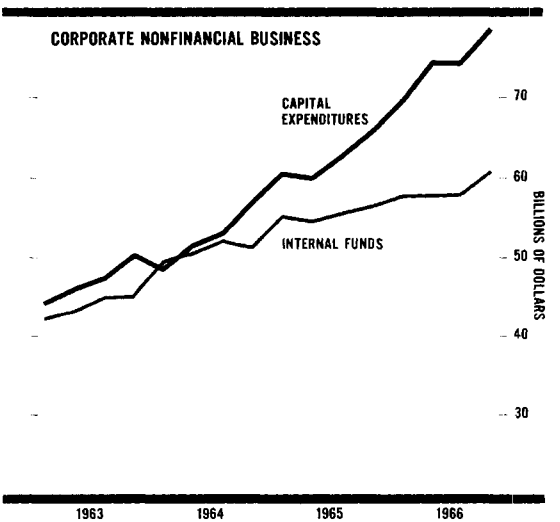
Nonfinancial business. Demands by businesses for credit to fill the widening gap between their capital outlays and their internally generated funds were a dominating element in credit and equity markets in 1966. This gap had begun to widen in mid-1965, and in the corporate sector it rose to a record $15 billion in 1966. To bridge the gap, businesses sought more external financing at a time when the supply of funds was being reduced by monetary policy.

Despite the slowing in multifamily housing and commercial construction, nonfinancial corporations spent $12 billion more for fixed investment and inventories than in 1965. Meanwhile

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their internal funds—primarily retained earnings and depreciation allowances—rose by only $3 billion. Noncorporate businesses too needed a large volume of external financing. As a result, corporate and noncorporate business together raised more than $33 billion in credit and equity markets, one-eighth more than in 1965.

5 **CORPORATE external financing needs increase sharply in 1966**



Flow of funds data; quarterly totals at seasonally adjusted annual rates. Capital expenditures are outlays for plant, equipment, and construction, and changes in inventories. Internal funds are retained earnings, inventory valuation adjustment, and capital consumption allowances. Data for fourth quarter of 1966 are preliminary.

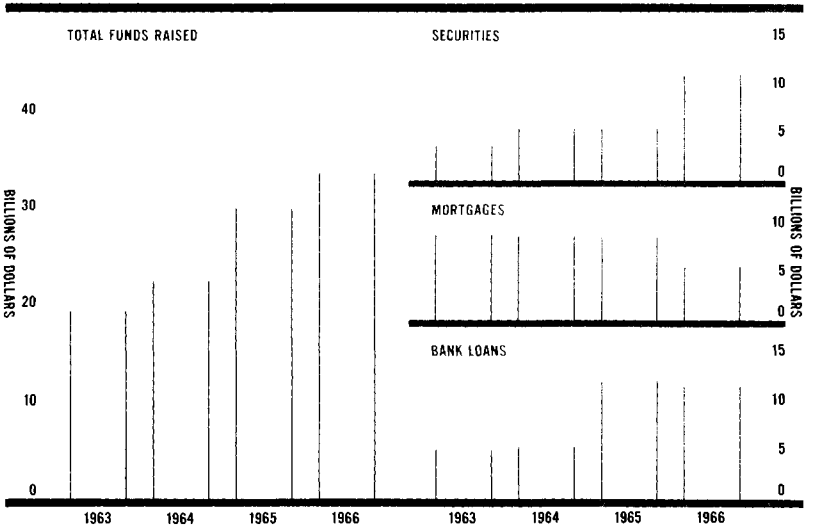
Business external financing grew at a fast rate in the first half of the year, and especially in the second quarter when such financing reached a seasonally adjusted annual rate of over $43 billion. Some of this unprecedented volume undoubtedly reflected efforts to meet prospective as well as current needs before credit supplies became even more costly and restricted. Moreover, the expanded corporate tax payments required under the revised schedules for payment of Federal income and withheld taxes increased the cash needs of business firms. These accelerations

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are estimated to have amounted to $4 billion, more than one-half of the year-over-year increase in tax payments in the second quarter. Corporations apparently met their enlarged tax payments by increased borrowing rather than by reducing liquid assets, since such holdings declined only a little more than seasonally in the quarter.

External financing slowed considerably in the second half of the year, to a rate about 10 per cent below that in 1965. The gap between capital expenditures and internal funds continued to widen, but with the increasing restraint being applied by monetary policy, businesses found it more difficult to obtain external financing, particularly from banks and other institutional lenders whose liquidity had been sharply reduced over most of the year. By the fourth quarter of 1966, the volume of funds raised in credit and equity markets by businesses had declined to a seasonally adjusted annual rate of less than $27 billion, and cor-

6 | Nonfinancial businesses borrow more in 1966 by issuing more securities



Flow of funds data. Includes domestic corporate and noncorporate (including farm) nonfinancial businesses. Funds raised exclude trade debt and miscellaneous liabilities. Bank loans include acquisitions of commercial paper and domestic acceptances. Data for 1966 are preliminary.

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porations resorted to drawing heavily on their low stock of liquid assets. The sharp reduction in seasonally adjusted liquid asset holdings in the second half more than wiped out the increase in holdings over the first half. This was the first time since 1956 that holdings of liquid assets by corporations were reduced significantly in a year of economic expansion.

All of the 1966 increase in external financing by nonfinancial business was accounted for by issues of corporate bonds and stocks, which rose to a record $11 billion. Earlier in the expansion, bank loans and mortgages had provided the predominant share of funds raised by business in credit and equity markets. But the increased volume of external financing in 1966, coupled with reduced availability of credit at financial institutions, shifted a greater share of business credit demands into the securities market. Bond issues were nearly double the 1965 volume, and net stock issues—despite some large retirements—provided considerably more funds than in most other recent years.

For 1966 as a whole, businesses borrowed less at banks than they had in 1965, when bank borrowing had accounted for all of the increase in external financing. In the first half, already heavy business demands on banks were inflated by accelerated tax payments, and banks were able to grant loans to businesses at a rapid rate by liquidating securities, reducing credit supplied to other borrowers, and by aggressively seeking time deposits. After midsummer, however, business loans of banks expanded less rapidly as demands abated and as the availability of bank credit to businesses shrank in consequence of the drying up of time deposit inflows, the erosion of bank liquidity, and the continuing pressures on bank reserve positions.

Federal Government. The Federal Government increased pressures on financial markets in 1966 both directly and indirectly. By accelerating tax payments and increasing defense orders, this sector contributed greatly to the increased financing needs of businesses. And by expanding issues of direct and agency securities and of participation certificates, it sharply increased

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its own borrowing in credit markets. On the other hand, the Federal Government also expanded the amount of funds it supplied to credit markets, mainly by increases in its acquisitions of mortgages.

The Government's cash deficit rose to $5.7 billion in the calendar year 1966, the highest level since 1961. The step-up of $12 billion in defense outlays accounted for more than one-half of the $23 billion increase in total Federal cash payments.

Tax receipts also rose to a record level during the year. The rapid growth of the economy accounted for a large share of this increase, but an estimated $6 billion of the almost $22 billion rise in receipts resulted from the acceleration in tax payments. The January 1 increase in social security taxes and institution of medicare taxes at midyear accounted for another $5.5 billion.

The types of securities issued by the Government and the size of its borrowings were affected by the legal limits on the size of the debt, the rate ceiling on U.S. Government bonds, the pattern of receipts, and the increasing tension in financial markets that developed in the spring and culminated in the late summer and early fall. The 4¼ per cent interest ceiling on Treasury bonds maturing in over 5 years precluded the issuance of any direct long-term debt, and a substantial part of the lengthening in average maturity of the debt that had been achieved during the previous 6 years was erased. Late in the year the outstanding debt approached its statutory ceiling, and at times the Treasury's operating balance reached low levels. In early December the Treasury borrowed $169 million directly from the Federal Reserve over one weekend.

During 1966 the Federal Government was a net seller of $10.0 billion of securities, more than twice as much as in 1965. This borrowing included a moderate amount of marketable direct debt—$3.4 billion, all with maturities of less than 5 years; a record volume of direct agency issues—$5.1 billion; and unusually large net sales of participation certificates in pools of Government financial assets—$1.5 billion.

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TABLE 4

U.S. TREASURY FINANCE AND TRANSACTIONS IN MARKETABLE OBLIGATIONS

(In billions of dollars)

Item	Calendar year 1965					Calendar year 1966				
	I	II	III	IV	Total	I	II	III	IV	Total
U.S. TREASURY FINANCE										
Cash receipts	30.7	37.7	29.2	25.8	123.4	33.3	46.2	34.6	31.1	145.1
Cash payments	28.3	32.6	33.1	34.0	127.9	34.6	36.2	41.3	38.8	150.9
Cash surplus, or deficit (−)	2.4	5.1	−3.9	−8.1	−4.5	−1.3	10.0	−6.7	−7.7	−5.7
Less: Change in cash balance	2.0	3.1	−4.3	−2.3	−1.4	−.1	6.6	−4.1	−2.5	−.1
Equals: Net cash borrowing, or repayment (−) [1]	−.5	−2.0	−.4	5.7	2.9	1.0	−3.7	2.4	5.1	4.8
TRANSACTIONS IN U.S. GOVERNMENT MARKETABLE OBLIGATIONS										
Net issues of:										
Direct marketable debt	.1	−3.8	−.3	6.2	2.2	.5	−6.0	2.6	6.3	3.4
Direct agency debt	*	1.1	.4	.2	1.7	.9	2.6	.8	.8	5.1
Plus: Net issues of participation certificates [2]	.....	−.2	.5	.1	.4	.4	1.7	−.6	.....	1.5
Less: Official purchases, or sales (−):										
By Government agencies and trust funds:										
Direct marketable debt	.5	−.3	.8	.2	1.2	.1	−.1	.5	.7	1.2
Direct agency debt	.....	.....	.....	.....	.....	.....	.....	.5	.8	1.3
By Federal Reserve System [3]	1.0	1.4	.9	.7	4.0	.3	1.4	.7	.7	3.2
Equals: Net Federal marketable and agency obligations acquired by public	−1.4	−4.0	−1.1	5.6	−.9	1.4	−3.0	1.1	4.9	4.3

[1] Net cash borrowing is less than the cash deficit minus the change in cash balance by the amount of seignorage. Net cash borrowing or repayment is made up of issues of direct marketable and agency debt and of nonmarketable debt, less purchases (or plus sales) of direct marketable and agency debt by Government agencies and trust funds.

[2] Included in cash payments of the Federal Government as a negative expenditure. Data include Export-Import Bank certificates, which are not as broadly marketable as other participation certificates.

[3] Excludes repurchase agreements.

* Less than $50 million.

NOTE.—Data are not seasonally adjusted.

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Sales of these types of securities were relatively large in the first quarter of the year. But with the expanded receipts resulting from acceleration of tax payments and the seasonal rise in tax receipts, the Federal Government reduced its outstanding debt in the second quarter. The entire decline, however, was in direct marketable debt; agency and PC debt rose sharply. The unprecedented volume of new issues of PC's and agency securities contributed importantly to the rise in money market rates and the congestion in capital markets. To ease these conditions, Treasury investment accounts began after midyear to make large purchases of agency securities, and after September the Government refrained from selling new PC's. With sales of agency securities and PC's reduced, the Treasury drew down its cash balance in the second half and stepped up its sales of direct securities as shown in Table 4.

Purchases by Treasury investment accounts and the Federal Reserve absorbed more than one-half of all net new issues of U.S. Government direct, agency, and PC debt during 1966. However, private financial markets still had to absorb over $4 billion of Federal obligations, a considerable turnaround from the liquidation of almost $1 billion of such securities by the public in 1965. In addition, many large institutional investors were heavy net sellers of Federal Government obligations during 1966. As a result consumers absorbed, at rising yields, a record amount of U.S. Government securities—over $7.5 billion.

The Federal sector sharply increased its extensions of credit to financial markets in 1966, mainly to alleviate pressures in mortgage markets. It purchased record amounts of mortgages in the secondary market as shown in Table 5 and increased its lending to savings and loan associations, a major source of mortgage credit to the public. While increased inflows of funds to nonbank institutions in late 1966 sharply reduced the need for these operations, credit extensions of the Federal Government for all of the year exceeded its net demand on private financial markets by a substantial margin. However, while Federal credit operations

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served mainly to make funds available to one particular market, Government borrowing tended to add considerable pressure to financial markets in general, with the result that the Federal Government remained an important factor in the general upward movement in interest rates over most of 1966.

TABLE 5

ACQUISITIONS OF CREDIT MARKET INSTRUMENTS BY U.S. GOVERNMENT
(In billions of dollars)

Item	Calendar year			1966, by quarters[1]			
	1964	1965	1966	I	II	III	IV
Mortgages	.3	1.0	3.5	4.6	4.1	3.1	2.4
Loans—Total	3.5	3.7	3.9	6.7	5.8	3.3	−.1
To savings and loan assns.	.5	.7	.9	2.8	2.3	1.1	−2.5
To all businesses	.9	1.0	1.0	1.7	1.0	.9	.7
To others[2]	2.1	2.0	2.0	2.2	2.5	1.3	1.7

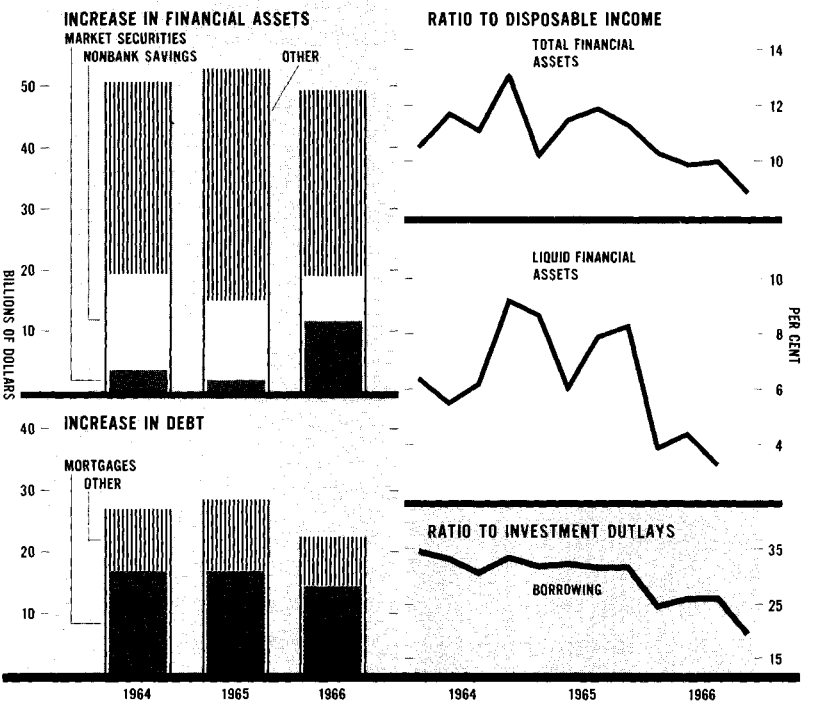
[1] Quarterly totals at seasonally adjusted annual rate.
[2] Loans to consumers, State and local governments, and foreigners.
NOTE.—Flow of funds data. Data for fourth quarter of 1966 are preliminary.

Consumers. The increased volume of securities offered by corporations and the Federal Government, the reduced pace of acquisitions of Treasury issues by financial institutions, and restrictive monetary policy led to a sharp rise in the yields on market securities over the first three quarters of 1966. Reacting to these higher yields, consumers purchased a record $11.5 billion of securities over the year, more than four times the amount they acquired in 1965. Most of the increase represented purchases of Federal, State, and local government obligations.

The larger purchases of open market securities by consumers apparently were made at the expense of their money holdings and their acquisitions of deposits and shares at financial institutions. The increase in their time and savings deposits at commercial banks was somewhat less rapid than in 1965, and the increase in their deposits and shares at nonbank institutions was only a

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7 CONSUMERS increase their purchases of securities, while acquiring fewer financial assets and borrowing less



Flow of funds data. Consumer sector includes nonprofit institutions. Increase in total financial assets excludes investment in noncorporate business and net security credit, with security credit subtracted from market security acquisitions. Mortgages are 1- to 4-family and other. Liquid financial assets are money, deposits at commercial banks and other financial institutions, U.S. savings bonds, and short-term marketable U.S. Govt. securities, all less security credit. Borrowing/investment ratio is consumer borrowing by mortgages, consumer credit, and bank and other loans (except security credit) divided by value of residential construction, nonprofit plant and equipment outlays, and outlays for consumer durable goods. All ratios based on quarterly totals at seasonally adjusted annual rates. Data for fourth quarter of 1966 are preliminary.

little more than half that of the previous year. Indeed, the proportion of financial asset acquisitions allocated by consumers to nonbank deposit-type claims was the smallest in the postwar period. In the last quarter of the year, however, when market yields began to decline and many financial institutions took advantage of new regulations to raise their offering rates, consumers stepped up their acquisitions of nonbank deposits and

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shares and reduced their purchases of market securities. Their acquisitions of time and savings deposits at banks continued to slow, in part because many banks were required to lower their deposit rates in compliance with the lower rate ceilings on time deposits enacted in September.

Despite record purchases of market securities, total acquisitions of financial assets by consumers declined in 1966. One reason was that their disposable income grew at a slower rate. Personal incomes continued to mount as fast as in 1965, but higher social security taxes and increased withholdings of income taxes cut deeply into this growth. Another factor was that the supply of consumer credit—particularly mortgage credit—was reduced and consumers had to finance a larger share of their outlays out of income; they were thus left with smaller amounts of surplus funds to put into financial assets. Indeed, the proportion of consumer expenditures for durable goods and housing financed on credit was the smallest since 1961.

Instalment credit outstanding increased by $6.1 billion, or about three-fourths of the record amount in 1965. Much of the reduction in growth was in automobile credit, but the expansion in personal loans and repair and modernization loans was also more moderate. The slowdown was most noticeable in the spring and fall, times of relative weakness in consumer demands for automobiles and other durable goods. In addition, as the supply of credit available to them became more limited and the cost greater, consumer credit lenders adopted increasingly restrictive lending policies; they screened credit applications more carefully, and they raised charges on many types of consumer loans.

State and local governments. In 1966 net new issues of securities of State and local governments rose somewhat less than in 1965. Their gross issues of long-term bonds were about the same as in the previous year—the first time since 1960 that the volume of such issues did not register a significant year-to-year

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increase—and their short-term issues contracted. The failure of long-term issues to exceed the 1965 pace reflected the higher level of interest rates; some interest-sensitive borrowers voluntarily postponed issues, while others were forced to defer financing because of statutory and other interest rate limitations. However, funds raised to finance new construction actually rose by 5 per cent in 1966, and only the much smaller volume of refunding issues kept total gross long-term issues from rising above the 1965 level.

The sharp cutback in short-term financing by State and local governments reflected chiefly the rapid increase in tax receipts and Federal grants-in-aid, which not only sharply increased the surplus of these governments but also reduced their need to borrow in anticipation of tax revenues. The increased revenues also help to explain why State and local government postponements of long-term borrowing did not appear to necessitate the substitution of short-term funds for financing construction projects under way.

The increase in financial assets administered by State and local governments, including those related to employee retirement systems, was only moderately larger than in 1965. However, in response to higher yields, these funds were used mostly to buy corporate securities, providing support to the market in a year of record offerings.

Rest of the world. Pressures on domestic financial markets in 1966 tended to restrain outflows of U.S. private capital, to increase inflows of foreign funds to U.S. financial markets, and to change the composition of assets acquired by foreigners.

The reflow of bank funds from abroad was an important factor in holding down net outflows of U.S. private capital. Bank credits to foreigners in the form of loans and acceptances, after expanding by a record $2.1 billion in 1964 and by $300 million in 1965, declined by more than $200 million in 1966. Long-term foreign credits by U.S. banks fell substantially, as repayments and

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amortization of earlier credits exceeded new disbursements; short-term credits to foreigners showed a small increase.

Relatively unfavorable terms available in this country to foreign borrowers in 1966 reinforced the cooperative efforts of U.S. banks under the VFCR program. When new guidelines for banks were issued in late 1966—as described on pages 37–42—outstanding foreign credits by U.S. banks were more than $1 billion below the target ceiling that had been established in December 1965. In addition, foreign private investors increased their purchases of securities offered abroad by U.S. companies to finance foreign direct investments in a manner consistent with the voluntary program of the Department of Commerce.

The net total inflow of foreign capital, liquid and nonliquid, amounted to almost $3 billion in 1966. Foreign official holders' claims on the United States were reduced. But dollar borrowings by U.S. banks through their foreign branches from foreign depositors exceeded $2½ billion. These borrowings reflected efforts by large domestic banks to supplement their financial positions by drawing on the Euro-dollar market, particularly at those times when they faced slow growth, and then declines, in their total time deposits after midyear.

The composition of foreign dollar asset acquisitions in the United States changed considerably in 1966. In part as a result of changes in yield relationships, foreign holders and international institutions liquidated more U.S. Government obligations than in any other postwar year and increased their holdings of other credit market instruments—mainly time deposits with maturities of more than 1 year and Federal agency issues—at a record rate.

The U.S. gold stock declined by $571 million in 1966—of which foreign purchases accounted for $430 million net, about one-third as much as in 1965. The gold outflow was held down by the high yields available on dollar assets—both in this country and in the Euro-dollar market—which induced foreign private investors to hold dollars that might otherwise have accrued to foreign central banks.

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FINANCIAL INTERMEDIATION

In 1966, the public's increased purchases of market securities and reduced acquisitions of claims on financial institutions limited the ability of these institutions to extend credit. As a result, the share of all credit supplied by financial institutions declined sharply.

Nonbank financial institutions. Financial institutions other than commercial banks added about one-fifth less to their assets in 1966 than they had in 1965, and their share of total funds supplied to credit markets declined to the lowest level of the postwar period. Virtually all of the reduction in asset growth occurred at depositary-type institutions—chiefly savings and loan associations, but also mutual savings banks. At life insurance companies, changes in interest rate relationships influenced the composition of assets acquired, but because of the contractual nature of their net savings inflows, their total asset growth was little affected. For the same reason, growth of assets in pension funds was not significantly affected.

Depositary institutions. The much smaller inflows to nonbank depositary institutions in 1966 reflected, on the one hand, high and rising yields on market instruments and continued aggressive competition of commercial banks, and on the other, a general reluctance or inability on the part of these institutions to raise rates on their own deposits and shares. The latter stemmed largely from the relatively fixed returns and long-term character of their investment portfolios—which had been acquired when rates were generally appreciably lower and which inhibited these institutions from raising rates paid on claims. In addition, during much of the year savings and loan associations were further constrained from raising rates by regulatory restrictions on Federal home loan bank advances. Under these circumstances, claims on nonbank institutions became increasingly less attractive than market instruments during the first three quarters of the year, and public acquisitions of savings and loan shares and mutual savings bank deposits were sharply reduced.

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As investors shifted to higher-yielding financial assets, dollar inflows at savings and loan associations in 1966 dropped to the lowest volume since 1952, and inflows at mutual savings banks dropped to the smallest level since 1961. Inasmuch as these two types of institutions generally account for more than one-half of all new residential mortgage credit, this reduction in their net inflows of funds caused a sharp reduction in supplies of mortgage credit and a consequent further marked increase in interest rates on mortgages. While other factors were also involved, these unfavorable financial conditions contributed to a substantial decline in the volume of new mortgage commitments and in housing starts in 1966.

During the first quarter of 1966 seasonally adjusted net inflows of funds to savings and loan associations declined to the lowest amount in almost 10 years. Then in April there was a very large net withdrawal of share capital following the crediting of March dividends. Until this point, the associations had generally maintained loan commitments at their earlier levels despite the decline in first-quarter inflows. However, the April experience caused them to reduce new loan activity abruptly, for it indicated not only that the associations were overcommitted in relation to current savings flows but also that net inflows were likely to deteriorate further, particularly in July when share capital withdrawals normally reach a seasonal peak.

At midyear—subsequent to a Federal Home Loan Bank Board decision to relax its earlier restrictions on advances to associations that raised their rates—some associations raised their dividend rates. But in spite of this action, competitive pressures on interest rates led to a record volume of aggregate withdrawals of share capital in July. Because of the April withdrawals and the generally reduced pace of new inflows, share capital at savings and loan associations showed the smallest seasonally adjusted second-quarter increase since the late 1940's; and in the third quarter, which included large withdrawals in July, the increase was the smallest postwar quarterly expansion experienced by the industry.

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In the face of heavy gross withdrawals, savings and loan associations increased their borrowing at the Federal home loan banks to a record amount. However, to avoid adding to pressures in capital markets by further increases in its own borrowing, the Federal Home Loan Bank Board felt constrained to husband the banks' lending power so that they would be in a position to cover withdrawals at member associations. For this reason, advances for purposes of expanding mortgage credit had to be dis-

TABLE 6

NONBANK DEPOSITARY INSTITUTIONS:
NET INFLOWS AND NET MORTGAGE ACQUISITIONS
(In billions of dollars)

Item	Calendar year			1966, by quarters[1]			
	1964	1965	1966	I	II	III	IV
Mutual savings banks:							
Savings deposits	4.2	3.6	2.6	2.8	1.0	3.0	3.8
Mortgage acquisitions	4.4	4.1	2.8	3.0	2.0	3.0	3.1
Savings and loan assns.:							
Savings shares	10.6	8.4	3.5	5.7	1.7	1.2	5.6
Mortgage acquisitions	10.4	8.9	3.6	8.3	5.1	.5	.7
Memo: Borrowing from FHLB	.5	.7	.9	2.8	2.3	1.1	−2.5

[1] Quarterly totals at seasonally adjusted annual rates.

NOTE.—Flow of funds data. Mortgages are 1- to 4-family and other. Data for fourth quarter are preliminary.

continued after early spring; in addition, member associations were required to draw down their liquid assets before they could borrow from the system against share capital withdrawals. With loanable funds from both the public and the home loan banks thus constricted, new loan commitments by savings and loan associations were at very low levels throughout the summer and early fall. By the end of the third quarter, with the backlog of outstanding commitments worked down, new mortgage acquisitions by savings and loan associations were no larger than the amounts received as repayments.

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Like savings and loan associations, the nation's mutual savings banks experienced sharp declines in deposit growth during 1966. However, reduced inflows were neither so severe nor so prolonged. Growth in seasonally adjusted savings deposits slowed sharply in the first quarter, and a record net outflow in April, followed by slow growth in May and June, reduced the seasonally adjusted second-quarter net inflow to the lowest level since late 1959 and early 1960. Early in July, however, most large savings banks increased their dividend rates to 5 per cent, and net inflows of funds increased.

While reduced net inflows at savings banks led to some reduction in mortgage commitments and acquisitions, these declines were less severe than at savings and loan associations. The ability of the mutual savings banks to better maintain their mortgage acquisitions reflected not only their deposit experience but also their more diversified portfolios, which permitted them to liquidate other securities in order to limit the reduction in their mortgage lending.

In late September the Federal Home Loan Bank Board, operating under new legislative authority, and the Federal Deposit Insurance Corporation established ceiling rates on deposits and shares for the first time. These ceilings, by modifying previous regulations on Federal home loan bank advances, permitted many savings and loan associations to raise their dividend rates. By that time market rates of interest had reached their peaks and had begun to decline, and rates on consumer-type time deposits at a number of the more aggressive commercial banks had been rolled back from 5½ to 5 per cent. As a result of these developments, growth of share capital at the savings and loan associations improved substantially during the fourth quarter, and savings bank deposits also increased more rapidly.

At first, savings and loan associations used their enlarged savings flows mainly to repay borrowings from the Federal home loan banks and to rebuild liquid assets. Savings banks also added to their depleted liquid assets. By the year-end, however,

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some savings and loan associations were beginning to make new loan commitments more freely, and savings banks had resumed a more nearly normal mortgage lending pattern, thus contributing to a generally improved tone of the mortgage market.

Other institutions. Insulated by the contractual nature of their cash inflows, life insurance companies acquired as many financial assets in 1966 as in the previous year, despite the pressures on financial markets. However, the effects of higher interest rates and general credit restraint caused some unexpected drains on the supply of lendable funds available to these companies.

For example, most life insurance companies are committed to extend policy loans at rates no higher than 5 per cent. Thus, as rates on other forms of credit were increased and the availability of credit was reduced, policy loans became an attractive means of borrowing. These loans grew from less than 5 per cent of the lendable funds at life insurance companies in the fourth quarter of 1965 to nearly 20 per cent in the third quarter of 1966; at some institutions the rate of expansion was even more rapid. Because these companies generally make loan commitments far in advance, on the basis of normally predictable projections of cash availability, the rate of increase in policy loans in 1966, and the large potential for still further increases, created widespread concern among life insurance company officials.

A decline in mortgage prepayments also reduced the volume of cash available to meet commitments below expected levels. This change reflected the reduced turnover of existing homes and the smaller volume of refinancings caused by the tight mortgage market. In addition, withdrawals of policy proceeds that had been left on deposit with life insurance companies increased as the public took advantage of the higher yields available on market securities. Life insurance companies were thus forced to draw down cash balances, liquidate securities, reschedule mortgage acquisitions, borrow at banks, and stretch out new commitments to prepare themselves for meeting takedowns on large outstanding obligations.

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The easing of tensions in financial markets in the fourth quarter also reduced these pressures on life insurance companies. Increases in policy loans tapered off, and the supply of funds immediately available came into better balance with takedowns on outstanding commitments. By the year-end some companies had again begun to increase loan commitments.

As would be expected, inflows to other types of insurance companies and to pension funds were not greatly affected by rising interest rates. However, finance companies—confronted with record borrowing costs and reduced availability of bank credit, as well as some cutback in consumer demands for credit —added only a little over $3 billion to their loans, considerably less than the record increase in 1965. For 1966 as a whole, finance companies reduced their bank debt for the first time since 1960, and they raised a record $3.2 billion through the sale of open market paper.

Commercial banks. In 1966, commercial banks provided almost $17 billion of credit, or less than one-fourth of total funds supplied to credit and equity markets—their smallest share since 1959. The decline in the bank share from an average of more than one-third in the 1961–65 period reflected mainly the reduced demand by the public for time and savings deposits associated with their increased purchases of securities.

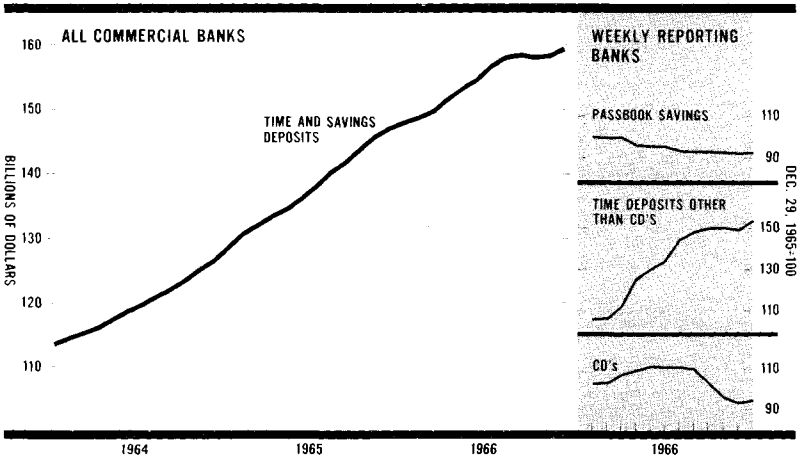
Time deposits. From the end of 1961 through 1965 net inflows of time and savings deposits to banks had increased at an average annual rate of 15 per cent, in large part because four increases in Regulation Q ceilings permitted banks to maintain relatively attractive offering rates on such deposits. During the first 8 months of 1966, as banks took advantage of the higher rate ceilings on time deposits established in December 1965, their time and savings deposits continued to increase, but at a somewhat slower annual rate—11 per cent.

While the slowing of inflows was modest during January–August, the composition changed dramatically. After the prime rate was raised to 5½ per cent in March, large banks began

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aggressively to seek negotiable CD's in large denominations. During the first half of 1966, banks increased their outstanding CD's by $1.6 billion, most of which occurred after mid-March. But with the cost of CD's rising sharply and with the ceiling rate on passbook savings accounts unchanged, banks turned increasingly to other forms of time deposits—especially those designed for consumers.

8 | TIME DEPOSIT growth slows in '66 and COMPOSITION OF NET INFLOWS changes sharply



Total time and savings deposits are seasonally adjusted monthly averages of daily figures and exclude domestic interbank and U.S. Govt. deposits. Data have been adjusted to eliminate the effect of a reclassification of deposits in June 1966. Data for weekly reporting banks are as of the last Wednesday of each month, and are not seasonally adjusted. The effect of a change in the reporting panel of weekly reporting banks at the end of June 1966 has been eliminated by subtracting from figures for each of the last 6 months the difference between the two sets of data at midyear.

At the large weekly reporting banks, consumer-type CD's began to rise sharply in early 1966 as banks offered higher rates on small-denomination time deposits. Passbook savings accounts, on the other hand, with their less attractive yields, declined abruptly because the more interest-sensitive depositors shifted their funds to other financial assets. Indeed, a large proportion of the growth of consumer time deposits resulted from shifts out of

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passbook savings accounts. Banks were not able to maintain their share of the consumer savings market by issuing time deposits, however, because consumers increasingly shifted their savings flows to direct purchases of market securities; at large weekly reporting banks the combined inflow of savings deposits and consumer-type time deposits generally remained below the pace of 1965.

In the late summer, inflows of interest-bearing deposits to banks slowed considerably, particularly at the large banks, which had been large issuers of CD's. As early as midyear, typical offering rates on 90-day CD's had reached the 5½ per cent ceiling, and CD growth ceased as banks replaced their maturing paper with 30- to 90-day maturities. However, by early August, rates on these shorter-term deposits had also reached 5½ per cent, and with yields on other money market instruments above the ceiling rate, banks found themselves unable to replace all of their maturing paper. Between mid-August and mid-December banks lost $3.2 billion of large-denomination CD's, mainly in September and October. It was to supplement their resources and to help offset this outflow that large banks in the second half of 1966 borrowed more than $2 billion through their foreign branches—mainly in Euro-dollars.

Over the period that large banks were losing negotiable CD's, inflows of consumer-type time deposits slowed—and some banks had net outflows. The development reflected both the late September rollback to 5 per cent of ceiling rates on time deposits below $100,000 and the movement of some funds into longer-term market instruments with higher yields.

As a result of outflows of negotiable CD's and the moderation in other time deposit inflows, the seasonally adjusted annual rate of growth of total interest-bearing deposits at all commercial banks (excluding the funds obtained through foreign branches) slowed. Growth during the 3 months September–November was at an annual rate of less than 1 per cent; in fact such deposits declined in October—for the first time since 1960. Large banks

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lost deposits during the 3 months. But the smaller country banks —with fewer interest-sensitive depositors—continued to attract total time and savings deposits at the 10 to 11 per cent rate prevailing earlier in the year—only slightly below the 1965 pace.

In December, rapidly declining market yields restored the relative attractiveness of time deposits, and these deposits rose at a seasonally adjusted annual rate of 9.1 per cent. Despite a record $5.6 billion of CD maturities during the month, banks were able to add to their outstanding negotiable CD's; their consumer-type time deposits also rose somewhat.

Bank credit. Continued relatively large inflows of time deposits permitted banks in the first half of 1966 to expand credit at a rate only slightly below their postwar record pace of over 10 per cent in 1965. In the second half of the year, as time deposit inflows moderated—and monetary policy became more restrictive until fall—bank loans and investments expanded at a much slower pace. For all of 1966, bank credit expanded about 6 per cent, a little more than half the pace in 1965, and banks reduced their total holdings of securities for the first time since 1959.

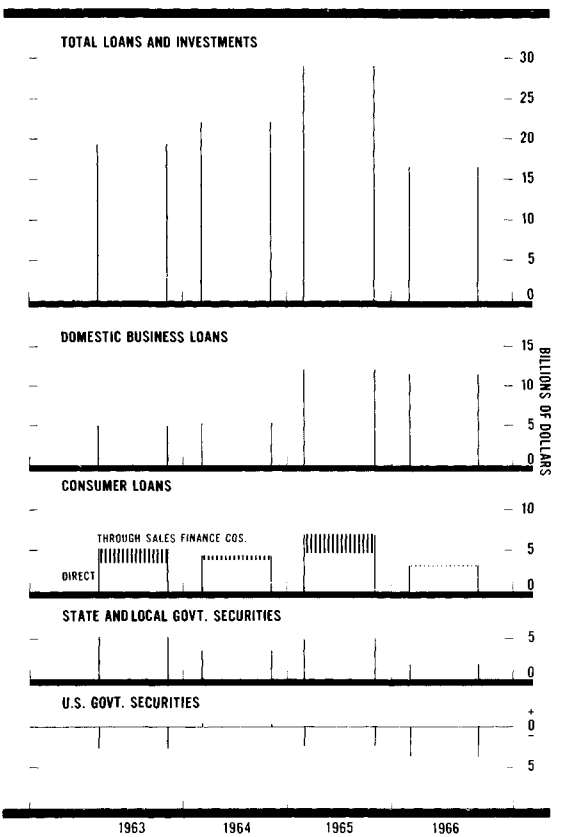
Over the first 7 months of the year, with business demands for credit large, and with time deposit inflows relatively well maintained, banks increased their business loans at an annual rate of more than 20 per cent, despite three increases in the prime rate over this period. These demands for credit reflected the large and rising external financing requirements of businesses, and borrowing in anticipation of more severe credit stringencies and to help finance acceleration in tax payments. Demands were generally broad-based but were particularly strong on the part of manufacturers of machinery and transportation equipment—a group under great pressure from the accelerated pace of capital outlays and/or defense expenditures.

Despite the large inflows of time deposits, banks found it increasingly necessary to cut back on additions to other parts of their portfolios in order to maintain this rate of business loan expansion. Treasury issues were liquidated, but requirements that

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these securities be held against public and other deposits and the already low levels of holdings of Government securities limited the ability of many banks to liquidate enough of these issues to accommodate the intense business loan demands. Consequently, large banks reduced the rates at which they were acquiring State and local bonds and expanding nonbusiness loans; they also raised their standards for business and other credits.

9 | BANK CREDIT expands less rapidly in 1966



Flow of funds data. Business loans are to all domestic nonfinancial businesses and include commercial paper and domestic acceptances. Consumer credit includes loans to, and purchases of commercial paper issued by, finance companies. U.S. Govt. securities include nonguaranteed debt of the U.S. Govt. and loan participation certificates.

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After midyear, business demands for loans apparently remained large, and with time deposit inflows leveling off, banks again raised the prime rate—to 6 per cent—in August. In addition, large banks became sellers of tax-exempt and agency securities and reduced their loans to finance companies. Large money market banks also cut back on their loans to security dealers by raising interest charges to very high levels. Bank loans to foreigners were also reduced over the year.

These adjustments in bank portfolios had a large impact on key credit markets. For example, banks' net acquisitions of State and local government bonds—which on the average had equaled about 75 per cent of the net volume of new issues in 1962–65—declined to 40 per cent of new issues in the first half of 1966 and to less than 20 per cent in the second half. Furthermore, reductions in credit extended by banks to sales finance companies had a significant effect on the banks' share of the total consumer credit market. In terms of their direct loans to consumers, the banks' share of the consumer credit market declined only slightly—from about 50 per cent in 1965 to less than 45 per cent in 1966. But when their credits to finance companies are included, their share of total consumer credit financing declined from almost three-fourths in 1965 to less than one-half in 1966. Banks also reduced somewhat the rate at which they acquired mortgages in 1966. Nonetheless, with total mortgage financing declining, banks accounted for slightly more than the nearly one-fifth of the mortgage market they had in 1965.

These portfolio adjustments contributed to intense financial pressures in some credit markets, particularly during the summer. It was in an effort to reduce these pressures that the Federal Reserve Bank Presidents on September 1 sent letters to member banks requesting them to rely more on curtailment of business loans—and less on other parts of their portfolios—in adjusting to liquidity pressures.

During the late summer and early fall, bank credit declined. As the cumulative impact of monetary policy curtailed deposit

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inflows and eroded bank liquidity and as business demands for credit—including loans to meet tax payments—abated, growth in business loans also slowed substantially. In the final 5 months of the year growth in such loans moderated to an annual rate of less than 5 per cent, compared with more than 20 per cent earlier in the year.

With demands for credit reduced and with signs that the pace of economic expansion was moderating, monetary policy was eased in the late fall. Business loans did not expand, however, and banks began to rebuild their liquidity, an adjustment that is typical of early stages of relaxation of monetary restraint. After mid-November, bank holdings of securities rose sharply. In December, with time deposit inflows rising faster and reserve availability increased, bank loans and investments increased by $2.3 billion, seasonally adjusted—the largest monthly increase since midsummer.

Money stock. In the first half of 1966 the private money stock increased at a seasonally adjusted annual rate of 4.7 per cent—

10 MONEY STOCK increases sharply in first half, declines in second half



Seasonally adjusted monthly averages of daily figures. Money stock consists of demand deposits and currency outside the Treasury, the FR System, and the vaults of commercial banks. Demand deposits exclude those due to domestic commercial banks and the U.S. Govt., cash items in process of collection, and FR float, but include foreign demand balances at FR banks.

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the same as for the year 1965. Reflecting the increased pace of economic activity, the turnover of demand balances at banks outside of New York also rose sharply because of increased efforts to economize on cash in response to rising interest rates.

As interest rates continued to increase after midyear, and then later as industrial production moderated, the money stock declined and the rate of growth of the turnover of demand deposits slowed. From midyear through mid-November the money stock declined at an annual rate of 2.4 per cent. About mid-November the money stock began to increase again—due in part to the downturn in market yields, and in part to a sharp decline in Treasury cash balances; late in the year it rose at a rate of more than 7.0 per cent.

CREDIT MARKETS AND INTEREST RATES

Interest rates rose sharply in the first 8 months of the year and many would-be borrowers—especially in mortgage markets—found their ability to obtain credit reduced. Most interest rates reached their peaks in late summer and then turned down. By the year-end a large share of the year's rise had been erased. Within this general profile, however, interest rate movements were not continuous but showed important temporary deviations from the dominant trend in accordance with variations in supply–demand pressures and expectations.

Early in the year market yields rose steeply. Heavy business demands for credit caused an increase in the number of offerings scheduled in capital markets and contributed to an acceleration in sales of securities by banks. Borrowing by Federal and State and local governments was also large. At the same time, the pace of the rate upswing was intensified by expectations of greater monetary restraint.

Expectations ran ahead of the more basic demand–supply forces until near the end of the first quarter when rates turned down. Much of this decline stemmed from the presumption that

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TABLE 7

SELECTED INTEREST RATES, 1966
(Per cent per annum)

Type of rate[1]	Net change			Level on 12/31/66
	12/31/65 to 1966 high	Date of high	1966 high to 12/31/66	
Short-term				
3-mo. Treasury bill	+1.05	9/23	− .72	4.80
6-mo. Treasury bill	+1.26	9/23	−1.00	4.92
Finance company paper	+1.13	{10/22 to 12/31}	.00	5.88
Federal funds	+1.33	11/16	− .39	5.57
Medium-term				
3–5-year U.S. Govt	+ .93	9/2	− .97	4.86
Long-term				
U.S. Govt	+ .43	9/2	− .33	4.54
Corporate (new issues)[2]	+1.12	9/2	− .47	[3]5.51
Municipal (Moody's Aaa)[4]	+1.00	8/26	− .47	5.83
Conventional mortgages (FHA series, new homes)	+ .70	Oct.-Nov.	− .05	6.65

[1] Weekly averages except for conventional mortgage rate, which is monthly.
[2] Adjusted to an Aaa basis.
[3] Week of Jan. 6, 1967.
[4] Tax-equivalent yield calculated for individuals in the 36 per cent personal income tax bracket.

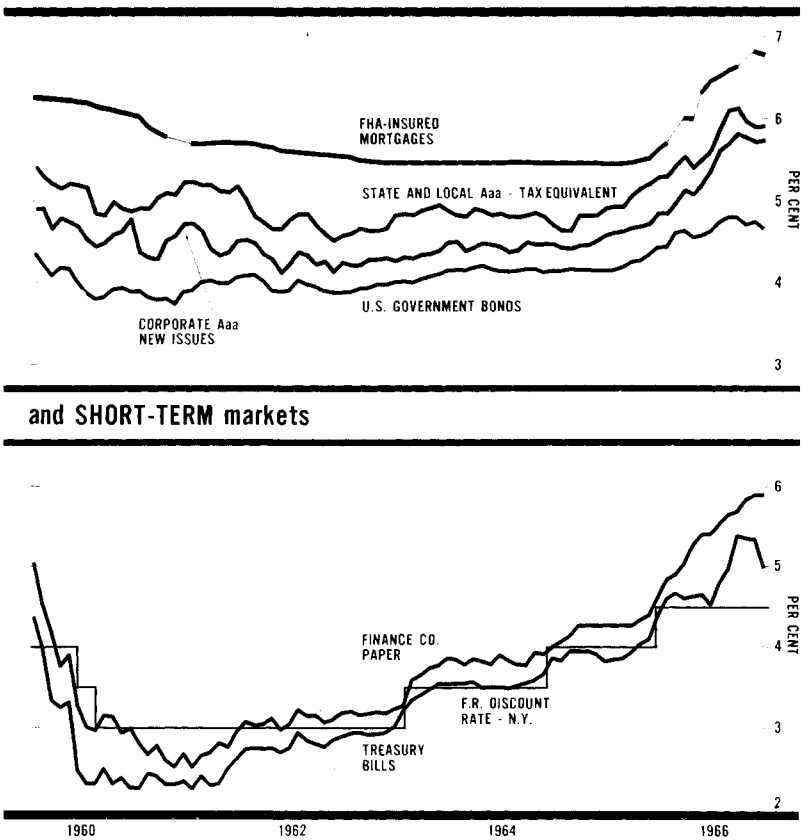
the administration would ask for a Federal tax increase by mid-year. But rate pressures also moderated because of a brief pause in demands for long-term funds and because of scattered signs of slower economic expansion—notably in the auto industry—which led to some readjustment of expectations about the pace of the economic boom.

As the second quarter progressed it became evident that slackness in the economy was limited chiefly to autos and housing and that substantial further growth in aggregate spending could be expected in the third quarter. With business credit demands at new records and with a growing consensus that no tax increase was forthcoming, upward pressures on interest rates were renewed. Efforts of banks to accommodate expanded business loan

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demands—by selling assets, rationing other types of credit, and competing more actively for savings—put special pressures on rates in money and securities markets and spread the effects of growing policy constraints to other types of lenders.

11 INTEREST RATES in 1966 rise steeply until September and then decline in both LONG-TERM and SHORT-TERM markets



Monthly averages of daily figures except for mortgages (based on quotations for 1 day each month). Yields: FHA-insured mortgages, weighted averages of private secondary market prices of certain new-house mortgages converted to annual yield; State and local Aaa—tax-equivalent, from Moody's Investors Service, adjusted to a tax-equivalent basis assuming a 36 per cent individual income tax rate; Corporate Aaa new issues, calculated from bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis; U.S. Govt. bonds, due or callable in 10 years or more; U.S. Treasury bills, market yields on 3-month issues; and finance company paper, 3- to 6-month directly placed paper.

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While the major impact of these influences on other lenders was centered in mortgage markets, there was also a substantial shrinkage in the amount of funds insurance companies had available for private placements. Businesses were thus forced to finance a larger share of their total needs through public offerings of longer-term securities. In addition, the shrinkage in flows to mortgage markets increased pressures on the resources of the Federal Home Loan Bank System and the Federal National Mortgage Association, and in turn greatly expanded the volume of security offerings by these two agencies.

Treasury bill rates, on the other hand, declined during the spring. The resultant widening of spreads between bill rates and other short-term rates—particularly on newly issued short-term offerings of Federal agencies—reflected the very large net reduction—$7 billion—in Treasury bills from March through June. This reduction was possible because normal seasonal inflows of funds were augmented by accelerated tax payments and by sales of PC's.

From the end of June to the end of September, however, Treasury bill rates rose more than 100 basis points. To a large extent, the advance was caused by the expansion in actual financing needs of the U.S. Government—including a $3.5 billion increase in outstanding bills—and in its anticipated needs. As bill rates rose relative to the 5½ per cent ceiling rate on bank CD's, the resulting constraints on bank credit availability caused a further increase in the prime rate to 6 per cent and reinforced the general advance in other short- and long-term rates. In addition, costs of financing made it more difficult and expensive for dealers and underwriters to take positions and thus impeded secondary market trading in securities markets as well as the distribution of new securities. Moreover, with large city banks facing a sizable net runoff of their near-dated CD's and with new loan commitments at some life insurance companies being drastically curtailed, many market partici-

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pants began to wonder whether a serious imbalance might not develop between available funds and prospective credit demands during the autumn.

In these circumstances, money market banks attempted to anticipate expected net runoffs of their CD's in September by liquidating large blocks of municipal securities. At the same time, some large corporations moved to float new security issues in the capital markets in what is usually a slack period of financing. Both actions accentuated interest rate increases and contributed to market fears of a severe credit squeeze.

Expectations again ran ahead of basic supply–demand factors, however, and by early September the steep summer advance in long-term rates began to be reversed. Some of the decline reflected the response of administration policies to the August upsurge in rates—for example, the request for temporary suspension of the investment tax credit, the announcement that nonmilitary Federal spending would be cut, and that Federal agency borrowing from the public as well as further PC sales would be postponed until market pressures abated, and indications that further tax action might be requested to balance potential increases in spending for the Vietnamese war.

After early September several factors reinforced the general decline in bond yields, which by late September began to influence the most sensitive short-term rates as well. These included the reduction in credit demands due in part to previous anticipatory borrowing and evidence suggesting that economic and financial developments in the private sector might not meet earlier market expectations. Some of the decline in rates was temporarily offset in November when a heavy year-end buildup in capital market financing by businesses and State and local governments threatened to combine with usual year-end money market pressures to create renewed financial market stringency. But evidence suggesting that the pace of economic activity might be slowing, and that the Federal Reserve's policy of monetary restraint had

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been moderated, subsequently created market expectations that interest rates would decline further.

In these circumstances, the large volume of capital market offerings in December was quickly distributed at declining rates, and money market conditions eased substantially. By the year-end, Treasury bill rates had erased two-thirds to four-fifths of their rise from the preceding December; long-term bond yields had offset about two-fifths to three-quarters of theirs. At these lower yields, bank CD's and other deposits and shares at financial institutions became more competitive, and flows to financial institutions increased dramatically.

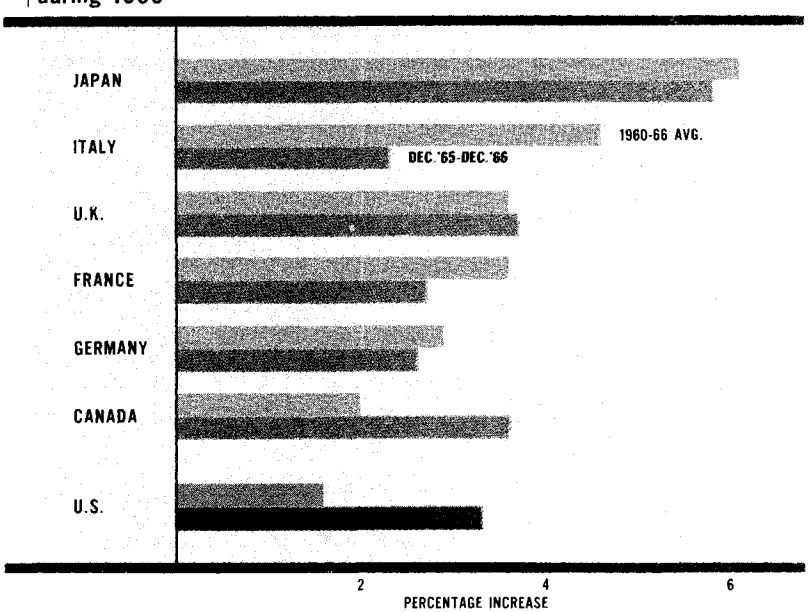
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U.S. BALANCE OF PAYMENTS

War in Vietnam and excessive demand pressures in the domestic economy prevented any significant further adjustment of the U.S. balance of payments toward equilibrium in 1966. A sharp deterioration in the balance on goods and services was offset by an improvement on capital account. But the drain on U.S. monetary reserves continued at a pace that, while slower than in 1965, was more rapid than in the two preceding years.

The net deterioration on current account in 1966 could be attributed in large part to cyclical forces of excess demand that lifted merchandise imports well above trend before they began to level off toward the end of the year. However, a renewed advance in domestic prices and costs, after several years of better price–cost performance in this country than abroad, indicated an interruption of the fundamental competitive adjustment that had been under way earlier.

12 CONSUMER PRICES rise as much in U.S. as in most other countries during 1966



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The capital account benefited greatly from the effects of unusually tight domestic credit conditions, reinforced by the interest equalization tax (IET) and by voluntary programs to restrain net outflows of U.S. capital; it also benefited from some large official transactions. Toward the year-end, when some easing of the credit stringency became appropriate for domestic needs, it became clear that the capital account was in danger of worsening again as the current account improved. Hence, the voluntary restraint programs were tightened and extended through 1967, and in January 1967 the administration proposed a 2-year extension of the IET and greater flexibility in its application.

The over-all payments deficit measured on the liquidity basis remained about unchanged in 1966, $1.4 billion compared with $1.3 billion the year before. U.S. official reserve assets declined by $568 million, and total U.S. liquid liabilities to foreigners and international institutions increased by about $850 million. In addition, however, long-term time deposits of foreign official and international institutions, which are not counted as liquid, increased by about $900 million. And holdings by international nonmonetary institutions of long-term securities of U.S. Government agencies, which are not direct debt of the U.S. Government and which are also classified as nonliquid, increased by about $250 million.

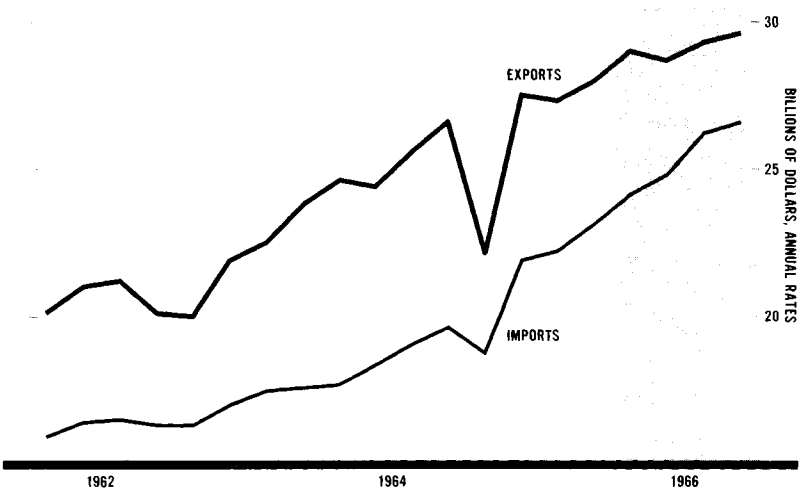
An alternative measure of the over-all balance—on the basis of official reserve transactions—showed a surplus of $0.3 billion in 1966, in contrast with a deficit of $1.3 billion in 1965. The difference between the two balances reflected an inflow of more than $2 billion of foreign liquid funds through the foreign branches of U.S. commercial banks. This record inflow resulted both from intense pressure on the reserve and liquidity positions of large U.S. banks, which led them to bid aggressively for foreign funds, and from the sterling crisis of the summer, which encouraged shifts of funds out of sterling into dollars. By the end of the year, the inflow appeared to have ceased.

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TRANSACTIONS IN GOODS AND SERVICES

The dominant feature of the current account in 1966, as in 1965, was a very rapid rise in merchandise imports. Imports were 19 per cent larger than the year before and 37 per cent larger than in 1964. They would have risen even more if the Government had not released from its stockpiles about $400 million of materials in 1965 and about $900 million in 1966. In each of the

13 MERCHANDISE IMPORTS rise rapidly until late 1966; trade surplus narrows



Seasonally adjusted balance of payments data.

past 2 years, imports increased more than twice as fast as GNP. The 1965–66 import boom was the most rapid and sustained, both absolutely and relative to GNP, since 1950–51. It provided early and persuasive evidence of the emergence and persistence of excessive domestic demand pressures.

The surge in merchandise imports was broadly based. Imports of capital equipment rose very sharply—by 41 per cent in 1965

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and by 64 per cent in 1966—reflecting intense domestic demand and pressures on capacity in that sector. The rise in imports of nonfood consumer goods was also rapid, even excluding the tripling of automotive imports from Canada under the agreement of 1965 between Canada and this country. And imports of industrial materials and supplies, which account for almost half of total imports, increased by 11 per cent despite the substantial releases of materials from Government stockpiles noted earlier; this rise reflected strong domestic demands for additions to inventories as well as for current use.

Exports of merchandise also increased in 1966. The 11 per cent gain over 1965 was high by historical standards, thanks to a further advance in agricultural exports and strong demands for other products by Canada, Japan, and nonindustrial countries. But with imports rising so much faster than exports, the trade balance shrank to $3.7 billion—its lowest level since 1959—compared with $4.8 billion in 1965 and a peak of $6.7 billion in 1964.

There was also a marked worsening during the year in military transactions in goods and services. Military expenditures abroad increased by about $800 million from 1965 to 1966, and by the end of the year they were running at an annual rate of $3.8 billion, compared with a low of $2.7 billion in late 1964 and early 1965. Nearly all of the increase could be attributed to operations in Vietnam, but outlays in Europe still constituted about 40 per cent of the global total. Meanwhile sales of military goods and services increased by only about $100 million to about $950 million.

Income receipts from foreign investments increased very little more than income payments on the investments of foreigners in the United States. The balance on other service transactions—travel, transportation, fees and royalties, and miscellaneous—also remained about unchanged. Travel receipts increased almost as much as travel expenditures.

The balance on all goods and services shrank to about $5.3

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billion, compared with $7.0 billion in 1965 and $8.5 billion in 1964. At the end of the year it was running at an annual rate of less than $5 billion.

FLOWS OF U.S. CAPITAL

Outflows of U.S. private capital—net of investment abroad of funds borrowed abroad for that purpose by U.S. corporations (see below)—declined further in 1966 to about $3.3 billion. This was the smallest outflow since 1959. During the year the unusually tight credit conditions in the United States became the main force limiting outflows. However, the voluntary restraint programs remained effective, particularly in connection with the financing of direct investments, and the IET continued to deter U.S. purchases of foreign securities and extensions of long-term bank loans.

U.S. banks reduced their claims on foreigners by about $160 million during 1966, although the voluntary program would have permitted an increase of $700 million. (The last year prior to 1966 in which U.S. banks reduced their outstanding claims on foreigners was 1953.) Japanese borrowers made substantial net repayments to banks of long- and short-term credits, and European borrowers repaid term loans. Credits to other areas increased only moderately, as U.S. banks adopted an even more restrictive attitude than the voluntary program would have required.

The foreign affiliates of U.S. nonfinancial corporations continued to increase their spending for plant and equipment in 1966, though not so rapidly as in earlier years. But in response to the Commerce Department's voluntary program to limit direct investment outflows of U.S. capital, domestic and foreign affiliates of U.S. corporations borrowed heavily abroad to finance foreign investments, and outflows from the United States net of the use of proceeds of such borrowing declined to about $3.0 billion from a record $3.3 billion the year before.

Purchases by U.S. residents of foreign securities newly issued

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in this country, mainly by Canadian governments and businesses, were smaller in 1966 than in 1965, despite the postponement into early 1966, at government request, of about $150 million of Canadian issues originally scheduled for late 1965. Redemptions of foreign securities held by U.S. residents rose well above the usual level as the Canadian Government redeemed $140 million in advance of maturity—and also purchased bonds of the International Bank for Reconstruction and Development (IBRD) from U.S. holders—in order to fulfill an intergovernmental understanding reached in connection with Canada's exemption from the IET. Finally, U.S. holdings of foreign securities that had not originally been issued in the United States continued to decline, as they had in every calendar quarter since mid-1963, when the IET took effect. Altogether, net U.S. purchases of foreign securities, at about $400 million, were the smallest since 1957.

As the year ended, outflows of U.S. private capital were on the increase. However, the fourth-quarter rise in direct investment outflows may have been only temporary; there was evidence that U.S. corporations, for the first time since 1961, were not planning a large further increase in foreign outlays and that they would continue to seek maximum financing abroad as requested by the Government. It seemed likely, nevertheless, that total outflows could not long remain so far below the long-run trend as they were in 1966 once domestic credit conditions became less tight, although continuation and strengthening of the voluntary restraint programs and the IET insured against a dangerous hemorrhage of the sort experienced in late 1964.

The extension of grants and credits by the U.S. Government to other countries increased by about $400 million in 1966, mainly as a result of larger disbursements by the Export-Import Bank to finance U.S. sales of civilian jet aircraft and military equipment. The United Kingdom made a scheduled year-end repayment on the U.S. loan of 1946—after obtaining waivers

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in each of the two preceding years—and nonscheduled repayments of $430 million were received, mainly from Germany, Italy, and France, as against only $220 million in 1965; as a result the flow of Government grants and credits net of repayments remained about unchanged, at $3.4 billion.

FLOWS OF FOREIGN CAPITAL

Tight money in the United States had even greater effects in 1966 on flows of foreign capital than on flows of U.S. capital. It led to a massive inflow of foreign private liquid funds, which reduced the dollar holdings of foreign central banks and thus tended to reduce U.S. reserve losses and to support the dollar in foreign exchange markets. Tight money also facilitated shifts of U.S. funds by foreign official and international institutions out of short-term deposits and Treasury securities into somewhat less liquid long-term deposits and nonguaranteed U.S. Government agency securities. These shifts had the effect of preventing the large increase in the liquidity deficit that might otherwise have occurred.

The main inflow of liquid funds came from the Euro-dollar market through the foreign branches of large U.S. banks, as noted earlier. Liabilities of U.S. head offices to their foreign branches increased by more than $2 billion during the year; at the year-end they were triple their level at the end of 1965. Half of the inflow in 1966 occurred in the third quarter when U.S. banks were under the most intense pressure to seek alternative sources of funds to meet domestic credit demands.

Major U.S. investors were not free to take advantage of the high Euro-dollar rates because of the strictures of the voluntary programs against such outflows and the policies of the foreign branches not to accept deposits from U.S. residents. And private foreigners, on balance, apparently did not withdraw significant amounts of funds from this country for placement in Euro-dollar accounts; holdings of liquid assets in the United States by private

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foreign residents other than banks increased at about the same pace as in earlier years, and holdings of foreign commercial banks other than branches of U.S. banks did not change appreciably.

Therefore, those foreigners who made Euro-dollar deposits with U.S. branches were mainly using dollars that they had acquired (or would otherwise have sold) in foreign exchange markets for other currencies, or that they had obtained by reducing their outstanding dollar loans to other foreigners, who in turn then had to buy more dollars in the foreign exchange markets. The resulting additions to the demand for, and reductions in the supply of, dollars in foreign exchange markets reduced the dollar accruals and holdings of foreign central banks to levels below those they would otherwise have reached.

The Bank of England in particular lost dollars heavily to the market during the summer, when confidence in sterling was at a low ebb. Even though confidence in sterling began to be restored following the restrictive fiscal and monetary actions taken by the British Government in July, high yields on Euro-dollars tended to slow the return flow of funds into sterling.

Later in the year flows of private funds out of assets denominated in continental European currencies and into dollars helped to reduce or reverse the earlier reserve gains of France and other countries. By the year-end, however, the inflow to the United States from the Euro-dollar market appeared to have ceased, and there were signs that U.S. banks were beginning to make repayments to that market as domestic credit conditions eased.

The acquisition by foreign official and international institutions of a substantial volume of over-1-year time deposits and U.S. Government agency securities was only partly related to interest rate considerations. International institutions, notably the IBRD, have for several years invested the proceeds of their new security offerings in the United States in nonliquid U.S. assets, and they have allowed their liquid assets to decline gradually, so as to minimize the adverse impact of their transactions on the U.S. payments deficit as measured on the liquidity basis.

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In 1966, however, they invested substantially more in nonliquid assets than they borrowed—about $450 million compared with about $100 million.

A number of foreign central banks placed in the United States a total of nearly $750 million in long-term deposits during the year. The outstanding volume of such deposits had not exceeded $200 million at any earlier time. These placements, and the corresponding reduction in more liquid holdings, served to reduce the liquidity deficit; they did not affect the balance calculated on the basis of official reserve transactions. Liquidation of U.S. securities other than Treasury issues by the British Government worked to increase both measures of the deficit, but such liquidations were much smaller in 1966 than they had been in 1965.

Residents of foreign countries other than the United Kingdom made net purchases of about $130 million of U.S. corporate securities (other than those sold to finance direct investments abroad) in 1966, in contrast to net sales of $130 million in 1965.

OFFICIAL RESERVE TRANSACTIONS

The United States had a small payments surplus—$270 million—in 1966 as measured on the basis of official reserve transactions. Yet U.S. reserve assets declined, as noted earlier, by $568 million net. The gold stock was reduced by $571 million; sales of $601 million of gold to France during the first 9 months of the year, of smaller amounts to other countries, and of $140 million to domestic users for industrial and artistic purposes outweighed net purchases, including $200 million from Canada, and gold deposits of $177 million made during the year by the International Monetary Fund. In addition, the IMF gold tranche position of the United States was reduced by $537 million net, as the United States drew foreign currencies from the Fund on several occasions (see pages 269-90). On the other hand, the U.S. Treasury and the Federal Reserve added $540 million

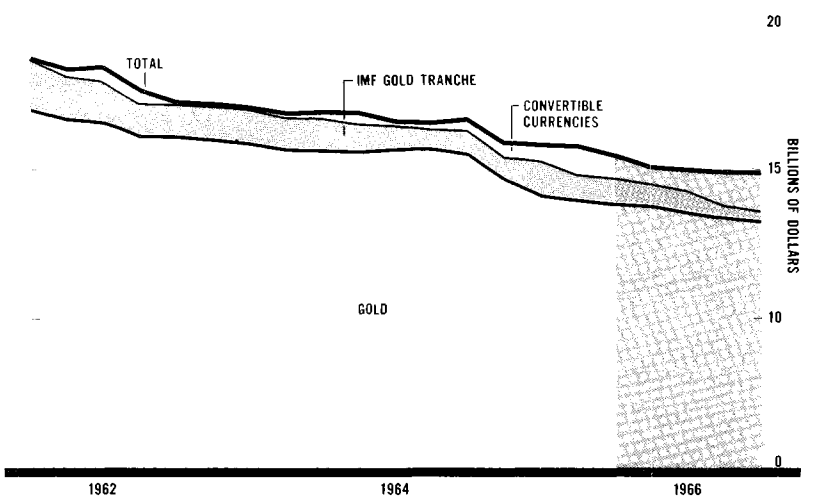
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equivalent to their holdings of foreign convertible currencies during the year.

While U.S. reserve asset holdings declined, U.S. liabilities to foreign official agencies—which constitute an important element in their reserve holdings—declined even more sharply—by $840 million. The decline in liquid liabilities to official holders was considerably greater than this, but there was an increase in certain nonliquid liabilities to foreign central banks and governments, as noted above. The outstanding amount of Treasury securities—some liquid, some nonliquid—denominated in foreign currencies fell from $1,208 million at the end of 1965 to $860 million at the end of 1966.

The favorable balance on the official reserve transactions basis was clearly temporary, depending heavily as it did upon a massive inflow of foreign private liquid funds. At the year-end it appeared that some of these funds were flowing out again as domestic credit conditions eased.

14 U.S. RESERVE ASSETS continue to decline in 1966



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During most of the postwar period, deficits in the U.S. balance of payments have been financed in part by increases in U.S. liabilities to foreign central banks and governments and only partly through declines in U.S. reserves. Thus these deficits have added more to the reserves of other countries than they have subtracted from U.S. reserves.

In 1965, however, this situation changed. In that year the U.S. deficit on the reserve transactions basis was financed almost entirely by a reduction in U.S. reserves. Indeed, the reduction in U.S. reserves exceeded the deficit if the latter is adjusted to take account of declines in U.K. official holdings of U.S. securities, which are not usually included in the calculation (Table 8);

TABLE 8

OFFICIAL RESERVE TRANSACTIONS, 1964–66
(In millions of dollars)

Type of transaction	1964	1965	1966	1964–66
Balance on official reserve transactions basis	−1,546	−1,305	+271	−2,580
Settled by:				
Decline in U.S. reserve assets (increase, −), total	171	1,222	568	1,961
Gold	125	[1, 2] 1,665	[2] 571	[1, 2] 2,361
Convertible currencies	−220	−349	−540	−1,109
IMF gold tranche position	266	[1] −94	537	[1] 709
Increase in U.S. liabilities to foreign official agencies, total [3]	1,375	83	−839	619
Liquid liabilities	1,073	[2] −17	[2] −1,574	[2] −518
Certain nonliquid liabilities [3]	302	100	735	1,137
Memo: Net U.K. sales (−) of U.S. securities other than Treasury issues (including private as well as official sales)	−3	−510	−82	−605

[1] Reflects $259 million payment of gold portion of increased U.S. subscription to the IMF.

[2] Reflects IMF gold deposits with the United States, and corresponding increase in U.S. liabilities to IMF, of $34 million in 1965 and $177 million in 1966.

[3] These liabilities do not include official U.K. holdings of U.S. securities other than Treasury issues; the memorandum item gives some indication of changes in those holdings.

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PART II

Records, Operations, and Organization

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foreign official claims on the United States including U.K. official holdings of securities actually declined in 1965.

This pattern was continued in 1966. Both U.S. reserves and U.S. reserve liabilities declined. Hence the reserve transactions of the United States with other countries had the effect of reducing total world reserves—rather than increasing them as in the years before 1965.

It will be seen from Table 8 that over the past 3 years combined the United States has not significantly increased its reserve liabilities if rough allowance is made for declines in official U.K. security holdings. Reserve assets of the United States have declined by almost the full amount of the cumulative U.S. deficit on the reserve transactions basis during this period. It is this persisting decline in U.S. reserves that gives increasing urgency to the task of restoring payments equilibrium.

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RECORD OF POLICY ACTIONS OF THE BOARD OF GOVERNORS

March 29, 1966

Amendment to Regulation R, Relationships with Dealers in Securities under Section 32 of the Banking Act of 1933.

Effective March 29, 1966, Regulation R was amended to include among the types of obligations excepted in Section 218.2 of the Regulation certificates of interest issued by the Commodity Credit Corporation.

Votes for this action: Messrs. Martin, Robertson, Shepardson, Daane, Maisel, and Brimmer. Votes against this action: None.

Section 32 of the Banking Act of 1933 provides that no officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve at the same time as an officer, director, or employee of any member bank of the Federal Reserve System. However, the statute authorizes the Board of Governors, by general regulations, to except limited classes of relationships from the prohibitions of the statute.

Pursuant to such authority, the Board had heretofore permitted officers, directors, or employees of member banks to serve at the same time as officers, directors, or employees of securities firms dealing only in U.S. Government securities, obligations fully guaranteed as to both principal and interest by the United States, general obligations of territories, dependencies, and insular possessions of the United States, obligations of Federal intermediate credit banks, Federal land banks, Central Bank for Cooperatives, Federal home loan banks, the Federal National Mortgage Association, and the Tennessee Valley Authority; and, subject to

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specifications contained in paragraph Seventh of Section 5136 of the U.S. Revised Statutes, obligations of the International Bank for Reconstruction and Development, the Inter-American Development Bank, public housing agencies, or any local public agency, and obligations insured by the Federal Housing Administrator.

The current amendment to Regulation R added to this list certificates of interest issued by the Commodity Credit Corporation, it appearing to the Board that the certificates were in the same general category as obligations previously listed.

Governor Maisel, while supporting the action, reiterated his preference that the list of exceptions be expanded to include all obligations that member banks are authorized to deal in or underwrite pursuant to paragraph Seventh of Section 5136, including general obligations of States and political subdivisions.

June 24, 1966

Amendments to Regulation D, Reserves of Member Banks, and Regulation Q, Payment of Interest on Deposits.

(1) Effective with the reserve computation periods beginning July 14, 1966, for reserve city banks and July 21, 1966, for other member banks, the Supplement to Regulation D was amended to increase from 4 per cent to 5 per cent the reserve requirement against time deposits (other than savings deposits) in excess of $5 million at each member bank.

(2) Effective September 1, 1966, Regulations D and Q were amended to bring promissory notes, with the exception of certain designated types of underlying transactions, within the coverage of the definition of "deposit."

Votes for these actions: Messrs. Martin, Robertson, Mitchell, Maisel, and Brimmer. Votes against these actions: None.

The reserve requirement action was designed to exert a tempering influence on issuance of time certificates of deposit (CD's) by banks. It also served to apply a moderate additional measure of restraint upon the expansion of loanable funds and thus re-

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inforce the operation of other instruments of monetary policy in containing inflationary pressures.

The effect of the action was to increase required reserves by approximately $350 million at reserve city banks and $70 million at other member banks. However, since the increased reserve requirement was not applicable to savings deposits and applied only to time deposits in excess of $5 million held by any member bank, it appeared that only about 950 banks throughout the country—primarily those issuing savings certificates and other CD's in large volume—would be affected.

The purpose of the action on shorter-term promissory notes and similiar instruments was to prevent the future use of those instruments as a means of circumventing the regulations governing reserve requirements and payment of interest on deposits. The types of promissory note transactions specifically excluded from the expanded deposit definition included Federal funds transactions, interbank borrowings, transfers of assets with agreements to repurchase, and bank notes issued for capital purposes with a maturity of more than 2 years and subordinated to claims of depositors. Although the action was not effective until September 1, 1966, it applied to all promissory notes covered by the action that were issued on or after June 27, 1966, and were outstanding on or after the effective date. Such notes and similar instruments had come into use only in the past few years, and the volume outstanding at this time was relatively small.

July 1, 1966

Credit facilities for nonmember depositary-type institutions.

Effective July 1, 1966, and until September 1, 1966, the Board authorized a program under which the Federal Reserve Banks could make credit facilities available to nonmember depositary-type institutions under certain conditions.

Votes for this action: Messrs. Robertson, Shepardson, Daane, Maisel, and Brimmer. Votes against this action: None.

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Information available to the Board suggested the possibility that during the period ahead some nonmember depositary-type institutions, including mutual savings banks and savings and loan associations, might be subjected to unusual withdrawals of funds. After consultation with the Federal Reserve Banks, the Board concluded that the Reserve Banks should be prepared to provide emergency credit facilities to such institutions in accordance with certain basic principles.

The Board advised the Federal Reserve Banks that in order to provide for prompt implementation of such a program if needed, it had taken the following action, effective immediately and until September 1, 1966:

(a) Member banks in your district are permitted, pursuant to the eighth paragraph of Section 19 of the Federal Reserve Act and Section 201.5 of Regulation A, to use as security for advances from your Bank, whether under Section 13 or Section 10(b) of the Act, assets acquired from mutual savings banks and other banks that are not members of the Federal Reserve System, but only in accordance with, and subject to, specified limitations; and

(b) Your Bank is authorized, in accordance with the third paragraph of Section 13 of the Federal Reserve Act, in unusual and exigent circumstances to discount for mutual savings banks and other depositary-type institutions paper of the kinds described in that paragraph, subject, however, to the limitations therein contained and in accordance with, and subject to, further limitations now specified by the Board.

Although occasion did not arise to use the emergency credit facilities, as a precautionary measure the Board subsequently twice extended the time during which such facilities were authorized, first to December 1, 1966, and then to March 1, 1967.

July 11, 1966

Termination of Regulation P, Holding Company Affiliates—Voting Permits.

Effective as of July 1, 1966, Regulation P was terminated.

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Votes for this action: Messrs. Robertson, Shepardson, Maisel, and Brimmer. Votes against this action: None.

Public Law 89-485, approved July 1, 1966, made numerous amendments, generally of a strengthening nature, to the Bank Holding Company Act of 1956. It also amended Section 2 of the Banking Act of 1933, Section 5144 of the Revised Statutes of the United States, and related statutes so as to eliminate the provisions pertaining to holding company affiliates and the issuance of permits to such affiliates to vote the stock of member banks. Since Regulation P was based on the provisions of law now repealed, the Regulation was terminated effective as of the date of enactment of Public Law 89-485.

July 11, 1966

Amendment to Regulation R, Relationships with Dealers in Securities under Section 32 of the Banking Act of 1933.

Effective July 11, 1966, Regulation R was amended to include among the types of obligations excepted in Section 218.2 of the Regulation securities of the Asian Development Bank.

Votes for this action: Messrs. Robertson, Shepardson, Maisel, and Brimmer. Votes against this action: None.

This amendment reflected the fact that Public Law 89-369, dated March 16, 1966, authorizing participation of the United States in the Asian Development Bank, permitted member banks of the Federal Reserve System to underwrite securities issued by that organization. The effect of the amendment was to allow interlocking relationships between member banks and securities firms dealing in or underwriting the securities in question. The prohibition in Section 32 of the Banking Act of 1933 and the Board's authority to grant exceptions are described in the entry regarding a previous amendment to Regulation R on March 29, 1966.

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July 15, 1966

Disapproval of proposed discount rate increase.

The Board disapproved action taken by the Boards of Directors of the Federal Reserve Banks of New York, Cleveland, Chicago, and St. Louis on July 14 establishing a rate of 5 per cent (an increase from 4½ per cent) on discounts for and advances to member banks under Sections 13 and 13a of the Federal Reserve Act, along with appropriately corresponding subsidiary rates on advances under other sections of the Act.

Votes for this action: Messrs. Robertson, Shepardson, Daane, Maisel, and Brimmer. Votes against this action: None.

(In accordance with provisions of the Federal Reserve Act, the Federal Reserve Banks establish rates on discounts and advances to member banks at least every 14 days and submit such rates to the Board for review and determination. No changes had been made in such rates since those referred to on pages 63-70 of the Board's ANNUAL REPORT for 1965.)

In considering the discount rates established by the several Federal Reserve Banks, the Board was not unmindful of considerations that might have formed a basis for approval. As described in the Record of Policy Actions of the Federal Open Market Committee, published elsewhere in this ANNUAL REPORT, the Committee had been pursuing for several months in the winter and spring a policy of reducing net reserve availability gradually in an effort to resist inflationary pressures. This monetary policy process, together with strong credit demands, had resulted in an upward movement of market interest rates that left the 4½ per cent discount rate substantially out of alignment. This circumstance had led to rather widespread expectations of a discount rate increase and had contributed to market uncertainties.

The directors of the Reserve Banks concerned reasoned that an adjustment of the discount rate would serve as a stabilizing influence. They also believed that a discount rate increase could be helpful in symbolizing continued concern about the persistent deficit in the U.S. balance of international payments and that the

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use of the discount rate instrument, along with other instruments of Federal Reserve policy, was called for to maximize the effectiveness of monetary policy in the absence of greater fiscal restraint, in the form of a tax increase, to limit excessive credit expansion.

For a variety of reasons, however, it was the conclusion of the Board that on balance a discount rate increase was not warranted at this particular time. Those reasons were not necessarily subscribed to *in toto* or accorded equal weight by each of the members of the Board.

There had been a recent international development on which some members placed considerable stress. On the preceding day, announcement had been made of an increase from 6 per cent to 7 per cent in the discount rate (Bank rate) of the Bank of England. This raised the question whether the effect of the British action, designed to strengthen the position of the pound sterling, should be weakened by offsetting action here.

With respect to the domestic situation, some doubt was expressed within the Board as to whether a discount rate increase of one-half of 1 percentage point would be sufficient to quiet prevailing uncertainties, and therefore to provide a stabilizing influence, or whether such an increase might not simply promote speculation concerning the possibility of additional discount rate action. In view of the many strains and crosscurrents prevailing in financial and credit markets, it also appeared possible that the announcement effect of even a modest change in the discount rate could be exaggerated and such action misconstrued, with ramifications extending beyond the intended scope of the action. Further, although the discount rate was lower than usual relative to market rates, it was not evident that this circumstance was hampering the pursuit of a policy of monetary restraint or that it was causing unmanageable problems in the administration of the Reserve Bank discount windows.

Another factor contributing to the Board's decision was the widespread desire to avoid further escalation of interest rates, in-

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cluding those being offered for funds by banks and nonbank financial institutions. Action was being announced today (July 15) by the Board (and also by the Federal Deposit Insurance Corporation) to lower the maximum rates payable by banks on time deposits with multiple maturities, and the Board had only recently raised the reserve requirement against time deposits in excess of $5 million at each member bank. In addition, the Board was even now submitting to the Congress, with a recommendation for prompt action, a legislative proposal to broaden the regulatory power over rate practices of banks and savings and loan associations.

As to the point that an increase in the discount rate could be regarded as primarily a technical adjustment in view of current money market rates, it was suggested that if the discount rate were moved regularly in order to conform to market rates and market expectations, that would tend to reinforce the role of expectations and make them still more dominant. Thus, control of monetary policy would tend to shift from the monetary authority to the market.

Members of the Board noted that, although the preceding reasons weighed against increasing the discount rate at this particular juncture, the rate might usefully be varied from time to time.

The effect of the Board's action was that the rates on discounts and advances contained in the existing rate schedules of the respective Federal Reserve Banks automatically continued in effect.

* * * * *

The Boards of Directors of several Federal Reserve Banks subsequently submitted to the Board of Governors additional proposals, as follows, for discount rate increases. The rates were

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disapproved in each instance for reasons generally similar to those stated above.

Reserve Bank	Proposed rate (per cent)	Date of Board action
Boston	5	July 19
Philadelphia	5	July 22
Minneapolis	5½	August 24
Cleveland	5	August 25
Chicago	5½	August 26
Boston	5	August 30
Philadelphia	5	September 2

July 15, 1966

Amendment to Regulation Q, Payment of Interest on Deposits.

Effective July 20, 1966, Regulation Q was amended to define multiple-maturity time deposits, and the Supplement to the Regulation was amended to prescribe maximum rates of interest on such deposits as follows: 5 per cent on such deposits of 90 days or more and 4 per cent on those of less than 90 days.

Votes for this action: Messrs. Robertson, Shepardson, Daane, Maisel, and Brimmer. Votes against this action: None.

The term "multiple-maturity time deposit" was defined as any time deposit (1) payable at the depositor's option on more than one date, whether on a specified date or at the expiration of a specified time after the date of deposit (for example, a deposit payable at the option of the depositor either 3 months or 6 months after the date of deposit), (2) payable after written notice of withdrawal, or (3) with respect to which the underlying instrument or contract or any informal understanding or agreement provides for automatic renewal at maturity.

Previously, member banks had been able to pay as high as 5½ per cent on such deposits. The Board's action, which made no change in the maximum permissible rate for time deposits

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having a single maturity (5½ per cent) or savings accounts (4 per cent), was designed to help forestall excessive interest rate competition among financial institutions at a time when monetary policy was aimed at curbing the rate of expansion of bank credit.

On the same day this action was taken, the Board sent to the congressional Committees on Banking and Currency draft legislation that would broaden existing authority to regulate interest rates payable by insured banks on time and savings deposits and extend parallel authority to the Federal Home Loan Bank Board with respect to dividend rates payable by savings and loan associations. The Board's letters pointed out that, although separate ceilings were being imposed on multiple-maturity time deposits in an effort to differentiate between money market CD's and consumer-type deposits, the multiple-maturity concept was not ideally suited for the purpose. However, it appeared to be the best alternative available under existing law. The Board noted that the only effective means for accomplishing the purposes sought to be achieved in the current situation might be to differentiate on the basis of amount of deposit, even though the Board had previously expressed reservations about such an approach except as a temporary expedient.

In its letters the Board also expressed doubt as to the efficacy of attempting to prevent a rate war by limiting rates payable only by banks and pointed out that the draft legislation therefore included authority for imposition of rate ceilings by the Federal Home Loan Bank Board. The Board observed that under the proposed legislation the imposition of rate ceilings would not be mandatory; instead, such ceilings could be imposed or placed on a standby basis by the appropriate agency, after consultation with the others, in the light of conditions existing at any given time.

August 17, 1966

Amendment to Regulation D, Reserves of Member Banks.

Effective with the reserve computation periods beginning September 8, 1966, for reserve city banks and September 15, 1966, for other member

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banks, the Supplement to Regulation D was amended to increase from 5 per cent to 6 per cent the reserve requirement against time deposits (other than savings deposits) in excess of $5 million at each member bank.

Votes for this action: Messrs. Robertson, Shepardson, Mitchell, and Brimmer. Votes against this action: None.

On June 24, 1966, effective on specified dates of the following month for reserve city and other member banks, respectively, the Board had increased from 4 per cent to 5 per cent the reserve requirement on time deposits (other than savings deposits) in excess of $5 million at each member bank.

On August 11, 1966, the Board considered a proposal that the requirement be increased from 5 per cent to 6 per cent (the maximum that could be imposed under existing law). The proposal was presented on the basis that such action would further discourage reliance on CD's as a base for credit expansion in the face of continuing strong loan demands. It was pointed out that banks might attempt to increase the issuance of negotiable CD's in anticipation of large September maturities and tax-period credit demands, and in the circumstances might be inclined to raise offering rates generally to the ceiling on minimum maturities, and perhaps on denominations under as well as over $100,000. In such an environment any additional increase in the cost of replacing CD's should reinforce the inducement to banks to restrict customer loan accommodation and to husband the liquidity of their asset portfolios. An increase in the reserve requirement to the legal maximum would also afford further indication that the Board meant to moderate both inflationary credit expansion and overly aggressive rate competition for savings.

Of the members of the Board present on August 11, three (Governors Robertson, Shepardson, and Mitchell) favored such action. However, the other two members present (Governors Daane and Brimmer) opposed it. Accordingly, since the provisions of Section 19 of the Federal Reserve Act require the affirmative votes of not less than four members of the Board of Gover-

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nors for a change in reserve requirements, the proposal failed of approval.

Governor Daane agreed that the System, in the absence of sufficient fiscal restraint, should move further in the direction of credit tightening, but in view of the existing sensitive state of the money market he believed that the announcement of an increase in reserve requirements could have severe repercussions. He also felt that such action would intensify the problem faced by banks in September in replacing CD's without achieving the differential impact on bank credit expansion that was intended, and he noted that the action could trigger an increase in the commercial bank prime rate. Furthermore, a cushioning of the impact of the reserve requirement increase, coming at a time when the System would normally be supplying reserves, would necessarily mean much larger open market operations than otherwise, with related technical difficulties. It seemed to him that further gradual credit tightening through open market operations would be a preferable course of action.

Governor Brimmer concurred to some extent in those views, with emphasis on his concern that the proposed action, if announced, might trigger an increase in the prime rate. Considering the delicacy of the present financial situation, including the state of money market conditions, he felt that alternative credit-tightening procedures should be explored carefully before a decision was made, especially the possibility of tightening through open market operations.

On August 17, 1966, when the proposed reserve requirement action was again considered by the Board, an increase in the commercial bank prime rate had been announced. Another development taken into account, from the standpoint of timing, was the fact that an auction of $3 billion of Treasury tax-anticipation bills was imminent, and it seemed appropriate on grounds of equity that any increase in reserve requirements be announced before rather than after bids had been made for the bills. Governor Daane, who was prevented from returning from out of town

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because of transportation difficulties related to the airline strike, made known to the Board by telephone that in light of the Treasury financing he would not request deferral of the action if a majority of the Board favored it, although he continued to have the serious reservations that he had expressed previously.

The members of the Board present at the August 17 meeting recognized the risk involved in announcement of a reserve requirement increase, given the sensitive state of the money market. However, they concluded that the risk was warranted by the need for further credit tightening and the greater prospect of obtaining a differential impact through the reserve requirement mechanism than through the use of other instruments. The members noted that some cushioning through open market operations might be required, along with assistance to individual member banks through the System's discount facilities, and it was suggested that clarification of the purposes for which the discount window could properly be used in the forthcoming period would be advisable.

The Board's announcement of the reserve requirement change pointed out that the increase was designed to exert a tempering influence on bank issuance of CD's and to apply some additional restraint upon the expansion of bank credit to businesses and other borrowers. While it was estimated that the action would increase required reserves by about $450 million—approximately $370 million at reserve city banks and $75 million at other member banks—the increase was expected to affect mainly the larger banks issuing savings certificates and other CD's in substantial volume.

The Board noted that monetary actions already taken had resulted in some moderation of the rate of bank credit growth, but that in view of increasing price pressures stemming from recent developments in the economy, this action was being taken to reinforce the anti-inflationary effects of over-all monetary restraint. The Board expressed recognition that in the period ahead some banks might be faced with unusual pressures, but it stated that in such circumstances Federal Reserve discount

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facilities would be available to assist member banks while they were making an orderly adjustment in their positions. Such adjustments, however, would be expected to emphasize increased restraint in lending policies and maintenance of an appropriate degree of liquidity on the part of borrowing banks.

September 1, 1966

Use of discount facilities in the current economic environment.

A letter was sent to all member banks of the Federal Reserve System expressing System views on bank credit expansion in the current economic environment and on the use of Federal Reserve discount facilities in such circumstances.

Votes for this action: Messrs. Robertson, Shepardson, Mitchell, Maisel, and Brimmer. Votes against this action: None.

While the growth of total bank credit and total bank lending had moderated somewhat as compared with the preceding year, total bank loans plus investments had grown at an annual rate of more than 8 per cent during the first 8 months of 1966 and total bank loans at a rate of more than 12 per cent. Meanwhile, bank lending to business had increased at an annual rate of about 20 per cent. Credit-financed business spending had tended toward unsustainable levels and had added appreciably to current inflationary pressures. Furthermore, the exceedingly rapid expansion in business loans was being financed in part by liquidation of other banking assets and by curtailment of other lending in ways that could contribute to disorderly conditions in credit markets.

Against that background a decision was made by the Board, in consultation with the Presidents of the Federal Reserve Banks, that a letter should be sent to each member bank over the signature of the President of the Reserve Bank in the member bank's district expressing System views on bank credit expansion in the current economic environment and on the use of Reserve Bank discount facilities.

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The text of the letter follows:

It is the view of the Federal Reserve System that orderly bank credit expansion is appropriate in today's economy. However, that expansion should be moderate enough to help insure that spending—and particularly that financed by bank credit—does not exceed the bounds that can be accommodated by the nation's growing physical resources. An excessive expansion of bank credits would aggravate inflationary pressures that are already visible.

While the growth of total bank credit and total bank lending has moderated somewhat as compared with last year, total bank loans plus investments have grown at an annual rate of over 8 per cent during the first 8 months of this year, and total bank loans at a rate of over 12 per cent. Meanwhile bank lending to business has increased at an annual rate of about 20 per cent.

It is recognized that business demands for bank credit have been particularly intense. While such credit requests often appear justifiable when looked at individually, the aggregate total of credit-financed business spending has tended towards unsustainable levels and has added appreciably to current inflationary pressures. Furthermore, such exceedingly rapid business loan expansion is being financed in part by liquidation of other banking assets and by curtailment of other lending in ways that could contribute to disorderly conditions in other credit markets.

The System believes that the national economic interest would be better served by a slower rate of expansion of bank loans to business within the context of moderate over-all money and credit growth. Further substantial adjustments through bank liquidation of municipal securities or other investments would add to pressures on financial markets. Hence, the System believes that a greater share of member bank adjustments should take the form of moderation in the rate of expansion of loans, and particularly business loans.

Accordingly, this objective will be kept in mind by the Federal Reserve Banks in their extensions of credit to member banks through the discount window. Member banks will be expected to cooperate in the System's efforts to hold down the rate of business loan expansion—apart from normal seasonal needs—and to use the discount facilities of the Reserve Banks in a manner consistent with these efforts. It is recognized that banks adjusting their positions through loan curtailment may at times need a longer period of discount accommodation than would be required for the disposition of securities.

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This program is in conformity with the provision in Section 201.0, par. (e) of the Board's Regulation A governing lending to member banks:

"In considering a request for credit accommodation, each Federal Reserve Bank gives due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally. . . ."

Federal Reserve credit assistance to member banks to meet appropriate seasonal or emergency needs, including those resulting from shrinkages of deposits or of other sources of funds, will continue to be available as in the past.

A slower rate of business loan expansion is in the interest of the entire banking system and of the economy as a whole. All banks should be aware of this consideration, whether or not they need to borrow from the Federal Reserve. Management of bank resources in accordance with the principles outlined above can make a constructive contribution to sustained economic prosperity, and the Federal Reserve System is confident that the banks will give their whole-hearted support to this effort.

* * * * *

Termination of the special discount arrangements set forth in the September 1 letter was announced on December 27, 1966. Credit conditions had changed in the interim, the expansion of business loans had been reduced to a more moderate rate, and banks were no longer unloading securities in unreceptive markets. Consequently, the purpose of the letter had been served.

September 21, 1966

Amendments to Regulation Q, Payment of Interest on Deposits.

Effective September 26, 1966, the Supplement to Regulation Q was amended (1) to reduce from 5½ per cent to 5 per cent the maximum rate of interest permitted to be paid by member banks on any time deposits under $100,000, and (2) to permit the effects of compounding to be disregarded in calculating the rate of interest on time or savings deposits, but with provision that the basis of compounding be stated explicitly.

Votes for this action: Messrs. Martin, Robertson, Shepardson, Mitchell, Daane, Maisel, and Brimmer.
Votes against this action: None.

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The action reducing to 5 per cent the maximum rate of interest permitted to be paid on time deposits of less than $100,000 was taken under the authority contained in Public Law 89-597, approved by the President earlier on this same date, providing increased flexibility for establishing maximum rates payable on time and savings deposits at commercial banks and other depositary institutions. (Actions under authority of the new legislation were also announced by the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board, such actions being applicable to rates payable by institutions under the respective jurisdictions of those agencies.)

The purpose of the reduction of the maximum rate payable on time deposits of less than $100,000 was to limit further escalation of interest rates paid in competition for consumer savings. The action, which also was expected to help in keeping the growth of commercial bank credit to a moderate pace, was the latest of a series of measures taken by the Federal Reserve System to temper the aggressive competition for funds by commercial banks and other financial institutions and at the same time to help assure an orderly and moderate rate of growth in bank credit in order to restrain inflationary pressures. The earlier actions had included a reduction of maximum rates on time deposits with multiple maturities, two increases in the reserves required to be maintained by member banks against a portion of their time deposits, and issuance of a letter to member banks concerning the need to follow lending policies that would result in reducing the rate of growth of business loans.

The current reduction in maximum rate did not, in itself, require any change in the rate of interest being paid on CD's and other time deposits outstanding on the effective date (September 26); if a member bank had agreed to pay a specified rate of interest on such a deposit, it could continue to pay the contract rate to maturity. If the obligation was then renewed, however, the rate of interest could not exceed the new 5 per cent maximum.

The action on compounding of interest was designed to permit

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member banks slightly greater flexibility in the terms of their deposit contracts and in their operations by authorizing the compounding of interest at the applicable maximum permissible rate on any basis that the member bank might choose to adopt. However, if a member bank elected to compound interest, either at the maximum permissible rate or at a lower rate, it must state the basis of compounding (such as semiannually, quarterly, monthly, weekly, daily, or continuously) in every advertisement, announcement, solicitation, and agreement relating to the rate of interest paid.

September 27, 1966

Increase in maximum interest rate on Regulation V loans.

Effective September 27, 1966, the Board raised from 6 per cent to 7½ per cent the maximum permissible rate of interest on loans made pursuant to Regulation V, Loan Guarantees for Defense Production, with retention of the ceiling of 6 per cent for purposes of calculating guarantee fees, and with no change in the maximum commitment fee of one-half of 1 per cent or in the schedule of guarantee fees.

Votes for this action: Messrs. Martin, Robertson, Shepardson, Mitchell, Maisel, and Brimmer. Votes against this action: None.

Under the provisions of the Defense Production Act of 1950 and implementing Executive Orders, certain designated procurement agencies of the Government are authorized to guarantee loans made by commercial banks and other private institutions to finance and expedite production for national defense and to finance contractors and subcontractors in connection with, or in contemplation of, the termination of their defense contracts. The Federal Reserve Banks act as fiscal agents of the guaranteeing agencies in receiving applications and in the making of contracts of guarantee. The Board's Regulation V, issued pursuant to the aforementioned statutory authority, provides that rates of interest, guarantee fees, commitment fees, and other charges that may

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be made with respect to guaranteed loans and guarantees executed through the agency of any Federal Reserve Bank pursuant to the Regulation will from time to time be prescribed, either specifically or by maximum limits or otherwise, by the Board of Governors after consultation with the guaranteeing agencies.

The action on the maximum permissible interest rate, which was taken after such consultation, was designed to permit a net return to financing institutions more in line with current lending and money market rates and thus help to assure financing from commercial sources for contractors and subcontractors engaged in defense work. The net return to financing institutions under the former ceiling rate, in effect since 1957, had become increasingly noncompetitive with alternative loan and investment opportunities, and the amounts disbursed under authorized Regulation V loans had dropped from $152 million in the fiscal year 1964 to $119 million and $78 million in the fiscal years 1965 and 1966, respectively, notwithstanding the substantial increase in military procurement.

Regulation V was reissued, effective September 27, 1966, in a form that included a Supplement setting forth the maximum permissible rate of interest, the schedule of guarantee fees, and commitment fees. In addition, minor technical changes were made in the body of the Regulation.

December 6, 1966

Amendments to Regulation D, Reserves of Member Banks, and Regulation Q, Payment of Interest on Deposits.

(1) Effective January 1, 1967, Regulations D and Q were amended to sharpen the technical distinctions between "time deposits" and "savings deposits."

(2) Effective January 5, 1967, the Supplement to Regulation D was amended to reduce from 6 per cent to 4 per cent the reserves required to be maintained against Christmas and vacation club accounts. (The lower rate of required reserves had already been in effect at member banks whose total time deposits, other than savings deposits, did not exceed $5 million.)

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Votes for these actions: Messrs. Martin, Shepardson, Mitchell, Daane, Maisel, and Brimmer. Votes against these actions: None.

Prior hereto, deposits of individuals or certain nonprofit organizations as to which the depositor was required by the deposit contract to give notice in writing not less than 30 days before making a withdrawal might be either "savings deposits" or "time deposits" (time certificates of deposit or time deposits, open account). Under the amended regulations, such a deposit could only be a "time deposit," the distinguishing feature of "savings deposits" being the reservation by the bank of the right to require 30 days' notice of withdrawal. In practice, banks routinely reserve such a right, although it is rarely exercised.

The amendments also were designed to make clear that a deposit payable on a specified date or at the expiration of a specified period of time after the date of the deposit (sometimes referred to as a "fixed maturity" deposit) does not constitute a "savings deposit."

As to Christmas and vacation club accounts, technically classified as time deposits, the Board concluded that with such accounts serving the same function as savings deposits there was no reason why reserves required to be maintained against them should be higher than for savings deposits.

December 9, 1966

Voluntary foreign credit restraint.

The Board adopted guidelines for 1967 for the use of banks and nonbank financial institutions in limiting foreign credits voluntarily as part of the President's balance of payments program.

Votes for this action: Messrs. Shepardson, Mitchell, Daane, Maisel, and Brimmer. Votes against this action: None.

In a message to Congress in February 1965, the President had presented a program aimed at achieving improvement in the U.S.

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balance of payments position, the principal focus of which was on measures to reduce the outflow of U.S. capital. One part of the program called upon the Federal Reserve System to work with financial institutions in limiting their foreign lending and investing on a voluntary basis. In March 1965 the Board adopted sets of guidelines applicable to banks and nonbank financial institutions, respectively. Several amendments to the guidelines were adopted during 1965, and in December revised guidelines were issued for use in 1966. On April 1, 1966, the guidelines applicable to nonbank financial institutions were amended to remove acquisition by such institutions of foreign equity securities held by U.S. investors from the purview of the guidelines for long-term lending and investing abroad.

After a series of discussions in which all of the members of the Board had participated, the Board at this time adopted revised guidelines for the use of banks and nonbank financial institutions in 1967.

The new bank guidelines were in substantially the same form as those that had been in use since 1965. The volume of outstanding credits to foreigners on December 31, 1964, was retained as the base, along with the ceiling of 109 per cent of that base that was in effect during 1966. However, banks were requested to limit the use of their leeway as of September 30, 1966 (the leeway for the banking system as a whole approached $1.2 billion), to a rate not exceeding 20 per cent thereof per quarter, beginning with the fourth quarter of 1966. Banks were also requested to limit the increase in nonpriority credits (defined as credits other than those that financed U.S. exports or met credit needs of developing countries) over the amount outstanding on September 30, 1966, to 10 per cent (about $120 million) of the total possible expansion. This change was designed to give added stimulus to priority credits by suggesting a quantitative limit for nonexport credits to developed countries.

The program for nonbank financial institutions was greatly simplified. The three guidelines used in the 1966 program were

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replaced by a single guideline that permitted an increase of 5 per cent during the 15 months ending December 31, 1967, in assets covered by that guideline. Covered assets were redefined to exclude certain types of assets previously subject to target ceilings—for example, bonds of the International Bank for Reconstruction and Development and of the Inter-American Development Bank.

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RECORD OF POLICY ACTIONS OF THE FEDERAL OPEN MARKET COMMITTEE

The record of policy actions of the Federal Open Market Committee is presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of Section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each such action, and that it shall include in its ANNUAL REPORT to the Congress a full account of such actions.

In the pages that follow, there are entries with respect to the policy actions taken at the meetings of the Federal Open Market Committee held during the calendar year 1966, including the votes on the policy decisions made at those meetings as well as a résumé of the basis for the decisions, as reflected by the minutes of the Committee. The summary descriptions of economic and financial conditions included in the entries are based on the information that was available to the Committee at the time of the meetings, rather than on data for the periods in question as they may have been subsequently revised.

It will be noted from the record of policy actions that in some cases the decisions were by unanimous vote and that in other cases dissents were recorded. The fact that a decision in favor of a general policy was by a large majority, or even that it was by unanimous vote, does not necessarily mean that all members of the Committee were equally agreed as to the reasons for the particular decision or as to the precise operations in the open market that were called for to implement the general policy.

The policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the

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System Open Market Account. Both the Manager of the System Open Market Account and the Special Manager of the Account for foreign currency operations attend the meetings of the Committee. In the area of domestic open market activities the Bank operates under two separate policy directives from the Open Market Committee—a continuing authority directive and a current economic policy directive. At the beginning of the calendar year the continuing authority directive in effect was as follows:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities in the open market from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed $125 million or 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York;

(c) To buy U.S. Government securities with maturities as indicated below, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of

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the Federal Reserve Bank of New York under agreements for repurchase of such securities or acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market. U.S. Government securities bought under the provisions of this section shall have maturities of 24 months or less at the time of purchase, except that, during any period beginning with the day after the Treasury has announced a refunding operation and ending on the day designated as the settlement date for the exchange, the U.S. Government securities bought may be of any maturity.

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate ¼ of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $500 million.

This directive was amended on five occasions during the year, as noted in the entries.

The current economic policy directive was changed frequently during the year. The directive in effect at the beginning of 1966 instructed the Federal Reserve Bank of New York as follows:

The economic and financial developments reviewed at this meeting indicate that domestic economic expansion is gaining in strength in a climate of optimistic business sentiment, with continuing active demands for credit and some further upward creep in prices. Although there

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appears to have been some recent improvement in our international payments, the need for further progress remains. In this situation, it is the Federal Open Market Committee's policy to complement other recent measures taken to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

Until the next meeting of the Committee, and taking into account the forthcoming Treasury financing activity and widely fluctuating seasonal pressures at this time of year in addition to the recent increase in Reserve Bank discount rates, System open market operations shall be directed to moderating any further adjustments in money and credit markets that may develop.

In the foreign currency area, until June 7, 1966, the Federal Reserve Bank of New York operated under three instruments—(1) an authorization regarding open market transactions in foreign currencies, (2) a statement of guidelines for System foreign currency operations, and (3) a continuing authority directive on System foreign currency operations. On June 7, as indicated in the entry for that date, these were replaced by two new instruments.

The foreign currency instruments in effect at the beginning of the year were as follows:

Authorization Regarding Open Market Transactions In Foreign Currencies

Pursuant to Section 12A of the Federal Reserve Act and in accordance with Section 214.5 of Regulation N (as amended) of the Board of Governors of the Federal Reserve System, the Federal Open Market Committee takes the following action governing open market operations incident to the opening and maintenance by the Federal Reserve Bank of New York (hereafter sometimes referred to as the New York Bank) of accounts with foreign central banks.

I. Role of Federal Reserve Bank of New York

The New York Bank shall execute all transactions pursuant to this authorization (hereafter sometimes referred to as transactions in foreign

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currencies) for the System Open Market Account, as defined in the Regulation of the Federal Open Market Committee.

II. Basic Purposes of Operations

The basic purposes of System operations in and holdings of foreign currencies are:

(1) To help safeguard the value of the dollar in international exchange markets;

(2) To aid in making the existing system of international payments more efficient and in avoiding disorderly conditions in exchange markets;

(3) To further monetary cooperation with central banks of other countries maintaining convertible currencies, with the International Monetary Fund, and with other international payments institutions;

(4) Together with these banks and institutions, to help moderate temporary imbalances in international payments that may adversely affect monetary reserve positions; and

(5) In the long run, to make possible growth in the liquid assets available to international money markets in accordance with the needs of an expanding world economy.

III. Specific Aims of Operations

Within the basic purposes set forth in Section II, the transactions shall be conducted with a view to the following specific aims:

(1) To offset or compensate, when appropriate, the effects on U.S. gold reserves or dollar liabilities of disequilibrating fluctuations in the international flow of payments to or from the United States, and especially those that are deemed to reflect temporary forces or transitional market unsettlement;

(2) To temper and smooth out abrupt changes in spot exchange rates and moderate forward premiums and discounts judged to be disequilibrating;

(3) To supplement international exchange arrangements such as those made through the International Monetary Fund; and

(4) In the long run, to provide a means whereby reciprocal holdings of foreign currencies may contribute to meeting needs for international liquidity as required in terms of an expanding world economy.

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IV. Arrangements with Foreign Central Banks

In making operating arrangements with foreign central banks on System holdings of foreign currencies, the New York Bank shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee.

The Bank shall instruct foreign central banks regarding the investment of such holdings in excess of minimum working balances in accordance with Section 14(e) of the Federal Reserve Act.

The Bank shall consult with foreign central banks on coordination of exchange operations.

Any agreements or understandings concerning the administration of the accounts maintained by the New York Bank with the central banks designated by the Board of Governors under Section 214.5 of Regulation N (as amended) are to be referred for review and approval to the Committee, subject to the provision of Section VIII, paragraph 1, below.

V. Authorized Currencies

The New York Bank is authorized to conduct transactions for System Account in such currencies and within the limits that the Federal Open Market Committee may from time to time specify.

VI. Methods of Acquiring and Selling Foreign Currencies

The New York Bank is authorized to purchase and sell foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the Stabilization Fund of the Secretary of the Treasury established by Section 10 of the Gold Reserve Act of 1934 and with foreign monetary authorities.

Unless the Bank is otherwise authorized, all transactions shall be at prevailing market rates.

VII. Participation of Federal Reserve Banks

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

VIII. Administrative Procedures

The Federal Open Market Committee authorizes a Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the

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Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) to give instructions to the Special Manager, within the guidelines issued by the Committee, in cases in which it is necessary to reach a decision on operations before the Committee can be consulted.

All actions authorized under the preceding paragraph shall be promptly reported to the Committee.

The Committee authorizes the Chairman, and in his absence the Vice Chairman of the Committee, and in the absence of both, the Vice Chairman of the Board of Governors:

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

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

(3) From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Problems.

IX. Special Manager of the System Open Market Account

A Special Manager of the Open Market Account for foreign currency operations shall be selected in accordance with the established procedures of the Federal Open Market Committee for the selection of the Manager of the System Open Market Account.

The Special Manager shall direct that all transactions in foreign currencies and the amounts of all holdings in each authorized foreign currency be reported daily to designated staff officials of the Committee, and shall regularly consult with the designated staff officials of the Committee on current tendencies in the flow of international payments and on current developments in foreign exchange markets.

The Special Manager and the designated staff officials of the Committee shall arrange for the prompt transmittal to the Committee of all statistical and other information relating to the transactions in and the amounts of holdings of foreign currencies for review by the Committee as to conformity with its instructions.

The Special Manager shall include in his reports to the Committee a

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statement of bank balances and investments payable in foreign currencies, a statement of net profit or loss on transactions to date, and a summary of outstanding unmatured contracts in foreign currencies.

X. Transmittal of Information to Treasury Department

The staff officials of the Federal Open Market Committee shall transmit all pertinent information on System foreign currency transactions to designated officials of the Treasury Department.

XI. Amendment of Authorization

The Federal Open Market Committee may at any time amend or rescind this authorization.

Guidelines for System Foreign Currency Operations

1. Holdings of Foreign Currencies

Until otherwise authorized, the System will limit its holdings of foreign currencies to that amount necessary to enable its operations to exert a market influence. Holdings of larger amounts will be authorized only when the U.S. balance of international payments attains a sufficient surplus to permit the ready accumulation of holdings of major convertible currencies.

Foreign currency holdings shall be invested as far as practicable in conformity with Section 14(e) of the Federal Reserve Act.

2. Exchange Transactions

System exchange transactions shall be geared to pressures of payments flows so as to cushion or moderate disequilibrating movements of funds and their destabilizing effects on U.S. and foreign official reserves and on exchange markets.

In general, these transactions shall be geared to pressures connected with movements that are expected to be reversed in the foreseeable future; when expressly authorized by the Federal Open Market Committee, they may also be geared on a short-term basis to pressures connected with other movements.

Subject to express authorization of the Committee, the Federal Reserve Bank of New York may enter into reciprocal arrangements with foreign central banks on exchange transactions ("swap" arrangements), which arrangements may be wholly or in part on a standby basis.

Drawings made by either party under a reciprocal arrangement shall

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be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

The New York Bank shall, as a usual practice, purchase and sell authorized currencies at prevailing market rates without trying to establish rates that appear to be out of line with underlying market forces.

If market offers to sell or buy intensify as System holdings increase or decline, this shall be regarded as a clear signal for a review of the System's evaluation of international payments flows.

It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions in order that System transactions do not conflict with those being undertaken by foreign monetary authorities.

3. Transactions in Spot Exchange

The guiding principle for transactions in spot exchange shall be that, in general, market movements in exchange rates, within the limits established in the International Monetary Fund Agreement or by central bank practices, index affirmatively the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public.

Temporary or transitional fluctuations in payments flows may be cushioned or moderated whenever they occasion market anxieties, or undesirable speculative activity in foreign exchange transactions, or excessive leads and lags in international payments.

Special factors making for exchange market instabilities include (i) responses to short-run increases in international political tension, (ii) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, or (iii) market rumors of a character likely to stimulate speculative transactions.

Whenever exchange market instability threatens to produce disorderly conditions, System transactions are appropriate if the Special Manager, in consultation with the Federal Open Market Committee, or in an emergency with the members of the Committee designated for that purpose, reaches a judgment that they may help to reestablish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified, curtailed, or eventually discontinued pending a reassessment by the Committee of supply and demand forces.

Insofar as is practicable, the New York Bank shall purchase a cur-

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rency through spot transactions at or below its par value, and sell a currency through spot transactions at rates at or above its par value.

Spot transactions at rates other than those set forth in the preceding paragraph shall be specially authorized by the Committee or by the members of the Committee designated in Section VIII of the Authorization for Open Market Transactions in Foreign Currencies, except that purchases of exchange to meet System commitments may be executed without special authorization at rates above par when necessary.

4. Transactions in Forward Exchange

Transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken:

(1) When forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to disequilibrating movements of short-term funds;
(2) When it is deemed appropriate to supplement existing market supplies of forward cover, directly or indirectly, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders;
(3) To allow greater flexibility in covering System commitments, including those under swap arrangements;
(4) To facilitate the use of holdings of one currency for the settlement of commitments denominated in other currencies.

Forward sales of authorized currencies to the U.S. Stabilization Fund out of existing System holdings or in conjunction with spot purchases of such currencies also may be undertaken in order to allow greater flexibility in covering commitments of the U.S. Treasury.

In all other cases, proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

Continuing Authority Directive for System Foreign Currency Operations

The Federal Reserve Bank of New York is authorized and directed to purchase and sell through spot transactions any or all of the following currencies in accordance with the Guidelines for System Foreign Currency Operations as amended November 23, 1965; provided that the aggregate amount of foreign currencies held under reciprocal currency arrangements shall not exceed $2.8 billion equivalent at any one time, and provided further that the aggregate amount of foreign currencies held as a

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result of outright purchases shall not exceed $150 million equivalent at any one time:

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

The Federal Reserve Bank of New York is also authorized and directed to operate in any or all of the foregoing currencies in accordance with the Guidelines and up to a combined total of $275 million equivalent, by means of:

(a) Purchases through forward transactions, for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements;
(b) Purchases and sales through forward as well as spot transactions, for the purpose of utilizing its holdings of one currency for the settlement of commitments denominated in other currencies;
(c) Purchases through spot transactions and concurrent sales through forward transactions, for the purpose of restraining short-term outflows of funds induced by arbitrage considerations; and
(d) Sales through forward transactions, for the purpose of influencing interest arbitrage flows of funds and of minimizing speculative disturbances.

The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing curren-

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cies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $100 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

The Federal Reserve Bank of New York is also authorized and directed to make purchases of sterling on a covered or guaranteed basis in terms of the dollar up to a total of $200 million equivalent.

The Federal Reserve Bank of New York is also authorized and directed to assume commitments for forward sales of lire up to $500 million equivalent as a means of facilitating the retention of dollar holdings by private foreign holders.

The continuing authority directive on foreign currency operations was amended on one occasion, as noted in the entry for April 12, 1966, prior to the adoption of the new foreign currency instruments.

January 11, 1966

Authority to effect transactions in System Account.

Economic activity was rising vigorously at the end of 1965, according to reports at this meeting, and over the year it had grown more rapidly than previously estimated. Although both plant capacity and the labor force expanded substantially in 1965, the margins of unutilized resources at the year-end were the narrowest in more than 8 years. Price increases had remained selective and moderate, but rises persisted and the wholesale price index for industrial commodities in December was about 2 per cent higher than in the summer of 1964. Despite uncertainties regarding the course of hostilities in Vietnam and the size of Federal outlays for defense, the outlook appeared to be for continued large gains in activity and further upward pressures on prices. Optimism about business prospects was reflected in the stock market; average prices of common stocks ended the year at a record high.

Estimates of gross national product in the first three quarters

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of 1965 had been raised substantially by the Department of Commerce. Preliminary indications were that GNP rose considerably further in the fourth quarter, and that for the year as a whole it was 7.5 per cent above 1964. The rate of capacity utilization in manufacturing, which had been rising since 1961, remained high throughout 1965. The total labor force expanded much more than expected—in the fourth quarter it was about 1.8 million persons larger than a year earlier, compared with the previous year's rise of 1.1 million persons—but employment increased by 2.2 million in the corresponding period, and the unemployment rate declined to 4.1 per cent in December 1965 from 5.0 per cent a year earlier.

Business plans called for another large increase in production facilities in 1966, and the labor force was expected to show substantial further growth. Nevertheless, if—as now seemed probable —GNP continued to expand at its recent high rate, it was likely that pressures on productive capacity would be as great or greater than in 1965 and that shortages of various types of labor would become increasingly severe. Under such circumstances prices probably would be under increased upward pressures.

Aggregate private demands for credit were particularly large in the fourth quarter of 1965, paralleling the vigorous rise in physical investment. Bank credit appeared to share about proportionately in the growth of total credit. For the year as a whole both bank credit and the money supply (private demand deposits plus currency outside of banks) rose more than in 1964—10 per cent and 4.8 per cent, respectively, compared with 8.4 per cent and 4.3 per cent in the prior year. Growth in time and savings deposits at commercial banks, at 16 per cent, also was more rapid than in 1964.

In December, bank credit expanded at a rate slightly faster than in the year as a whole, chiefly as a result of heavy demands for business loans. The money supply rose sharply during the month. The inflow of time and savings deposits slackened, however, despite advances in interest rates on new certificates of

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deposit (CD's), particularly on certificates of shorter maturity. Required reserves of member banks increased markedly, not only because of rapid growth in total deposits, but also because of relative shifts in the deposit "mix," involving accelerated rates of expansion in high-requirement demand deposits and in deposits at high-requirement reserve city banks.

The Treasury had been active in security markets recently. On the day before this meeting subscriptions had been accepted for a cash offering of $1.5 billion of 10-month certificates, bearing a 4¾ per cent coupon and priced to yield 4.85 per cent; early indications were that the offering had been well received by investors. Near the end of December $1 billion of tax-anticipation bills maturing in June had been auctioned, and beginning in January the size of the weekly auctions of 3-month bills was increased from $1.2 billion to $1.3 billion to raise $100 million in new cash each week. The next Treasury financing operation would involve the refunding of $4.8 billion in notes maturing February 15, of which $2.5 billion were held by the public. An announcement concerning the terms of the refunding was anticipated late in January.

Conditions in financial markets had been unsettled in recent weeks as a result of the conjunction of year-end seasonal pressures, heavy private credit demands, the successive Treasury financing operations, continuing adjustments to the official actions of early December increasing the discount rate and the maximum rates permitted to be paid on time deposits, and a transit strike in New York City, which reduced the efficiency with which market transactions could be conducted. At the same time, investor expectations were affected by conflicting reports of developments with respect to Vietnam, growing concern over inflationary pressures, and uncertainty about Federal budget prospects. On balance, yields on long-term securities changed little after the rises of early December that followed the official rate actions. Short- and intermediate-term yields advanced substantially further, however, with the market rate on 3-month Treasury bills

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moving up about 20 basis points to 4.55 per cent on the day preceding this meeting. Money market conditions were quite firm, partly because of the large increase in required reserves of member banks and the concentration of pressures on large banks.

Open market operations during the period were directed at accommodating the enlarged needs for reserves and at moderating the upward pressures on short-term rates. As a result of these operations, in December the supply of nonborrowed reserves of member banks increased at the unusually rapid annual rate of 21 per cent, and borrowings of member banks on the average exceeded their excess reserves by only $25 million, as compared with $80 million in November and $135 million in October.

Tentative estimates of the U.S. balance of payments in 1965 suggested that the deficit was substantially diminished from the prior year on both the "liquidity" and "official reserve transactions" bases of calculation.[1] On the former basis the deficit appeared likely to have been about $1¼ billion, or less than half that in 1964, and on the latter basis it was estimated at about $750 million, compared with $1.2 billion in the prior year. Prospects for further substantial reductions in the "liquidity" deficit in 1966 appeared to depend heavily on improvement in the U.S. trade surplus; changes from recent levels in other categories of the payments accounts seemed likely to be roughly offsetting.

In the discussion of policy, Committee members noted that short-term interest rates were higher at present than had been expected at the time of the preceding meeting as a result of developments in the market and despite sizable additions to the supply of bank reserves. The Committee decided that open market

[1] The balance on the "liquidity" basis is measured by changes in U.S. reserves and in liquid U.S. liabilities to all foreigners. The balance on the "official reserve transactions" basis is measured by changes in U.S. reserves and in liquid and certain nonliquid liabilities to foreign official agencies, mainly monetary authorities. The latter balance differs from the former by (1) treating changes in liquid U.S. liabilities to foreigners other than official agencies as ordinary capital flows, and (2) treating changes in certain nonliquid liabilities to foreign monetary authorities as financing items rather than as ordinary capital flows.

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operations until the next meeting should be directed toward maintaining about the prevailing conditions in the money market. It recognized, however, that economic, military, or Federal budget developments might lead to sharp changes in market conditions, which System operations should be expected only to moderate.

The Treasury financing schedule was a primary consideration in the decision to maintain relatively steady money market conditions, but other reasons for this course also were advanced. Thus, it was noted that the need for actively seeking changes in conditions could be determined better after the President's Budget Message and Economic Report were transmitted to the Congress later in the month; that market adjustments to the official rate actions of December were still under way; and that more time was required to appraise the effects of recent increases in interest rates.

At the same time, a number of members expressed concern over the recent pace of growth in reserves, bank credit, and the money supply, in view of the potential for inflationary developments in the period ahead. The Committee agreed that for the longer run some moderation in these growth rates would be desirable and, accordingly, it modified the statement of policy in the first paragraph of its current economic policy directive to the Federal Reserve Bank of New York. The directive issued read as follows:

> The economic and financial developments reviewed at this meeting indicate that domestic economic expansion has strengthened further in a climate of optimistic business sentiment and with some further upward creep in prices. Interest rates are higher in most markets in response to strong credit demands and recent official rate actions. Our international payments position improved considerably during 1965 but further progress is needed to attain effective balance. In this situation, it is the Federal Open Market Committee's policy to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, by moderating the growth in the reserve base, bank credit, and the money supply.

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In light of the Treasury financing schedule, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current conditions in the money market.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Patterson, Robertson, Scanlon, and Shepardson. Votes against this action: None.

February 8, 1966

Authority to effect transactions in System Account.

Business activity continued to advance vigorously in early 1966, and the outlook was becoming increasingly expansive. In addition to sharply rising Federal expenditures, large consumer demands, and record business outlays on plant and equipment, heavy inventory accumulation was adding to aggregate demands. Total business inventories had risen sharply in the fourth quarter of 1965 despite rapid liquidation of steel stocks following the wage settlement in that industry; and in the current quarter, with liquidation of steel stocks ending, further substantial accumulation seemed probable.

The recent surge in activity carried rates of resource use to advanced levels. In December the rate of capacity utilization in manufacturing edged up to a 10-year high. In January the unemployment rate declined again, reaching the administration's "interim" target of 4.0 per cent. As yet, pressure on resources had not been reflected in an accelerated rate of advance in average industrial prices—the price index continued to creep up at about the 1.5 per cent annual rate of the last 15 months—but reports of moderate price advances were becoming more frequent.

Loan expansion at commercial banks was unusually strong in January as business borrowing remained heavy. The money supply continued to rise rapidly, although the increase was concentrated in the early part of January and for the month as a whole was less than the sharp December advance. The inflow of

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time and savings deposits to commercial banks slowed considerably further from the reduced December pace. Net borrowed reserves of member banks averaged about $60 million in January; they had been below $100 million in November and December also, but earlier in 1965 they had fluctuated around $150 million.

Yields on long-term Treasury and corporate bonds, which had been relatively stable following their initial adjustments to the early December increase in the discount rate, had advanced by 10 to 15 basis points since the preceding meeting of the Committee. Contributing to the advances were the resumption of bombing in North Vietnam; the growing calendar of new corporate issues; the prospect of large sales of financial assets by the Federal Government under provisions of the administration's budget document; and increasing market discussion of the possibility that a firmer monetary policy might be required to restrain inflationary pressures in the months ahead. Short-term interest rates also moved irregularly higher, with the market yield on 3-month Treasury bills advancing by about 5 basis points to above 4.60 per cent.

Money market conditions had been, on the whole, relatively comfortable in the recent period as earlier heavy pressures on banks in the central money markets moderated. System operations generally had been directed toward maintaining an "even keel" in the money market, as is customary during periods of Treasury financing. The current financing involved both a refunding of issues maturing in mid-February and an advance refunding of April, May, and August maturities, with settlement scheduled for February 15. In exchange for these securities, of which $13.7 billion were held by the public, the Treasury offered two new issues: a 5 per cent 4¾-year note (priced to yield 4.97 to 5.00 per cent, depending on the issue exchanged), and a 4⅞ per cent 18-month note (priced to yield 4.96 per cent). The refunding was well received by investors despite the weakening of prices on outstanding issues subsequent to its announcement; $6.5 billion of subscriptions were entered for the 4¾-year note and $0.9 billion

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for the 18-month note. Subscriptions by Government security dealers were relatively small, and there appeared to be little speculative activity in the new issues.

The deficit in U.S. international payments in 1965 was now estimated to have been about $1.3 billion on both the "liquidity" and "official reserve transactions" bases, compared with $2.8 billion and $1.2 billion, respectively, in 1964. Growth of merchandise exports had resumed in the second half of the year, and prospects for further increases were favorable. However, the rate of expansion of imports—of both manufactured goods and materials—had accelerated during 1965. In the fourth quarter, despite some reduction in imports of steel, total imports reached a level relative to GNP that was quite high by historical standards.

In the judgment of the Committee, recent and prospective economic developments clearly called for added policy measures to dampen the rise in aggregate demands. It was noted that efforts had been made to develop a Federal budget for fiscal year 1967 that would avoid adding to inflationary pressures. The budget estimates recently submitted to the Congress had to be regarded as more than usually uncertain, however, because of the difficulty of predicting the course of developments in Vietnam.

The Committee concluded that, while unfolding developments might lead to additional fiscal counteraction at some later date, the appropriate objective for monetary policy in the immediate future was a somewhat greater degree of restraint. Members observed that reserve availability had been permitted to increase in recent months so as to moderate market adjustments to the official rate actions of early December. It also was noted that the market situation with respect to the securities involved in the current Treasury financing probably would make it unnecessary to maintain an "even keel" policy for the entire period until the Committee's next meeting. Accordingly, the Committee agreed that gradual action to reduce net reserve availability should be initiated as soon as feasible in the light of the financing.

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The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that the domestic economy is expanding vigorously, with prices continuing to creep up and credit demands remaining strong. Our international payments continue in deficit. In this situation, it is the Federal Open Market Committee's policy to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, by moderating the growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee, with appropriate regard for the current Treasury financing, shall be conducted with a view toward a gradual reduction in reserve availability.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Patterson, Robertson, Scanlon, and Shepardson. Votes against this action: None.

March 1, 1966

1. Authority to effect transactions in System Account.

Estimates of the pace of the business expansion had been scaled upward recently, according to reports at this meeting, and activity was now expected to increase more in 1966 than had appeared likely a few weeks earlier. Revised data indicated that GNP had advanced at a $16 billion annual rate in the fourth quarter of 1965—compared with the $12 billion average rate of the two preceding quarters—and recent developments suggested that it was continuing to rise at about the same rate in the current quarter.

Pressures on manpower and industrial resources were increasing as enlarged defense expenditures were superimposed on high and rising private demands. From October through January nonfarm employment grew at an annual rate of 7 per cent, and

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with tightening labor markets, wages were advancing somewhat more rapidly than earlier in many industries. Industrial production rose sharply further in January, and the rate of capacity utilization in manufacturing edged up again. Retail sales, which had increased more in late 1965 than previously estimated, declined slightly in January but appeared to be rising again in early February.

Only a slight acceleration in the rate of advance in industrial commodity prices was indicated by data for January and preliminary estimates for February. It seemed likely, however, that the continued rapid expansion of demands expected in coming months and the associated pressures on resources would be conducive to somewhat larger and more widespread price increases.

The pace of bank credit expansion was considerably reduced in late January and early February, according to data for city banks. Growth of business loans moderated from the earlier high rate but remained fairly rapid. Growth in time and savings deposits at commercial banks slackened further to a rate less than half that of the fourth quarter, with the slowdown concentrated at city banks. The money supply, which reached a peak in early January and declined substantially later in that month, was estimated to have changed little in February.

Unusually large demands were being made on capital markets. The volume of new corporate and municipal bond issues in January and February, and the calendar of prospective offerings for March, suggested that the combined total of offerings in the first quarter would be greater than in any prior quarter. In addition, a sizable volume of Government agency issues was being sold. Against a background of inflationary expectations associated with the vigorous economic expansion and of continuing market discussions of a possibly firmer monetary policy, investor response to the offerings was cautious and interest rates on long-term corporate, municipal, and Treasury issues rose sharply further. Yields on some maturities of Treasury bonds were now at the highest levels in more than 40 years. Average prices of

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common stocks reached a new peak in early February but subsequently declined in active trading.

Recent open market operations were directed at restraining net reserve availability, and conditions in money markets were firm. Since the preceding meeting of the Committee, yields on 3-month Treasury bills advanced by about 5 basis points on balance, to around 4.65 per cent; rates offered by large banks on negotiable CD's edged higher; and the effective rate on Federal funds was usually above the discount rate. For February as a whole, member bank borrowings rose somewhat, to about $470 million from $430 million in January, and net borrowed reserves averaged about $110 million compared with a revised figure of $50 million for January. Growth rates of total and nonborrowed reserves declined substantially.

Partial data on the U.S. balance of payments for early 1966 suggested a continued deficit on the "liquidity" basis of calculation, after allowance for seasonal influences. U.S. banks reduced the volume of their credits to foreigners more than seasonally in January, partly as a result of the pressures of domestic credit demands. On the other hand, the surplus on U.S. merchandise trade was reduced; in January, as well as in December, exports were lower than the October–November average, and imports were higher.

The Committee agreed that, in the light of existing and prospective inflationary pressures, it should continue to pursue the policy initiated at the preceding meeting of moving gradually to reduce net reserve availability with a view to limiting growth of bank reserves, bank credit, and the money supply to moderate rates. A number of reasons were advanced for proceeding cautiously in reducing net reserve availability. These included the existing strains in financial markets and the seasonal pressures expected around the March tax and dividend dates; the need for more time to determine the effects of recent System policy actions on the growth trends of bank credit and the money supply; and the desirability of avoiding further rises in market interest rates

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to levels that would require consideration of another increase in the discount rate. Several members expressed the hope that Federal fiscal policy would soon assume an increased share of the burden of curbing excessive increases in aggregate demands, and some mentioned that possibility as a further reason for moving slowly in firming monetary policy.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that the domestic economy is expanding vigorously, with prices continuing to creep up and credit demands remaining strong. Our international payments continue in deficit. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, by moderating the growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining some further gradual reduction in reserve availability.

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

2. Amendment of continuing authority directive.

Section 1(a) of the continuing authority directive to the Federal Reserve Bank of New York regarding domestic open market operations was amended to reduce from $2 billion to $1.5 billion the limit on changes in holdings of U.S. Government securities in the System Open Market Account between meetings of the Committee. With this amendment, Section 1(a) read as follows:

To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government

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securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $1.5 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting.

Except for the change resulting from this amendment, the directive was renewed in its existing form, as set forth in the preface to this record of Federal Open Market Committee policy actions for 1966.

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

The limit in question had been increased from $1.5 billion to $2 billion in early December, when the Manager of the System Open Market Account reported that transactions in excess of the prior limit might conceivably be necessary to carry out the intent of the current economic policy directive then in effect. It was reduced at this meeting on recommendation of the Manager, who indicated that the circumstances calling for the higher limit seemed to have passed.

3. Review of continuing authorizations.

This being the first meeting of the Federal Open Market Committee following the election of new members from the Federal Reserve Banks to serve for the year beginning March 1, 1966, and their assumption of duties, the Committee followed its customary practice of reviewing all of its continuing authorizations and directives. The action taken with respect to the continuing authority directive for domestic open market operations has been described in the preceding portion of the entry for this date.

The Committee reaffirmed its authorization regarding open

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market transactions in foreign currencies, its guidelines for System foreign currency operations, and its continuing authority directive on foreign currency operations, in the forms in which all three were outstanding at the beginning of the year 1966, as set forth in the preface to this record of policy actions.

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

March 22, 1966

Authority to effect transactions in System Account.

Economic activity was still advancing rapidly, and pressures on available resources were growing. Although business inventory accumulation tentatively was estimated to have slowed somewhat in the first quarter of 1966 from the high fourth-quarter rate, final demands appeared to be rising more rapidly.

Federal defense purchases were undergoing a particularly large increase in the first quarter. Consumer spending also appeared to be running well above the fourth quarter; January retail sales figures, originally estimated to show a slight decline, were being revised upward substantially, and estimates for February indicated that sales were maintaining an advanced pace. Businesses planned to increase their spending on plant and equipment throughout 1966, according to a Commerce Department–Securities and Exchange Commission survey taken in February. For the year as a whole, planned capital expenditures were reported to be about 16 per cent larger than the high outlays of 1965.

With industrial production recording another sizable increase in February, capacity utilization rates in manufacturing again edged up, and the average workweek lengthened to a new postwar record. Nonfarm employment increased substantially further,

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and the unemployment rate dropped from 4.0 per cent in January to 3.7 per cent, the lowest level since the early 1950's.

Pressures on resources were being reflected increasingly in cost and price developments. Average hourly earnings in manufacturing continued to rise at a moderate and steady pace, and unit labor costs now also appeared to be moving up. New data suggested some acceleration in the rate of advance of industrial commodity prices in the first 2 months of the year, accompanied by a broadening of the range of commodities that were showing increases. Weekly indexes indicated little further change in average industrial prices through mid-March, but other information suggested that a further rise was in process. Average wholesale prices of foodstuffs rose sharply in February, but apparently declined slightly thereafter.

Growth in member bank reserves slackened considerably in February and early March, and bank credit expanded only slightly. In the face of continuing strong demand for loans, city banks reduced their holdings of both Treasury and other securities in early March, and on March 10 major banks increased their prime lending rate from 5 to 5½ per cent. Time and savings deposits continued to grow relatively slowly. The money supply declined in February but then rose quite sharply in the first half of March; for the first quarter as a whole, its growth was tentatively estimated at an annual rate of 5.5 per cent, compared with 7.5 per cent in the preceding quarter.

Treasury coupon securities experienced their first sustained rally in several months during the first 3 weeks of March, with yields on 5- to 10-year maturities falling by almost ¼ of a percentage point and longer-term bond yields declining by as much as ⅛ of a percentage point. The rally appeared to be partly a technical reaction to the extended increases in yields of previous months, but it drew strength from a decline in common stock prices and, in particular, from growing discussion of possible additional Federal tax measures to contain inflationary pressures. Yields on State and local government bonds and new corporate

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issues also turned down after 6 weeks of nearly continuous advance. Contributing to the declines in municipal yields were cancellations and postponements of some new issues that had been planned and a reduction in dealer inventories to the lowest level in several years.

System open market operations since the preceding meeting of the Committee had been directed toward limiting net reserve availability while facilitating the large financial flows associated with quarterly corporate payments of dividends and taxes. In the 3 weeks ending March 16, net borrowed reserves of member banks averaged almost $215 million and borrowings from the Reserve Banks about $540 million, compared with revised averages for February of $120 million and $475 million, respectively. Money market conditions were generally firm, and most short-term interest rates continued to move up. However, yields on 3-month Treasury bills declined irregularly from about 4.65 per cent in early March to 4.52 per cent on the day preceding this meeting, as a result of strong investor demand and low dealer inventories.

The U.S. balance of payments position improved in the first 2 months of 1966, according to incomplete data, as tightening U.S. credit markets contributed to large net reflows of bank credit. The demand for imports continued to expand under the influence of the rapidly advancing pace of domestic activity, however, and the outlook for U.S. foreign trade suggested that it might be difficult to maintain the favorable payments trend in coming months.

In the Committee's discussion it was noted that the policy actions taken at the two preceding meetings apparently were beginning to have the desired effect of moderating growth rates in bank reserves, bank credit, and the money supply. As to the policy to be pursued in the coming 3 weeks, some members favored continuing the process of gradually increasing the reserve pressure on the banking system. Others expressed a preference for maintaining about the current state of net reserve availability,

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or of money market conditions in general, pending a clearer indication of the consequences of previous policy actions. Some members in each of these groups thought that the conduct of open market operations should be conditioned in part by the strength of demands that might be made on the banking system; they felt that net reserve availability could be allowed to become tauter than otherwise if bank credit and money supply growth proved strong and required reserves consequently expanded sharply.

Despite these shadings of opinion, the range of difference in views on policy for the next 3 weeks was not great; no members advocated overt firming action at this time, and none favored relaxation. At the conclusion of the discussion the Committee agreed to renew the current economic policy directive adopted at the preceding meeting without change.

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

April 12, 1966

1. Authority to effect transactions in System Account.

Rapid economic advance continued unabated through the end of the first quarter, according to reports at this meeting. The driving forces of the expansion—defense outlays and business capital expenditures—showed no signs of slackening, and consumer spending was being spurred by sharp rises in incomes and employment. Further large gains in expenditures by Government, business, and consumers were expected in the second quarter.

Industrial production rose considerably further in March; for the first quarter as a whole it increased at an annual rate of about 13 per cent from the fourth quarter of 1965. Retail sales also

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expanded further in March, according to preliminary estimates, after rising substantially in February. Nonfarm employment continued to grow rapidly, and shortages of experienced workers were becoming increasingly serious. In March, after six consecutive months of decline, the unemployment rate rose slightly—from 3.7 per cent to 3.8 per cent—but the rise was accounted for mainly by teenagers, a group for which monthly unemployment changes tend to be volatile.

Average prices of industrial commodities advanced further in March, but because of a slight decline in prices of farm products and foods, the total index of wholesale prices was unchanged from February. Over the first 3 months of the year average prices of industrial commodities had increased at an annual rate of about 3 per cent, approximately twice the rate of 1965. The consumer price index rose in February to a level about 2.5 per cent above a year earlier. Most of the February rise was accounted for by foods, but average prices of other commodities and of services also advanced.

Commercial bank credit, which had changed little in February, expanded substantially in March. Business loan demands in particular were strong over the corporate tax and dividend payment dates. Finance companies, which had a substantial volume of open market paper maturing in the same period, also borrowed heavily. Banks liquidated a large volume of securities, including municipals, to help finance these loan demands. Some reduction in the rate of growth of bank loans was expected after the April tax date, but underlying credit demands appeared likely to remain strong.

The money supply rose sharply in March, in part reflecting a contraseasonal reduction in Treasury deposits at commercial banks. Growth in time and savings deposits continued at the more moderate February rate. Time deposit inflows at city banks expanded considerably in response to higher offering rates on both negotiable and nonnegotiable certificates of deposit. However, some of the funds probably were withdrawn from sav-

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ings deposits at these banks, and possibly also from time and savings deposits at country banks, where growth slackened.

In security markets, the declines in yields on Treasury notes and bonds and on new corporate and municipal issues that had begun in early March continued into early April. The month-long rally—in which one-half to two-thirds of the yield advances following the December increase in the discount rate were erased—apparently reflected increasing expectations of a Federal tax increase, a growing belief that earlier yield advances had outpaced economic developments, and some moderation in the flow of new private offerings. Most recently, however, a general note of caution appeared to have returned to security markets, and some yields edged up again. Near the end of April the Treasury was expected to announce the terms on which it would refund securities maturing in mid-May, of which about $2.5 billion were held by the public.

Recent System open market operations had kept bank reserve positions under pressure. Over the three statement weeks ending April 6, net borrowed reserves averaged about $230 million and member bank borrowings about $580 million—in each case slightly higher than the levels of the previous 3-week period. For March as a whole, higher member bank borrowing accounted for all of the increase in total reserves; nonborrowed reserves declined for the first time since September. The effective rate on Federal funds had been 4¾ per cent on most days since the preceding meeting of the Committee, and on one day a small volume of funds traded at a new high rate of 4⅞ per cent. Most other short-term yields remained at the recent highs established after the March 10 increase in the prime loan rate of banks, or they edged up further. The yield on 3-month Treasury bills fluctuated but on balance rose somewhat to 4.59 per cent on the day preceding this meeting.

The Committee agreed that additional stabilization policy measures would be desirable in light of present and prospective inflationary pressures. In the course of the discussion note was

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taken of the President's recent request that businesses reduce their planned capital outlays, and also of the possibility that the administration might recommend an increase in Federal taxes. It was pointed out, however, that large cutbacks in actual investment expenditures probably could not be expected quickly because of the long lead-times of most capital projects and the firm commitments already made. As to a tax increase, even if one were recommended soon—and that issue remained in doubt—some time would be required for congressional consideration, and additional time probably would elapse before any increase enacted had substantial effects on aggregate spending.

In the area of monetary policy divergent views were expressed about the appropriate interpretation of recent banking and capital market developments. Some members felt that the recent high growth rates in the money supply and bank credit had been undesirable in light of the objective of resisting inflationary pressures, and a similar view was advanced with respect to the declines in longer-term market interest rates. Of the members who held these views some thought that, in retrospect, the Committee's recent policy directives might better have been formulated in terms calling for greater resistance to such developments, which they considered to be evidences of a relaxation in monetary conditions.

Other members shared the view that monetary relaxation would be undesirable under present circumstances, but thought that there had been no relaxation in the pressure the System was placing on banks nor in the trend toward firmer lending policies at banks. In their judgment the recent developments had to be interpreted in light of the fact that there often were marked short-run fluctuations in banking variables and interest rates—in the latter partly because of the effects of changing expectations.

At the conclusion of the discussion the Committee agreed that its policy of gradually reducing net reserve availability, initiated at the February 8 meeting, should be continued until the next meeting; and that consideration should be given in the conduct

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of open market operations to the trends in aggregate reserves, with somewhat tauter reserve conditions permitted if the aggregates rose sharply. However, it was felt that at this juncture reserve pressures should not be intensified to the point at which rising market rates would call into question the viability of the current discount rate and the maximum rates permitted to be paid by member banks on time and savings deposits. At the same time it was agreed that the forthcoming Treasury financing should be taken into account although, because of the moderate size and probable routine nature of the financing, it was expected that the requirements for maintaining an "even keel" in the money market would be less than usually was the case during Treasury operations.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that the domestic economy is expanding vigorously, with industrial prices continuing to creep up and credit demands remaining strong. Our international payments continue in deficit. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining some further gradual reduction in reserve availability, while taking into account the forthcoming Treasury financing.

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

2. Authority to purchase and sell foreign currencies.

The Committee amended the third paragraph of its continuing authority directive for System foreign currency operations to increase, from $100 million to $200 million, the dollar limit

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on spot purchases and concurrent forward sales to the U.S. Stabilization Fund of currencies in which the U.S. Treasury had outstanding indebtedness. With this amendment, the paragraph read as follows:

The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing currencies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $200 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

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

Transactions of the kind authorized by this paragraph, which involved no risk of loss, were for the purpose of facilitating payment by the Treasury of maturing bonds denominated in foreign currencies. The amendment was approved after the Special Manager of the System Open Market Account reported that a larger sum than previously authorized probably could be usefully devoted to this purpose at present.

May 10, 1966

Authority to effect transactions in System Account.

Economic activity continued to expand in April, following a first quarter in which personal consumption expenditures, business fixed investment, and Federal outlays all increased substantially. For the first quarter, GNP was officially estimated to have been at a seasonally adjusted annual rate $17 billion higher than

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in the fourth quarter of 1965. This was the largest quarterly rise since the Korean war. About one-third of the advance reflected price increases, but growth in real output was large considering the high rate of plant utilization and the reduced supply of available labor. Some developments in April and early May, including declines in sales of new automobiles and in prices of common stocks, suggested that the economy was somewhat less ebullient than earlier. The over-all outlook, however, was for further substantial expansion and upward pressures on prices.

In April, retail sales weakened somewhat, primarily because purchases of new domestic automobiles declined by about 15 per cent from the advanced first-quarter rate. Nonfarm employment, which was affected by strikes, was unchanged for the month, but the unemployment rate edged down to the February level of 3.7 per cent from 3.8 per cent in March. Incomplete figures suggested that industrial production had increased in April, but by less than in other recent months. Wholesale prices of foodstuffs declined appreciably further, but prices of industrial commodities continued to advance at the accelerated first-quarter rate.

Growth in consumption expenditures seemed likely to moderate in the current quarter from the rapid first-quarter pace, but further substantial advances in Federal outlays and in business capital spending appeared to be in process. In connection with the latter, a private survey taken in March found that business concerns planned to spend 19 per cent more on plant and equipment in 1966 as a whole than in 1965. First-quarter developments were more nearly in line with this finding than with the 16 per cent planned increase reported in the Commerce–SEC survey a month earlier.

Commercial bank credit expanded substantially further in April, at a rate about the same as in March and almost half again faster than in the first quarter as a whole. Growth in business loans was moderate relative to the first-quarter rate, but bank holdings of securities increased markedly as corporations sold securities to help finance Federal tax payments.

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Expansion in the money supply, which had been rapid in March, accelerated in April to an annual rate of 13.5 per cent, compared with about 4.5 per cent in the first quarter. Growth in time and saving deposits also accelerated, to more than twice the 7 per cent rate of the first quarter. Earlier in the year inflows of savings funds to commercial banks—as well as to savings and loan associations and mutual savings banks—had been sharply reduced as investors, attracted by rising interest rates on market securities, acquired such instruments in a volume unprecedented in the postwar period. Inflows to commercial banks recovered in late March and April, however, after many banks increased rates paid on time deposits (other than passbook savings) following the rise in their prime lending rates. Partial data suggested that nonbank intermediaries experienced larger than seasonal withdrawals of funds in April.

Despite the reduction of savings flows to depositary-type institutions in the first quarter, total mortgage debt outstanding grew more than in any prior first quarter. Savings and loan associations and mutual savings banks reduced their mortgage acquisitions moderately, but the Federal National Mortgage Association greatly increased its net purchases and banks and other lenders generally maintained their earlier rates of acquisition. Recently, savings and loan associations and mutual savings banks reportedly had become more restrictive in their lending policies, and a future slackening in the rate of growth of mortgage debt appeared probable as outstanding commitments were worked down. In March, yields on mortgages on new homes reached their highest levels in 5 years.

In security markets, average prices of common stocks edged down in late April and then fell more sharply in early May. Yields on new corporate bonds and on State and local government securities had risen since the preceding meeting of the Committee; new issues were marketed in sizable volume in April, and many market participants apparently concluded that prospects for a tax increase were diminished and that those for further firming

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of monetary policy were enhanced. Treasury note and bond yields also advanced over most of the period, but they subsequently declined again as common stock prices fell and automobile production cutbacks were announced. The 3-month Treasury bill rate was little changed over the interval, closing at 4.61 per cent on the day before this meeting, but yields on a variety of other short-term instruments moved higher. Late in the period Federal funds traded at 5 per cent for the first time, and a few transactions were reported at 5⅛ per cent.

The Treasury's mid-May refunding, involving a new 18-month 4⅞ per cent note priced to yield 4.98 per cent, was accorded a relatively poor reception; of the $2.5 billion of maturing issues held by the public, 43 per cent were redeemed for cash. This refunding reportedly completed the Treasury's financing activity for the current fiscal year. However, large offerings by Federal agencies were scheduled before the end of June, and these were likely to add considerably to pressures in financial markets.

System open market operations since the Commitee's preceding meeting had been aimed at reducing net reserve availability further, while taking due account of the Treasury refunding operation. Net borrowed reserves in April averaged around $275 million, compared with $210 million in March; and average borrowings increased to about $640 million from $545 million. Yet nonborrowed reserves rose at the rapid annual rate of about 13 per cent in April as the System supplied most of the reserves to accommodate the sharp rise in deposits.

The first-quarter deficit in the U.S. balance of payments was estimated at about a $2 billion annual rate on the "liquidity" basis of calculation, after seasonal adjustment. This was somewhat above the rate in the second half of 1965 and higher than had been expected. The surplus on merchandise trade was reduced as imports rose faster than exports, and although there were further reflows of bank credit, the outflow of U.S. capital into new foreign security issues increased.

It was the consensus of the Committee that recent growth rates

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in bank reserves, bank credit, and the money supply were excessive, particularly in the light of prevailing inflationary pressures. While it was noted that April banking developments reflected a number of special factors and were not necessarily indicative of underlying trends, the members agreed that both domestic and balance of payments considerations called for further monetary restraint.

There were differences in view, however, with respect to the manner in which such a policy decision should be implemented. Some members indicated that they would be prepared to accept a relatively large reduction in net reserve availability in the period before the next meeting if that should prove necessary to restrict growth in bank reserves. Other members, noting the stresses evident in various financial markets and the risks of precipitating undesirably large market adjustments, favored a more cautious approach toward reducing net reserve availability. No members recommended increases in the discount rate or in ceiling rates on time and savings deposits at present, although some noted that conditions might develop that would require consideration of an increase in the discount rate.

The Committee concluded that net reserve availability should be reduced gradually further and that the reduction should be greater if growth in required reserves failed to moderate substantially. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The economic and financial developments reviewed at this meeting indicate that the domestic economy is expanding vigorously, with industrial prices continuing to rise and credit demands remaining strong. Our international payments continue in deficit. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.
>
> To implement this policy, while taking into account the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining some further

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

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

June 7, 1966

1. Authority to effect transactions in System Account.

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

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

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

Both defense expenditures and business capital outlays con-

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

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

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

Interest rates on most types of market securities had increased since the preceding meeting of the Committee as a result of heavy demands for funds. Treasury, corporate, and municipal bond yields all advanced, with yields on new corporate issues

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

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

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

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

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

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that, while the mortgage market is tight, automobile sales have fallen off, and some concern exists about the liquidity of nonbank financial institutions, the domestic economy is continuing to expand, with industrial prices rising further and credit demands remaining strong. The foreign trade surplus has declined and the international payments deficit has increased. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining net reserve availability and related money market conditions in about their recent ranges; provided, however, that if required reserves expand considerably more than seasonally expected, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions.

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

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2. Authority to purchase and sell foreign currencies.

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

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

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

The one substantive change made in the new instruments re-

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

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

AUTHORIZATION FOR SYSTEM FOREIGN CURRENCY OPERATIONS

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

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

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foreign monetary authorities, and with the Bank for International Settlements:

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

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

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

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

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

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

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

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

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

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

2. The Federal Open Market Committee directs the Federal Reserve

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Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

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

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

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

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

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

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

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

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

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

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

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

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

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

FOREIGN CURRENCY DIRECTIVE

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

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

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

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

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

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

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

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

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

C. To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension, (2)

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

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

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

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

June 28, 1966

1. Authority to effect transactions in System Account.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

At the conclusion of the discussion the following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that, while there has been some reduction in automobile sales and residential construction, over-all domestic economic activity is continuing to expand, with industrial prices rising further. Mortgage market conditions remain tight and total credit demands continue strong. The foreign trade surplus has declined and the international payments deficit has increased. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current state of net reserve availability and related money market conditions, except as changes may be needed to moderate unusual liquidity pressures at financial institutions; provided, however, that if such liquidity pressures are not unusually strong and required reserve increases are larger than expected, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions.

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

2. Amendment of continuing authority directive.

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

To buy U.S. Government securities, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank

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

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

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

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taken only if found necessary to supply needed reserves. It was expected that the continuing authority directive would be amended again to restore the maturity limitation after the current period of reserve need had passed.

July 26, 1966

1. Authority to effect transactions in System Account.

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

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

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

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

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

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

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

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

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levels somewhat more in line with other short-term rates. The 3-month bill rate, after rising above 4.90 per cent after mid-July, closed at 4.78 per cent on the day before the meeting, compared with 4.33 per cent 4 weeks earlier. Yields in longer-term securities markets also moved sharply higher in late June and early July, but subsequently tended to stabilize.

The Treasury was expected to announce on July 27 the terms on which it would refund securities scheduled to mature in mid-August. About $3.2 billion of the maturing issues were held by the public.

System open market operations since the preceding meeting had been directed toward maintaining net reserve availability and money market conditions in about the range of recent weeks, while keeping alert to movements in required reserves and also to possible liquidity pressures at financial institutions around the end of the quarterly interest-crediting period. Operations were complicated, however, by a large increase in float stemming from an airline strike that began on July 8 and the resulting delays in transmittal of checks between Federal Reserve Banks. This rise in float led to a sharp increase in net reserve availability in the statement week ended July 13. In the following week surplus reserves were absorbed by sales of Treasury bills with matching forward purchase contracts, in accordance with an understanding reached during a telephone meeting of the Committee on July 11. Weekly average net borrowed reserves fluctuated from about $90 million to $480 million in the first 3 weeks of July and averaged about $340 million, slightly below the June average of $355 million.

The deficit in the balance of payments in the second quarter was estimated at a seasonally adjusted annual rate of about $600 million on both the "liquidity" and "official reserve transactions" bases. The apparent improvement in the liquidity deficit from its first-quarter rate of $2¼ billion was accounted for by an increased flow of funds of foreign official and international institutions out of liquid claims on the United States into certain types of claims classed as nonliquid—specifically, time deposits

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with original maturities of more than 1 year, and agency bonds or notes of over-1-year original maturity. Since the magnitude of further net shifts of these kinds was not predictable, the reduction in the liquidity deficit provided no guide to current trends, particularly in view of the sharp decline in the merchandise trade surplus.

During the period since the previous Committee meeting there had been an increase from 6 per cent to 7 per cent in the discount rate of the Bank of England, followed by announcement by the British Government of a broad program designed to dampen private and public spending in Britain and to limit overseas expenditures. Nevertheless, strong speculative pressures against the pound sterling persisted.

There was a general desire within the Committee to keep a tight rein on bank credit expansion. However, there was also a recognition that the forthcoming Treasury refunding constituted an important reason for continuing approximately the current state of net reserve availability and money market conditions, in accordance with the customary practice of maintaining an "even keel" during periods of Treasury financing activity. Some members—citing factors such as present and prospective inflationary pressures, the continuing strong business loan demand and the risk of another upsurge in bank credit such as had occurred in March and April, the lack of steps to date toward a more restrictive fiscal policy, and the balance of payments situation and outlook—expressed the view that a good case could be made for a further gradual firming of monetary policy at this time to the extent that the Treasury financing permitted. It was the consensus, however, that even if the Treasury financing permitted, such firming should not be sought unless the rate of growth in required reserves, after seasonal adjustment, was more rapid than the very small rise currently projected by the staff.

Accordingly, the following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity appears to be expanding

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somewhat more rapidly than in the second quarter despite weakness in residential construction, with industrial prices rising further. Total credit demands continue strong and financial markets, particularly for mortgages, remain tight. Despite the statistical improvement resulting largely from special transactions, the balance of payments situation continues to reflect a sizable underlying deficit. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

To implement this policy, while taking into account the forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current state of net reserve availability and related money market conditions; provided, however, that if required reserves expand more rapidly than expected and if conditions associated with the Treasury financing permit, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions.

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

2. Amendment of continuing authority directive.

The Committee amended Section 1(a) of the continuing authority directive to the Federal Reserve Bank of New York regarding domestic open market operations, to raise from $1.5 billion to $2 billion the limit on changes in holdings of U.S. Government securities in the System Open Market Account between meetings of the Committee. With this amendment, Section 1(a) read as follows:

To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securi-

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ties held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting.

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

This action was taken after the Account Manager reported that the previously existing "leeway" might conceivably prove too small. There was a prospective need for the System to supply a rather large volume of reserves in the period until the next meeting, and in addition the uncertain duration of the airline strike was a complicating factor.

At the meeting of June 28, 1966, as indicated in the entry for that date, the Committee had amended Section 1(c) of the continuing authority directive to remove the 24-month maturity limitation on Government securities that might be held under repurchase agreements with nonbank dealers, in the expectation that the directive would be amended again to restore the maturity limitation after the then-current period of reserve need had passed. Because of the possibility that procedures similar to those described in the preceding entry might again be required in the period before the next meeting, the Committee agreed to continue paragraph 1(c) in its existing form for the time being.

August 23, 1966

Authority to effect transactions in System Account.

The economic outlook remained expansive, and prospects were for continuing high levels of resource use and strong upward pressures on wages and prices. Defense expenditures apparently were rising at an unabated rate, business fixed investment outlays were continuing to grow, and consumer spending was showing renewed strength after lagging in the spring.

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Industrial production rose further in July, and nonfarm employment continued to expand vigorously. The unemployment rate, at 3.9 per cent, was little changed from the 4.0 per cent rate of the two prior months. On the other hand, private housing starts declined sharply further to the lowest monthly level in 6 years, as mortgage funds remained quite limited.

The wholesale price index increased appreciably in July, mainly because of a large rise in prices of foodstuffs; average industrial prices advanced only slightly further. Consumer prices continued to rise at a substantial rate, leading to further wage increases in industries with cost-of-living escalator contracts and stimulating demands for higher wages in industries where negotiations were under way or imminent. The settlement of the recent strike of airline machinists involved an increase in wages and other benefits well above administration guideposts.

Commercial banks increased their prime lending rate in mid-August to 6 per cent, from the 5¾ per cent rate that had been established near the end of June. Growth in business loans, which had reached the unusually high annual rate of 30 per cent in the June–July period, was slackening in August, in part because cash needs of corporations were temporarily reduced following the earlier accelerated payments of withheld Federal taxes. Banks reportedly were expecting loan demands to intensify again in September despite the increase in the prime rate. Inflows of private liquid funds through foreign branches of U.S. banks, which had been sizable in the first half of 1966, were exceptionally large in July and early August.

Total time and savings deposits of commercial banks continued to grow relatively rapidly, but most of the recent expansion was outside the major money centers. Large city banks, already paying the ceiling rate of 5½ per cent on negotiable CD's, were finding it increasingly difficult to replace maturing certificates as market interest rates rose. A large volume of such certificates would mature in September, and some run-off seemed likely although its dimensions were highly uncertain. Private

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demand deposits were estimated to have shown little net change over the 3 months since May, and Government deposits were estimated to have declined. For August it appeared that both total deposits [2] and required reserves of member banks would fall below the levels projected earlier by the staff. With underlying loan demands remaining strong, however, staff projections for September suggested some acceleration in growth of member bank deposits, perhaps to an annual rate of 6 per cent, although the outlook was clouded by the uncertainties associated with possible run-offs of CD's.

The atmosphere in security markets since the preceding meeting of the Committee was one of marked uncertainty and apprehension. During this period average prices of common stocks declined to new lows for 1966, and yields on Treasury, corporate, and municipal bonds advanced sharply to the highest levels since the 1920's and early 1930's. Short-term interest rates also rose markedly further, with the yield on 3-month Treasury bills reaching 5.10 per cent—more than 30 basis points above its level 4 weeks earlier—before receding somewhat. Money market conditions continued to firm; dealer loan rates posted by major banks again reached new record levels, and Federal funds traded at rates as high as 6 per cent.

The recent pressures, which were evident in all maturity ranges and in all sectors of the financial markets, reflected the extremely large demands currently being made on those markets and concern over the extent of credit demands ahead. Total

[2] In recent months the Committee had been making increased use of daily-average statistics on total member bank deposits as a "bank credit proxy"—that is, as the best available measure, although indirect, of developing movements in bank credit. Since they can be compiled on a daily basis with a very short lag, the deposit figures are more nearly current than available bank loan and investment data. Moreover, average deposit figures for a calendar month are much less subject to the influence of single-date fluctuations than are the available month-end data on total bank credit, which represent estimates of loans and investments at all commercial banks on one day—the last Wednesday—of each month. For recent statistics on daily-average member bank deposits, see the Federal Reserve *Bulletin* for October 1966 (p. 1478) and subsequent months. Some brief comments on the relation between the deposit series and bank credit statistics are given in the note on p. 1460 of the October *Bulletin*.

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offerings of new corporate issues in August appeared likely to exceed those of any August on record, and the calendar of municipal issues was sizable. In addition, the Treasury, after completing its mid-August refunding, announced an auction of $3 billion in tax-anticipation bills for payment on August 26. Also contributing to the uncertain atmosphere were concern about inflationary developments and prospective monetary policy and the possibility of a substantial run-off of negotiable CD's.

Recent System open market operations were directed towards keeping continued pressure on bank reserve positions while maintaining an "even keel" in the money market during the Treasury's refunding operation. Weekly average net borrowed reserve figures fluctuated in a range of $300 million to $465 million in three statement weeks ending August 17; over the period they averaged $400 million, compared with $365 million in the preceding 4 weeks. Member bank borrowings averaged about $765 million, up about $25 million from the preceding 4-week period.

The balance of payments deficit on the "liquidity" basis widened to an annual rate of roughly $3 billion in July and early August, twice the rate of the first half of 1966 when the deficit had been held down by large shifts of foreign official funds from liquid to nonliquid claims on the United States. The balance on the "official reserve transactions" basis behaved differently, however. Following a deficit at a rate of nearly $1 billion in the first half of 1966, there was a substantial surplus in July and early August, as private liquid funds in unusually large volume were attracted to the United States from abroad.

On August 17 the Board of Governors announced a further increase in reserve requirements on time deposits in excess of $5 million, from 5 to 6 per cent, effective September 8 at reserve city banks and September 15 at other member banks. The action, which would increase required reserves by an estimated $450 million, was taken for purposes similar to those under-

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lying the increase in such reserve requirements from 4 to 5 per cent that had been announced on June 26; namely, to exert a tempering influence on bank issuance of time certificates of deposit, and to apply some additional restraint upon the expansion of bank credit to businesses and other borrowers.

The Committee agreed that no relaxation in the prevailing degree of monetary restraint would be warranted at this juncture, unless unusual liquidity pressures developed or money market conditions threatened to become disorderly. A substantial number of members thought that, absent such developments, open market operations should be conducted so as to reduce net reserve availability somewhat further, in coordination with the Board's action to increase reserve requirements. Some of these members favored seeking still greater restraint if bank credit appeared to be expanding at a rate in excess of that projected by the staff for September. At the same time it was noted that any move toward further restraint should be implemented gradually and cautiously, in view of current and prospective strains in financial markets.

Other members, who tended to give somewhat greater weight to the risks of placing undue pressures on financial markets and to the recent moderation of bank credit growth, favored reducing net reserve availability only if bank credit were expanding more rapidly than expected. A third view expressed was that the risks of developments disruptive to financial markets and to the economy in general might be sufficiently great to militate against any further increase in credit restraint at this juncture.

At the conclusion of the discussion, the following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding more rapidly than in the second quarter, despite further weakening in residential construction. Recent wage and price developments suggest that inflationary pressures are becoming more intense. Credit demands continue strong, financial markets have tightened further, and interest rates have risen

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substantially in an atmosphere of great uncertainty. The balance of payments continues to reflect a sizable underlying deficit. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to supplying the minimum amount of reserves consistent with the maintenance of orderly money market conditions and the moderation of unusual liquidity pressures; provided, however, that if bank credit expands more rapidly than expected, operations shall be conducted with a view to seeking still greater reliance on borrowed reserves.

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

September 13, 1966

1. Authority to effect transactions in System Account.

Economic expansion remained vigorous, according to reports at this meeting, with the main stimuli continuing to come from defense spending and business outlays on fixed investment. On September 8 the President proposed a number of fiscal actions to reduce inflationary pressures, including (1) measures to reduce lower-priority Federal spending and (2) a 16-month suspension of two tax incentives for corporate investment: the 7 per cent tax credit on machinery and equipment investment and the accelerated depreciation allowances on commercial and industrial building.

Defense spending was now estimated to be rising more rapidly in the third quarter than the second. Earlier estimates of the pace of business capital outlays were supported by results of the August Commerce–SEC survey of spending plans. That survey, like the May canvass, indicated that capital spending in 1966 as a whole would be 17 per cent above 1965, but would rise at a slower pace in the second half of the year than in the

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first. With respect to consumer spending, a Census Bureau survey taken in mid-July indicated that consumer intentions to buy new automobiles were about as numerous as a year earlier, and that plans to buy household durable goods were considerably stronger.

Industrial production rose substantially further in August, according to preliminary estimates. Nonfarm employment also continued to rise quite vigorously, and the unemployment rate remained unchanged at 3.9 per cent. The gains in employment were somewhat more selective than earlier; in particular, advances in manufacturing were increasingly concentrated in industries oriented to defense and business capital goods. The latest data for manufacturers' inventories—for July—indicated a sharp step-up in the pace of accumulation from the high second-quarter level, with all of the acceleration in durable goods industries.

Estimates suggested that average wholesale prices rose further in August, but by less than in July. It appeared that food price advances were smaller than in the preceding month and that increases in industrial prices were at the reduced July rate. The recent moderation in the rise of average industrial prices was attributable mainly to declines for sensitive materials, which began in June. Price developments in the months ahead seemed likely to be especially influenced by the outcome of wage negotiations, more of which would take place in coming months than earlier in the year. An early-September wage settlement affecting telephone installers—like the August airline-machinists settlement—involved an increase well above administration guideposts.

The money supply declined somewhat further in August, bringing growth for the first 8 months of 1966 to an annual rate of about 1.5 per cent, compared with 4.8 per cent for the full preceding year. Time and savings deposits of commercial banks increased rapidly in the first half of August, but the rate of growth fell off sharply after midmonth when major banks began to experience declines in their negotiable CD's outstanding. Daily averages of both total deposits of member banks—the "bank credit proxy"—and required reserves were weaker in

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August than had been expected earlier. Between the last Wednesdays of July and August total commercial bank credit expanded at about a 6 per cent annual rate, but the growth appeared to be attributable wholly to bank acquisitions of tax-anticipation bills issued by the Treasury late in August.

New staff projections for September, which allowed for a substantial further run-off in negotiable CD's, suggested little or no increase in total deposits of member banks, in contrast with an earlier expectation of moderate growth. At the same time, loan demands were expected to intensify, and the conjuncture of heavy loan demands with run-offs of CD's was expected to result in substantial pressures on banks in coming weeks.

On September 1 the Presidents of the Federal Reserve Banks addressed a letter [3] to all member banks indicating that, while the System considered orderly bank credit expansion appropriate in today's economy, it regarded the recent growth in business loans as excessive. The letter went on to indicate that the System believed a greater share of member bank adjustments should take the form of moderation in the rate of expansion of loans, particularly business loans, and it stated that member banks would be expected to cooperate in the System's efforts to hold down the rate of business loan expansion—apart from normal seasonal needs—and to use the discount facilities of the Reserve Banks in a manner consistent with those efforts. The letter added that Federal Reserve credit assistance to member banks to meet appropriate seasonal or emergency needs, including those resulting from shrinkages of deposits or of other sources of funds, would continue to be available as in the past.

The atmosphere of apprehension in security markets that had been evident before the August 23 meeting of the Committee intensified in the week following that meeting. Yields on Treasury, corporate, and municipal bonds rose sharply further and market conditions became increasingly unsettled, requiring special intervention in the market by the Federal Reserve to supply reserves. On August 30, however, following a statement by a

[3] For the full text of the letter, see p. 103.

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Treasury official that was generally interpreted as foreshadowing a change in prospects for fiscal policy measures, a sharp, sustained rally began that brought bond yields down by the time of this meeting to levels below those of 3 weeks earlier. The downward tendency of yields was reinforced by the President's announcement concerning fiscal policy measures on September 8; by a Treasury announcement on September 10 that until year-end no additional new money would be raised in the open market by Government agencies and that there would be no sales of participation certificates in that interval unless market conditions warranted; and by the suggestion of the System's September 1 letter that banks would be under less pressure to liquidate securities.

In contrast, markets for short-term securities remained under strain, partly because of expectations that a large increase in Treasury bill financing would be required over the remainder of the year as a result of the change in Federal agency financing plans. Money market conditions became quite taut late in the period as the September tax and dividend dates approached. Banks in the major money centers experienced deep basic reserve deficits. Posted rates on dealer loans again reached new highs and, for the first time, some Federal funds transactions occurred at a rate as high as 6¼ per cent. Yields on 3-month Treasury bills advanced to about 5.30 per cent from a level that was slightly below 5 per cent at the time of the preceding meeting.

System open market operations continued to be directed toward keeping bank reserve positions under pressure, while at the same time giving close attention to the unsettled conditions that pervaded securities markets. Net borrowed reserves averaged $370 million in the three statement weeks ending September 7, compared with a revised figure of about $410 million in the preceding 3 weeks. Member bank borrowing averaged $720 million in the latest period, down about $45 million from the preceding 3 weeks.

The underlying international payments position of the United

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States remained one of substantial deficit; in July and August together, the deficit was estimated at an annual rate of roughly $2½ billion to $3 billion on the "liquidity" basis. The trade balance continued to deteriorate in July as imports increased sharply further. Inflows of liquid funds through foreign branches of U.S. banks kept U.S. payments in surplus in August on the "official reserve transactions" basis, but the rate of inflow in August was only about half that of July and appeared likely to slacken further. In foreign exchange markets, sterling continued under intermittent pressure.

One view expressed in the course of the Committee's discussion was that recent trends in bank credit and other monetary aggregates suggested that the degree of restraint resulting from the Committee's earlier policy actions was substantially greater than might have been thought, and that operations now might well be directed toward seeking more nearly normal growth rates. On the other hand, it was argued that a slowdown in bank credit expansion that simply reflected the process of financial "disintermediation" at banks (that is, shifts of depositor funds out of bank time deposits and into credit market instruments in response to relatively more attractive rates on the latter) need not importantly affect total credit availability, even though the distribution of total credit would undoubtedly be altered.

The Committee concluded that the current degree of monetary restraint should be maintained unless unusual liquidity pressures developed or there were significant deviations of bank credit from its expected course. An overt change in policy toward greater ease was considered undesirable at present in light of the persistence of inflationary pressures. At the same time, a number of factors were cited as militating against further intensification of restraint; these included the fiscal measures proposed by the President, the cumulating evidence that past monetary policy actions were having substantial impact, the continuing strains in markets for short-term securities, and the special pressures expected in financial markets over coming weeks.

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It was noted that widely different levels of member bank borrowings and net borrowed reserves might be consistent with the current degree of monetary restraint, depending on the intensity of strains in financial markets and the extent to which banks chose to make reserve adjustments with or without recourse to the discount window under the terms of the System's September 1 letter. For this reason the Committee agreed that measures of net reserve availability should be given subordinate importance in operations and that the degree of restraint should be judged primarily by general money market conditions.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding vigorously, despite the substantial weakening in residential construction, with inflationary pressures persisting. Aggregate credit demands continue strong and short-term financial markets remain under strain. The balance of payments continues to reflect a sizable underlying deficit. In this situation, and in light of the new fiscal program announced by the President, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm but orderly conditions in the money market; provided, however, that operations shall be modified in the light of unusual liquidity pressures or of any apparently significant deviations of bank credit from current expectations.

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

2. Ratification of amendment to authorization for System foreign currency operations.

At this meeting the Committee ratified an action taken by members on September 9, 1966, amending paragraph 2 of its

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authorization for System foreign currency operations to read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Maximum period of arrangement (months)
Austrian National Bank	100	12
National Bank of Belgium	150	12
Bank of Canada	500	12
Bank of England	1,350	12
Bank of France	100	3
German Federal Bank	400	6
Bank of Italy	600	12
Bank of Japan	450	12
Netherlands Bank	150	3
Bank of Sweden	100	12
Swiss National Bank	200	6
Bank for International Settlements (System drawings in Swiss francs)	200	6
Bank for International Settlements (System drawings in authorized European currencies other than Swiss francs)	200	6

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

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This action increased the authorized amounts of the System's swap arrangements with most of the foreign banks with which such arrangements were maintained, for the purpose of providing a broader margin of safety for the stability of the international monetary system. The increases raised the aggregate size of the network to $4.5 billion from $2.8 billion.

At its preceding meeting the Committee had authorized the Special Manager of the System Open Market Account to undertake negotiations looking toward an enlargement of the swap network, subject to notification by the Secretary of the Treasury to the Chairman or Acting Chairman of the Board that the proposed program was fully consistent with U.S. international financial policy at this time. Following receipt of such notification by the Acting Chairman of the Board and advice from the Special Manager that preliminary discussions had been completed with the foreign banks involved, Committee members approved the amendment to the authorization. In addition to the revisions of the dollar amounts of individual arrangements, shown in the second column of the table contained in the affected paragraph, the caption to the third column was modified by adding the word "maximum" before the words "period of arrangement." This change was made to permit different maturities, not exceeding those indicated, to be employed for different portions of individual arrangements.

October 4, 1966

Authority to effect transactions in System Account.

GNP rose more in the third quarter than in the second, according to tentative staff estimates, as defense expenditures accelerated sharply. About half of the third-quarter rise in GNP apparently reflected higher prices. Further sizable increases in both defense spending and business capital outlays appeared

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probable in the fourth quarter—suggesting another large gain in GNP and continuing pressures on available manpower and plant resources. Wage rates were advancing more rapidly than earlier, and rising costs seemed likely to reinforce the effects of strong demands on prices.

While business activity continued to expand vigorously, sentiment appeared less ebullient than earlier, and signs of growing economic imbalance raised some uncertainties about the longer-run outlook. Average prices of common stocks, which had rallied in early September, later declined again. Residential construction activity continued to contract in August as the supply of mortgage funds remained highly limited; private nonresidential building also had declined appreciably in recent months. Some of an unusually large increase in manufacturers' inventories in July and August was probably involuntary; stock–sales ratios rose abruptly, and a Commerce Department survey of anticipations suggested a sharp drop in the growth of inventories in the fourth quarter.

The money supply, which had declined in July and August, was estimated to have risen at an annual rate of about 7 per cent in September. Total time and savings deposits of commercial banks increased much less than in preceding months as a substantial run-off occurred in negotiable CD's outstanding. Estimates indicated that growth in business loans was smaller than expected and considerably below the average rate of recent months—perhaps because of both restrictive lending policies of banks and lighter demands than anticipated. Daily-average figures on member bank deposits implied little change in total bank credit in September, and required reserves appeared to have declined slightly.

Business loan demand was expected to be strong in October, partly because cash needs would again be increased by accelerated payments of withheld Federal taxes. Reflecting this expectation, staff projections suggested resumed growth in daily-average member bank deposits—the "bank credit proxy"—at an annual rate of perhaps 5 or 6 per cent, and a more rapid increase in

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required reserves. The projections allowed for a rise in Government and private demand deposits, the former as a result of an anticipated Treasury financing. Little or no increase was anticipated in total time and savings deposits, however, partly because further substantial run-offs of negotiable CD's were expected. Also, it appeared that banks would be in a slightly less favorable position than formerly in competing for other time deposits under the new ceiling rates that had been established for various depositary institutions in late September, following enactment of new legislation.

The strains evident in short-term financial markets at the time of the preceding meeting of the Committee continued through the mid-September tax and dividend dates, and the yield on 3-month Treasury bills rose by about 30 basis points further to a peak of 5.59 per cent. Subsequently, however, the atmosphere improved considerably, and the 3-month bill yield fell below 5.35 per cent. Federal funds rates and posted rates on dealer loans also moved down.

Yields on long-term securities had fluctuated widely in recent weeks, first rising and then declining in response chiefly to shifting expectations regarding fiscal and monetary policy and changing assessments of the buoyancy of the economy and the prospects for peace in Vietnam. On the whole, however, long-term yields remained significantly below their late-August levels and showed little net change over the interval. The volume of new corporate bond flotations in September was somewhat lower than had been anticipated, and the calendar for October was smaller than offerings in September, although larger than those of October 1965. On the other hand, the Treasury was expected to be making heavy demands on capital markets over the rest of the year, with gross new borrowings of perhaps $8 billion. An announcement of an auction of $3 billion to $3½ billion in tax-anticipation bills, to be held around mid-October, was anticipated shortly; and the terms of the Treasury's November refunding, in which some new money probably also would be raised, were expected to be announced near the end of October.

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System open market operations over most of the recent period were directed toward absorbing reserves supplied by movements in market factors, but day-to-day operations were conditioned by the shifting market atmosphere. Thus, only a moderate amount of reserves was absorbed early in the period, when short-term markets were under strain, but reserve absorption was stepped up later when market conditions became more comfortable. As a result, weekly-average figures for net borrowed reserves fluctuated over a wide range—from about $190 million to $570 million—with the bulk of the fluctuation occurring in excess reserve positions of country banks. For September as a whole, net borrowed reserves averaged about $375 million, a little less than the August average; member bank borrowings, at $765 million, were slightly above those of August.

The U.S. balance of payments in the third quarter was tentatively estimated to have been in deficit at a seasonally adjusted annual rate of about $2 billion on the "liquidity" basis of calculation. However, a substantial surplus was recorded on the "official reserve transactions" basis. The divergence in the two measures was a consequence primarily of the substantial inflows of liquid funds through foreign branches of U.S. banks. The surplus on merchandise trade, which had declined markedly in the second quarter, fell further in the third quarter as imports increased more rapidly than exports.

Committee members differed somewhat in their assessments of the various elements in the economic outlook. Some stressed the implications of rising defense expenditures for the course of over-all developments and the persistence of inflationary pressures, while others placed greater emphasis on the evidences of recent and prospective weakening in the expansion of aggregate private demands.

The Committee agreed, however, that no change in policy should be made at this time, both because the economic situation at present did not appear to warrant an overt move in either direction and because Treasury financing activity was im-

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minent. The desirability of encouraging moderate expansion in bank credit was noted, and it was agreed that account should be taken in open market operations of any apparently significant deviations of bank credit growth from current expectations.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding vigorously, despite the substantial weakening in residential construction, uncertainties in equity markets, and a sharp increase in business inventories. Inflationary pressures are persisting and aggregate credit demands still remain strong. The balance of payments continues to show a sizable liquidity deficit. In this situation, and in light of the new fiscal program announced by the President, it is the Federal Open Market Committee's policy to resist inflationary pressures and to continue efforts to restore reasonable equilibrium in the country's balance of payments.

To implement this policy, and taking account of forthcoming Treasury financings, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm but orderly conditions in the money market; provided, however, that operations shall be modified in the light of unusual liquidity pressures or of any apparently significant deviations of bank credit from current expectations.

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

November 1, 1966

1. Authority to effect transactions in System Account.

Reports at this meeting indicated that economic activity was continuing to expand under the stimulus of rising defense expenditures, although moderating tendencies were appearing in some sectors of the private economy. The outlook was clouded by uncertainties relating to Vietnam and to prospects for fiscal policy actions in addition to the temporary suspension, approved

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

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

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

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

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

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

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

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

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

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

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

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

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing to expand with sharply rising defense expenditures but some evidences of moderating tendencies in sectors of the private economy. While prices of some

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

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

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

2. Amendment of continuing authority directive.

The Committee amended Section 1(c) of the continuing authority directive to the Federal Reserve Bank of New York to authorize repurchase agreements in obligations of U.S. Government agencies. Previously, repurchase agreements had been authorized only in U.S. Government securities and bankers' acceptances. With this amendment, Section 1(c) read as follows:

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

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covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

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

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

November 22, 1966

1. Authority to effect transactions in System Account.

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

Industrial production rose relatively little in October after

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

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

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

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

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3 weeks earlier. Private demand deposits appeared to be expanding less rapidly than expected as loan growth weakened, and Government deposits at banks appeared to be declining somewhat more rapidly than anticipated. Some further decline in member bank deposits seemed likely in December, if money market conditions remained unchanged, as a result of continuing run-offs of negotiable CD's and reductions in Government balances. Treasury deposits at both commercial banks and Federal Reserve Banks were expected to reach relatively low levels by midmonth, perhaps requiring the Treasury to borrow directly from the Federal Reserve for short periods.

Yields on long-term bonds moved higher over the first 3 weeks of November, partly as a result of substantial additions to the calendar of prospective new corporate and municipal bond offerings. Long-term yields also were affected by press reports that the Federal National Mortgage Association might resume sales of participation certificates before the end of the year and by continuing uncertainties regarding the prospects for further fiscal measures.

System open market operations since the preceding meeting of the Committee had been directed at maintaining steady conditions in the money market while the distribution of securities issued in the Treasury's November refinancing was under way. Pressures on reserve positions of central money market banks developed early in November partly as a result of a marked shift in reserves toward other banks. Rates on Federal funds and dealer loans advanced, and 3-month Treasury bill yields rose by about 20 basis points to around 5.45 per cent at midmonth. In view of the pressures in the central money market and of the relatively weak performance of bank credit, the Federal Reserve provided a large volume of reserves through open market operations early in the period, expanding net reserve availability somewhat. Net borrowed reserves averaged about $230 million in the two statement weeks ending November 16, compared with $340 million in the two preceding weeks and $430 million in October.

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The pressures eased after midmonth, and by the date of this meeting Treasury bill yields and money market rates had fallen back to about their levels of 3 weeks earlier.

The U.S. balance of payments in the first 9 months of 1966 was estimated to have been in deficit at an annual rate of about $1.2 billion on the "liquidity" basis, and to have been in surplus at a rate of $0.8 billion on the "official reserve transactions" basis. Preliminary data suggested that the liquidity deficit in October and early November was at a rate of roughly $2 billion, about the same as would have been recorded earlier in the year in the absence of shifts of foreign official funds from liquid to nonliquid form. Inflows of liquid funds through foreign branches of U.S. banks accelerated sharply in late October and early November; in the 4 weeks ending November 9 they were at a rate approaching the July peak, although some reflow occurred in the following week. With net inflows of liquid funds thus continuing large, the balance on the official reserve transactions basis apparently remained near zero early in the fourth quarter. A cessation, and possibly a reversal, of those flows seemed likely in coming weeks as a result of year-end seasonal pressures in the Euro-dollar market.

In the Committee's discussion it was noted that the appropriate course for monetary policy over the coming months would depend importantly on the nature of fiscal policy actions. The Committee concluded, however, that an overt, although modest and gradual, lessening of monetary restraint was warranted at present in view of the evidences of moderating tendencies in private demands and the recent lack of expansion in bank credit and money. Accordingly, it was agreed that somewhat easier money market conditions should be sought unless bank credit expansion became unduly rapid.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing to expand, with

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sharply rising defense expenditures but with evidences of moderating tendencies in various sectors of the private economy. While there has been some slowing in the pace of advance of broad price measures, upward price pressures persist for many finished goods and services. Bank credit and money have shown no expansion in recent months. Long-term interest rates have again risen somewhat after declining from their late summer peaks. The balance of payments remains a serious problem. In this situation, it is the Federal Open Market Committee's policy to maintain money and credit conditions conducive to noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be resuming a rapid rate of expansion.

Votes for this action: Messrs. Martin, Bopp, Brimmer, Clay, Hickman, Irons, Maisel, Mitchell, Robertson, and Shepardson. Votes against this action: Messrs. Hayes and Daane.

In dissenting from this action, Messrs. Hayes and Daane, recognizing the less rapid pace of expansion in the private sector of the economy, indicated that they would have preferred to maintain the somewhat easier money market conditions already prevailing at the time of this meeting and to resolve doubts on the side of ease. In their judgment, with defense expenditures apparently continuing to rise rapidly, inflation—both demand-pull and cost-push—remained a serious threat to both the domestic economy and the U.S. balance of payments in which the trade balance was a crucial element. Furthermore, they felt that any premature pronounced easing could bring about adverse effects on capital outflows. Hence, they deemed it unwise to shift more overtly to a posture of less monetary restraint at this time, particularly in advance of more concrete information on Federal taxes and expenditures.

2. Amendment of continuing authority directive.

The Committee amended Section 2 of the continuing authority directive to the Federal Reserve Bank of New York to

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increase, from $500 million to $1 billion, the dollar limit on special short-term certificates of indebtedness purchased directly from the Treasury that might be held by the Federal Reserve Banks at any one time. With this amendment, Section 2 read as follows:

The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate ¼ of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

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

This action was taken after the Account Manager reported that the amount the Treasury might have to borrow directly from the Federal Reserve Banks in December was highly uncertain and that it appeared at least possible that the amount might be somewhat in excess of the $500 million limit previously specified.

December 13, 1966

Authority to effect transactions in System Account.

Additional indications that the pace of economic expansion was moderating were reported at this meeting. Growth was slowing in business capital expenditures and apparently in Federal defense outlays. Expansion in consumer spending also was slackening, despite continued rapid gains in nonfarm employment through November and a dip in the unemployment rate to 3.7 per cent from 3.9 per cent in October. Staff projections of

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GNP growth in the fourth quarter had again been reduced somewhat.

A Commerce Department–SEC survey taken in late October and November indicated that business expenditures on plant and equipment had been somewhat lower in the third quarter than estimated earlier, and that outlays planned for the fourth quarter had been reduced appreciably—the first significant downward revision in capital spending plans in 3 years. Plans for the first half of 1967 implied an increase less than one-third the size of the large gain actually recorded in the corresponding half of 1966. While estimates of current and prospective defense expenditures were conjectural, the best available evidence suggested continued sizable increases in the fourth quarter of 1966 and the first quarter of 1967, but at rates progressively slower than the extraordinarily rapid rate of the third quarter of 1966.

The proportions of consumers planning to buy automobiles and major appliances within 6 months were significantly lower in mid-October than a year earlier, according to a Census Bureau survey. Retail sales, which had changed little in September and October, declined by 1 per cent in November according to preliminary data, mainly because of a 5 per cent reduction in sales at automobile dealers. Retail inventories rose sharply in October, and manufacturers of automobiles and some other consumer durable goods subsequently announced production cutbacks. With output of steel and construction materials also declining, the industrial production index for November was tentatively estimated at only slightly above its August–September average.

The rate of housing starts was likely to be lower in the fourth quarter as a whole than in the third, although not so low as in October. It appeared that the extended decline in residential construction might taper off in the first quarter of 1967; if so, this would provide some offset to the slowing of growth foreseen for other categories of demand.

The consumer price index rose in October at the substantial pace of the preceding 4 months, with prices of services continu-

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ing to increase rapidly. It was likely that a smaller increase would be shown in the consumer index for November, as earlier declines in wholesale prices of foodstuffs carried over to retail prices. At the wholesale level, on the other hand, the declines in prices of both foodstuffs and sensitive materials appeared to be leveling off after the end of October, and industrial commodities were under upward pressure from rising labor costs.

The money supply declined further on the average from October to November, but turned up after mid-November as Government deposits were drawn down. With the run-off of negotiable CD's at banks slackening to less than half the September–October rate, total time and savings deposits increased slightly. Daily-average member bank deposits—the "bank credit proxy"—declined at an annual rate of about 5 per cent from October to November, somewhat more than expected earlier. On a last-Wednesday-of-the-month basis, bank credit rose slightly in November because of bank acquisitions of tax-anticipation bills issued by the Treasury late in the month. Bank holdings of other securities declined, and loan volume was unchanged on balance.

New staff projections for December suggested that member bank deposits would show relatively little increase from November if money market conditions remained unchanged. Total time and savings deposits were expected to grow slightly, despite anticipated further attrition in outstanding CD's at a rate probably somewhat above that of November. Private demand deposits and the money supply were expected to continue rising as Government deposits were reduced further. On Friday, December 9, the Treasury replenished its cash balances by selling a special certificate of indebtedness in the amount of $169 million to the Federal Reserve. The certificate was redeemed 3 days later.

System open market operations since the preceding meeting of the Committee had been directed at attaining somewhat easier conditions in the money market. A substantial volume of reserves was provided through outright purchases of Treasury bills

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and through repurchase agreements with nonbank dealers, including some repurchase agreements involving obligations of Federal agencies as authorized by the Committee on November 1. Various money market rates moved lower, partly as a result of System operations and of market interpretations that these operations reflected a shift of monetary policy in the direction of less restraint. The 3-month Treasury bill rate declined by nearly 20 basis points, to 5.03 per cent on the day before this meeting. Long-term interest rates also edged down, despite increased current and prospective borrowing by corporations and State and local governments and market expectations of a sale of participation certificates by the Federal National Mortgage Association.

The deficit in the U.S. balance of payments on the "liquidity" basis was relatively large in October and November, and the balance on official reserve transactions reverted to deficit from the surplus recorded in the third quarter. It was likely that the liquidity balance would improve in December, particularly if British debt service payments were not waived—as they had been in the two prior years—and if an expected payment under the German military offset agreement were made before the end of the year. The December balance on official reserve transactions could depend heavily on the changes in liabilities of U.S. banks to their foreign branches; if these liabilities declined toward the year-end, as they had in earlier years, the deficit incurred in the fourth quarter could be enlarged. Such liabilities had fluctuated widely in November and early December, but had increased on balance.

Guidelines and targets for 1967 in the President's voluntary program to improve the nation's balance of payments were announced on the day of this meeting by the Board of Governors and the Department of Commerce. The Federal Reserve guidelines for banks retained the existing ceiling for outstanding foreign assets, but banks were asked to limit the rate at which they used their leeway under the ceiling. Nonbank financial institu-

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tions were asked to limit the increases in covered assets to 5 per cent over the period from September 1966 through December 1967. The new target formula set by the Department of Commerce for corporations' direct investment transactions was designed to keep the total net outflow on direct investments in 1967 close to the volume presently expected for 1966.

The Committee concluded that the additional evidence of moderation in the pace of the business expansion confirmed the appropriateness of the decision at the preceding meeting to relax monetary restraint somewhat, and a majority of the members thought that some further relaxation would be desirable at present in light of both the outlook for slower economic growth and the persisting lack of expansion in bank credit. While it was agreed that the balance of payments continued to pose a serious problem, the view was expressed that the voluntary program in that area, as extended, would serve to enlarge the scope for adaptation of monetary policy to developments taking place in the domestic economy.

Within the majority favoring further relaxation of monetary restraint there were divergent views regarding the manner in which the goals for open market operations over the next 4 weeks might best be specified in the current economic policy directive to be issued to the Federal Reserve Bank of New York. One group suggested specifying the objective of operations in terms of attaining moderate expansion in the money supply and bank credit, noting that relatively vigorous operations might possibly be required to achieve that goal under present circumstances. Another group favored continuing the approach initiated at the preceding meeting, by calling again for somewhat easier conditions in the money market unless bank credit expansion became unduly rapid. At the conclusion of the discussion, however, the members of both groups joined in voting for the following current economic policy directive:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing to expand, with

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rising defense expenditures but with additional evidences of moderating tendencies in the private economy. While there has been some slowing in the pace of advance of most broad price measures, upward price pressures persist for many finished goods and services. Bank credit and money have shown no net expansion in recent months. Although demands on bond markets have increased, upward pressures on long-term interest rates have moderated. The balance of payments remains a serious problem. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions conducive to noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be resuming a rapid rate of expansion.

Votes for this action: Messrs. Martin, Brimmer, Clay, Hickman, Maisel, Mitchell, Robertson, and Wayne. Votes against this action: Messrs. Hayes, Daane, Irons, and Shepardson.

The members dissenting from this action favored maintaining the easier money market conditions achieved under the approach initiated at the preceding meeting, but not actively seeking further easing of conditions at this time. While the emphasis on particular factors varied, they generally stressed the underlying strength of the economy and their continuing concern about the balance of payments situation. They also voiced concern about recent and prospective cost and price developments. Despite the recent evidences of slower growth, the private sector of the economy did not appear to them as fundamentally weak and there were expansionary forces in the public sector. They thought, therefore, that the possibility of a reappearance of general strength and resurgence of pressures could not be ruled out.

Dissenting members were skeptical that defense spending would decelerate and emphasized that the continuing uncertainties regarding fiscal policy were grounds for proceeding cautiously in making monetary policy changes. Caution was par-

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ticularly called for, in their view, because of the possible threat to the balance of payments from any deterioration in the capital account. The voluntary guidelines did not appear to provide full safeguard against such outflows.

Furthermore, it was noted that there were indications that the money supply had begun growing again in recent weeks. Efforts of banks to improve their liquidity positions before expanding loans and investments might have accounted for the seeming lack of response of bank credit thus far to the easing of monetary restraint already accomplished. The latter view was shared by some members of the majority.

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OPERATIONS OF THE SYSTEM OPEN MARKET ACCOUNT

The following two reports describe the actions taken during 1966 to carry out the policy directives of the Federal Open Market Committee.

The report on operations in domestic securities was prepared by Alan R. Holmes, Manager of the System Open Market Account, who supervises these operations. It is written from the vantage point of the Trading Desk at the Federal Reserve Bank of New York, where operations in these securities are effected to carry out the policy directives of the Federal Open Market Committee. The report outlines the factors that the Manager takes into account in the day-to-day provision of bank reserves.

The report on foreign currency operations was prepared by Charles A. Coombs, Special Manager of the System Open Market Account, who supervises the Federal Reserve's operations in such currencies. The Federal Reserve has been buying and selling foreign currencies since early 1962 as part of the efforts to defend the dollar and strengthen the world payments system. All of these operations for the System Account are carried out, under the authorization of the Federal Open Market Committee, by the Federal Reserve Bank of New York, which also handles foreign currency transactions for the U.S. Treasury.

The report on operations in foreign currencies begins on page 269.

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REVIEW OF OPEN MARKET OPERATIONS IN DOMESTIC SECURITIES

In broad terms, the objectives of open market operations passed through five phases during the year 1966. Operations were directed first at moderating the adjustment of financial markets to the increase in the discount rate in December 1965. Then they were used to bring steadily increasing pressure on bank reserve positions in order to restrict the growth of the reserve base, bank credit, and the money supply in the face of mounting inflationary pressures in an overheated economy. Later on, as the effects of earlier steps took hold, the objective was to maintain firm but orderly conditions in the money market, while moderating the unusual liquidity pressures that were prevailing in a market atmosphere of considerable uncertainty. Operations toward the end of the year permitted some relaxation of the pressure on banks reserve positions, and finally, after a while, sought a modest but overt easing in money market conditions and a resumption of growth in the money and credit aggregates amid signs of moderating tendencies in some sectors of the economy.

The heavy burden placed on monetary policy to counter inflationary pressures during the year—in the absence of greater fiscal restraint on spending and incomes—led to considerable stresses and strains on financial institutions and markets, and these strains in turn often complicated the conduct of System operations. In late August interest rates mounted to the highest levels in 40 years, and fears of a market crisis began to be expressed by some participants. While these fears were exaggerated, it was necessary to take them into account in the conduct of open market operations. The fears subsided after further restrictive fiscal actions were proposed in September. By the end of the year, many interest rates had returned to levels near those existing at the start of the year, a better atmosphere prevailed in financial markets, and a resumption of bank credit expansion appeared to be under way.

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In carrying out open market operations in the economic and financial environment that prevailed in 1966, several innovations were made, and considerable flexibility was required. An innovation in early May involved the addition of a "proviso clause" to the content of the Federal Open Market Committee's current policy directive, instructing the Manager of the System Open Market Account to make some modifications in operations in the light of cumulating evidence of developments in required reserves or bank credit. In early July, when very unsettled conditions prevailed in the Treasury bill market and an airlines strike added suddenly to the supply of reserves by increasing float, the System introduced a new operating technique of "matched sale–purchase transactions" to absorb reserves on a temporary basis with as little impact on the general market atmosphere as possible. These transactions involved the sale by the System of Treasury bills for immediate delivery and the simultaneous purchase of the same issues of bills at competitive prices for delivery at a future date. This new technique was employed on a number of other occasions during the year, and it proved to be an effective means for the temporary absorption of reserves, somewhat akin to the function performed by repurchase agreements in dealing with temporary reserve needs. Finally, the Committee broadened the avenues for reserve injections during the year by removing the 2-year limitation on the maturity of Treasury securities that might be purchased for the Open Market Account under repurchase agreements, and by authorizing—pursuant to new legislation—repurchase agreements against direct obligations of Government agencies and obligations fully guaranteed by such agencies.

On an over-all basis, including repurchase agreements and matched transactions, the System bought and sold nearly $45.5 billion of securities during the year, with the net increase in System holdings over the year amounting to $3.5 billion. (See table on page 207.) These net purchases served to offset the drain on reserves resulting from the continuing outflow of gold and the

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rise in currency in circulation over the year. The purchases also provided for an increase of $1.1 billion in the reserve base over the year.

In describing the System's open market operations in 1966 in more detail, it is useful to divide the year into the following five periods:

1. January 1–February 8: Transition to a Firmer Policy Posture
2. February 9–June 7: Gradual but Steady Increase in Pressure on Bank Reserve Positions
3. June 8–September 13: Peaking of Financial Market Pressures
4. September 14–November 22: Relaxation of Market Tensions
5. November 23–December 31: Modest but Overt Move Toward Ease

January 1–February 8: Transition to a firmer policy posture. The first 6 weeks of 1966 were a period of transition for Federal Reserve open market operations. Economic activity and credit demands were expanding vigorously, as a rapidly growing military effort for the war in Vietnam was added to the strong demands of the private sector. Capacity limits were being approached, inflationary pressures were increasing, and the outlook was for further strength in economic activity and credit demands over the year ahead.

In response to these forces the Federal Reserve had, in early December 1965, raised the discount rate and the maximum permissible rates on time and savings deposits under Regulation Q. During the weeks immediately following, open market operations were directed at moderating the sharp upward adjustments in interest rates that ensued and at preserving a generally "even keel" situation while the Treasury conducted several sizable financing operations. In this way, operations helped to accommo-

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date the widely fluctuating seasonal pressures around the end of the year, which—as it happened—were accentuated by a transit strike in New York City.

These adjustments worked themselves out during the period under review, and by early February open market operations had restored average net borrowed reserves in the banking system to approximately the level that prevailed before the increase in the discount rate. Meanwhile, the Federal Open Market Committee set the stage for a shift in its general policy stance by moving at its January 11 meeting from a position of "accommodating moderate growth in the reserve base, bank credit, and the money supply," as had been the case throughout 1965, to "moderating the growth" in these aggregate measures.

Implementing the Committee's objectives in the environment of considerable market churning and of wide fluctuations in various factors affecting reserve availability and distribution —such as usually occur in the opening weeks of a new year— involved a fairly large volume of open market operations over the 6-week period. Gross outright purchases of Treasury bills for the System Open Market Account over the period totaled $1.4 billion, while gross sales and redemptions amounted to $1.2 billion. In addition, $1.7 billion of Treasury issues were purchased under repurchase agreements with nonbank securities dealers, and $1.6 billion of such contracts matured or were withdrawn by the dealers. Operations in bankers' acceptances, also relatively large during the period, were a useful supplement in meeting the Committee's reserve objectives. In all, gross transactions by the System on an outright basis and under repurchase agreements averaged more than $250 million a day during the period; there were net purchases in the opening days of January, net sales in the 2 weeks ended January 19, and net purchases again in the final 3 weeks of the interval.

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SYSTEM OPERATIONS IN GOVERNMENT SECURITIES DURING 1966
(In millions of dollars)

Type of operation	Jan. 1–Feb. 8	Feb. 9–June 7	June 8–Sept. 13	Sept. 14–Nov. 22	Nov. 23–Dec. 31	Total
Outright purchases:						
Treasury bills:						
From market	784	3,381	[1] 4,769	[1] 2,764	963	[1] 12,661
From foreign accounts	629	466	767	326	327	2,515
Coupon issues	.....	[2] 254	185	.....	35	[2] 474
Special certificate of indebtedness	.....	.....	.....	.....	169	169
Outright sales:						
Treasury bills:						
To market	677	2,210	[1] 3,570	[1] 2,185	.....	[1] 8,642
To foreign accounts	287	524	500	344	.....	1,655
Coupon issues	.....	.....	.....	.....	.....	.....
Redemptions:						
Treasury bills	228	524	257	664	503	2,176
Special certificate of indebtedness	.....	.....	.....	.....	169	169
Repurchase agreements:						
Government securities:						
Purchases	1,741	1,499	716	1,021	4,779	9,756
Sales	1,618	1,911	716	1,021	4,153	9,419
Government agency issues:						
Purchases	.....	.....	.....	.....	197	197
Sales	.....	.....	.....	.....	163	163
Net change in holdings	+344	+431	+1,394	−103	+1,482	+3,548
Memorandum item:						
Matched sale-and-purchase transactions:						
Sales	.....	.....	2,836	1,220	.....	4,056
Purchases	.....	.....	2,836	1,220	.....	4,056

[1] See "Memorandum" item at bottom of table for amounts of matched sale-and-purchase transactions included in this total.
[2] Includes $28 million from foreign accounts.
NOTE.—All figures are as of date of delivery.

The pattern of financial market developments that accompanied these operations varied considerably over the period. On the one hand, there was a continuing upward adjustment in many short-term interest rates. Leapfrogging of rates on negotiable time certificates of deposit (CD's) led the parade, as banks competed aggressively for funds under the new, more liberal rate ceilings. By the end of the period a 5¼ per cent rate on deposits maturing in more than a year was available at major New York City banks, compared with a high of 4⅞ per cent in late 1965. Offering rates on 3-month CD's were up as much as 20 basis points to 5 per

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cent. This upward ratcheting of rates on CD's, among other things, contributed to a state of nervousness in the Treasury bill market through much of the period, and the market rate on 3-month bills moved up by 15 basis points to 4.64 per cent bid on February 8. Rates on bankers' acceptances and commercial and financial paper rose by ⅛ of a percentage point.

In the money market, on the other hand, tautness in the first 2 weeks of the period, when the major money market banks had very large basic reserve deficits, was followed by somewhat more relaxed conditions in subsequent weeks as reserves shifted back to the money centers. Although nationwide net borrowed reserves gradually deepened to the levels prevailing prior to the change in the discount rate, Federal funds were generally available in sizable volume at rates of 4½ or 4⅝ per cent—the same range as in December. Member banks' borrowings from the Federal Reserve fluctuated from week to week, but the daily average of $440 million over the period as a whole was about the same as the average in the last 2 months of 1965.

Finally, although demands for bank credit and capital market financing proved considerably stronger than usual for that time of year, these demands were met without major difficulty at the higher rate levels that developed in the wake of the increase in the discount rate. Outstanding business loans at commercial banks declined by only about half as much as normal, and on a seasonally adjusted basis total bank credit rose at an annual rate of more than 12 per cent in January. In the capital markets, a total of $5.5 billion of new cash was raised through sales of corporate, municipal, Treasury coupon, and Government agency issues in the first 6 weeks of the year. Despite these demands, prices of most long-term securities rose for a time in January. Although subsequent price declines in the final weeks of the period more than erased the earlier gains, the atmosphere for Treasury financing remained sufficiently promising through January for the Treasury to seek and achieve a helpful lengthening of the debt in its February refunding. As the period drew to a

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close, however, there was renewed concern over the tenability of existing interest rates in the face of signs that still stronger credit demands lay ahead.

System operations. Several developments complicated the conduct of open market operations as the period unfolded. The first was a transit strike in New York City, which began on January 1 and for a time prevented many employees of banks and securities firms in the city from getting to their offices. This made it difficult for the banks to obtain accurate estimates of their reserve positions and tended to make them cautious in managing their reserves, a situation which in turn made the System's evaluation of underlying conditions in the money market more difficult. The strike also impeded the consummation of securities transactions, including those carried out by the System to inject and absorb reserves, as only limited work forces were available for the physical processing and delivery of the securities involved. To ease some of the delivery problems, the New York Reserve Bank requested on Monday, January 3, that dealers in Government securities avoid making outright transactions for "cash" (that is, same day) delivery for the duration of the strike.

The first several days of the strike coincided with a period of reserve need by the banking system and an emerging tightness in the money market. Heavy year-end demands for bank credit persisted somewhat longer than expected into the new year. As a result, banks in the major money centers, where much of the demand often converges, continued to experience very deep basic reserve deficits, which averaged more than 15 per cent of their aggregate required reserves.

In injecting reserves to head off undue tightness in the market, the System made extensive use of repurchase agreements and also purchased large amounts of Treasury bills being sold by foreign accounts. In all, these operations added $721 million of reserves over the January 3–10 period and enabled the System to avoid outright transactions in the market at the height of the strike difficulties. The repurchase agreements also served to mitigate

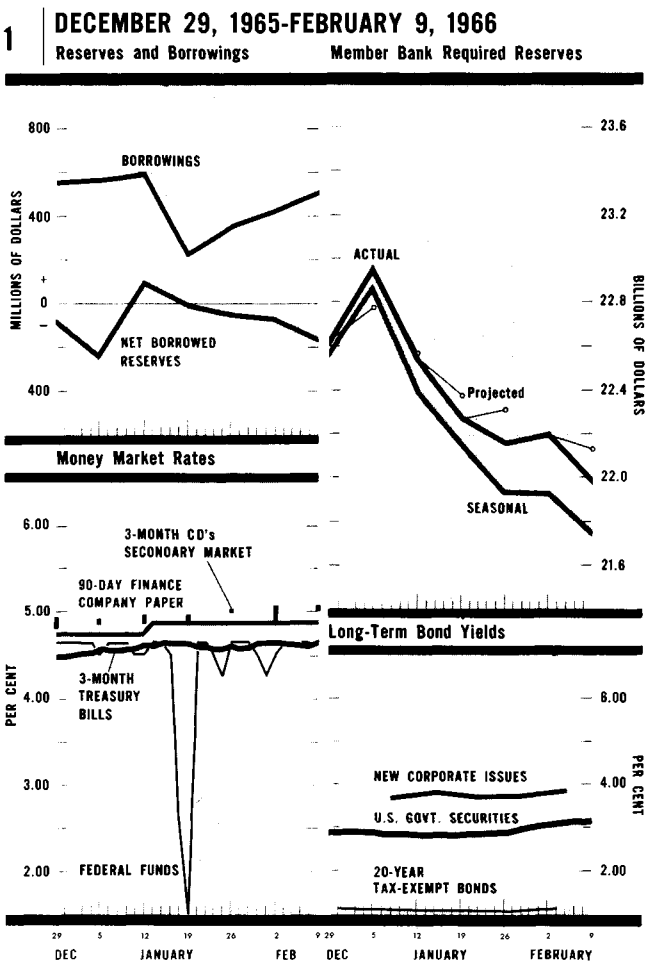
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the nervousness pervading the Treasury bill market and to moderate the upward pressure on short-term interest rates that stemmed from the sharply higher dealer loan rates posted by the New York City banks.

Conditions in the Treasury bill market increasingly complicated open market operations as January wore on. In this period, the System had to shift from reserve-supplying to reserve-absorbing operations to offset movements in factors that were releasing reserves—particularly the decline in required reserves of member banks as some of the year-end bulge in loans and deposits gradually was liquidated. Around this time, however, dealers were reluctant buyers and aggressive sellers of bills, as they reacted to the rise in rates on CD's, to high financing costs, to the addition of $100 million to the volume of Treasury bills sold in each weekly auction and the sale (after overallotments) of more than $1.6 billion of Treasury certificates in a cash financing on January 10, and finally, to the general difficulties in trading securities before the New York City transit strike was settled on January 13. In this environment the System proceeded cautiously in absorbing reserves. Repurchase agreements with the nonbank dealers were allowed to mature or be withdrawn without replacement, and a small amount of bills was sold outright in response to unsolicited dealer bids for scarce issues and directly to foreign accounts. In addition, some of the System's holdings of maturing bills were redeemed in the auction on January 10.

Because of this only gradual absorption of reserves, net reserve availability bulged to an average of $98 million of free reserves in the week ended January 12 (see Chart 1). Net borrowed reserves in the preceding week had been deeper than expected—at $243 million. Even with the extra reserve availability, money market conditions did not ease immediately. Major money center banks moved into an even deeper basic reserve deficit position than earlier, and most of the extra reserve availability was lodged in country banks, whose average excess reserves rose to a very high level of $617 million in the January 12 statement week.

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Finance company paper, offering rate. Treasury bills, daily bid rate. Federal funds, effective rate. New corporate issues, Aaa basis.

In the following statement week, excess reserves accumulated earlier by country banks did flow into the money centers, and somewhat easier market conditions emerged. Not until the end of that week, however, did the atmosphere in the bill market improve sufficiently to permit large-scale sales of bills by the System to absorb some of the redundant reserves. By then Treas-

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ury bill rates had moved up to levels that dealers thought might begin to attract greater investor demand. The average issuing rate on 3-month bills auctioned on January 17 was at a record (to that date) of 4.673 per cent, 22 basis points higher than the rate in the final auction of December 1965.

Further sales of bills by the System toward the end of the week ended January 26—after it was learned that nationwide net reserve availability was higher than had been thought earlier—were accomplished without difficulty. For several days dealers had been rebuilding inventories in anticipation of possible demand for bills arising out of the Treasury's forthcoming refunding operation. In any event, investment demand for bills proved rather disappointing to the dealers over the next several days. By this time, however, the System was in the process of meeting month-end reserve needs, and it purchased a sizable volume of bills from the dealers over the January 28–February 1 period. These purchases exerted some steadying influence on the bill market while the books were open for the refunding operation. The System also injected reserves around this period through the purchase under repurchase agreements of rights to the refunding issues. These agreements facilitated financing of the rights until the February 15 payment date in a period when there was renewed concern among market participants over the high cost of alternative sources of funds.

Capital markets. Developments in the longer-term securities markets during the period have already been summarized briefly. In general, the markets were in a technically strong position in early January, following the sharp decline in prices in December and the preceding months of 1965. By the week ending January 12, dealers' total positions in Treasury coupon issues had fallen to a daily average of $160 million, and they had a net short position in issues maturing in more than 1 year. Moreover, dealers and investors reacted favorably to limitation by the Treasury of its early January cash financing to the short-term area. Indeed, the offering of the 4¾ per cent 10-month certificate priced to

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yield 4.85 per cent, which was announced on January 5 for sale on January 10, attracted subscriptions totaling more than $10 billion. Allotments totaled a little more than $1.6 billion. As switching activity for tax purposes expanded and investor and professional demand emerged, prices of outstanding Treasury notes and bonds rose sharply, with gains ranging from ⅛ to more than a full point over the first 12 days of January.

Market participants remained generally cautious even during this rally, however, and as the period progressed, some of their apprehensions gradually came to the forefront again. A major concern—which was to affect the securities markets in varying degrees throughout the year—related to Vietnam; in this period there was a disappointment over waning prospects for a peace settlement during the pause in U.S. bombing attacks on North Vietnam and a feeling that resumption of the air strikes was close at hand. There was also a growing realization of the strength of the economic outlook, especially with the continued fighting in Vietnam, and of the likely strength of credit demands ahead.

The size of these demands was underscored by a steady stream of large additions to the calendar of prospective corporate and municipal bond offerings. In addition, some market participants were disappointed that the President had not recommended stronger measures of fiscal restraint in his messages to the Congress. Skepticism over the possibility of attaining an administrative budget deficit of only $1.8 billion for the fiscal year 1967, and a growing awareness that very large sales of Government assets were projected in the budget, contributed to the apprehension in the market.

Despite these latent worries, prices held generally steady for a time and activity gradually decreased in anticipation of the Treasury's February financing operation. A number of participants thought that the market would be receptive to and might derive direction from an offering in the 5-year area, the longest maturity that could be sold given the 4¼ per cent coupon ceiling on longer-term issues. The financing that was announced on

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January 26 offered holders of February, April, May, and August maturities the right to exchange their holdings for a new 5 per cent note to mature in 4 years and 9 months. Holders of the February and April maturities were also offered the right to exchange into a 4⅞ per cent 18-month note, priced to yield 4.96 per cent. A total of $13.7 billion of publicly held securities, plus holdings by the Federal Reserve and other official accounts, were eligible for exchange. Initial reaction to the combination refunding and prerefunding was favorable, and when-issued prices of the two new notes rose to premiums of 7/64 and 3/32 of a point above their offering prices.

The general market atmosphere deteriorated soon thereafter, however, as bombing of North Vietnam was resumed, as credit demands continued to grow, and as concern increased that, in the absence of more restrictive fiscal policies, monetary policy would move toward further restraint once the refunding was completed. Syndicates handling several corporate and municipal bond issues that were moving slowly were terminated, with yields on these issues adjusted upward by 4 to 6 basis points. Prices of outstanding Treasury coupon issues fell sharply; those on the refunding issues also came under downward pressure, although this was cushioned somewhat by Treasury trust account purchases of the new issues. In this atmosphere, dealers were reluctant to assume large underwriting positions in the refunding.

Investors at large, on the other hand, apparently placed greater weight on the high, intermediate-term yield than on current market developments, for the total public exchange into the new issues was unexpectedly large—$6.5 billion for the 5 per cent issue and $860 million for the 4⅞ per cent notes. This very successful completion of the refunding added about 1 month to the average maturity of the Federal debt and reduced the sizes of the prospective May and August financings to routine proportions.

Over the remainder of the period bond prices continued to fall in an unfavorable market atmosphere. Rumors of a peace feeler from North Vietnam had a temporary, buoyant effect, but this

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soon faded. By February 8 prices of some long-term Treasury issues had fallen by more than 2 points from their mid-January highs, and most issues were ⅛ to 2¼ points below the prices prevailing at the year's start. At these lower prices long-term Treasury issues yielded as much as 4.70 per cent, 11 basis points higher than at the end of December. In the corporate market, where the calendar of future offerings was growing, a utility issue rated Aa was offered without special call protection at a yield of 5.04 per cent on February 9, compared with a 4.89 per cent yield offered on a similarly rated issue in early January. Reoffering yields on municipal securities were also up somewhat from earlier in the year, with the Bond Buyer's index of yields on 20 seasoned tax-exempt issues at 3.58 per cent on February 10, compared with 3.54 per cent on the last Thursday of December.

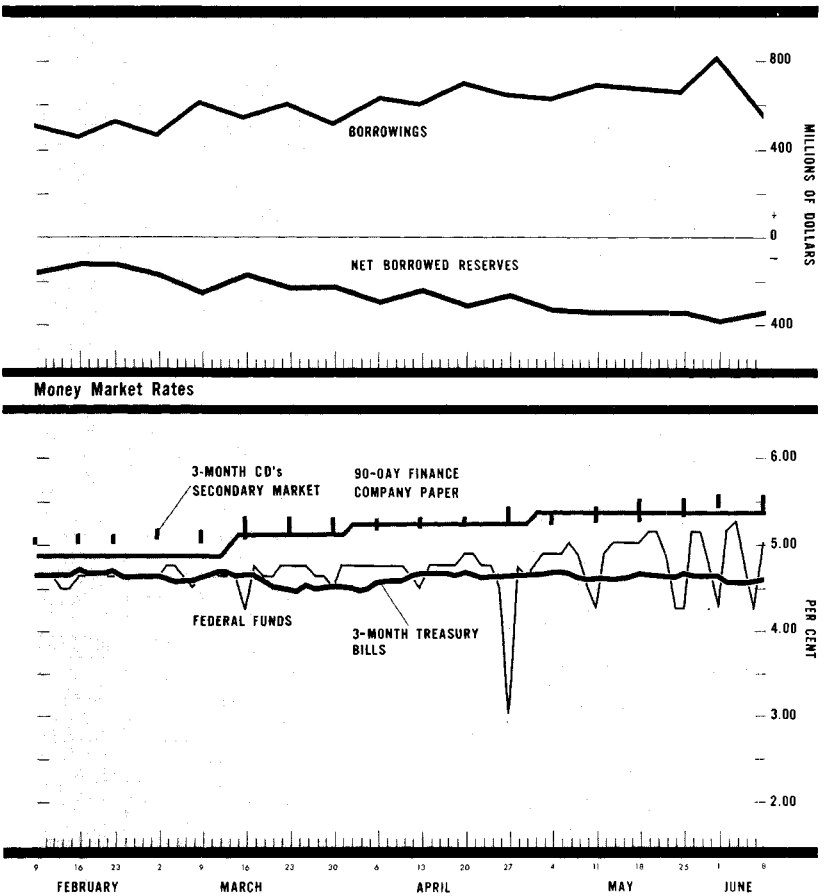
February 9–June 7: Gradual but steady increase in pressure on bank reserve positions. By the second week of February, the period of even keel requirements in connection with the Treasury's refunding operation was nearing an end. The economy was expanding vigorously amid rising prices and continuing strong demands for credit. Against this background, a series of steps were taken, beginning with actions at the meeting of the Federal Open Market Committee on February 8, to bring gradually increasing pressure on bank reserve positions. Implementation of these actions led to a progressive deepening in nationwide net borrowed reserves from an average of about $70 million in the 6 weeks ended February 9 to around $200 million by late March, $300 million by early May, and $350 million in the final three statement weeks of the period under review here (see Chart 2). There was a corresponding steady rise in borrowings by member banks from the Reserve Banks, from an average of $440 million in the opening 6 weeks of the year to an average of $670 million in the final 3 weeks of the period under review.

The interaction of this increased pressure on bank reserve positions and of still swelling demands for credit led to consider-

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2 **FEBRUARY 9 - JUNE 8, 1966**

Reserves and Borrowings

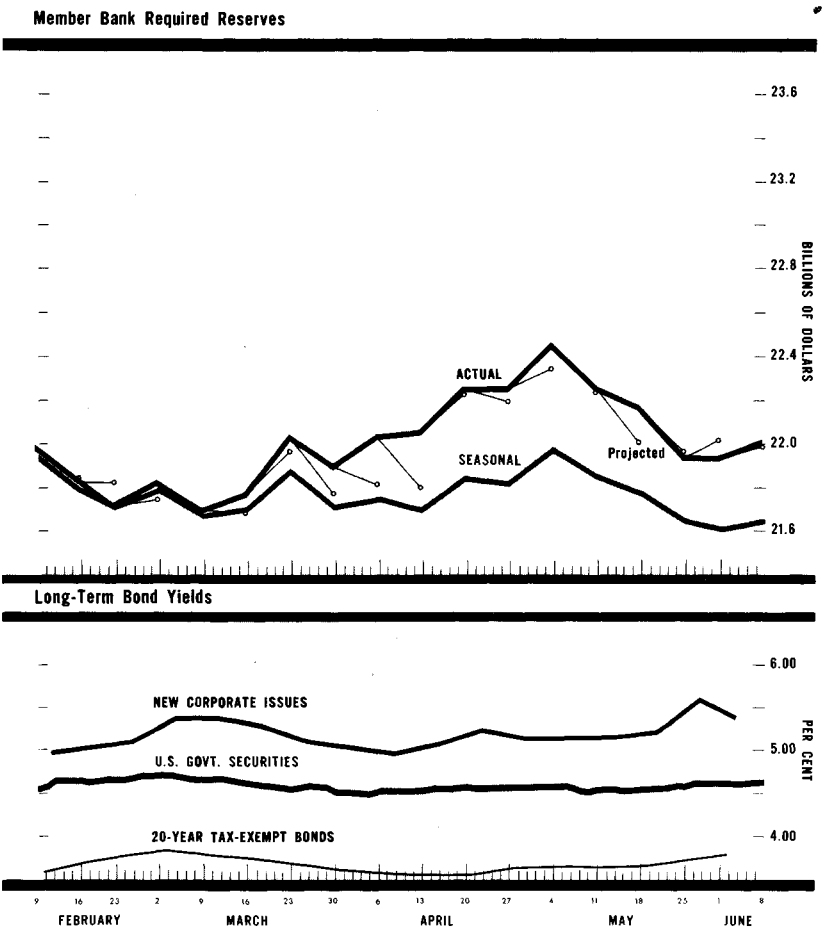


For note see p. 211.

able further upward movement of most interest rates over the period. These rate increases in turn, and the related flows of funds that were set in motion, served somewhat to temper the speed and degree of the System's moves toward greater monetary restraint.

Rates on Federal funds rose in steps of ⅛ of a percentage

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point, and by the end of the period these funds were often being traded at 5¼ per cent, compared with only limited trading at rates as high as 4¾ per cent in the early weeks of the year. Rates available on CD's at major banks in New York City moved up from 5¼ per cent on 12-month money at the start of the period to the 5½ per cent ceiling on deposits as short as 3

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months by early June. Increases in rates on bankers' acceptances and commercial and sales finance company paper ranged from ½ to ⅝ of a percentage point over the period, and rates on short-term Government agency securities moved up by approximately 45 basis points. Even then, a 9-month issue of the Federal intermediate credit banks yielding 5.60 per cent was accorded a poor reception in late May. Meanwhile, commercial banks raised their lending rate to prime business customers from 5 to 5½ per cent on March 10, and a general increase in borrowing costs also occurred in most sectors of the capital markets as the period progressed.

Only Treasury bill rates were insulated from this general upward pressure. In fact most bill rates actually showed net declines over the period. This reflected, in large part, the heavy seasonal demand for bills from State and local governments, combined with a reduction in the supply of bills outstanding as tax-anticipation bills matured in March and another sizable volume of maturities was in prospect for June. In addition, however, many investors continued to prefer the added liquidity provided by bills in a period of generally rising interest rates, and under these circumstances market supplies of bills were continually being depleted despite the widening rate spread between bills and other instruments. One period in which there was an acute scarcity of bills was around March 24, when the rate on 3-month bills dipped to a low for the year to date of 4.46 per cent bid. On June 7, 3-month bills were bid at yields of 4.60 per cent compared with 4.64 per cent on February 8. This performance of the Treasury bill market was a dramatic demonstration of how independent the various sectors of the securities markets can be, even over an extended period of time, when special circumstances dominate.

Despite the increased pressure on bank reserve positions and the sharp upward movement of most interest rates, credit continued to expand at a rapid rate. Businesses had particularly heavy demands for credit during the spring and early summer as they

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sought to finance accelerated payments of taxes to the Treasury. The speedup of tax payments had been one of the fiscal measures proposed by the President in January.

The strength of the credit–deposit expansion at the banks was reflected in movements in member banks' required reserves. In each of 11 consecutive statement weeks from early March through early May, the actual level of aggregate required reserves turned out to be higher than the estimates prepared at the start of each week for use by the Manager of the System Open Market Account, and the level continued to run well above a normal seasonal pattern in subsequent weeks (see Chart 2). In the capital markets, despite the cancellation of some offerings, underwriters were continually facing a heavy calendar of corporate, municipal, and especially Federal agency securities. Furthermore, a steady stream of announcements forewarned of large future flotations.

In underscoring its concern over the rapid expansion of credit, the Federal Open Market Committee voted at its April 12 meeting to change the statement of its policy stance in the first paragraph of its directive from a position of "moderating" to one of "restricting" the growth in the reserve base, bank credit, and the money supply. Then, at the May 10 meeting, the Committee changed the content of the operating instructions contained in the second paragraph of its directive. As before, the Committee called for operations "with a view to attaining some further gradual reduction in net reserve availability." But to this it added a "proviso clause" calling for "a greater reduction if growth in required reserves does not moderate substantially."

Such a proviso clause, which had been under discussion by the Committee and its staff for several months, was designed to permit the Manager to modify day-to-day operations if cumulating evidence of an undesirably rapid expansion of credit developed during the interval between Committee meetings. The initial choice of required reserves as the conditioning variable in the proviso was made largely on practical considerations in-

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volving the timely availability of data relating to current bank credit and money supply expansion. Later in the year the conditioning variable was shifted to total member bank deposits subject to reserve requirements, the so-called "bank credit proxy."

The proviso clause was used in one form or another in the directives throughout the rest of the year. It provided a means of responding to unexpectedly or undesirably large movements in the banking aggregates, while still allowing open market operations to facilitate a generally smooth day-to-day functioning of the banking system and the over-all payments mechanism in the face of sharply fluctuating flows of reserves and deposits in the short run.

System operations. In conducting its day-to-day operations during the period February 9 through June 7, the System purchased slightly more than $3.8 billion of Treasury bills on an outright basis and sold or redeemed about $3.2 billion of bills. It made somewhat less use of repurchase agreements against Treasury issues than it had earlier in the year. Gross purchases under such agreements totaled about $1.5 billion, and terminations of these and earlier contracts amounted to $1.9 billion. On the other hand, the System did reenter the market for Treasury coupon securities during this period after an absence from this market since early September 1965.

The System's first purchases of coupon issues, on February 17, were confined to very short maturities. Later on, the maturity range of the System's purchases was lengthened gradually, although the Federal Reserve remained only a marginal factor in over-all market activity in coupon issues. System purchases of coupon securities for the whole period amounted to $254 million, of which all but $31 million had maturities of 3 years or less. These purchases proved especially helpful as a means of injecting reserves in March and again in early June when acute scarcities prevailing in the Treasury bill market were hampering System operations. Repurchase agreements against bankers' ac-

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ceptances also were a helpful supplement to operations when Treasury bills were scarce.

While the total volume of System operations was somewhat less on a daily-average basis than it had been in the opening weeks of the year, swings between buying and selling securities were considerably more frequent than they had been earlier. This variability resulted from the System's efforts to maintain continuing pressure on member bank reserve positions in the face of inter- and intra-weekly cycles in the level and distribution of nationwide net reserve availability and/or in bank reserve management strategy.

The statement week ended February 9, the last week covered in the preceding period, and the following 4 weeks (through March 9) witnessed an extended series of short-run reversals of System operations. The distribution of nationwide reserve availability tended to favor the major banks in New York City during the period, as these banks evidently sought to improve their basic reserve positions in anticipation of the seasonal pressures expected around the corporate dividend and tax payment dates in mid-March. On the other hand, banks in other money centers and country banks generally were under some reserve pressure. These banks managed their reserve positions cautiously and were fairly aggressive bidders in the Federal funds market on the opening days—Thursday and Friday—of each of the 5 statement weeks from February 3 through March 9.

With nationwide net reserve availability at generally low levels on Thursdays and Fridays, conditions in the money market became rather taut and virtually all trading in Federal funds on such days was in the 4⅝ or 4¾ per cent area. To meet some of the indicated reserve needs and forestall undue tightness in the money market, the Federal Reserve injected roughly $200 million to $450 million of reserves at the beginning of each of the weeks in question, mostly through outright purchases of Treasury bills. In the wake of these operations, banks generally were able to cover most of their deficiences, and their borrowings at

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Federal Reserve Banks on each Thursday and Friday of the period were only a little above the weekly average.

Money market pressures tended to subside for a time following the weekends in each of the statement weeks. As it turned out, nationwide net reserve availability persistently exceeded earlier estimates, and many banks came through the weekends with accumulated reserve surpluses. In this environment, banks that still had deficiences were able to cover their needs in the Federal funds market on Monday and Tuesday of each week at rates generally ⅛ to ¼ of a percentage point below those prevailing before the weekend, and aggregate member bank borrowings from the Reserve Banks dropped appreciably on these days. Undue easing was headed off, however, as the System reversed direction in each of the 5 statement weeks and absorbed about $150 million to $550 million of reserves through outright sales of Treasury bills. Generally by Wednesday of each week a renewed firmness appeared in the money market, with Federal funds again trading at the higher rates prevailing before the weekend and borrowings from the Reserve Banks expanding.

System open market operations were of more limited scope and did not shift direction so often in the following several weeks, which included the March dividend and tax payment dates and the unwinding after these dates. The rise in the bank prime rate on March 10 temporarily caused some nervousness in financial markets, and as usual for this time of year there was considerable market churning. In the week ended March 16, credit demands converged on the New York City banks, and their total loans and investments rose by $1.4 billion. At the same time these banks lost a net of around $160 million of CD's, and they also lost other funds as repurchase agreements with corporations matured. These developments led to some deterioration in basic reserve positions at New York City banks. In general, however, the pressures were less than anticipated and advance preparations proved to be more than adequate. In fact, money market conditions were fairly comfortable in the week

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immediately surrounding the tax date, and this fact helped to calm the nervousness in other markets. Thus the System waited until late in the week to meet the modest reserve need that was indicated.

The New York City banks soon moved back into a basic reserve surplus after mid-March as a result of an unusually rapid repayment of loans made earlier and also of their success in attracting new CD money at somewhat higher rates. Other banks, however, continued to be under pressure, and nationwide net reserve availability now tended to fall progressively short of levels initially expected by the Account Manager. The System moved to head off some of the emerging tautness in the money market late in the week ended March 23, but it proceeded cautiously in making these reserve injections because of the current scarcities of Treasury issues in the market.

Money market pressures mounted further around mid-April when banks, particularly those in New York City, experienced a much larger than anticipated expansion of credit over the midmonth tax date. In the week ended April 20 the basic reserve deficit of the major New York City banks rose to an average of nearly $1 billion. System operations during this period were directed toward absorbing the reserves supplied by the midmonth rise in float; other reserves were absorbed when the Treasury initially used part of its tax receipts to replenish its depleted balances at the Reserve Banks. Money center banks as a group apparently did not realize for a time how large their reserve deficiencies would be. When the deficiencies became apparent, after the April 16–17 weekend, these banks bid strongly for Federal funds, and a large amount of trading took place for the first time at 4⅞ per cent. Even so, large reserve needs remained to be filled, and borrowings from the Reserve Banks bulged to $1,026 million on Tuesday, April 19, and to $1,587 million on Wednesday, April 20. By not acting to mitigate these pressures, the System gave financial markets a clear indication of its basic policy stance.

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Similarly tight money market situations recurred at the end of alternate weeks over the next month or so, a period when System open market operations again frequently reversed direction, this time to counter repetitive 2-week cycles in nationwide reserve availability and bank reserve management strategy. The cycles took the form of a generally cautious approach to reserve management on the part of banks on the opening days of each of the statement weeks ended April 27, May 11, and May 25, the first week in each 2-week cycle. Banks sought to avoid carrying reserve deficiencies over the weekend by bidding aggressively for Federal funds at progressively higher rates on Thursdays and Fridays and borrowing heavily from the Reserve Banks.

As it turned out, reserves became more plentiful after the weekends, partly because of the overborrowing earlier; the result was that money market conditions eased and member bank borrowings dropped progressively on Monday, Tuesday, and Wednesday of each of these weeks. This ease carried over into the opening days of the new statement weeks, the second week of the cycles. This was particularly true in the weeks ending May 4 and May 18, when banks as a group tended to borrow only modest amounts from the Federal Reserve discount windows on Thursdays and Fridays. Then as the reserve needs became more apparent late in the week, there was a scrambling for funds in the Federal funds market and a bulge in borrowings at the Reserve Banks on Tuesdays and Wednesdays. This return of tautness in the money market marked the full swing of the 2-week cycle, and as the tautness carried over into a new reserve settlement period a new cycle was begun.

Open market operations during this period generally sought to counter these swings in conditions in the money market, insofar as possible, to prevent undue easing that would undermine a steadily restrictive policy toward bank credit expansion or to head off extreme tautness that might generate instability in financial markets. This involved providing some reserves to meet apparent needs in the tight money market environment at the

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beginning of the 2-week cycles and then absorbing at least part of the excess that emerged after the weekends. As a rule, the absorptions were not sufficient to head off completely the money market ease that was developing, although they did serve as an indication of the System's intent to keep the banks under pressure. In the second half of the cycle, when money market pressures become quite intense, the System generally provided only limited amounts of reserves and thereby allowed most of the weight of the pressures to be felt.

The cumulative effects of the tightening of System policy were being felt more and more as the February–early June period drew to a close. Most System operations during this period were directed at offsetting drains from other factors, but the money market was generally quite firm, with some Federal funds transactions at 5¼ per cent for the first time and with borrowings from the Reserve Banks heavy. In this environment, banks in the money centers stepped up their bidding for CD's and adjusted their asset portfolios to improve their basic reserve positions in apparent anticipation of very heavy pressures around the June dividend and tax payment dates.

The acceleration of corporate tax payments as well as of payments of withheld Federal income taxes and social security taxes —anti-inflationary measures enacted by the Congress earlier in the year—was expected to make pressures over the coming weeks more intense than usual. In addition, with most market rates of interest having moved sharply higher, there was increasing concern at thrift institutions over potential large-scale withdrawals of funds in search of higher yields during the interest-crediting period at the end of June. Savings banks and savings and loan associations had experienced heavy losses of deposits and shares at the end of the first quarter of the year, and many had already virtually ceased to make any new mortgage commitments in order to preserve at least some liquidity cushion.

Treasury bill market. As noted earlier, little of the steady increase in money market pressures over the February–June

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period carried into the Treasury bill market. To be sure, with dealer financing costs high—and moving higher—through the period, dealers continually were constrained from taking any overly optimistic view of future developments in the bill market. And at times, the high costs of financing and the concern over increases in supplies of bills combined to produce a very cautious atmosphere in the market. This happened for example, in the first several weeks of the interval when the Treasury's weekly bill auctions were continuing to be enlarged by $100 million and when participants began to focus on the possibility of a large return of bills to the market around the March dividend and tax payment dates. The Treasury raised a total of $1.3 billion of new money through additions to the weekly auctions during the first 3 months of the year; however, the extra supply of bills from this source was more than offset when $3 billion of tax-anticipation bills matured in late March. Another period of hesitancy occurred in late April and early May when dealers were disappointed over the lack of demand for bills arising out of the Treasury's May refunding operation.

Even in the periods of greatest caution, however, rates on 3-month bills rose no more than 5 basis points above the level prevailing at the start of the interval. The more dominant tendency by far was for rates to drift lower—a testimony to the very strong demand for bills that prevailed on balance over the period from a wide range of investors. As usual during this time of year, public funds managed by State and local governments were the largest and most persistent buyers. They continually sought a temporary investment outlet for growing tax receipts as well as for some of the proceeds of the heavy volume of tax-exempt issues floated in the capital market.

From the end of January through the end of May, State and local governments increased their bill holdings by more than $1.1 billion. Proceeds of corporate bond flotations also often found their way temporarily into the bill market. In addition, some investors, both large and small, used the bill market as a haven

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for funds while awaiting more favorable conditions in the stock or bond markets. And finally, there was the Federal Reserve's activity in the bill market, which, while somewhat less than in comparable periods of other recent years, took up about $600 million of bills, net, from the supply of bills over the period as a whole.

Capital markets. The capital markets were marked by very sharp swings in sentiment over the February–early June period —from deepening gloom through the end of February to considerable optimism in March and early April and then back to a heavy atmosphere by late May and early June. Demands for credit in these markets were quite heavy throughout the period. In dollar amounts, the greatest demands came from corporate and State and local government borrowers, which together sold $10.1 billion of new securities from early February through early June, or about 7½ per cent more than during the comparable period of the preceding year.

The source of greatest pressure during most of the period—and particularly in May and June—however, was the sharp increase in borrowings by Government agencies. These agencies, both through increases in the size of regular issues and through heavy sales of new participation certificates by the Export-Import Bank and the Federal National Mortgage Association, offered issues totaling $8.1 billion from early February through early June and raised a net of $3.8 billion of new money, volumes in both cases that were about twice as large as in the comparable period of the preceding year. In terms of market impact, this agency financing far more than offset the effects of an actual reduction in the outstanding amount of direct Treasury obligations over the period.

A number of factors underlay the swings in sentiment that confronted this heavy financing schedule. These included alternately pessimistic and optimistic interpretations of the latest business developments, of the need for and prospects of a tax increase to restrain inflationary pressures, of the probable extent

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of further moves toward monetary restraint by the Federal Reserve, and finally, of the prospects for a peaceful settlement of the war in Vietnam. A mere listing of these factors, however, does not tell the whole story; it was not uncommon for similar developments to have a bearish impact in the bond market at one time and a bullish impact at another time.

In February, for example, participants in the bond market tended to view reports of further sharp rises in business activity and increasing inflationary pressures as being bearish for bond prices. In this environment new issues coming to market were accorded generally unenthusiastic receptions; prices of outstanding bonds moved sharply lower; and yields on Government, corporate, and municipal securities reached the highest levels in more than 40 years. At their peak near the beginning of March, long-term Treasury issues yielded as much as 4.86 per cent compared with a high of 4.70 per cent 3 weeks earlier. At about the same time, a new Aa-rated corporate bond was released from syndicate pricing restrictions and was traded in the free market at a yield of 5.30 per cent, 30 basis points higher than the yield on similar issues traded in early February.

Later, after a technical reaction had sparked the March rally in prices—which was then fueled by investor and dealer buying amid talk of a possible tax increase—reports of rising economic activity tended to have quite a different influence on most sectors of the bond markets. In particular, reports of increasing pressures on capacity, of higher prices, and of business plans to expand capital expenditures were generally interpreted as enhancing prospects for a tax hike and thus were followed by increases in bond prices. Some temporary caution emerged after the announcement of the increase in the commercial bank prime rate on March 10—which for a time led to some fears that the Federal Reserve discount rate might soon be raised—and also on occasion after publication of reports indicating successively deeper levels of net borrowed reserves.

Other factors, however, quickly helped to restore the general

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feeling of optimism about the outlook for bond prices. Among these factors was the cancellation of a large tax-exempt bond issue that had been scheduled for sale on March 17. As funds previously put aside for this issue were released, demand improved in all sectors of the markets. Remarks by President Johnson on March 29 that he would not hesitate to ask for a tax increase if consumer and wholesale prices should continue to rise too fast led to still further large gains in bond prices. So too did Secretary of the Treasury Fowler's plea in early April for restraint on bank lending "without skyrocketing of interest rates." Developments in Vietnam generally had little effect on bond markets during this period.

The buoyancy in the market extended generally through the first week of April. By that time prices of most Treasury notes and bonds had more than regained their February losses and yields on some short-term issues—which were in scarce supply—were at their lows for the year. Offerings of new corporate and municipal issues were well received during this period, and underwriters were left with little in the way of unsold issues. In this environment an Aa-rated corporate issue was brought to market on April 5 at a yield of 5.00 per cent. The Bond Buyer's index of 20 seasoned tax-exempt bonds reached a low of 3.53 per cent a week or so later, on April 14, compared with 3.83 per cent at its peak on March 3.

The improvement in general atmosphere also appeared in the market for Government agency securities, and prices of outstanding agency issues rose for a time. On the other hand, the heavy volume of new agency issues coming to market, which included the sale of $410 million of FNMA participation certificates around mid-March, generated somewhat mixed reactions. Receptions of these issues generally turned out quite good, but only because offering yields remained near their earlier highs.

The rally in the capital markets came to an end around mid-April. Prices drifted lower for a time and then fell off more sharply in late May and early June. Further discussion of the

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need for a tax increase intermittently buoyed the markets on individual days—as did occasional rumors of peace efforts in Vietnam. On the whole, however, participants came to the view that prospects for fiscal action had dimmed while hopes for peace usually were quickly dashed by new belligerent statements from North Vietnam or its allies. In this atmosphere, increased attention was paid to the gradual further increase in monetary restraint.

Meanwhile, scheduled offerings of corporate and municipal bonds began to build up, and there was particular concern over the capacity of the market to digest the very large volume of Government agency issues that still had to be sold before the end of the fiscal year. Dealers' inventories of agency issues had built up even further from an already high level. Indeed, by the end of April, inventories of such securities were up to about $950 million, compared with average holdings of about $300 million in the first 3 months of the year.

It was in this environment that the Treasury had to conduct its May refunding operation. Public holdings of the maturing issues, fortunately, had been reduced by earlier prerefundings to the relatively modest amount of $2.5 billion. To keep the operation as routine as possible, the Treasury offered holders a straightforward exchange into a new 4⅞ per cent 18-month note priced at a discount to yield 4.98 per cent. This was in line with market expectations, and the announcement had no apparent effect on prices of outstanding issues.

Interest in the new issue proved extremely apathetic, however, and despite some when-issued purchases by Treasury trust accounts, the price of the notes dropped almost immediately to a level just below the initial offering price. Dealers took an extremely small underwriting position in the new issue, and only a little more than half of the maturing issues held by the public were exchanged. The 43 per cent "attrition" was the highest in any modern refunding. With market attention diverted around this time by sharp declines in stock prices and reports of cutbacks

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in automobile production, the actual results of the refunding had little impact on bond prices, and the Treasury announced that its cash position was sufficiently strong to absorb the attrition without any modification of its current financing plans for the months immediately ahead.

A plethora of Federal agency securities came to market over the following weeks. Despite successively higher yields, all were accorded slow initial receptions as investors held back, waiting to buy at lower prices in the secondary market. Anticipation of heavy future offerings, including a probable large-sized offering of participation certificates under authorization of the recently enacted Participation Sales Act of 1966, added to the heavy atmosphere overhanging the market.

By the end of the period under review prices of most Treasury notes and bonds had dropped to levels near their lows for the year, and yields on long-term issues were as high as 4.78 per cent. Aa-rated corporate issues with 5 years of protection against special call were trading at yields around 5.5 per cent, about the same as at the April peak and up 50 basis points from the rates prevailing in early February. The Bond Buyer's index of yields on 20 seasoned tax-exempt issues was up to 3.78 per cent by early June, within 5 points of the March peak. And in the market for agency issues, where the upward pressures on rates were most intense, the participation certificates that came to market on June 9 carried yields as high as 5.70 per cent on 1-year maturities, about 60 basis points higher than rates on similar maturities in mid-February.

June 8–September 13: Peaking of financial market pressures. Stresses and strains on the nation's financial system mounted to a peak of intensity during the June 8–September 13 interval. To be sure, there were intermittent lulls when participants in the money and bond markets tentatively began to hope that the crest of pressures had passed. One such lull occurred in the opening weeks of the period. New corporate, municipal, and agency issues began to attract good investment demand, and for a time prices of securi-

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ties generally rose. Very heavy credit demands over the June dividend and tax payment period had pushed money center banks into deep basic reserve deficits, but no undue stress was in evidence. Near the end of June the thrift institutions seemed to be weathering the midyear interest-crediting period with smaller than expected withdrawals of deposits and shares. Another lull occurred in the second half of July, when market participants cautiously took heart from the fact that the Federal Reserve had not raised the discount rate, as it had been widely expected to do.

Except for these respites, however, the period was marked by progressively deepening gloom in all financial markets. Indeed, by late August—before official policy actions succeeded in restoring a degree of calm in early September—there were even some fears being expressed that a financial crisis might be near at hand. Although such fears were not borne out, the feeling of apprehension led a number of borrowers to accelerate their capital market offerings, and this in turn added to an already congested market situation. At the depths of the gloom in the second half of August, conditions in the market for tax-exempt securities were on the verge of disorder, and yields throughout short- and long-term markets were at the highest levels in more than 40 years.

In addition to the heavy current demands for credit, the major immediate cause of the highly unsettled conditions in late August was a growing apprehension over the ability of the markets to accommodate the pressures that seemed to be building up for September. In particular, it was expected that large fall loan demands would at that time be converging on a banking system that faced the possibility of a large-scale runoff of maturing negotiable CD's. To this was added a growing concern over the capacity of the market to digest a sizable offering of Treasury tax-anticipation bills in late August and an expected sale of FNMA participation certificates and other Federal agency offerings in September. The prospective FNMA and agency financings were of particular concern because of the already heavy schedule of new corporate and municipal offerings.

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Meanwhile, hopes for a tax increase to combat inflationary pressures had waned, and the conviction spread that the major burden of economic restraint would continue to rest on monetary policy. Federal Reserve actions on June 27 and August 17 to raise reserve requirements against certain time deposits of member banks were interpreted as consistent with such a view. In this environment, market participants came to feel not only that the squeeze on the banks imposed by current Regulation Q ceilings would not be removed by increases in the ceilings, but also that general monetary policy might tighten further.

These various apprehensions became particularly heavy on Friday afternoon, August 26, and securities prices, which had eroded throughout the capital markets in preceding weeks, began to drop at an accelerated pace. Some temporary steadiness emerged in the market for Treasury securities the next Monday after sizable purchases of Treasury bills by the Federal Reserve early in the day. But a second break in prices occurred late that afternoon in the wake of an upward adjustment of about 25 basis points in the yield of a recent corporate bond offering that had been moving slowly. Finally, late on Tuesday, August 30, a better atmosphere seemed to be in the making, and it was kept alive by a series of statements and actions over the next 2 weeks.

The initial spark to the rally was a sudden revival of hopes for a tax increase, following a statement by the Under Secretary of the Treasury to the effect that monetary policy should not be called on for further restraint and that, if such restraint were needed, it would have to come in the form of a rise in taxes or a cut in Government spending. To this was added a report late on the following day that the FNMA might reconsider its offering of participation certificates now widely expected in September.

On the next day, September 1, the Federal Reserve System issued a letter seeking to assure member banks that funds would be available at the discount window to meet unusual liquidity pressures over the period ahead and calling on banks to accomplish additional necessary adjustments in their portfolios over

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ensuing weeks by holding down the growth of business loans rather than by further substantial liquidation of tax-exempt and other securities. Then on Thursday, September 8, President Johnson announced a program of fiscal and debt management actions to restrain inflationary forces and help moderate financial market pressures. The program included cutbacks in "lower priority" Federal expenditures, a temporary suspension of certain tax benefits applicable to business investment, and a sharp curtailment in Federal agency borrowing in the capital markets. Taken together, the actions succeeded in restoring a feeling of confidence in the markets.

Open market policy. Federal Reserve open market policy was conditioned in an important way by the gyrations in market sentiment in August and September as well as by several other developments during the period under review here. Open market operations through much of the period were directed primarily at maintaining net reserve availability and related money market conditions in about the range reached in late May and early June, with continued reliance on the "proviso clause" to provide for modifying operations in the light of developments in required reserves and bank credit. In addition, however, operations had also to be concerned with a series of special considerations.

In late June, for example, the Federal Open Market Committee was concerned with the possible need for moderating unusual liquidity pressures at financial institutions that might develop around the midyear interest-crediting period. In the event, as noted earlier, mutual savings banks and savings and loan associations got through the period better than many observers had expected, and no special System action was needed. Beginning in late July there was a need for maintaining generally "even keel" conditions around the time of the Treasury's August refunding operation. And then later in August, against the background of the extreme uncertainty in the markets, the Committee directed that operations be conducted specifically with a view to supplying the minimum amount of reserves consistent

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with maintenance of orderly money market conditions and moderation of unusual liquidity pressures.

As these policies were carried out, nationwide net borrowed reserves in the banking system fluctuated around an average of $370 million for the period as a whole. In general, net reserve availability was allowed to run somewhat higher than average in the first half of the 2-week reserve settlement periods for country banks, to accommodate the large amounts of excess reserves that these banks typically held at that time. This was followed by a somewhat deeper than average level of net borrowed reserves in the second half of the 2-week settlement period when the previously accumulated excess reserves generally were released into the money market. In this way bank reserve positions were kept under a fairly constant degree of pressure, as reflected in the rather narrow week-to-week fluctuations in member bank borrowings from the Reserve Banks around an average of $755 million for the period as a whole (see Chart 3).

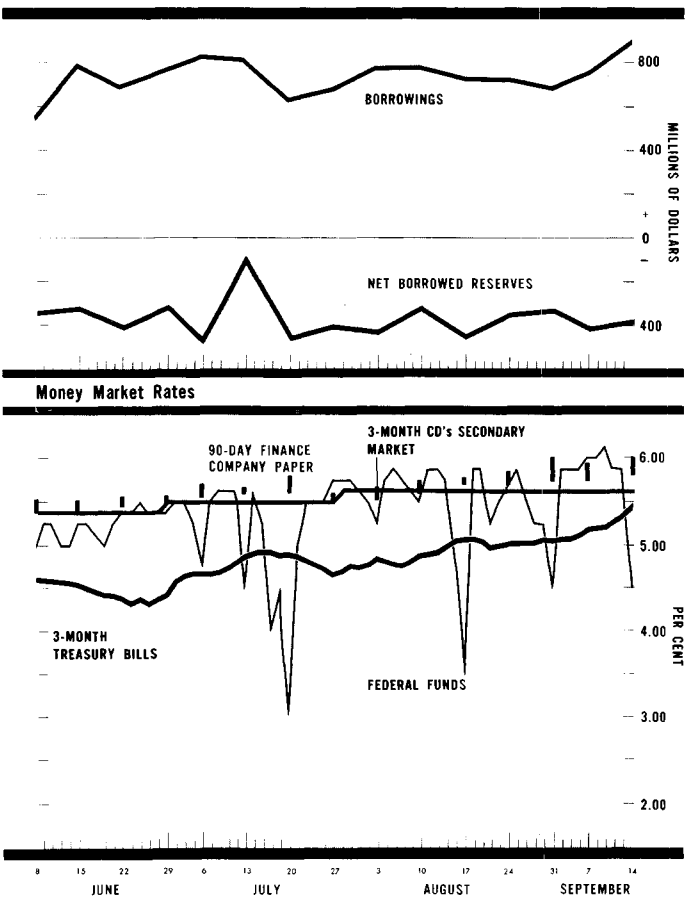
Meanwhile, bank credit did bulge temporarily in the latter half of June, as the banking system accommodated business demands arising out of the need to make enlarged corporate tax payments around midmonth and also the accelerated payments of withheld income taxes and of social security taxes that went into effect on June 20. Total loans and investments at weekly reporting banks rose by $3.7 billion in the 2 weeks ended June 22, compared with a net rise of only $1.9 billion in the roughly comparable weeks of the preceding year. Later on, however, growth in bank credit slackened somewhat and weekly averages of required reserves fell rather persistently short of the levels projected as each week began. Indeed, in August the so-called "bank credit proxy"—daily-average member bank deposits subject to reserve requirements—actually declined on a seasonally adjusted basis, following the sharp increases earlier in the year.

With banks' reserve positions maintained under steady pressure over the June–September period, short-term interest rates continued to climb. Federal funds traded at successively new high

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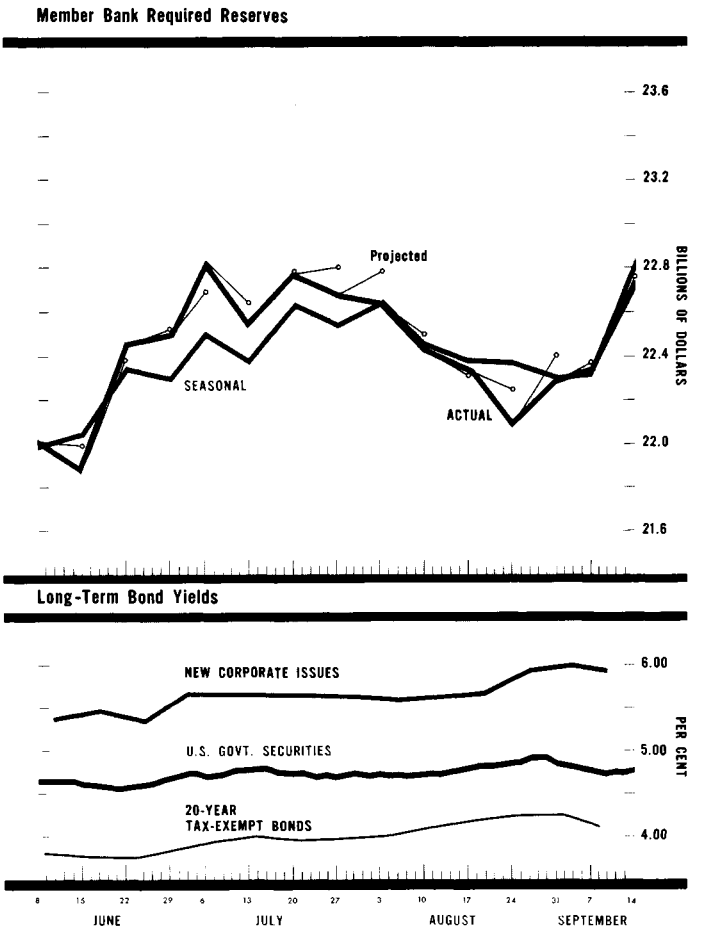
Reserves and Borrowings



For notes see p. 211.

rates of 5⅝ per cent by June 24, 5¾ per cent by July 8, 5⅞ per cent by August 4, 6 per cent 2 weeks later, and even 6¼ per cent in the final statement week of the period. Major banks raised the prime loan rate to 5¾ per cent at the end of June and then to 6 per cent in mid-August, and New York City banks posted dealer lending rates generally in a range of 6¼–6½ per cent.

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Some banks occasionally posted even higher rates or were not willing to make loans at all. Rates on bankers' acceptances and commercial and finance company paper all rose by ¼ to ½ of a percentage point over the period. Even Treasury bill rates, which had been lower than other short-term rates by an unusually wide margin in the first half of the year, moved up sharply from their

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late June lows, with increases of more than a full percentage point recorded on some maturities over the next 2½ months.

There was one exception, of course, to this upward march in short-term rates, namely the rates offered on negotiable CD's. After having led the parade through the early months of the year, rates offered on CD's by some banks in New York City reached the 5½ per cent Regulation Q ceiling on deposits of any maturity by late June, amid the pressures following the corporate tax dates. The banks were able to about hold their own in replacing sizable amounts of maturing CD's—albeit generally with new deposits of only very short term—up through mid-August.

In subsequent weeks, however, with market rates on competing instruments well above the 5½ per cent ceiling rate on CD's, banks experienced a steady erosion in their outstanding volume of CD's—the apprehension of which, as noted earlier, was one of the main factors underlying the late-August gloom throughout the financial markets. As one means of offsetting the potential and actual loss of domestic funds, several of the major money market banks with overseas branches became active seekers of funds in the Euro-dollar market during the period under review here. In the 2 months through the end of August a group of these banks increased their outstanding Euro-dollar liabilities by nearly $1.2 billion, and such liabilities rose by another $1.2 billion through mid-December.

System operations. In conducting open market operations over the June–September period, the Account Manager sought to carry out over-all System policy objectives without adding unnecessarily to the basic apprehensions dominating market psychology. Operations were complicated by the fact that the markets for Government securities tended to be quite thin. Dealers were reluctant to hold sizable positions in the face of the uncertain environment, the rapid upward movement of interest rates, and the high cost and limited availability of dealer financing. Over the first 2 months of the period, until the Treasury auctioned $3 billion of tax-anticipation bills in mid-August, the

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total amount of Treasury bills held by dealers in their trading positions averaged only $1.1 billion, compared with an average of $3 billion in the comparable months of 1965. On occasion, such as around the end of June and again in early August, their holdings of bills in trading accounts dropped to around $250 million. In the environment of this period large outright purchases or sales by the System would have risked contributing to exaggerated movements in bill rates.

Difficulties in injecting reserves in the face of market scarcities of bills had been present in varying degrees throughout the spring, as noted in the preceding period. They became pressing again in the second half of June as the System moved to meet part of the sizable reserve needs accompanying the large expansion of credit over the tax date, and to provide for the needs around the July 4 holiday. The money market had become taut in the statement week ended June 22 as the convergence of credit demands had produced a basic reserve deficit of more than $1.5 billion at major money center banks. On the last day of that week Federal funds traded predominantly at 5⅜ per cent, and there was some trading for the first time at 5½ per cent. The System moved to head off further tightening by purchasing $308 million of Treasury bills from dealers and foreign accounts, for both cash and regular delivery. These purchases, plus heavy demand for bills from public funds as well as from commercial banks, which were buying bills to include in midyear statements, reduced dealers' holdings of bills in trading positions to less than $270 million on June 23.

With the July 4 reserve needs still to be met, the Federal Open Market Committee at its June 28 meeting broadened the avenues for reserve injection by removing the 2-year limitation on the maturity of Treasury issues that the System could purchase under repurchase agreements. In recommending approval of this added flexibility, the Manager noted that it might be necessary over the period immediately ahead to make repurchase agreements against Treasury issues that the dealers themselves might acquire

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under repurchase agreements with investors. Such "back-to-back" agreements would in effect make use of the dealers as direct channelers of funds to points of need in the market.

In the event, there proved to be no real problems in injecting reserves, as a large supply of bills became available over succeeding days directly from foreign accounts that had to meet midyear liquidity needs and also in the market as banks unwound their midyear window-dressing operations. As a result, there was no need for using back-to-back repurchase agreements, and only limited use was made of the authorization to purchase Treasury issues of any maturity under repurchase agreements. The broader authorization remained in effect throughout the rest of the year, however, and proved helpful in meeting reserve needs on other occasions.

Reserve injections were also accomplished in late June by System purchases of a sizable amount of bankers' acceptances under repurchase agreements and of Treasury coupon issues, with the maturity range of the coupon issues purchased extending, for the first time during the year, to more than 10 years. After the end-of-June operation the System remained out of the coupon market during the period of unsettled conditions during the summer and fall and did not make any additional purchases of coupon issues until late December.

The operating difficulties of absorbing a large amount of reserves in an uneasy market environment came into particular prominence in the wake of a strike against five major domestic airlines beginning on Friday, July 8. The strike hampered the clearing of checks through the banking system. As the Federal Reserve continued to grant credit on the uncollected checks according to normal schedules, however, there was a sharp rise in Federal Reserve float and a corresponding bulge in nationwide net reserve availability. By Tuesday, July 12, float had risen to a level about $1 billion higher than normal for that time of year, and it remained $800 million or more above normal throughout the strike, which was not settled until August 19.

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Although some of these extra reserves were absorbed as the Treasury agreed to increase its balance at the Reserve Banks, a sizable amount remained to be absorbed by open market operations. Treasury bill rates were rising sharply at the time, however, and the market was not expected to be receptive to large outright sales of bills. Moreover, any such sales might have had to be followed quickly by large outright purchases, if the strike were suddenly settled. Thus, in the thin market then existing, the use of outright transactions to deal with the rise in float could have resulted in very large fluctuations in interest rates.

In this situation the Account Manager—after consultation with the Open Market Committee in a special telephone meeting on July 11—initiated a new operating technique of selling selected issues of Treasury bills to dealers for cash and simultaneously making a commitment to purchase the same issues of bills at competitively determined prices for delivery to the System a few days later. Such matched sale–purchase transactions could be carried on in large size because they did not involve an indeterminate market risk for the dealers. Furthermore, they automatically kept the reserve absorption on a short-term basis, while leaving open the possibility of extending the period of reserve absorption with new transactions if the airline strike continued.

The first of these operations was undertaken too late in the statement week ended July 13 to have more than a small effect on the average level of net reserve availability for that week as a whole, during which net borrowed reserves turned out to be only $94 million. In the next several weeks, however, such operations were a major factor in pushing net borrowed reserves back over the $400 million level. In all, more than $1.9 billion of bills were sold in six matched sale–purchase operations through the end of July, with outstanding commitments to purchase under such transactions reaching a high of $822 million in the July 15–18 period.

Subsequently, matched sale–purchase transactions were used on other occasions when reserves had to be absorbed temporarily.

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Many of these cases involved mopping up short-lived reserve redundancies that emerged late in a statement week. Only a limited amount of reserves had to be absorbed through other means during the strained market situation in August. This was easily accomplished by a redemption of bills in the regular weekly auction on August 8 and the sale around the same time of a few short-dated bills—which were in demand—to the market and directly to foreign accounts.

The System injected reserves at the beginning of August to offset reserve drains from other factors, and again toward the end of the month to supply the reserves needed around the Labor Day holiday. In each case the injections were made in the way that seemed most likely to contribute to the continued orderly functioning of the market. Early in the month, when dealers were concerned about the high cost of financing positions that had been swollen by acquisitions of rights to the Treasury's August refunding, the System confined its operations to the purchase of rights and other Treasury issues under repurchase agreements. In the latter part of the month, on the other hand, after dealers' positions in longer-term bills had begun to weigh rather heavily on the market in the wake of the Treasury's auction of tax-anticipation bills, the System made large outright purchases of bills. One such operation was conducted at the opening of the market on Monday, August 29, following the sudden acceleration in the pace of price declines in all market sectors late the preceding Friday afternoon. In all, the System purchased $419 million of Treasury bills from dealers in this operation, for both cash and regular delivery. As noted above, these purchases had a temporary, steadying influence on the markets.

For the June 8–September 13 period as a whole, the System's outright transactions in Treasury bills included gross purchases of $5.5 billion and gross sales and redemptions of $4.3 billion, with $2.8 billion of each representing bills sold and simultaneously purchased under matched transactions. Purchases of coupon issues, all of which were consummated before the end of June,

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totaled $185 million. Except for the use of repurchase agreements against rights during the Treasury's August refunding, the System made only limited use of this instrument over the period. Thus, total purchases of Treasury issues under such agreements amounted to only $716 million, of which nearly two-thirds were arranged in early August. All of these repurchase agreements were arranged at the 4½ per cent discount rate, which at times was 2 percentage points or more below the cost of alternative sources of dealer financing.

Treasury finance. The uncertainty and progressively heavier atmosphere in securities markets presented problems over the period for Treasury debt management operations as well as for Federal Reserve open market operations. In a number of Treasury bill auctions during the period, investor bidding was so weak that the total offering was covered by only a small margin—and then only at sharply higher rates than prevailed on outstanding bills. This was particularly true of the first two weekly auctions in July, which followed the increase in reserve requirements against certain time deposits and the rise in the bank prime rate at the end of June. The auctions also came at a time when there was widespread expectation in the markets that the Federal Reserve discount rate would soon be raised. In each of these auctions the average issuing rates on the new 3- and 6-month bills were 15 or more basis points higher than the bid rates on comparable bills at the close of the day preceding the auction. Moreover, tenders were accepted in these auctions at rates as much as 10 basis points above the average issuing rates, although such margins generally run no more than 2 or 3 basis points in more normal times.

Similarly weak bidding prevailed in the weekly bill auction held in mid-August and in the auction of 1-year bills held about a week later. Although the atmosphere in the bond markets changed for the better shortly thereafter, it remained quite heavy in the bill market, and bidding in the auctions was still generally restrained throughout the rest of the period. In part,

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this reflected dealers' concerns over continued high financing costs—with loan rates at some New York City banks occasionally reaching 6⅝ per cent. There was also considerable apprehension over the increased supply of bills stemming from the auction of $3 billion of tax-anticipation bills on August 28 as well as over the impending return of bills to the market around the September dividend and tax dates.

Toward the end of the period, there was also concern over prospects of large-scale Treasury financing in the bill area throughout the rest of the fall. The curtailment of agency financing, included as part of the President's program announced on September 8, was generally expected to mean that the Treasury would have to sell more bills to raise the needed cash. In this environment, bidding was weak in the final weekly auction of the period, and rates on most bill issues closed on Tuesday, September 13, at new highs. Rates on 3- and 6-month bills that day were 5.43 and 5.85 per cent bid, respectively, compared with 4.60 and 4.76 per cent at the start of the period in June.

Financing in the Federal agency market also ran into difficulties over the period. Despite the progressively higher yields that were offered, each of the new agency issues that came to market during July and August encountered investor resistance. By the end of August a 2-year issue of 5⅞ per cent debentures, which had been offered at a yield of 5.91 per cent earlier in the month, was trading in the secondary market at a yield as high as 6.15 per cent. By way of comparison, a 1-year issue of debentures had been sold in mid-June, during the temporary improvement in the markets, at a yield of 5.75 per cent.

This continued upward pressure on yields in the agency market reflected, among other things, the very large amount of new money being raised through sales of agency issues. To be sure, the volume of such financing fell off in July and August from the extraordinary pace in May and June. Still, more than $1 billion of new funds were raised in this market during July and August, more than double the amount raised in the comparable

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period of the preceding year. Moreover, as noted above, there was growing apprehension that a still larger volume of offerings would be forthcoming in September, including the sale of a large volume of FNMA participation certificates, in accordance with the provision for $4.2 billion of such sales in the 1967 Federal budget. It was in an effort to quiet these apprehensions that the President's program included a curtailment of agency financing in the public sector during the last 4 months of 1966.

Against this background of the general deterioration in market atmosphere over the period as a whole, the Treasury had to refund its August 15 maturities. Fortunately, from the Treasury's standpoint, one of the periods of temporary improvement in the market began after mid-July and continued through the period that the subscription books were open on August 1–3. The improvement stemmed in large part from the fact that uncertainties in the market associated with the widespread expectation of an increase in the Federal Reserve discount rate had temporarily been resolved because the 4½ per cent rate was left intact.

In the absence of a change in the discount rate, some participants came to feel that prices had declined too much and that yields might be near their peaks. By late July the market seemed receptive to a Treasury issue maturing in 4 or 5 years, and in fact the announcement of an offering on a rights basis of both a 5¼ per cent 1-year certificate and a 5¼ per cent note due in May 1971 was accorded a favorable response. Holders of the issues maturing in August were allowed to exchange for either of the new maturities, and holders of issues due to mature in November were offered the opportunity to exchange into the new note.

The 5¼ per cent coupons, which represented the highest rate paid on Treasury coupon issues since 1921, proved attractive, and the exchanges were sufficient to extend the average maturity of the marketable Federal debt by 1 month. Nearly 80 per cent of the $3.1 billion of publicly held August maturities and about a third of the $4.9 billion of the November maturities held by

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the public were exchanged. By the time the subscription books had closed, however, the atmosphere in the markets had begun to change. The steel industry announced a price increase on August 3, the day the books closed, and around the same time large additions were being made to the already heavy calendar of future corporate bond offerings. As prices in all securities markets weakened over subsequent days, some of the new Treasury issues that were overhanging the market were bought for Treasury trust accounts. Even so, by the payment date for the refunding, on August 15, the new certificates and notes were trading at discounts of $^{8}/_{32}$ and $^{14}/_{32}$ of a point below par.

Yield movements. Prices of both new and outstanding Treasury issues moved steadily lower over most of the balance of August. In some cases they fell by as much as 2 points. At the lows on Monday, August 29, the new 5-year notes were bid at $97^{31}/_{32}$ to yield 5.75 per cent. Yields throughout the Treasury coupon market were at the highest levels since the 1920's. Some issues in the 2- to 5-year range were yielding as much as 6.25 per cent; some 5- to 10-year issues 5.96 per cent; and some long-term bonds 5.26 per cent. At the start of the period, in early June, the highest available yields in these three maturity ranges had been 5.08, 4.99, and 4.78 per cent, respectively.

The subsequent very sharp improvement that took place in the markets in early September—the causes for which were reviewed above—brought yields on Treasury coupon issues down by as much as 54 basis points from their peaks. By the close on September 13 the highest yield in the 2- to 5-year range was down to 5.80 per cent, while maximum yields in the 5- to 10-year range and on longer-term issues were down to 5.48 and 5.04 per cent, respectively. Yields on outstanding longer-term agency issues also declined, especially as it became clear that there would be no offering of FNMA participation certificates, though in the short-term market two new issues that were offered around the middle of September bore record rates of 6.05 and 6.20 per cent.

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Movements in yields on corporate and municipal bonds generally paralleled those on Treasury issues. More than $3.3 billion of corporate bond issues were floated between mid-June and the end of August, with about half coming in the month of August alone, when many borrowers accelerated their market offerings. The offerings encountered increasing investor resistance as the period progressed, and even with record yields buyers generally were not interested unless the borrower extended special protection against early call to 10 years and also agreed to accept delayed payment. At the late August peak, an Aa-rated issue with 10 years of special call protection was offered at a yield of 6.34 per cent, compared with an offering yield of 5.75 per cent in early June on a slightly lower-rated issue with only 5 years of special call protection. Yields on corporate issues fell by as much as 40 basis points over the first 2 weeks of September, and shortly after the period under review here, an Aa-rated issue was sold quickly at a 5.90 per cent yield.

In the tax-exempt market, which became by far the most unsettled of all the markets during August, there was only a routine volume of new issue activity. Several large commercial banks, however, were making very sizable sales of tax-exempt issues in order to ease some of the pressures on their reserve positions. On a nationwide basis, commercial banks' holdings of securities other than Governments (a balance sheet category that in fact includes mostly tax-exempt issues) fell by $200 million in August. With commercial banks acting as net sellers rather than in their normal role of net buyers, and with other investors and dealers generally discouraged, it was difficult to find bidders for offerings of tax-exempt issues even at sharply reduced prices and higher yields. By the end of August the Bond Buyer's index of yields on 20 seasoned tax-exempt bonds had risen to 4.24 per cent, a full ½ of a percentage point above the level prevailing around mid-June. The over-all market atmosphere improved over subsequent weeks, and by mid-September the index had declined to 4.11 per cent.

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September 14–November 22: Relaxation of market tensions. The better atmosphere that developed in financial markets in early September—in the wake of the various official measures taken to stem inflationary pressures and ease stresses in securities markets—continued and was consolidated, with occasional setbacks, over the September 14–November 22 interval. The markets were alternately buoyed and depressed by a number of factors on individual days and within particular short intervals. On the whole, however, the feeling prevailed that the strains of late August would not soon recur, and although the banking system continued under pressure, confidence reappeared that the financial markets could cope with the demands immediately ahead.

Among the various factors affecting the markets during the period were shifting views on (1) the adequacy of the new fiscal measures and the likelihood of still further fiscal action to redress continuing imbalances in the economy, (2) prospects for peace in Vietnam, (3) the outlook for the domestic economy in the face of weakness in some sectors, and (4) the prospects for monetary policy. With respect to the last, the conviction developed among participants that monetary policy would not permit a renewed buildup of money market pressures that would propel interest rates back toward their late summer peaks. To this was added—as the period drew to a close—an emerging feeling that some slight easing of monetary policy already was in process.

In this environment, bond prices rose fairly steadily in all markets through October, at which point yields were down to levels not seen since early June. However, a buildup in the corporate and municipal bond calendar after a post-August breather led to renewed caution in the capital markets during the first half of November, and prices declined again for a time. Net price changes over the period as a whole were mixed. In the Treasury bill market, a deepening apprehensiveness persisted through the third week of September amid worries over prospective large increases in the supply of bills outstanding around the corporate tax payment date and as the Treasury sought to meet

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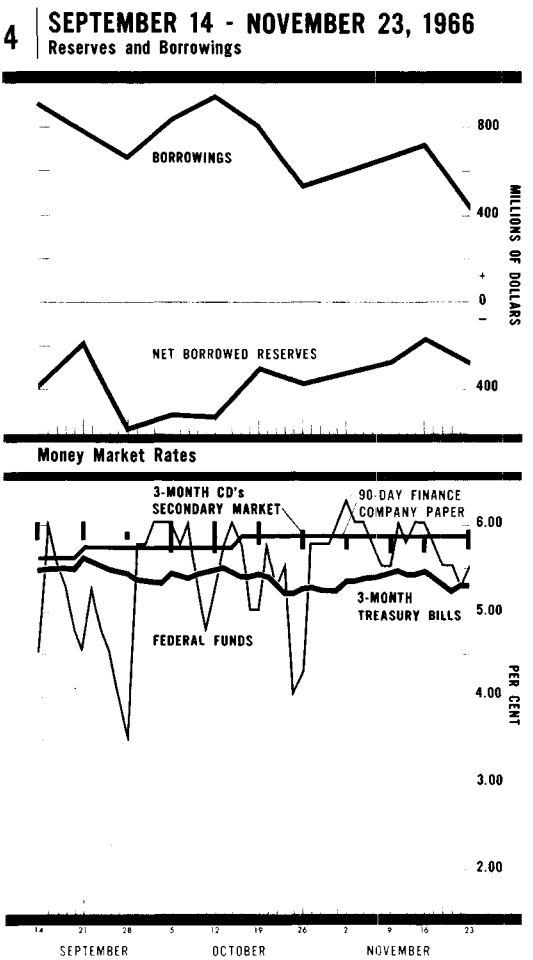
its enlarged cash needs over the remainder of the year in the wake of the curtailment of Federal agency financing. As it turned out, the additions were absorbed rather easily and bill rates moved down rather sharply over the balance of the period (see Chart 4).

The banking system emerged from the September tax payment period in a considerably better position than many had expected. Despite continued losses of outstanding CD's, banks were able to cover their reserve deficits in a money market atmosphere that was more relaxed than a few weeks earlier. This easier money market environment may have reflected in part firmer lending policies at the banks and in part some abatement in demands for credit in the wake of overborrowing earlier in the year and the slower pace of economic expansion. Whatever the reasons, total outstanding bank credit declined by $2.7 billion on a seasonally adjusted basis between the end of August and the end of October.

As in earlier months of the year, open market operations in the September–November period were directed at both proximate and "provisory" objectives. The proximate objective over much of the period was the maintenance of "firm but orderly" conditions in the money market—though this was modified to the maintenance of "generally steady" conditions in the market during the last 3 weeks of the interval around the time of the Treasury's November refunding operation. Throughout the period, however, the directive included a proviso clause calling for modification of operations in the light of developments in bank credit and, for a time, also in the light of unusual liquidity pressures.

In contrast to the proviso clauses in effect during the late spring and throughout the summer—which provided only for resistance to undesirably or unexpectedly rapid increases in required reserves (or bank credit)—a "two-way" clause was adopted by the Committee at its September 13 meeting. The new clause called for seeking either greater or less firmness in the

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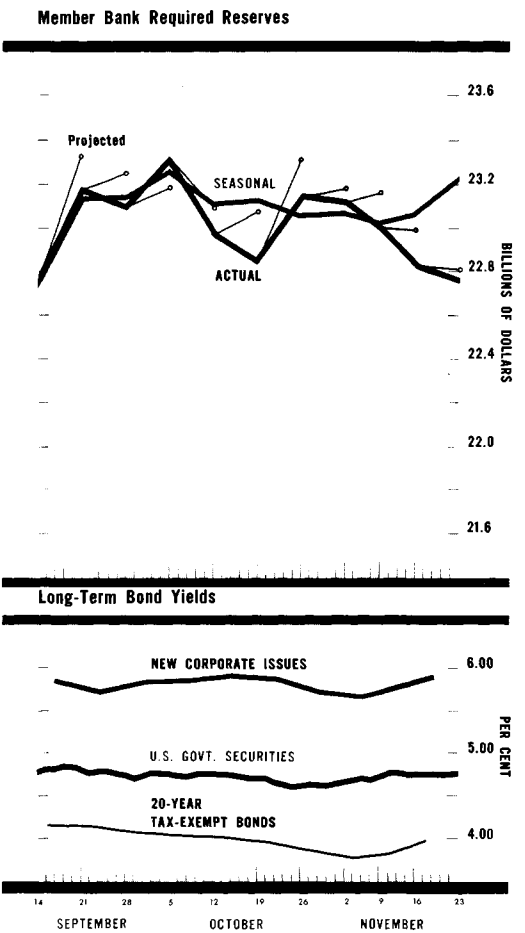


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money market, depending upon developments in bank credit. Because there were persistent shortfalls of bank credit below projected levels as the period progressed, System operations gradually leaned toward a little less firmness.

Over the period as a whole, the System's outright purchases of Treasury bills totaled $3.1 billion, while sales and redemp-

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tions of bills amounted to $3.2 billion. With the market for coupon issues still in a state of flux—albeit with prices generally rising in contrast to the sharp declines during the summer—no outright purchases were made of such issues over the period. The System continued to use repurchase agreements rather sparingly, although in all it did purchase a little more than

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$1 billion of securities under such agreements during the period. Most of these agreements were arranged in early November when high rates on dealer loans at the New York City banks were causing some nervousness in the securities markets at a time when issues from the Treasury's November refunding remained to be distributed. Over the period the System absorbed reserves for several weeks around the middle of each of the months of September, October, and November, and only briefly provided reserves around the ends of September and October when Federal Reserve float was at a low ebb.

In the wake of these operations the general atmosphere in the money market became more relaxed than it had been in the summer, although quantitative indicators of money market conditions tended at times to move in somewhat divergent directions. Nationwide net borrowed reserves, for example, fluctuated in a wide range in the first several weeks of the interval before being eased back to a persistently lower level around mid-October. By that time, staff projections were pointing to a third consecutive month of weakness in daily-average member bank deposits subject to reserve requirements—the proxy for bank credit. With the weakness in bank credit persisting, net borrowed reserves were allowed to fall to an average of about $220 million in the final 2 weeks of the period reviewed here, compared with weekly averages of more than $400 million during the summer and early fall.

Member banks' borrowings from the Reserve Banks also tended to decline as the period progressed, although there were wide week-to-week fluctuations, in part because a few banks apparently shifted their strategies for managing their reserve positions. Banks borrowed particularly large amounts from the Reserve Banks in the week ended October 12 even though Federal funds appeared to be relatively abundant. This development for a time impaired the System's abilty to judge the state of the money market and the true state of reserve availability. In the final 2 weeks of the period borrowings averaged $575 million,

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compared with an average of about $755 million over the June–September period.

In the Federal funds market, on the other hand, the most relaxed atmosphere seemed to prevail during the first month and a half of the interval—that is, through late October—when a considerable volume of trading occurred on a number of days at rates below 6 per cent. Later, in the opening weeks of November, reserves shifted sharply away from banks in the major money centers. Bidding for funds was fairly aggressive, and trading was for the most part at rates of 6 per cent or more, even with the increased level of nationwide net reserve availability. In the final week of the period, the Federal funds rate eased again as reserves flowed back toward the money center banks.

Other short-term interest rates showed mixed changes over the period. Rates on commercial and finance company paper rose in two steps by a total of ¼ of a percentage point. Rates on dealer loans at the New York City banks held generally in a 6 to 6½ per cent range through the end of October, then moved up to as high as 6¾ and even 6⅞ per cent over much of the next 3 weeks, a time when dealers' financing needs were enlarged by their recent acquisitions of Treasury bills and other securities. Rates on Treasury bills and CD's of major money market banks trading in the secondary market, on the other hand, declined generally by ⅛ to ⅜ of a percentage point, net, over the period.

System operations. At the beginning of the period there was still some apprehension in the money and securities markets stemming from the churning and pressures around the mid-September corporate tax date. Major banks across the country faced CD maturities on the tax date itself totaling about $1.2 billion, and they had large amounts maturing throughout the rest of the month as well.

In the event, open market operations insured that the banking system had the funds needed to avoid undue strain during the period. The banks were able to replace about three-fourths of their maturing certificates over the period with new CD's, albeit

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mostly of 1-month maturity. This performance—along with a sharp, further buildup of Euro-dollar deposits by a few banks—and a temporary rise in nationwide net reserve availability helped the banking system to operate during the period of seasonal pressure with considerably less strain than many observers had expected. Even at major banks in New York City, which lost about $560 million of CD's and experienced an increase in credit of $540 million over the September 21 statement week, pressure on reserve positions was only about average for a tax period. Moreover, with the very quick payoff of many of these loans the next week, New York City banks found themselves in quite comfortable reserve positions by the end of September.

Open market operations during the last 2 weeks of September generally proceeded cautiously to absorb a part of the bulge in reserves generated by the midmonth rise in float and other factors. Early in the period rates on Treasury bills were rising sharply, because market participants thought the decision to avoid sales of participation certificates and to limit Government agency financing in the market would require an increase in direct Treasury financing. In this nervous market atmosphere the System for a time made considerable use of matched sale–purchase transactions, which absorbed reserves with minimal effects on market rates of interest. Outright sales by the System during this period were limited to responding to unsolicited dealer bids and to orders from foreign accounts. Partly because of this cautious approach, net borrowed reserves declined to an average of $179 million in the week ended September 21, helping to accommodate the churning in the markets and an unusually large increase in excess reserves held by country banks.

The spillover of accumulated excess reserves into the following week preserved a generally comfortable money market environment, which in turn contributed to a gradual strengthening in the bill market. Rates on Federal funds remained at 5 per cent or less until the very end of the week. As the week progressed, the System made fairly large-scale sales of Treasury bills, both out-

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right and under matched transactions, and net borrowed reserves were deepened to an average of $583 million, the deepest level of the year.

Estimates of bank credit were persistently revised downward over succeeding weeks. In response to this development the System began around mid-October to absorb less than the full amount of reserves released by movements in other factors and thus allowed net reserve availability to expand somewhat. As a generally relaxed atmosphere emerged and persisted in the money market, some market participants began to feel that the System's policy had shifted slightly in an effort to avoid a renewed escalation of interest rates. The actions in late September by the Board of Governors of the Federal Reserve System and by the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board in exercising newly enacted powers to set interest rate ceilings on consumer-type savings deposits were interpreted as generally consistent with this view.

In early November, reserves began to shift away from banks in the money centers. This reflected in large part the Treasury's drawing down of its tax and loan accounts at these and other banks as its cash balances began moving toward a seasonal low. Funds coming into the banking system, on the other hand, were widely dispersed among banks outside money centers, which tended to hold onto somewhat larger than normal amounts of excess reserves, partly because of the uncertainties around that time of year caused by the closing of the markets for the Veterans' Day and Election Day holidays. With New York City banks bidding strongly for the limited amount of money available in the Federal funds market, the funds rate moved quickly to 6 per cent and above on the first of November, and a generally taut situation became evident in the money market. As the New York City banks raised their lending rates to securities dealers above 6½ per cent, a feeling of nervousness began to pervade the Treasury bill market—and longer-term markets as well—at the time the Treasury was conducting its November refunding.

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Under these circumstances the System moved promptly to supply additional reserves. It arranged $122 million of repurchase agreements on Tuesday, November 1, and bought about $270 million of bills on an outright basis from the market and foreign accounts the next morning. With pressures still in evidence, the System reentered the market that same day and purchased an additional $202 million of Treasury issues under repurchase agreements. Further prompt injections of reserves over subsequent days continued to help avoid undue tautness in an environment of expanding net reserve availability. Not until the week ended November 22, however, when reserves shifted back toward banks in the money centers, did the money market regain the tone prevailing in the second half of October.

Securities markets. Conditions in the securities markets, as noted earlier, generally showed further improvement over the September–November period, even though there was a temporary reemergence of caution in the first 2 weeks of November. The sharp curtailment of financing by Government agencies, one of the actions included in the administration's September package, removed one of the most pressing sources of supply overhanging the market. As it turned out, agency financing in the public sector over the period actually involved a net reduction of $560 million in outstanding issues. All the new money raised by the agencies during the period came through sales of issues to the Treasury trust accounts, a new debt management procedure initiated by the Treasury earlier in the year.

This curtailment of agency financing in the market, of course, necessitated increased Treasury borrowing on its own behalf over the balance of the year. The Treasury indicated on September 20 that its over-all cash needs over the final months of the year would total about $8 billion and that most of these funds would be raised through sales of bills. In anticipation of this heavy financing, the bill market continued to exhibit considerable nervousness in the opening week of the period, as noted earlier. By Monday, September 19, guesses about rates on the

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3-month bills to be auctioned that afternoon reached as high as 5.65 per cent. In any event, the rates turned out to be somewhat lower than initial expectations, but were still at records of 5.586 and 6.039 per cent for the 3- and 6-month bills, respectively. This marked the high in bill rates for the year, and over subsequent weeks these rates declined by as much as 53 basis points. At the close of the period, rates on 3-month bills were at 5.28 per cent bid, compared with 5.59 per cent around mid-September.

A very good demand for bills prevailed over the period, and dealers made net sales at a rate averaging about $200 million a day. As in the spring, public funds were a predominant source of demand, although there was also considerable interest on the part of individuals, who were attracted by the high yields. In the face of this demand, the supply of new bills coming to the market was readily absorbed, and dealers were often aggressive bidders in the various auctions as they sought to rebuild their inventories.

Part of the Treasury's financing in the bill market involved a change in the cycle of monthly offerings of bills. Instead of selling $1 billion of 1-year bills at the end of each month, the Treasury began in late September to sell $900 million of 1-year bills and $500 million of 9-month bills. The latter represented a reopening of an issue that had been sold initially 3 months earlier. Previous experience suggested that the initial offering of the 1-year bill series had been a little large, but that the issue had become quite scarce after a few months. The new cycle was designed to remedy these difficulties and also to raise a total of $1.6 billion of new cash over the last 4 months of the year. The remainder of the bill financing during the period involved the sale of $3.5 billion of tax-anticipation bills on October 11 and the sale of a strip of $1.2 billion of month-end bills on November 17, just after the early November hesitation in the bill market had run its course. These auctions were well received.

Financing activity in the longer-term markets took something

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of a breather in the second half of September and during October. Offerings of new corporate bonds during this period were considerably lighter than in the immediately preceding months, and most issues were sold out by underwriters in fairly quick order. New tax-exempt offerings also sold well over this interval. For a while it appeared that some potential borrowers were holding back on their offerings, waiting to see how far the trend toward lower yields would go.

Then, after several aggressively priced issues failed to move well in early November, the calendar of corporate and tax-exempt offerings scheduled for November and December began to build up to considerable size. This, along with discussion of the possibility of renewed sales of FNMA participation certificates before the end of the year, exerted a renewed measure of caution in the capital markets, where the atmosphere was also affected in part by the temporary, renewed tautness that emerged in the money market at this time. The possibility of additional sales of participation certificates had been left open when the administration announced its fiscal and debt management package early in September, but market participants had for a time generally assumed that no such offering would be forthcoming.

The growing calendar of future offerings continued to weigh on the corporate and tax-exempt markets over the rest of the period. By the end of the period an Aa-rated corporate issue was trading at a yield of 5.80 per cent after having been offered in late October at a yield of 5.70 per cent. The Bond Buyer's index of 20 seasoned tax-exempt bonds, after reaching a low of 3.74 per cent in early November, moved up to 4.00 per cent by the end of the period.

The renewed hesitancy in the longer-term markets occurred at the time that the Treasury was refunding $4.1 billion of issues coming due at mid-November. Before this had happened, the prolonged price rise during October had led many observers to feel that the market would be receptive to an offering beyond the short-term maturity area. Indeed, when the Treasury an-

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nounced on October 27 a cash offering of $2.5 billion of new 5⅝ per cent 15-month notes and $1.6 billion of new 5⅜ per cent 5-year notes, prices of outstanding issues actually improved, and a firm tone was in evidence. Subsequently, the new issues came under some selling pressure, and by November 14 when-issued prices had dropped by as much as $\frac{5}{32}$ of a point below par. Prices of some outstanding Treasury issues fell by more than 2¼ points over this period—erasing about two-thirds of the gains since mid-September.

After mid-November, however, the return of more comfortable conditions in the money market and renewed demand for Treasury bills and coupon issues sparked a better atmosphere. Prices in the short- and intermediate-term sectors were the first to improve, while gains in the longer-term area were delayed until the end of the month. At the end of the period yields on long-term Treasury issues were generally around 4.95 per cent, compared with about 5.00 per cent in mid-September.

November 23–December 31: Modest but overt move toward ease. Federal Reserve open market operations during the final 6 weeks of 1966 were directed at attaining somewhat easier conditions in the money market and providing the base for a resumption of bank credit growth. The easing that had already been permitted in the immediately preceding weeks under the proviso clause had contributed to a more relaxed atmosphere throughout financial markets, but bank credit had remained weak and interest rates had risen again for a time in the first half of November.

Against this background, the Federal Open Market Committee voted at its November 22 meeting to take a modest but overt step toward ease, with a revised proviso clause calling for modification of this stance only if bank credit appeared to be resuming a rapid rate of expansion. A move toward somewhat greater ease was voted at the Committee's December 13 meeting. Financial markets reacted strongly to the System's shift toward less restraint, and bank credit showed signs of picking up again as the period progressed.

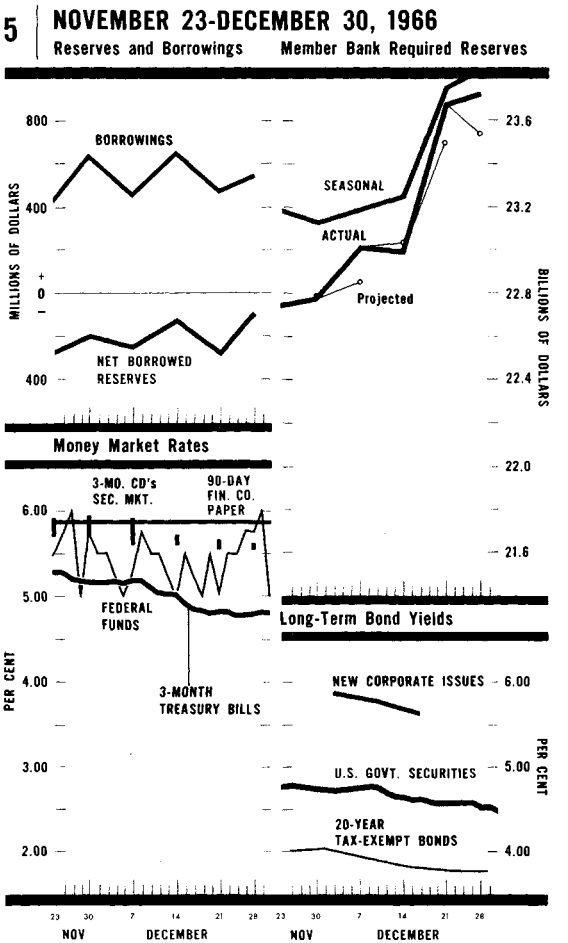
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In carrying out the Committee's policy, the Manager of the System Open Market Account moved promptly, and at times aggressively, to inject reserves ahead of developing needs, and as it turned out, the System made no outright sales of securities to absorb reserves. In the wake of these operations, most Federal funds trading was in a 5 to 5½ per cent range during the period, compared with a range generally from 5½ to 6 per cent in the preceding period. Treasury bill rates declined by as much as 65 basis points over the period, and New York City banks lowered their rates on dealer loans first to a 6¼–6½ per cent range and then to a 5¾–6¼ per cent range for a time around mid-December. Rates on bankers' acceptances were reduced by ¼ of a percentage point over the period. Member banks' net borrowed reserves and their borrowings from the Reserve Banks moved irregularly downward, averaging about $190 million and $510 million, respectively, in the final 2 weeks of December (see Chart 5).

Market participants, many of whom had for a time been looking for concrete signs of a change in System policy, were quick to react to the new money market environment. This was especially true following aggressive actions by the System to inject reserves in late November when it appeared that net reserve availability after the Thanksgiving Day holiday was falling far short of expected levels. Dealers bid aggressively for Treasury bills in each of the following bill auctions, both to build up positions in expectation of lower rates and to meet a heavy demand for bills from public funds and corporations, and later on from banks. Demand for Treasury coupon issues also expanded, from both dealers and investors. In the corporate and municipal markets a heavy buildup of the calendar had caused considerable concern earlier, but the new issues moved readily at declining yields.

By mid-December the 3-month Treasury bill rate had fallen below 5 per cent, and the 6-month bill rate was nearly a full percentage point below September's high of 6.04 per cent. Rates

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For notes see p. 211.

on short-term Federal agency issues had also retreated sharply, and 3-month CD's were trading in the secondary market at rates as low as 5.60 per cent, compared with rates of around 5¾ per cent in November. In this environment new CD's offered at the 5½ per cent Regulation Q ceiling began to become competitive again. Thus, after 4 months of decline and a net loss of $3.2 billion in CD's, the volume of outstanding CD's at weekly re-

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porting banks increased in each of the last two statement weeks of December.

The greater availability of funds encouraged banks to begin rebuilding their liquidity. For example, large banks that report weekly expanded their holdings of Treasury bills by $1.1 billion during December, which was considerably more than in comparable weeks of earlier years. They also sharply increased their lending to Government securities dealers. Both of these developments played a key role in the renewed expansion of bank credit in December.

Moreover, with funds from domestic sources more readily available and less expensive, some banks that previously had been aggressive bidders for Euro-dollars also began around mid-December to cut back somewhat on their participation in that market. This, together with cooperative central bank action to maintain availability in the Euro-dollar market, enabled that market to get through December without undue pressures.

System operations. The System's open market operations during the period involved extensive use of repurchase agreements, an instrument well suited to dealing with the seasonal pressures and uncertainties in financial markets that are characteristic of December. In all, $5 billion of Treasury and Government agency securities were purchased under such agreements during the period, more than half of the total for the year as a whole, while $4.3 billion of such agreements were terminated. The amount of agreements outstanding at any one time reached as high as $800 million on December 27, and the average amount outstanding over the period as a whole was just over $450 million. The Account Manager initiated purchases of Federal agency issues under repurchase agreements on December 5, under authority voted by the Federal Open Market Committee at its November 1 meeting, pursuant to new legislation enacted by the Congress earlier in the fall.

Other System operations during the period included the outright purchase of nearly $1.3 billion of Treasury bills from the

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market and from foreign accounts and the purchase of $35 million of Treasury coupon issues. The purchases of coupon issues were the first since late June, and they reaffirmed the System's intent to supply some portion of the normal growth in the reserve base in this manner, while remaining a marginal participant in the market. In addition, on Friday, December 9, the System purchased directly from the Treasury a special 4¼ per cent 3-day certificate of indebtedness in the amount of $169 million to assist the Treasury through a period of seasonally low cash balances. This marked the first use of this special facility since 1958.

There were no outright sales of securities by the System during the period, as the pursuit of easier money market conditions generally called for leaving in the banking system the few excesses of reserve availability that did emerge. However, the System did bid in several of the weekly bill auctions to redeem part of its holdings of bills scheduled to mature the following Thursday. Bills totaling $503 million were redeemed over the period.

The heavy use of repurchase agreements during the period reflected several considerations. In particular, there was the desire to preserve as much day-to-day flexibility as possible in dealing with the wide and uncertain swings in reserve needs that generally are typical of the last weeks of the year. This is a period usually marked by surging credit demands around the quarterly tax payment date, as well as by large fluctuations in float and currency in circulation. By using repurchase agreements rather than outright purchases, the System could afford to inject large amounts of reserves temporarily on days when the money market threatened to tighten without committing itself to a possibly more permanent addition to the reserve base since the agreements were scheduled to mature automatically a few days later.

As it turned out, with the renewed expansion of bank credit in December persistently pushing required reserves beyond initial estimates, the maturing agreements tended to be constantly replaced and supplemented. The eventual maturity of most of the agreements around the end of December left room at that time

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for large outright purchases of Treasury bills by the System from foreign accounts, which were selling bills in quantity to make year-end payments. Purchases of bills were also made at that time from the market where demands were drying up after completion of banks' purchases before the year-end statement publishing date.

The use of repurchase agreements also served to inject reserves at what threatened to be the point of greatest pressure in the money market. Dealers' financing needs expanded progressively over the period, as dealers steadily built up their net trading positions to around $4.5 billion toward the end of December from about $3 billion at the end of November. Moreover, the availability of such agreements reduced the financing burden on the major New York City banks, which were already experiencing some deterioration in basic reserve positions, and contributed to the easing of money market rates. The proportion of dealers' trading positions financed in December through System repurchase agreements, on the average, was not much larger, however, than in other recent Decembers.

A few specific examples illustrate the general character of System operations during the period. At the very beginning of the period the System was concerned with meeting indicated reserve needs around the Thanksgiving Day holiday and over the November month-end. For this purpose the Account Manager had made net purchases of securities, both outright and under repurchase agreements, totaling $652 million on Wednesday, November 23, and Friday, November 25.

After the ensuing weekend, however, it was learned that net reserve availability for the week was turning out considerably short of earlier expectations. At the same time, trading in Federal funds opened at 6 per cent on Monday—above the levels generally prevailing on other recent days—and dealers needed substantial amounts of funds. Under these circumstances, the System moved quickly to head off further tightening in the money market. It purchased $126 million of bills in the market and from

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foreign accounts and bought an additional $185 million of bills from the market for foreign accounts, which had funds to invest that day. As soon as these outright purchases had been consummated, the System moved aggressively back into the market and purchased an additional $424 million of Government securities and bankers' acceptances under new 10-day repurchase agreements. In arranging these repurchase agreements against Government securities, the Account Manager gave the dealers time to acquire additional collateral over whatever amounts might have been immediately available.

The money market turned more comfortable after this massive reserve injection, and some Federal funds traded as low as 5 per cent on Monday, November 28, and as low as 4¾ per cent on the following day. The reappearance of a firm tone on Wednesday, November 30, was countered with the injection of an additional $289 million of reserves, net, under new repurchase agreements. All in all, over this 8-day period the System injected about $1.1 billion of reserves. These injections more than offset the reserve drains stemming from movements in other factors, and member banks' net borrowed reserves declined in the week to an average of $175 million.

Operations over subsequent weeks, while generally more modest in size, followed a similar pattern. Net reserve availability fell rather persistently short of initial estimates, partly because of greater than expected bulges in required reserves as expansion of bank credit resumed. The shortfalls in net reserve availability were particularly large in the weeks ended December 21 and 28. The bulk of the credit expansion during this period occurred at major banks in money centers throughout the country. These banks accumulated basic reserve deficits averaging nearly $2.2 billion in the statement week ended December 21 before benefiting from a gain in reserves in the following week. By quickly renewing maturing repurchase agreements, however, and then injecting additional reserves through further purchases late in the statement weeks, the System maintained an ample level of

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reserve availability throughout the banking system, and the pressures were accommodated quite smoothly.

Some pressures did emerge on the next to last business day of the year, Thursday, December 29. Banks sought to meet, in advance, their reserve needs for the following holiday weekend so as to avoid having to borrow on the year-end statement date. Dealer financing needs were also quite heavy, in part because more than $500 million of repurchase agreements with the System matured that day. Trading in Federal funds opened at 6 per cent that morning and threatened to move to higher rates as the availability of money appeared limited.

In these circumstances the System purchased $233 million of bills in a go-around of the market and an additional $260 million of bills directly from foreign accounts. To this amount was added a total of $532 million of Treasury and Government agency securities and bankers' acceptances purchased under new repurchase agreements, bringing the net reserve injection for the day to about $500 million. The Federal funds market did not tighten further after these operations, although member banks borrowings from the Reserve Bank bulged to $2.1 billion that day. The next day—Friday, December 30, which was the statement publishing date—the Federal funds market eased again and member banks' borrowings dropped back to $173 million.

Securities markets. The sizable injections of reserves around the end of November were generally interpreted by participants in the securities markets as a clear signal that System policy had shifted. This view became stronger as the easier conditions in the money market continued in subsequent weeks. To the buoyancy in the markets stemming from this factor was added further discussion of a slowing in the pace of the over-all economic advance, of the possibility that the administration's forthcoming annual messages to the Congress would include a request for additional fiscal action to redress imbalances in the economy, and finally, renewed hopes for peace negotiations in Vietnam. In this environment the feeling prevailed that prices of securities

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would rise. As demand from professional and investment sources expanded, prices in fact did rise quite sharply.

In the short-term markets, demand for Treasury bills was especially strong. Dealers built up their net trading positions in bills to nearly $3.5 billion by the end of December and still sold sizable amounts of bills to public funds and commercial banks. Bill rates moved down by 20 to 65 basis points over the period, with 3-month bills bid at 4.81 per cent on December 30. This was 78 basis points below the high reached in mid-September and only 29 basis points above the rate prevailing at the beginning of the year. The spread between rates on 3- and 6-month bills, which had widened to as much as 50 basis points in early September, was only 11 basis points at the year-end—reflecting the increased confidence in the outlook for interest rates generally among market participants.

Demand for Treasury coupon issues also expanded over the period, and there was a considerable amount of tax switching transactions as the year drew to a close. In the corporate and municipal markets, underwriters approached the forthcoming heavy supply of new issues with increasing confidence, and when the offerings attracted good investor response, all sectors of the markets were encouraged further. Against this background, further discussion of the possibility of renewed sales of FNMA participation certificates had little effect on market sentiment, and indeed by midmonth participants seemed to be optimistically awaiting formal announcement of the terms of sale. The announcement, which came on December 19, indicated that the offering early in the new year would consist of $600 million to be sold to the public and $500 million to be sold to Government trust accounts. The size of the offering to the public was somewhat less than had been expected, and prices of outstanding bond issues rose sharply further in all market sectors.

The markets took further encouragement from the Federal Reserve's formal announcement on December 27 that due to the change in credit conditions, including the more moderate

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rate of expansion of business loans, the special discount arrangements announced in the System's September 1 letter were terminated. This was taken as additional evidence of the System's move toward an easier policy stance. By the month-end, prices of Treasury coupon issues were up by as much as 4⅛ points from their levels on November 22. Yields in the 1- to 5-year and long-term sectors of the Treasury market were down to 4.98 and 4.63 per cent, respectively. These were 127 and 63 basis points below the peaks reached around the end of August and indeed were not very far from the levels prevailing at the year's start.

The decline in tax-exempt yields over the period brought the Bond Buyer's index of yields on 20 seasoned tax-exempt issues down to 3.77 per cent by the end of December. While this level was nearly 50 basis points below the August peak, it was still about 25 basis points higher than at the year's start. In the corporate market, on the other hand, the better atmosphere in the final weeks of the year had less of an impact on yields. Over the year as a whole, borrowers had sold a total of $17 billion of new issues in this market, or 9 per cent more than in 1965, and yields at the year-end were still well above their beginning-of-year levels. Indeed, yields were only about 30 basis points below their August peaks. Thus, by mid-December an index of yields on new corporate issues, adjusted to an Aaa basis—calculated by the staff of the Board of Governors—was 5.63 per cent, compared with 5.98 per cent in early September and 4.82 per cent at the start of the year.

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REVIEW OF OPEN MARKET OPERATIONS IN FOREIGN CURRENCIES

There were very heavy flows of funds across the foreign exchanges and in the Euro-dollar market during 1966. These stemmed from the continuing deficit in the U.S. balance of payments, from sharp shifts in the balance of payments positions of several other industrial countries, and from the emergence of another major crisis for the pound sterling. The potentially adverse effects of some of these developments on the U.S. dollar and the U.S. gold stock were cushioned to a considerable extent by large inflows of private capital to the United States induced by tightening monetary conditions in this country. At the same time, the use of official international credit facilities again helped to protect a number of major currencies, including the dollar, from too much buffeting.

One of the significant developments of the year was the further strengthening of the international monetary system to withstand the pressures generated by speculative shifts and payments swings. This strengthening included an enlargement of the Federal Reserve System's reciprocal currency arrangements with foreign central banks and the Bank for International Settlements (BIS) from $2.8 billion to $4.5 billion and an increase of more than 25 per cent in the resources of the International Monetary Fund (IMF). Moreover, the scope of official operations was extended at the year-end as several monetary authorities and the BIS entered into operations designed to ease year-end pressures in the Euro-dollar market.

With the United States still in payments deficit, partly as a result of the Vietnam war, the dollar again experienced a backwash from a major sterling crisis. During the late spring and early summer very large amounts of sterling were converted into dollars, some of which flowed to continental European central banks. Moreover, the payments surpluses of France and Italy remained large—although they moderated during the course of

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the year—while Germany's balance of payments swung sharply from deficit to surplus.

These developments would have resulted in a much greater pressure on the dollar in the exchange markets had it not been for the increasing stringency of monetary policy in the United States. U.S. commercial banks, through their branches in Europe, bid actively for Euro-dollar deposits at rates high enough to induce private foreigners to hold larger amounts of dollars in this form rather than convert them into local currencies. Inflows through the branches were particularly large during the third quarter, when the sterling crisis was at its peak, and thus greatly reduced the flow of dollars to continental central banks and the amount of U.S. official financing that might otherwise have been required. Nevertheless, the over-all flow of dollars through central banks was very large during the year, and in response to these flows the foreign exchange operations of the Federal Reserve and the Treasury continued to expand.

During the first part of 1966 the Federal Reserve was able to repay all of its outstanding drawings under swap agreements. In addition, significant progress was made in reducing other foreign exchange commitments of the United States. The deficit in Germany's payments position that had emerged in the latter half of 1965 persisted into 1966, and the U.S. Treasury was able to acquire enough marks to liquidate $252 million of its outstanding German mark-denominated securities. The Treasury also reduced its indebtedness in Swiss francs and Austrian schillings.

In the first quarter the tone of the sterling market continued to reflect the improvement that had begun in September 1965, and the Bank of England was able to repay its swap drawings from the Federal Reserve. However, the position of sterling began to deteriorate in late spring, as Britain's payments deficit persisted and the country suffered a prolonged maritime strike.

In early summer, sterling again came under extremely heavy pressure in exchange markets, and the British Government enacted a drastic stabilization program. To finance its support of

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the pound, the Bank of England relied heavily on short-term international credit facilities, including those with the Federal Reserve and U.S. Treasury, the Basle group of central banks, and the BIS.

As part of the outflow of funds from Britain and from the continuing U.S. deficit found its way into the hands of central banks on the continent, the United States was called upon to make use of its own credit lines. Swap drawings totaling $570 million were made in the third quarter by the Federal Reserve in Swiss francs, Dutch guilders, Belgian francs, and Italian lire. In August the Treasury made a new drawing of $250 million equivalent of lire on the IMF and sold the lire to the Federal Reserve, which used them to repay short-term borrowings. In addition, in September the Italian and French Governments prepaid some of their postwar debt to the United States, as the German Government was to do at the year-end.

TABLE 1

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Other party to arrangement	Amount of facility (in millions of dollars equivalent)	
	Dec. 31, 1965	Dec. 31, 1966
Austrian National Bank	50	100
National Bank of Belgium	100	150
Bank of Canada	250	500
Bank of England	750	1,350
Bank of France	100	100
German Federal Bank	250	400
Bank of Italy	450	600
Bank of Japan	250	450
Netherlands Bank	100	150
Bank of Sweden	50	100
Swiss National Bank	150	200
Bank for International Settlements	[1] 300	[1] 400
Total	2,800	4,500

[1] Half available in Swiss francs and half in other European currencies.

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The pressures that developed in exchange markets during the spring and summer created widespread apprehension and prompted the Federal Reserve to initiate discussions aimed at increasing its reciprocal currency facilities with a number of major central banks. As market fears intensified, these talks were broadened to include virtually all parties to the swap network. In mid-September the Federal Reserve announced a general enlargement of the swap lines from $2.8 billion to $4.5 billion (Table 1). These increases brought the credit lines to levels well above the size of any routine drawings that might reasonably be expected and thus created a broad margin of safety against any unforeseeable threats to international currency stability. At the same time the Bank of England announced an increase in its credit facilities with a number of other central banks as well as with the Federal Reserve.

Following the announcement of this reinforcement of the international financial mechanism, and as some of the extreme pessimism in financial markets began to lift, the exchanges started to calm. Although U.S. banks continued to attract Euro-dollar funds, the markets were much less strained, and sterling staged a strong recovery in the exchange market.

As the year-end approached, however, there was the danger that the customary large flows of funds back into continental European centers for year-end payments and balance-sheet window dressing would put a severe strain on the Euro-currency and exchange markets, and on sterling in particular. In order to head off such a development, the Federal Reserve, the BIS, and several major continental central banks joined forces in operations in Euro-dollars. The BIS injected into the Euro-dollar stream some $275 million of funds drawn from the Federal Reserve under the swap facility and from its own resources, while the Swiss National Bank, as in past years, rechanneled into the Euro-dollar market its dollar gains stemming from year-end flows. The Federal Reserve and the U.S. Treasury moved into the market for sterling and executed a total

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TABLE 2

FOREIGN CURRENCY TRANSACTIONS OF THE FEDERAL RESERVE, 1966

(In millions of dollars equivalent)

Currency	Transactions under swap lines					Third-currency swaps		Other transactions			
				Acquisitions of funds for repaying swaps				With U.S. Treasury		With others[1]	
	Drawings	Repayments	Disbursements of swap-acquired balances	From U.S. Treasury	From others	Purchases and reacquisitions	Sales and repayments	Purchases	Sales	Purchases	Sales
Operations initiated by the System:											
Belgian franc	30.0	65.0	30.0	.....	64.9	.....	.....	.....	.....	.....	.....
Pound sterling	.....	.....	.....	.....	.....	50.0	50.0	.....	31.7	430.0	304.0
German mark	140.0	.....	140.0	.....	2.5	40.1	.....	.....	54.8	72.3	61.2
Italian lira	325.0	410.0	325.0	225.0	140.9	[2]50.0	50.0	25.5	.....	23.9	.....
Dutch guilder	65.0	30.0	65.0	.....	30.0	.....	.....	.....	.....	.....	2.5
Swiss franc	150.0	60.0	150.0	.....	61.0	.....	40.1	.....	48.0	88.9	.....
Total	**710.0**	**565.0**	**710.0**	**225.0**	**299.3**	**140.1**	**140.1**	**25.5**	**134.5**	**615.1**	**367.7**
Swap operations initiated by others:											
Pound sterling	625.0	750.0	.....	.....	.....	.....	.....	.....	.....	.....	.....
Other	302.6	102.6	.....	.....	.....	.....	.....	.....	.....	.....	.....
Total	**927.6**	**852.6**									

[1] Includes forward as well as spot transactions; excludes Italian lira forward operations and renewals of forward sales.
[2] Used to repay swap drawing.

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of $88 million of 1-month swaps to help insulate sterling from the year-end strain. During the closing weeks of the year the Netherlands Bank also redeposited some funds in the Euro-dollar market, while the German Federal Bank and the Bank of Italy took action to reduce the seasonal pullback of funds by their commercial banks. The effect of these coordinated actions was to damp emerging pressures in the Euro-dollar market and to enable that market to pass through a potentially dangerous period without undue strain.

The remainder of this report presents a more detailed review of Federal Reserve operations in sterling, German marks, Swiss francs, Italian lire, Netherlands guilders, and Belgian francs. It also gives an account of U.S. transactions with the IMF; some of these were related to System activities.

Sterling. During the first few weeks of the year, sterling was riding the crest of a recovery that had begun with the September 10, 1965 announcement of renewed international support for the pound. By early February the Bank of England had completely paid off the $890 million of credits received from the Federal Reserve and U.S. Treasury in 1965, including $475 million outstanding at the end of the year under the reciprocal currency arrangement with the Federal Reserve.

During February, however, the exchange markets became more cautious in view of disappointing January trade results and the impending British general election. By the end of February, the sterling rate had moved below par for the first time since September 1965, and the rate eased further in March as uncertainties about sterling were reinforced by a tightening of the Euro-dollar market.

The Labor Party's decisive victory at the polls on March 30 had been expected by the market, and relatively quiet conditions prevailed throughout April in guarded anticipation of Chancellor Callaghan's budget for the new fiscal year. The market interpreted the budget announced on May 3 as being only moderately restrictive, particularly since the principal provisions were not

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scheduled to take effect until the fall, and initially there was some selling of pounds. This was countered by support from the Bank of England and the U.S. Treasury, and the market quickly regained its equilibrium; but it remained vulnerable to new setbacks as British imports continued at abnormally high levels.

In this atmosphere, the outbreak of the British seamen's strike in mid-May brought a rapid deterioration of confidence in sterling, and a series of intensive selling waves began on June 3. Temporary relief from these pressures was provided by the announcement in mid-June that the credit lines from U.S., European, and other sources that had been made available in support of the pound during the autumn of 1965 had now been placed on a continuing basis. The respite for sterling provided by this announcement was short-lived, however, as increasing stringency in the Euro-dollar market left British interest rates not fully competitive, with consequent outflows from sterling in late June.

While spot sterling came under pressure, forward sterling quotations narrowed and a sizable arbitrage incentive in favor of the United Kingdom developed in relation to short-term instruments in the New York market. Consequently, the Federal Reserve Bank of New York, with the agreement of the Bank of England, undertook market swap transactions in which, for System and Treasury accounts, it bought a total of $67 million equivalent of sterling spot against delivery 1 month forward. This operation both reduced the arbitrage incentive to shift funds from New York and eased exchange market pressures on spot sterling quotations.

Although the seamen's strike was settled by the end of June, market attitudes had deteriorated and sales of sterling rose to a climax during July. Figures that were released on July 4 indicated that during the preceding 4 months British reserves had declined $372 million, even after recourse to international assistance (including $275 million from the United States). In addition, there was disagreement within the Labor Party over the

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proposed tightening of the incomes policy, an important element in the long-term resolution of Britain's payments difficulties. As selling of sterling reached very heavy proportions toward mid-July, the Bank of England continued to provide firm support for the pound in both spot and forward markets. On July 14 it raised its discount rate from 6 per cent to 7 per cent and doubled the special deposits required of the London and Scottish banks. However, the market shrugged off the discount rate increase as merely a technical adjustment to rising interest rates abroad. Selling of sterling then intensified when the Prime Minister, in speaking to Parliament, confirmed that Britain faced a new financial crisis and warned of new restrictive measures.

Against this background of massive sales of sterling, the British Government, on July 20, introduced a drastic austerity program, including a wage freeze, restraint on prices and dividends, additional taxes, reduced travel allowances, and further curbs on public expenditures at home and overseas. In order to emphasize to the market the confidence of U.S. authorities in the ultimate success of the British program and to help stem and possibly reverse reserve losses by the Bank of England in the market, the Federal Reserve Bank of New York moved into the sterling market in New York and began buying pounds for both System and U.S. Treasury account as the sterling rate advanced from $2.7866 before the announcement of the new program to above $2.7900 by July 22.

During the next few weeks, sterling remained vulnerable, both because the market was skeptical of the political feasibility of the strong new measures and because British foreign trade figures remained disappointing. In addition, a sharp rise in yields on dollar-denominated instruments exerted a strong pull on funds from sterling, while the approach of the IMF-World Bank meeting, which was to be held in September, tended to unsettle market sentiment. Against this background of uncertainty in the exchange market and the seriously strained conditions in many national money markets, the Federal Reserve on September

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13 announced the increase in its over-all reciprocal currency facilities with other central banks from $2.8 billion to $4.5 billion. Included was an increase of $600 million to $1,350 million in the arrangement with the Bank of England. The Bank of England simultaneously announced that it had arranged additional facilities with other central banks.

With this renewed evidence of central bank solidarity, the market atmosphere improved and selling pressures on sterling subsided. In following weeks the restrictive measures initiated by the British Government in earlier months began to show results, and as public opinion rallied in support of the Government's defense of sterling, speculative talk about sterling died down and short-covering began. Additional demand for sterling came from the requirements of international oil companies and from favorable reaction to a progressive improvement in Britain's trade performance. In October and November the Bank of England took in a substantial amount of dollars; of this, $120 million was added to reserves, while a start was made on repaying central bank assistance.

During the final weeks of the year, the market atmosphere was somewhat uneven, although on balance the Bank of England was still able to add to reserves from market operations. Some selling of sterling was occasioned by concern about mounting tension surrounding the Rhodesian issue. Even more importantly, the year-end preparations in several financial centers gave rise to very large flows of funds across the exchanges, and in the process money moved out of sterling on a short-term covered basis. The flow of covered funds contributed to an appreciable narrowing in the discount for 1-month sterling; simultaneously, U.S. money rates were declining. As under similar circumstances earlier in the year, the Federal Reserve and the Treasury, in consultation with the Bank of England, again purchased spot sterling against sales for 1-month forward delivery at increasingly wide discounts. These operations—totaling $88 million—complemented coordinated action taken by several

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other central banks and the BIS to relieve potentially disruptive year-end pressures in the Euro-dollar market.

Sterling thus was insulated from year-end window-dressing pressures, and during December it benefited again from encouraging trade figures and from some repatriation of corporate profits at the end of the year. Consequently, in December British reserves would have increased $11 million even after some further repayment of short-term central bank debt, had it not been for $193 million of year-end debt payments on North American loans. Because of these repayments, reserves dropped by $182 million in December to $3,100 million.

As sterling moved through crisis to convalescence, the Bank of England made extensive use of the network of central bank credit facilities of various types that have been constructed during the past 5 years. In the case of the Federal Reserve swap line, Bank of England drawings rose to a peak of $450 million at the end of July, declined to $400 million by the end of September and to $350 million at year-end, and were paid off completely by early March 1967. In addition to these drawings on the Federal Reserve swap line, the Bank of England made use of sizable special credits provided by the U.S. Treasury, and to a lesser extent—that is, a maximum of $50 million—by the Federal Reserve. After rising to a peak during the midsummer months, such special credits declined to $175 million at the end of September and to $160 million at the year-end and were fully liquidated during January 1967. At the height of the crisis the Bank of England also secured credit assistance from other central banks with repayments being effected later.

German mark. The German balance of payments swung from deficit to substantial surplus during 1966. This swing was related largely to a cyclical slowdown in the German economy, which had been overheated during most of 1965 and early 1966. As German imports stabilized early in 1966 and exports began to rise sharply, the trade surplus expanded. This improvement on the trade account was a major force in 1966 behind

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an over-all improvement in Germany's external position, as other current-account items continued in deficit and the capital accounts were about in balance.

At various intervals both German and U.S. authorities acted to moderate the impact of the German payments position on the exchange markets and on German official reserves. The German Federal Bank intervened in support of the mark early in the year, but as an over-all payments surplus emerged during the second quarter, the German Federal Bank began to purchase dollars, and it closed the year with a net gain of $419 million in holdings of gold and convertible currencies. Similarly, the U.S. authorities purchased sizable amounts of marks in the first half of the year and liquidated $252 million of mark-denominated U.S. Treasury securities. In December, however, the Federal Reserve sold a sizable amount of marks in the New York market and absorbed $155 million of official German gains—using mainly marks drawn under the Federal Reserve swap line, which had been increased in September by $150 million to $400 million.

During the first 4 months of the year the German balance of payments was still in deficit, primarily because of seasonal outflows of short-term funds from German banks and because of rising German expenditures for services from abroad. Consequently, the mark was generally on offer at rates somewhat below its parity of $0.2500, and support operations by the German Federal Bank resulted in a decline of $281 million in official German reserves by April 30.

The ready availability of German marks enabled the U.S. authorities to buy marks as they had been doing since June 1965 in order to repay mark-denominated U.S. Treasury indebtedness to the German Federal Bank. During the first half of 1966 a total of $232 million of marks was bought for Treasury account, mostly in the New York market. The Treasury used these marks, together with balances on hand, to redeem at maturity a total of $252 million equivalent of mark-denominated securities held by

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the German Federal Bank. With these repayments, and with those that had been initiated in the second half of 1965, the Treasury within the 12-month period ended July 1 had reduced its mark-denominated indebtedness by $329 million, to $350 million equivalent.

The German Federal Bank pursued a generally restrictive monetary policy during the year, and the resulting firmness in the money market encouraged German firms to borrow abroad. On May 26 the Federal Bank announced an increase in its discount rate to 5 per cent from 4 per cent, and in June the money market tightened further in connection with large tax payments and the usual midyear window-dressing operations. Moreover, in late June and during July the sterling crisis led to flows of funds to Germany.

As a result of these developments, as well as of the recovery of the German trade position, the German balance of payments began moving into surplus during the second quarter, and the demand for marks increased. In June and July the spot rate moved back to parity and above, and the German Federal Bank added $467 million to its reserves of gold and convertible currencies, thus more than recouping losses incurred during the first 4 months of the year.

More balanced conditions prevailed later in the summer, but by October demand for marks began to increase again as the German trade surplus continued to widen and a tight German money market prompted German firms to continue borrowing abroad. As a result, spot quotations for the mark resumed their rise. The German Federal Bank purchased dollars on a large scale in October and again beginning in late November, when demand for marks intensified in connection with mounting year-end liquidity requirements in Germany.

The German Federal Bank had sought to relieve some of these pressures by announcing in early November a 9 per cent reduction in commercial banks' reserve requirements for December. Nevertheless, beginning in late November large short-term capital

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flows to Germany took place in preparation for the year-end and for a mid-December tax payment. The spot rate for the mark advanced almost to its ceiling, and during December the Federal Bank made very sizable purchases of dollars.

Under the circumstances, the System acted in December to relieve pressures on two fronts. First, in order to meet the demand for marks that had spilled over to the New York market, the System, in consultation with the German monetary authorities, sold marks in that market from its available balances; early in the month it sold spot $29 million equivalent. Then just before Christmas the market began to bid strongly for marks on a 1-month swap basis. The System shifted its intervention accordingly and sold $17.5 million of marks spot against 1-month forward purchase. In addition, the System absorbed $155 million of the large gains in Germany's official dollar holdings; it purchased $15 million with marks accumulated during 1965 and $140 million with marks drawn under its swap facility with the German Federal Bank.

In the last 2 days of December, when trading was for delivery after the year-end, marks began coming on offer in connection with a reversal of some of the earlier short-term flows of funds to Germany. The German Federal Bank then gave up some of its earlier December gains as the rate for the mark declined to $0.2514½, while the System began buying marks on a small scale in New York to help cover swap commitments.

Swiss franc. The rate for the Swiss franc declined steadily during the first quarter of 1966 as a result of seasonal influences and of sizable outflows of capital induced by easy monetary conditions in the Swiss market, rising Euro-dollar rates, and attractive yields on offshore U.S. corporate issues. By early March, the Swiss franc had fallen to $0.2304⅛ and the Swiss National Bank began selling dollars to moderate the rate decline. At the same time, payments to foreign countries by the Swiss Government and by federal agencies further reduced the reserves of the National Bank. To replenish its dollar balances the Swiss National

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Bank between February and May bought $133 million from the Federal Reserve and the U.S. Treasury, mostly against Swiss francs but also through sales of $18 million of gold.

The Federal Reserve and the Treasury in turn used the Swiss francs they acquired to repay Swiss-franc-indebtedness and to add to balances. The Federal Reserve fully repaid its $40 million equivalent German mark–Swiss franc swap with the BIS, while the Treasury liquidated a similar swap for $15 million equivalent. The System temporarily added $46 million equivalent to its balances—simultaneously selling the Swiss francs forward to the Treasury for delivery on May 16 and July 20, on which dates the Treasury repaid at maturity two Swiss-franc-denominated securities issued to the Swiss National Bank as fiscal agent for the Swiss Confederation. (These repayments reduced the amount of outstanding Treasury securities denominated in Swiss francs to $304 million equivalent.) At the same time, the Treasury added $17 million equivalent to its Swiss franc balances.

During April, monetary conditions in Switzerland tightened and the Swiss franc began to strengthen. The rate reached its effective ceiling of $0.2317½ in early May, and the Swiss National Bank entered the market as a buyer of dollars for the first time in 1966. The franc remained at the ceiling in subsequent weeks as the Swiss banking community began to repatriate funds to meet midyear liquidity needs and as foreigners who had previously borrowed Swiss francs switched to less costly Eurocurrencies—purchasing Swiss francs outright to pay off their franc borrowings. At the same time, mounting pressures on sterling added to the demand for Swiss francs. During May and June the Swiss National Bank took in $200 million through outright purchases and an additional $82 million in short-term swaps with Swiss commercial banks to help provide for their temporary midyear requirements.

By July uncertainties generated by the pressures on sterling again dominated the foreign exchange markets, and the usual seasonal outflow of funds from Switzerland was replaced by

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an inflow. Accordingly, in July the Federal Reserve reactivated its swap facilities with the Swiss National Bank and with the BIS —drawing $75 million of francs from each bank to absorb dollars from the Swiss central bank. The Swiss authorities also purchased $20 million of gold from the U.S. Treasury.

Beginning in late July, Swiss francs gradually came on offer. As pressure on sterling subsided and high money market rates abroad induced extensive foreign investments on a short-term basis, the spot rate declined. By autumn, the rate had eased to $0.2305¼, and the Swiss National Bank began selling dollars to the market. In addition, Swiss reserves were drawn down in connection with fairly sizable official requirements between September and November. With its dollar holdings reduced the Swiss central bank once again purchased dollars from the System against francs. The System used the $60 million equivalent so acquired to reduce its $75 million franc swap drawing from the Swiss National Bank to $15 million equivalent. The System's Swiss franc swap drawing of $75 million equivalent from the BIS, however, remained unchanged through the year-end.

The facilities with the Swiss National Bank and with the BIS that provide for swaps against Swiss francs were each increased on September 13, 1966, from $150 million to $200 million; another swap facility with the BIS, which provides for swaps against European currencies other than Swiss francs, was increased from $150 million to $200 million on the same date.

In the final weeks of 1966, Swiss banks began to repatriate large amounts of funds to cover their usually heavy year-end requirements, and by November 23 the spot rate for the franc had again reached its ceiling. The Swiss National Bank first purchased $75 million spot, but toward the end of November it announced that it was ready to buy dollars from banks on a swap basis, as it had under similar circumstances on previous occasions. The spot rate thereupon quickly receded from its ceiling and held in a range of $0.2310½ to $0.2315½ throughout December; the Swiss National Bank purchased a total of $398

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million on a swap basis from Swiss banks. In order to prevent these movements of funds from putting pressure on the Euro-currency markets, the Swiss National Bank, as usual, rechanneled to the Euro-dollar market the dollars it acquired during November and December. At the year-end the market for the Swiss franc was calm.

Italian lira. Italy's balance of payments surplus declined significantly in 1966 from its exceptionally high level of $1.6 billion in 1965. But it still remained large—$0.7 billion. The reduction stemmed in part from a wider trade deficit, but mainly from substantial outflows of capital associated with relatively easy conditions in Italian financial markets and active bidding for funds by foreigners, including industrial firms. Both Italian and U.S. authorities again employed a variety of techniques to moderate gains in Italian official dollar reserves.

At first Italy's reserve gains were moderate. The Italian authorities provided swap facilities to Italian commercial banks, and those banks reinvested in the Euro-dollar market a substantial amount of the funds they had repatriated late in 1965 in connection with year-end requirements; in addition, the Italian Government purchased some IBRD bonds.

Also during the first quarter U.S. authorities were able to reduce short-term lira commitments arising from an August 1965 System drawing of $100 million equivalent of lire under the swap facility with the Bank of Italy. In February the System liquidated this drawing by using $50 million equivalent of lire purchased in a special transaction with a foreign central bank and $50 million acquired through a sterling–lira swap with the BIS. In March and May there were some small offerings of lire in the New York market and the Federal Reserve purchased a total of $10 million equivalent. These lire were used on May 25 to reduce the third-currency swap with the BIS from $50 million to $40 million equivalent.

About midyear, however, demand for lire began to rise as Italy's tourist season moved into full swing, Italy's trade account

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improved seasonally, and the mounting sterling crisis precipitated flows of funds out of sterling into lire. By then, moreover, most Italian banks had eliminated any net liabilities to foreigners, and the Bank of Italy was no longer prepared to shift dollars abroad through short-term swaps with those commercial banks at preferential rates.

All these factors contributed to a marked rise in official Italian reserves. In July and early August the Federal Reserve drew $225 million of lire under its $450 million swap facility with the Bank of Italy and used the lire to absorb dollars that had accrued to the Italian authorities. These drawings were repaid on August 22 when the U.S. Treasury drew $250 million of lire from the IMF and sold the lire to the System. The System used the remaining $25 million of lire, plus $1 million equivalent in balances, to reduce its sterling–lira swap with the BIS from $40 million to $14 million.

Additional large amounts of dollars continued to flow into official Italian reserves during August. In early September the System reactivated its swap—drawing lire to absorb $100 million from the Italian authorities. Soon afterward, however, Italian reserves began to decline as strong seasonal inflows of funds subsided, a tighter Euro-dollar market exerted a renewed pull on Italian bank funds, and the Italian authorities prepaid $145 million of postwar debt to the United States. In late September the System purchased $14 million of lire from the Bank of Italy and extinguished its remaining sterling–lira swap with the BIS.

As the fall progressed, dollars were generally in demand in Italy in response to the conversion of lira borrowings by foreign firms and outflows to the Euro-dollar market. Lira quotations eased steadily toward par, offerings of lire in the market were sizable, and the System made large purchases in New York through the remainder of the year. By the year-end the swap commitment had been reduced from $100 million equivalent to $15 million.

Although the change in Italy's balance of payments in late

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1966 was sufficient to make possible the reduction in System lira commitments, Italy's over-all reserve position strengthened over the year as a whole. In particular, its creditor position in the IMF increased some $336 million. In view of the substantial surplus in their payments position, the Italian authorities at the year-end purchased $60 million of gold from the U.S. Treasury in order to replenish their gold holdings.

Federal Reserve and Treasury technical forward commitments in Italian lire that had been undertaken in 1965 were rolled over periodically during 1966. As the year closed, U.S. commitments in lire—aside from technical forward commitments—consisted of: (1) $15 million under the $600 million swap facility with the Bank of Italy (this facility had been increased by $150 million in September 1966) and (2) $125 million equivalent in medium-term U.S. Treasury bonds issued to the Bank of Italy.

Netherlands guilder. The Dutch guilder was generally on offer during the first 4 months of 1966, as both seasonal weakness and some special factors contributed to a widening in the Netherlands trade deficit. As early as January the guilder was quoted below its par of $0.2762⅜, and by late April it had reached $0.2750¾, the lowest level since the revaluation of March 1961.

Effective May 2 the Netherlands Bank raised its discount rate to 5 per cent from 4½ per cent in an effort to curb the growth of domestic bank credit and stem the deterioration of the Dutch balance of payments. The guilder rallied at once and by early June had reached par. After midyear, increasingly tight money market conditions in Amsterdam and growing tensions in the sterling market led to a sizable inflow of funds. Dutch reserves increased by $94 million in July and rose further in early August. At that point the Federal Reserve reactivated its $100 million swap facility with the Netherlands Bank; it drew $65 million of guilders and used them, together with $2.5 million of guilder balances, to purchase an equivalent amount of dollars from the Netherlands Bank.

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By mid-August, however, the Dutch money market had eased, and as increasingly attractive interest rates on dollar investments exerted a pull on Dutch funds, the spot guilder began to drift off and went below parity by mid-September. In order to moderate the decline, the Netherlands Bank sold some dollars to the market and later bought $10 million from the System against guilders. The System in turn used the guilders to reduce its swap commitment to $55 million equivalent. (As part of the September 1966 increase in the Federal Reserve's reciprocal swap facilities, the System and the Netherlands Bank agreed to increase their arrangements from $100 million to $150 million.)

During the autumn the guilder moved back to a level somewhat above par. It fluctuated within a narrow range during the remaining weeks of the year as the Dutch trade account displayed seasonal strength and as an intermittently tight money market in Amsterdam exerted a pull on funds. The Netherlands Bank intervened only sporadically during this period to relieve money market pressures in Amsterdam, which were particularly strong in early November and in mid-December. When it did intervene, it used the technique of market swaps, as on some earlier occasions—buying dollars spot from Dutch commercial banks and selling them forward for January 1967 delivery. To help moderate year-end pressures in the Euro-currency markets, the Netherlands Bank reinvested its December dollar purchases in the Euro-dollar market.

At the year-end foreign currency requirements of the Dutch Government led the Netherlands Bank to buy $20 million against guilders from the Federal Reserve. The Federal Reserve immediately used the guilders to reduce its outstanding swap drawings from that bank to $35 million equivalent.

Belgian franc. During the latter part of 1965 the National Bank of Belgium had intervened in the Brussels market in support of the franc on several occasions and had recouped its dollar losses by purchases from the Federal Reserve against Belgian francs. As a result, by January 1, 1966, the System's swap obli-

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gation to the National Bank had been reduced to $35 million equivalent. During the first 2 weeks of January 1966 the Belgian central bank continued these activities, thus enabling the System to repay its remaining swap drawings. The only remaining official U.S. debt in Belgian francs early in 1966 consisted of two U.S. Treasury bonds totaling $30 million equivalent held by the National Bank.

During the next few months the market was steady as the Belgian balance of payments was about in equilibrium. In the late spring, however, credit policy in Belgium tightened, the money market firmed, and the spot rate for the franc began to strengthen. The National Bank reinforced its existing measures of restraint by raising its discount rate by ½ of a percentage point to 5¼ per cent on June 2. Nevertheless, official reserve gains remained small until July. At that time funds were repatriated to Belgium as a result both of the domestic liquidity squeeze and of the speculative pressure on sterling. As the spot rate for the franc moved to its ceiling in late July, the National Bank began to buy fairly sizable amounts of dollars.

In order to absorb some of Belgium's rapidly increasing holdings of dollars, the Federal Reserve in August drew $30 million equivalent of funds under the $50 million standby portion of its $100 million swap facility with the National Bank of Belgium and used these funds to purchase dollars from the Belgian authorities. Later in August, however, the trade account moved into sizable deficit, and with an easing in the Belgian money market, funds again began to flow abroad in response to higher rates for dollar investments. The National Bank then began supplying foreign exchange to the market and later covered these losses by purchasing dollars from the Federal Reserve against Belgian francs. By late September such purchases totaled $30 million, and the System had no uncovered Belgian franc commitments to the National Bank of Belgium under the reciprocal swap facility; the facility had been increased from $100 million to $150 million earlier in the month.

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During the early fall the Belgian franc drifted somewhat below par because of a continued deterioration on the trade account. In late November the Belgian central bank once again began to lose dollars. Because of these market losses, coupled with the exchange needs of the Belgian Treasury, the National Bank again needed dollars in the last few weeks of the year. It bought $30 million from the U.S. Treasury against Belgian francs, which the Treasury used to build up a balance for future contingencies. Thus, by the end of 1966 the U.S. authorities no longer had an uncovered position in Belgian francs; the Treasury's franc balances matched its franc-denominated bond indebtedness.

International Monetary Fund. During 1966 the United States made two types of drawings on the IMF. The first, designated "technical," extended the practice—initiated in February 1964—of obtaining currencies from the IMF for sale to other countries that were making repayments to the Fund. For this purpose the U.S. Treasury obtained drawing facilities totaling $400 million equivalent in Canadian dollars and $30 million equivalent in German marks. Whereas early in the year the facilities were fully used at the time they were arranged, later drawings were usually made as needed.

The second type of drawing was the conventional kind in which member countries obtain currencies for direct use in financing their international payments deficits. The United States first had such recourse to the Fund in July 1965. On August 22, 1966, the Treasury again went to the Fund for this purpose; this time it drew $250 million equivalent of Italian lire. As noted earlier, it sold the lire to the Federal Reserve, which used them to liquidate its $225 million equivalent outstanding swap drawings from the Bank of Italy and to repay part of a sterling–lira swap with the BIS. The Fund, whose lira balances were at a low level, borrowed the required lire from the Italian Government under an agreement outside the $6 billion General Arrangements to Borrow (GAB). This was the first occasion on which the IMF had employed its authority under the articles

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of agreement to borrow a needed currency from a member country other than under the GAB, and it marked another significant step in the evolution of the Fund's credit machinery.

U.S. drawings from the Fund between February 1964 and December 1966 totaled $1,640 million equivalent. During this period, other countries drew dollars from the Fund; thereby the Fund's holdings of dollars and this country's repayment obligation to the Fund were reduced. Consequently at the end of 1966, the net U.S. obligation to the Fund was $964 million.

The resources of the IMF were reinforced in February 1966. At that time a general Fund quota increase of 25 per cent or more, approved in 1964 by the Governors of the Fund, became effective for 58 members who had accepted the proposal and whose combined quotas as of February 23, 1965, constituted the requisite two-thirds majority for approval. By December 31 an additional 34 members had submitted their ratifications, and Fund resources had been increased from $16 billion to $20.6 billion—close to the $21 billion target for the Fund's entire 105-nation membership.

A member must pay a part of its quota increases to the Fund in its own currency and a part in gold. The gold payments have entailed gold losses for the two key-currency countries—the United States and the United Kingdom—because other members have converted dollar and sterling reserves into gold for payment of their gold subscriptions. In order to compensate for these losses, the quota increase arrangement provides that the Fund will deposit a total of up to $350 million of gold with the Federal Reserve Bank of New York and the Bank of England. As of December 31, 1966, the Federal Reserve Bank of New York held for U.S. Treasury account $211.5 million of gold so deposited by the IMF.

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SPECIAL STUDIES BY THE FEDERAL RESERVE SYSTEM

From time to time the Federal Reserve System has undertaken extensive economic studies to reappraise the workings of its various instruments of monetary and regulatory policy. The broad aim of these studies has been to keep Federal Reserve policy and action adapted to the changing economic and financial scene. The four studies currently under way are described below.

Reappraisal of the Federal Reserve discount mechanism. The fundamental reappraisal of the Federal Reserve discount mechanism, announced in last year's ANNUAL REPORT (page 216), is still in progress. A number of research studies have been commissioned and are being brought to completion; included are historical and analytical studies of Federal Reserve experience, as well as of the activities of other governmental financial institutions in this country and of central banks in other major industrial nations.

Investigations to date have come to focus on several present and potential functions of discount operations that might, in combination, lead to a more active role for the discount mechanism in the future.

For the reappraisal of certain important uses of the discount window, it has proved useful to distinguish between what might be termed operational and strategic reserve demands within the banking system. Operational reserve needs of banks are regarded as those arising from such factors as random short-falls from money position projections, seasonal patterns of loan demand, and short-term deposit shifts. Strategic needs, on the other hand, are considered to include borrowing demands arising from changes in general monetary policy. In practice, of course, these two dimensions of discounting often blend together, since operational needs tend to increase somewhat during periods of credit restraint, and alternative means of adjustment become less readily available.

In addition to studying means of meeting these reserve needs

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as effectively as possible through a combination of open market operations and discount window assistance, consideration is being given to other means of contributing to better utilization of reserves and to better functioning of secondary markets for various types of bank assets.

One other basic function of the discount window that is receiving special attention is the provision of emergency credit assistance. Such assistance is being studied with a view to better definition and implementation of appropriate System responsibilities and objectives in this area.

A paramount consideration in these studies is the maintenance of an appropriate control of over-all reserve availability. A variety of methods for regulating discounting activity are being reviewed, some growing out of Federal Reserve experience and others drawn from the discount mechanisms employed by various other central banking systems. One early conclusion suggested by this review is the wisdom of maintaining a degree of flexibility in the design and operation of the discount window to make it adaptable to changing circumstances.

During the coming months the results of the research outlined above will be interpreted and evaluated by System authorities. The ultimate objective of this entire reappraisal is to insure that the means for provision of central bank credit through the discount window are kept up to date with the significant changes that are taking place in the financial system and in the economy that it serves.

U.S. Government securities market. Considerable progress was made during 1966 in the study of the U.S. Government securities market being undertaken jointly by the Treasury and the Federal Reserve. Questionnaires were sent to, and responses received from, dealers in U.S. Government securities and also several hundred financial and nonfinancial institutional investors in such securities. In addition, individual consultations were held with dealers. Moreover, a number of staff studies were undertaken on a variety of topics relating to the structure, perform-

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ance, and financing of the market for direct U.S. Government and Federal agency securities. These studies were in varying stages of completion by the year-end.

It is anticipated that the results of the study will be made public in phases as they are completed during the course of 1967.

Foreign operations of member banks. The study on the foreign operations of member banks is intended to provide additional knowledge and understanding of the nature and expanded scope of the international lending and deposit activities of U.S. banks and of the forces influencing these operations. To obtain new and up-to-date information on these activities, extensive discussions were held during 1966 with U.S. banks and bankers—at offices in this country and abroad—and with their subsidiary corporations organized under Sections 25 and 25(a) of the Federal Reserve Act. The information obtained, supplemented by staff analyses, was to serve as a basis for a report of the study's findings. This report was in preparation at the end of the year.

Effects of monetary policy on economic activity. Work on the longer-run Federal Reserve research effort to fill the gaps in knowledge about the processes through which monetary policy affects the general economy, the so-called "linkage" project, continued in 1966.

It is still too early to give a comprehensive review of the results of the work to date on this project, but individual pieces of inquiry have been completed and in some cases have been made available to the public. Several have been summarized in the Staff Economic Studies section of the Federal Reserve *Bulletin* and have been made available in full in mimeograph form on request. Other papers will follow from time to time as they become available.

The Federal Reserve's research work in the general area of the effects of monetary policy on economic activity continues to involve System-wide working groups of economists. It also includes a large econometric project involving a number of economists on the Board's staff who are working with a group of

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university economists led jointly by Professor Modigliani of the Massachusetts Institute of Technology and Professor Ando of the University of Pennsylvania. The university portion of the project is being financed by the Board of Governors through the Social Science Research Council.

The group is involved in the construction and testing of a 50- to 60-equation quarterly model of the U.S. economy. The main purposes of the model are to establish the likely effects of alternative monetary policies on major economic aggregates and to aid in short-term forecasting. This quantitative model will be used as a supplement to, and in conjunction with, judgmental models now being used in policy formulation. It is hoped that the initial construction of the model will be completed and that testing will be begun in 1967.

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INTERNATIONAL LIQUIDITY AND BALANCE OF PAYMENTS ADJUSTMENT

During 1966 the Federal Reserve continued its active participation with the Treasury Department in the international discussions and negotiations regarding arrangements for the future creation of reserve assets that would supplement gold and reserve currencies.

A major benchmark was passed in 1966 with the initiation of a second stage in the negotiations. Joint meetings of the Executive Directors of the International Monetary Fund and the Deputies of the Finance Ministers and Central Bank Governors of the Group of Ten were held in Washington in November 1966 and were continued in London in January 1967. It is hoped that these joint meetings, which have already shown great promise, will by the time of the next annual meeting of the Fund lead to a further convergence of views on the structure and major provisions of a contingency plan for creating reserve assets.

The need for drawing up such a contingency plan for deliberate reserve creation became increasingly evident in 1966. For one thing, there was a growing awareness of the fact that since 1964 deficits in the U.S. balance of payments had not made any net contribution to the rise in world reserves. Taking the two years 1965 and 1966 together, the declines in the U.S. gold stock and in the gold tranche position in the IMF were more than twice as large as the cumulative deficit on official settlements. Hence the manner in which the U.S. deficit was financed had the effect of reducing, rather than augmenting, the total of world reserves.

Another development contributing to the growing urgency of contingency planning was the sharply reduced flow of gold into monetary stocks. In 1965 only $240 million of new gold was taken into monetary holdings, and in 1966 monetary stocks actually showed a slight decline. By contrast, in the years preceding 1965 monetary gold stocks had increased on the order of $500 million to $600 million per year.

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Given these considerations, it was encouraging to find that the international liquidity negotiations were making significant progress in 1966. Although much still remained to be done before complete agreement could be obtained on the details of machinery for deliberately creating new reserves, the principles and many of the characteristics of a possible agreement were beginning to emerge by the end of the year. For example, it was agreed that reserve creation should not be geared or directed to the financing of balance of payments deficits of individual countries, but rather should take place on the basis of a collective judgment of the reserve needs of the world as a whole. It was agreed that new reserve assets should be distributed to all members of the IMF, either on the basis of Fund quotas or some other objective standard.

There also seemed to be wide and growing acceptance of the view that the same type of reserve asset should be created for all countries, regardless of size or stage of development. In general, the principle of "universality"—treating all countries alike—seemed to gain broad acceptance. The major issues at the end of 1966 on which a consensus had not yet been reached were the provisions governing the holding and use of the new asset and the detailed procedures for voting, both for entry into force of the agreement and for subsequent activation.

In their statement of August 1964 the Ministers and Governors of the Group of Ten had requested Working Party 3 of the Organization for Economic Cooperation and Development to make a thorough study of the measures and instruments best suited for achieving faster and more effective adjustment of international imbalances without sacrificing the pursuit of essential domestic objectives and to report their findings. This important report, entitled "The Balance of Payments Adjustment Process," was completed and published in August 1966.

One significant aspect of the report was its emphasis on the need for the balance of payments objectives of individual countries to be mutually consistent. Working Party 3 has instituted

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informal arrangements under which it will continue to be informed of, and will discuss the implications of, the balance of payments aims of individual countries. The report also stressed the necessity for early identification and better diagnosis of payments imbalances, for the development of a set of informal guidelines regarding the appropriate use of various policy instruments in specified situations of payments imbalance, and for a continued development of intergovernmental consultation and cooperation. The report as agreed upon clearly recognized that the correction of payments imbalances is the responsibility of both surplus and deficit countries.

The Group of Ten countries have agreed that improvements in the adjustment process are needed and possible. It is important that further progress be made along these lines together with progress in achieving agreement on the creation of new reserve assets.

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BANK SUPERVISION BY THE FEDERAL RESERVE SYSTEM

Examination of Federal Reserve Banks. The Board's Division of Examinations examined the 12 Federal Reserve Banks and their 24 branches during the year, as required by Section 21 of the Federal Reserve Act. In conjunction with the examination of the Federal Reserve Bank of New York, the Board's examiners also audited the accounts and holdings related to the System Open Market Account and foreign currency operations conducted by that Bank in accordance with policies formulated by the Federal Open Market Committee, and rendered reports thereon to the Committee. The procedures followed by the Board's examiners were surveyed and appraised by a private firm of certified public accountants, pursuant to the policy of having such reviews made on an annual basis.

Examination of member banks. National banks, all of which are members of the Federal Reserve System, are subject to examination by direction of the Board of Governors or the Federal Reserve Banks. However, as a matter of practice they are not examined by either, because the law charges the Comptroller of the Currency directly with that responsibility. The Comptroller provides reports of examinations of national banks to the Board of Governors upon request, and each Federal Reserve Bank purchases from the Comptroller copies of reports of examination of national banks in its district.

State member banks are subject to examinations made by direction of the Federal Reserve Bank of the district in which they are located by examiners selected or approved by the Board. The established policy is to conduct at least one regular examination of each State member bank, including its trust department, during each calendar year, with additional examinations if considered desirable. Wherever practicable, joint examinations are made in cooperation with the State banking authori-

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ties, or alternate independent examinations are made by agreement with State authorities. All but 27 of the 1,351 State member banks were examined during 1966.

The Board of Governors makes its reports of examination of State member banks available to the Federal Deposit Insurance Corporation, and the Corporation in turn makes its reports of insured nonmember State banks available to the Board upon request. Also, upon request, reports of examination of State member banks are made available to the Comptroller of the Currency.

In its supervision of State member banks, the Board receives, reviews, and analyzes reports of examination of State member banks and coordinates and evaluates the examination and supervisory functions of the System. It passes on applications for admission of State banks to membership in the System; administers the disclosure requirements of the Securities Exchange Act of 1934 with respect to equity securities of banks within its jurisdiction that are registered under the provisions of the 1934 Act; and under provisions of the Federal Reserve Act and other statutes, passes on applications for permission, among other things, to (1) merge banks, (2) form or expand bank holding companies, (3) establish domestic and foreign branches, (4) exercise expanded powers to create bank acceptances, (5) establish foreign banking and financing corporations, or (6) invest in bank premises in an amount in excess of 100 per cent of a bank's capital stock.

By Act of Congress approved September 12, 1964 (Public Law 88-593), insured banks are required to inform the appropriate Federal banking agency of any changes in control of management of such banks and of any loans by them secured by 25 per cent or more of the voting stock of any insured bank. In 1966, 38 instances of changes in ownership of the outstanding voting stock of State member banks were reported to the Reserve Banks as changes in control of such member banks. In addition,

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reports of 29 loans secured by 25 per cent or more of the stock of a State member bank were forwarded to the System. Arrangements continue among the three Federal supervisory agencies for appropriate exchanges of reports received by them pursuant to the Act. The Reserve Banks send copies of all the reports they receive to the appropriate district office of the Federal Deposit Insurance Corporation, the regional Comptroller of the Currency, and the State bank supervisor.

Upon receipt of reports involving changes in control of State member banks, the Reserve Banks are under instructions to forward such reports promptly to the Board, together with a statement (1) that the new owner and management are known and acceptable to the Reserve Bank or (2) that they are not known and that an investigation is being made. The findings of any investigation and the Reserve Bank's conclusions based on such findings are forwarded to the Board. The investigations made by the Reserve Banks have disclosed no instance where failure or serious deterioration in a bank's condition could be expected to result from the change in control reported.

Misleading advertising. Because of concern with respect to misleading advertising practices of some financial institutions in their quest for funds, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the Board of Governors of the Federal Reserve System sent a uniform letter in December to the executive officer of each of the institutions that they supervise. The letter emphasized the concern of the four agencies regarding the effect on the public's attitude toward the nation's financial system, and outlined the following principles that the institutions should follow in their efforts to attract funds:

(1) Interest or dividend rates should be stated in terms of annual rates of simple interest, and the advertisement should state whether such earnings are compounded and, if so, the basis of compounding. Neither the total percentage return if held to

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final maturity nor the average annual rate achieved by compounding should be stated unless the annual rate of simple interest is presented with equal prominence.

(2) No reference should be made to "profit" to the investor for use of his funds over a period of time.

(3) If an advertised rate is payable only on investments or deposits that meet fixed time or amount requirements, such requirements should be stated.

(4) No statement should be made implying that more than $15,000 of Federal insurance is provided for each depositor in a bank or each member in a savings and loan association.

Federal Reserve membership. As of the end of December 1966, member banks accounted for 45 per cent of the number of all commercial banks in the United States and for 63 per cent of all commercial banking offices, and they held approximately 84 per cent of the total deposits in such banks. State member banks accounted for 15 per cent of the number of all State commercial banks and 30 per cent of the banking offices, and they held 60 per cent of total deposits in State commercial banks.

Of the 6,150 banks that were members of the Federal Reserve System at the end of 1966, 4,799 were national banks and 1,351 were State banks. During the year there were net declines of 16 national and 55 State member banks. The decline in the number of national banks reflected 48 conversions to branches incident to mergers and absorptions and 7 conversions to nonmember banks, which was partly offset by the organization of 25 new national banks and the conversion of 10 nonmember banks to national banks. The decrease in State member banks reflected mainly 18 conversions to branches incident to mergers and absorptions and 32 withdrawals from membership.

At the end of 1966 member banks were operating 12,900 branches, 837 more than at the close of 1965; this included 773 de novo establishments.

Detailed figures on changes in the banking structure during 1966 are shown in Table 19, page 348.

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Bank mergers. Under Section 18(c) of the Federal Deposit Insurance Act (12 U.S.C. 1828(c)), the prior written consent of the Board of Governors of the Federal Reserve System must be obtained before a bank may merge, consolidate, or acquire the assets and assume the liabilities of another bank if the acquiring, assuming, or resulting bank is to be a State member bank. Before acting on each application the Board must request reports from the Attorney General, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on the competitive factors involved in each transaction, unless it finds that it must act immediately to prevent the probable failure of one of the participating banks. The Board in turn responds to requests by the Comptroller or the Corporation for reports on competitive factors involved when the acquiring, assuming, or resulting bank is to be a national bank or an insured nonmember State bank.

During 1966 the Board disapproved 1 and approved 21 applications, and it submitted 101 reports on competitive factors to the Comptroller of the Currency and 52 to the Federal Deposit Insurance Corporation. As required by Section 18(c) of the Federal Deposit Insurance Act, a description of each of the 21 applications acted on and approved by the Board, together with other pertinent information, is shown in Table 21 on pages 352–78.

Statements and orders of the Board with respect to all bank merger applications, whether approved or disapproved, are released immediately to the press and the public and are published in the Federal Reserve *Bulletin*. These statements and orders set forth the factors considered, the conclusions reached, and the vote of each Board member present.

Bank holding companies. On July 1, 1966, the Bank Holding Company Act of 1956 was amended as described under "Legislation Enacted" (see page 308). As a result of the amendments thereto and pursuant to Section 5(a) of the Act, 5 bank

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holding companies registered with the Board prior to the year-end 1966.

Pursuant to Section 3(a)(1) of the Act, the Board approved 6 applications for prior approval to become a bank holding company and denied 2 applications. Pursuant to the provisions of Section 3(a)(2) of the Act and Section 3(a)(3), as amended, the Board approved applications by 12 bank holding companies, involving acquisition of shares in 15 banks, and denied 2 applications. Two of the approved acquisitions involved 2 affiliated bank holding companies, both of which were required to file applications. To provide necessary current information, annual reports for 1965 were obtained from all registered bank holding companies pursuant to the provisions of Section 5(c) of the Act.

Statements and orders of the Board with respect to applications to form or to expand bank holding companies, whether approved or disapproved, are released immediately to the press and the public and are published in the Federal Reserve *Bulletin*. These statements and orders set forth the factors considered, the conclusions reached, and the vote of each Board member present.

The July 1, 1966 Act that amended the Bank Holding Company Act also repealed the provisions of law relating to holding company affiliates. Therefore, since that date, no voting permits or determinations have been issued, and outstanding permits and determinations, including the conditions and agreements imposed for their issuance, are no longer in effect.

Before the Act was repealed—during the period January 1 to July 1, 1966—pursuant to Section 5144 of the Revised Statutes and Section 9 of the Federal Reserve Act, the Board authorized the issuance of 8 voting permits for general purposes and 6 for limited purposes to holding company affiliates of member banks. In accordance with established practice, several holding company affiliates were examined by examiners for the Federal Reserve Banks in whose districts the principal offices of the holding companies are located.

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Until July 1, 1966, Section 301 of the Banking Act of 1935 provided that the term "holding company affiliate" should not include—except for the purposes of Section 23A of the Federal Reserve Act, which restricts loans to affiliates and loans on, or investments in, the stock or obligations of affiliates—any organization that is determined by the Board not to be engaged, directly or indirectly, as a business in holding the stock of, or managing or controlling, banks, banking associations, savings banks, or trust companies. During the period January 1 to July 1, 1966, the Board made such a determination with respect to 25 organizations.

Foreign branches of member banks. At the end of 1966, 13 member banks had in active operation a total of 244 branches in 53 foreign countries and overseas areas of the United States; 7 national banks were operating 230 of these branches, and 6 State member banks were operating 14 such branches. The number and location of these foreign branches were as shown in the tabulation on the following page.

Under the provisions of the Federal Reserve Act (Section 25 as to national banks and Sections 9 and 25 as to State member banks), the Board of Governors during the year 1966 approved 46 applications made by member banks for permission to establish branches in foreign countries and overseas areas of the United States.

During the year member banks opened branches in foreign countries as follows: 1 branch in Bombay and Calcutta, India; Lahore, Pakistan; Riyadh, Saudi Arabia; Tamuning, Guam; La Paz, Bolivia; Valparaiso, Chile; Quito, Ecuador; Callao and Lima, Peru; Santo Domingo, Dominican Republic; Puerto Rico; Tegucigalpa, Honduras; Colon, Panama; Antwerp and Brussels, Belgium; Duesseldorf and Frankfurt-am-Main, Germany; Zurich, Switzerland; and London, England; 2 branches in Panama, Republic of Panama; Saigon, South Vietnam; and Hong Kong; and 4 branches in Santiago, Chile. One member bank closed a branch in London, England.

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Latin America	*102*
Argentina	17
Bahamas	3
Bolivia	1
Brazil	15
Chile	8
Colombia	6
Dominican Republic	5
Ecuador	3
El Salvador	1
Guatemala	2
Guyana	1
Honduras	1
Jamaica	1
Mexico	5
Nicaragua	1
Panama	15
Paraguay	2
Peru	4
Trinidad	3
Uruguay	2
Venezuela	4
Virgin Islands (British)	2
Continental Europe	*26*
Austria	1
Belgium	6
Germany	8
France	4
Greece	1
Italy	1
Netherlands	3
Switzerland	2
England	*21*
Ireland	*1*
Africa	*2*
Liberia	1
Nigeria	1
Near East	*6*
Dubai	1
Lebanon	3
Saudi Arabia	2
Far East	*57*
Hong Kong	8
India	8
Japan	12
Malaysia	5
Okinawa	2
Pakistan	3
Philippines	5
Singapore	8
Taiwan	2
Thailand	2
Vietnam	2
U.S. Overseas Areas and Trust Territories	*29*
Canal Zone	2
Guam	2
Puerto Rico	16
Truk Islands	1
Virgin Islands	8
Total	**244**

Acceptance powers of member banks. During the year the Board approved the application of 2 member banks, pursuant to the

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provisions of Section 13 of the Federal Reserve Act, for increased acceptance powers. The banks were granted permission to accept drafts or bills of exchange drawn for the purpose of furnishing dollar exchange as required by the usages of trade in such countries, dependencies, or insular possessions of the United States as may have been designated by the Board of Governors.

Foreign banking and financing corporations. At the end of 1966 there were 4 corporations operating under agreements with the Board pursuant to Section 25 of the Federal Reserve Act relating to investment by member banks in the stock of corporations engaged principally in international or foreign banking. Three of these "agreement" corporations with head offices in New York were examined during the year by examiners for the Board of Governors. The fourth "agreement" corporation is a national bank in the Virgin Islands and is owned by a State member bank in Philadelphia.

During 1966, under the provisions of Section 25(a) of the Federal Reserve Act, the Board issued final permits to 5 corporations to engage in international or foreign banking or other international or foreign financial operations. Four of these corporations commenced operations in 1966. At the end of the year there were 41 corporations in active operation under Section 25(a): 24 have home offices in New York City, 3 in Boston, 4 in Philadelphia, 1 in Pittsburgh, 1 in Winston–Salem, 1 in Atlanta, 2 in Chicago, 2 in Detroit, 2 in San Francisco, and 1 in Seattle. The corporation in Seattle has 4 active branches in Hong Kong. Examiners for the Board of Governors examined 39 of these corporations during 1966.

Bank Examination Schools and other training activities. In 1966 the Bank Examination School conducted three sessions of the School for Examiners, four sessions of the School for Assistant Examiners, and one session of the School for Trust Examiners. The Bank Examination School, established in 1952 by the three Federal bank supervisory agencies, has been conducted jointly

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by the Federal Reserve System and the Federal Deposit Insurance Corporation since withdrawal of the Office of the Comptroller of the Currency in 1962.

Since the establishment of this program, 3,033 persons have attended the various sessions. This number includes representatives of the Federal bank supervisory agencies; the State Banking Departments of California, Connecticut, Idaho, Indiana, Louisiana, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia, and Washington; the Treasury Department of the Commonwealth of Puerto Rico; and 13 foreign countries.

LEGISLATION ENACTED

Bank Merger Act amendments of 1966. An Act of Congress approved February 21, 1966 (Public Law 89-356), amended the Bank Merger Act of 1960 (Section 18(c) of the Federal Deposit Insurance Act) to (1) modify the standards for approval or disapproval of bank mergers by the Federal bank supervisory agencies, (2) make the modified standards applicable also in court actions under the antitrust laws challenging agency-approved bank mergers, and (3) exempt such mergers from the antitrust laws where not challenged by suit brought within 30 days following agency approval. The 1966 amendments also granted amnesty to certain bank mergers consummated pursuant to agency approval under the 1960 Act and subsequently challenged in antitrust court actions.

Asian Development Bank. An Act of Congress approved March 16, 1966 (Public Law 89-369), providing for participation of the United States in the Asian Development Bank, amended Section 5136 of the Revised Statutes to permit member banks to deal in and underwrite, subject to a specified limitation on amount, obligations issued by the Asian Development Bank that are eligible for purchase by a national bank for its own account.

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The Act also authorized the Federal Reserve Banks to act as depositories and as fiscal agents for the Asian Development Bank.

Destruction of unfit Federal Reserve notes. An Act of Congress approved May 20, 1966 (Public Law 89-427), amended certain provisions of law, including Sections 11(d) and 16 of the Federal Reserve Act, so as to authorize decentralization of the destruction of Federal Reserve notes that are unfit for further circulation.

Defense Production Act of 1950. An Act of Congress approved June 30, 1966 (Public Law 89-482), extended through June 30, 1968, the termination date of the Defense Production Act of 1950, Section 301 of which is the basis for guarantees of loans for defense production.

Direct purchases of Government obligations by Federal Reserve Banks. An Act of Congress approved June 30, 1966 (Public Law 89-484), extended through June 30, 1968, the authority of Federal Reserve Banks, under Section 14(b) of the Federal Reserve Act, to purchase direct or fully guaranteed obligations of the United States directly from the United States.

Bank Holding Company Act and related statutes. An Act of Congress approved July 1, 1966 (Public Law 89-485), made numerous amendments to the Bank Holding Company Act of 1956, including (1) repeal of previous exemptions for certain registered investment companies and religious, charitable, and educational institutions; (2) inclusion within the coverage of the Act of long-term trusts; (3) redefinition of "bank" to limit the term to institutions accepting deposits withdrawable on demand; (4) application to the bank holding company field of the standards and antitrust procedures made applicable to bank mergers by the Act of February 21, 1966 (described earlier); and (5) repeal of the provisions of Section 6 of the Act relating to loans by holding company banks to other companies in the holding company system. In addition, the Act made a number of amendments to Section 23A of the Federal Reserve Act (which relates to loans by member banks to their affiliates) and

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extended the limitations of that section to nonmember insured banks; amended Section 25 of the Federal Reserve Act to permit direct investments by member banks in the stock of foreign banks under regulations of the Board of Governors; and repealed the provisions of Section 5144 of the Revised Statutes and of Section 9 of the Federal Reserve Act that required "holding company affiliates" to obtain permits to vote the stock of member banks.

Administrative Procedure Act. An Act of Congress approved July 4, 1966 (Public Law 89-487), amended Section 3 of the Administrative Procedure Act to broaden public access to Government records effective July 4, 1967.

Interest on deposits; reserves of member banks; open market operations. An Act of Congress approved September 21, 1966 (Public Law 89-597), (1) conferred on Federal supervisory agencies more flexible authority to regulate the maximum rates of interest or dividends payable by banks and certain other financial institutions on deposits or share accounts; (2) authorized higher reserve requirements on time deposits of member banks; and (3) authorized open market operations by Federal Reserve Banks in direct or fully guaranteed obligations of any agency of the United States. The additional powers granted by this law expire September 21, 1967.

Financial Institutions Supervisory Act; Federal deposit insurance. An Act of Congress approved October 16, 1966 (Public Law 89-695), strengthened the authority of the Federal agencies that supervise and regulate banks and savings and loan associations, and authorized such agencies to institute "cease and desist" proceedings and proceedings directed at the removal from office, in prescribed circumstances, of directors or officers of institutions under their supervision. The Act also provided for temporary cease and desist and removal orders, and for judicial relief therefrom on petition of the affected institution or party. The foregoing provisions will be effective only through June 30, 1972. The Act also increased from $10,000 to $15,000 the insurance coverage of deposits insured by the Federal Deposit Insurance

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Corporation and accounts insured by the Federal Savings and Loan Insurance Corporation.

Member banks dealing in certain insured obligations; real estate loans by national banks. An Act of Congress approved November 3, 1966 (Public Law 89-754), entitled the "Demonstration Cities and Metropolitan Development Act of 1966," amended Section 5136 of the Revised Statutes of the United States so as to permit member banks to deal in and underwrite obligations that are insured under the new Title XI of the National Housing Act, which provides mortgage insurance on facilities for the group practice of medicine, dentistry, and optometry. Purchase of such securities for investment is also excepted from the usual limitation of 10 per cent of the bank's capital and surplus. The Act also amended Section 24 of the Federal Reserve Act so as to make certain limitations and restrictions on real estate loans by national banks inapplicable to such insured obligations.

Delegation of functions of Board of Governors. An Act of Congress approved November 5, 1966 (Public Law 89-765), amended Section 11 of the Federal Reserve Act by adding a new subsection (k) authorizing the Board of Governors to delegate certain of its functions to hearing examiners, members or employees of the Board, or Federal Reserve Banks.

LEGISLATIVE RECOMMENDATIONS

Lending authority of Federal Reserve Banks. Under present law, when a member bank borrows from its Reserve Bank on collateral other than U.S. Government obligations or paper (such as promissory notes of the member bank's customers) that meets certain "eligibility" requirements, it must pay interest at a rate one-half of 1 per cent higher than the Reserve Bank's normal discount rate. For several years the Board of Governors has urged legislation that would permit a member bank, in appropriate circumstances, to borrow on any collateral satisfactory to its Reserve Bank without the necessity of paying a higher rate of interest simply because "ineligible" collateral was presented.

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The need for such legislation has increased as member banks have reduced their holdings of Government securities and broadened the scope of their lending in order to meet the expanding credit demands of their customers. Many of these loans cannot qualify as collateral for Federal Reserve advances except at the "penalty" rate of interest, although their quality may be equal to that of presently "eligible" paper.

To enable the Federal Reserve System always to be in a position to perform promptly and efficiently one of its principal responsibilities—the extension of credit assistance to enable the banking system to meet the legitimate needs of the economy—and to avoid penalizing those uses of credit that generate sound paper that is not "eligible" under existing law, the Board again urges legislation to permit member banks to borrow from Federal Reserve Banks, at current discount rates, on the security of any sound assets.

"Par clearance." Most banks pay the face amount of all checks presented to them for payment; this practice is frequently described as "par clearance." In certain areas of the country, however, many small banks deduct a so-called "exchange charge" from the face amount of checks presented by mail and remit only the balance. In such circumstances the drawee bank shifts all or a portion of the expense incurred by it in connection with the collection process to the payee of the check or to an indorsee. In the Board's view there is no justification for the increased costs, delays, and inefficiencies that result when banks do not pay all checks at their face amount. Accordingly, the Board reiterates the recommendation in its ANNUAL REPORT for 1965 that legislation be enacted to require all insured banks to pay the face amount of all valid checks drawn upon them.

Reserve requirements. In its ANNUAL REPORTS for 1964 and 1965 the Board of Governors favored legislation that would (1) authorize it to fix reserve requirements on a graduated basis according to the amount of a bank's deposits and (2) make such requirements applicable to all federally insured banks (rather

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than only to member banks). Legislation enacted in 1966 gave the Board increased flexibility in fixing reserve requirements; but that legislation is temporary in nature, it retains the outmoded differentiation between reserve city and "country" banks, and it does not apply to nonmember banks.

The reasons for changes in the structure of bank reserve requirements have become stronger with the passage of time. The classification of member banks into reserve city and "country" banks has become increasingly arbitrary as the differences between them, in both size and functions, have decreased. Since deposits in nonmember banks are part of the country's money supply just as are those in member banks, their exemption from federally imposed reserve requirements cannot be justified. It would be far more rational and equitable to require that every federally insured bank maintain reserves against deposits solely on the basis of their amount. Under such a requirement, all federally insured banks of the same size, in terms of demand deposits, would carry equal reserves against such deposits.

Accordingly, the Board renews its recommendation that legislation be enacted (1) to authorize the Board to fix graduated reserve requirements on the basis of the amount of a bank's demand deposits and (2) to bring all insured banks within the coverage of such requirements. In connection with the latter action, nonmember insured banks should be granted access to Federal Reserve discount facilities.

Margin requirements for securities transactions. The Board again urges enactment of legislation modifying Section 7 of the Securities Exchange Act of 1934 (15 U.S.C. 78g) to eliminate an unwarranted difference in the status, for credit purposes, of securities that are registered on a national securities exchange and securities that are traded only "over the counter."

Section 7 now authorizes the Board of Governors to limit the credit that brokers and dealers may extend on securities that are registered on exchanges and the credit that banks (and other lenders) may extend for the purpose of purchasing or carrying

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equity securities that are so registered. With respect to over-the-counter securities, that section, generally speaking, forbids brokers and dealers to extend any credit whatever, while permitting banks to extend credit unlimited by any governmentally imposed margin requirements.

This legislative arrangement is inequitable in its divergent treatment of brokers and banks; it unnecessarily deprives persons interested in purchasing over-the-counter securities of credit facilities that might appropriately be extended by brokers and dealers; and it limits the effectiveness of salutary controls over security credit. The growth of the over-the-counter securities market has given this problem increased importance, and the Securities and Exchange Commission's *Special Study of Securities Markets,* submitted to Congress in 1963, recommended amendment of the 1934 Act along the lines urged by the Board.

Purchase of obligations of foreign governments by Federal Reserve Banks; loans to bank examiners; loans to executive officers. The Board reiterates the recommendations included in its ANNUAL REPORTS for 1964 and 1965 that legislation be enacted to:

(1) Amend Section 14(e) of the Federal Reserve Act to permit Reserve Banks to invest in obligations of foreign governments or monetary authorities that will mature within 12 months and are payable in a convertible currency;

(2) Relax the criminal prohibition against bank loans to examiners in order to permit federally insured banks to make home mortgage loans up to $30,000 to bank examiners; and

(3) Modify the provisions of Section 22(g) of the Federal Reserve Act (a) to permit an executive officer of a member bank to borrow from his own bank up to $5,000, or in the case of a home mortgage loan up to $30,000; (b) to substitute, with respect to such borrowings, a requirement of a report by the officer to his board of directors in lieu of the present requirement of prior approval by such board; and (c) to require an executive officer to inform his board of directors of borrowings from other banks only where they would exceed $5,000 in the aggregate, rather than with respect to each such borrowing.

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LITIGATION

Whitney Holding Corporation, New Orleans, Louisiana. A Louisiana Circuit Court of Appeal affirmed the decision of the lower State court, holding the Louisiana anti-bank holding company statute to be applicable to the Whitney proposal for becoming a bank holding company, and not unconstitutional as so applied (see ANNUAL REPORT for 1965, pp. 242 and 243).

On November 7, 1966, the Louisiana Supreme Court denied a petition for review of the holding of the Circuit Court of Appeal. Following the Louisiana Supreme Court decision, and on the basis of that decision, the opposing banks requested the Board to deny the Whitney application, subsequent to which counsel for Whitney filed a motion with the Board to withdraw the Whitney application.

On December 30, 1966, the Board granted the motion to withdraw and vacated the Board's Order of May 3, 1962. The May 3 Order had granted approval of the Whitney bank holding company plan and had been remanded to the Board by the Fifth Circuit Court of Appeals for reconsideration in the light of the U.S. Supreme Court opinion in *Whitney* v. *Saxon,* 379 U.S. 411, indicating that the Board should determine the applicability and effect of the Louisiana anti-bank holding company statute, which had become effective July 10, 1962. The Board's Order of December 30, 1966, concluded the administrative proceeding.

Baker, Watts & Co. et al.* v. *Saxon. In 1966, a group of investment bankers filed suit in the U.S. District Court for the District of Columbia for a declaratory judgment and an injunction, seeking to restrain the Comptroller of the Currency from purporting to authorize national banks to underwrite and deal in governmental securities known as "revenue bonds." Revenue bonds are issued by governmental instrumentalities but are not supported by general powers of taxation; interest and principal are payable out of funds received from a specified source.

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The problem arose out of interpretations by the Comptroller of provisions of paragraph Seventh of Section 5136 of the Revised Statutes (12 U.S.C. 24), which prohibit national banks from underwriting, purchasing, and dealing in securities, with certain exceptions including "general obligations of any State or of any political subdivision thereof." The question before the Court was whether revenue bonds qualify as such "general obligations."

Because the statutory provisions in question apply also to member State banks (under Section 9 of the Federal Reserve Act) and because the Board of Governors, in its interpretations and enforcement of the provisions in question, has taken a position different from that of the Comptroller, the Board was invited by the District Court to submit a memorandum of law on the subject, in the capacity of a "friend of the court" *(amicus curiae).*

The Court rejected the Comptroller's interpretation of the statute in question and adopted the position taken by the plaintiffs and the Board. In its final judgment, dated December 22, 1966, the Court concluded that the exception in Section 5136 of the Revised Statutes for "general obligations" of States and political subdivisions is limited to "obligations that are supported by an unconditional promise to pay, directly or indirectly, an aggregate amount which (together with any other funds available for the purpose) will suffice to discharge, when due, all interest on and principal of such obligations, which promise (1) is made by a governmental entity that possesses general powers of taxation, including property taxation, and (2) pledges or otherwise commits the full faith and credit of said promisor; said term does not include obligations not so supported that are to be repaid only from specified sources such as the income from designated facilities or the proceeds of designated taxes." This interpretation is identical with a legislative proposal urged by the Board in its ANNUAL REPORTS for 1964 and 1965 as a means of reaffirming and clarifying existing law on the subject

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of bank underwriting of revenue bonds and is the reason for omission of such recommendation in this year's REPORT.

Detroit Bank & Trust Co. et al.* v. *Saxon and Board of Governors of Federal Reserve System. Four Michigan banks, of which two are national banks and two are member State banks, filed suit in 1966 in the U.S. District Court for the District of Columbia, against the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, for the purpose of preventing consummation of a proposal by Michigan National Bank, Detroit, Michigan, to increase its authorized common stock and to exchange shares of the new issue for outstanding shares of stock of Michigan Bank N.A. The court permitted Michigan National Bank to intervene as a co-defendant.

The complaint asserts that consummation of the proposed acquisition of stock would violate various Federal banking laws, including (1) Section 5136 of the Revised Statutes prohibiting a national bank from buying shares of stock for its own account, except as authorized by law, (2) Section 5155 of the Revised Statutes governing branch banking, (3) Section 5190 of the Revised Statutes specifying the locations where a national bank may conduct business, and (4) the Bank Holding Company Act of 1956. The complaint asserts also that consummation of the said proposal would be violative of the dual banking system concept as reflected by various provisions of the Michigan Financial Institutions Act and the Federal banking laws.

The plaintiffs have requested the Court to enter a declaratory judgment to the effect that Michigan National Bank has no lawful right to acquire, or hold for its own account, the capital stock of Michigan Bank N.A., and that neither the Comptroller nor the Board of Governors is authorized to approve the proposed acquisition of stock; the plaintiffs have also asked the Court to enjoin the Comptroller from issuing any certificate under 12 U.S.C. 57, or any approval purporting to authorize or validate the issuance of shares of Michigan National Bank for the purpose of the above-mentioned acquisition.

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RESERVE BANK OPERATIONS

Earnings and expenses. The accompanying table summarizes the earnings, expenses, and distribution of net earnings of the Federal Reserve Banks for 1966 and 1965.

EARNINGS, EXPENSES, AND DISTRIBUTION OF NET EARNINGS OF FEDERAL RESERVE BANKS, 1966 AND 1965

(In thousands of dollars)

Item	1966	1965
Current earnings	1,908,500	1,559,484
Current expenses	207,401	204,290
Current net earnings	1,701,099	1,355,194
Net addition to current net earnings[1]	996	1,022
Net earnings before payments to U.S. Treasury	1,702,095	1,356,215
Dividends paid	33,696	32,352
Payments to U.S. Treasury (interest on F.R. notes)	1,649,455	1,296,810
Transferred to surplus	18,944	27,054

[1] Includes net losses on sales of U.S. Govt. securities of $2,476,000 in 1966 and of $9,000 in 1965.

Current earnings were $1,908 million, an increase of $349 million, or 22 per cent, from 1965. Of this increase $329 million was from U.S. Government securities, $9 million from discounts and advances, and $8 million from foreign currencies.

Current expenses were $3 million, or 1.5 per cent, more than in 1965. Statutory dividends to member banks amounted to $34 million, an increase of $1 million from 1965. This rise in dividends reflected an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Federal Reserve Banks.

Payments to the Treasury as interest on Federal Reserve notes totaled $1,649 million for the year, compared with $1,297 million in 1965. This amount consists of all net earnings after divi-

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dends and the amount necessary to bring surplus to the level of paid-in capital.

Expenses of the Federal Reserve Banks include costs of $866.19 for 11 regional meetings incident to the Treasury Department Savings Bond program.

A detailed statement of earnings and expenses of each Federal Reserve Bank during 1966 is shown in Table 7 on pages 336 and 337 and a condensed historical statement in Table 8 on pages 338 and 339.

Holdings of loans and securities. The accompanying table shows holdings, earnings, and average interest rates on loans and securities of the Federal Reserve Banks during the past 3 years.

Average daily holdings of loans and securities during 1966 amounted to $42,612 million—an increase of $3,382 million

RESERVE BANK EARNINGS ON LOANS AND SECURITIES, 1964–66

Item and year	Total	Discounts and advances	Acceptances	U.S. Govt. securities
	In millions of dollars			
Average daily holdings:[1]				
1964	34,985	294	76	34,615
1965	39,230	492	77	38,661
1966	42,612	649	117	41,846
Earnings:				
1964	1,337.0	10.5	2.8	1,323.7
1965	1,545.0	19.8	3.2	1,522.0
1966	1,885.8	29.2	5.8	1,850.8
	In per cent			
Average rate of interest:				
1964	3.82	3.57	3.67	3.82
1965	3.94	4.03	4.14	3.94
1966	4.43	4.50	4.96	4.42

[1] Based on holdings at opening of business.

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over 1965. U.S. Government securities accounted for $3,185 million of the increase, and discounts and advances for $157 million.

The average rates of interest on holdings were up from 4.03 per cent to 4.50 per cent on discounts and advances, from 4.14 per cent to 4.96 per cent on acceptances, and from 3.94 per cent to 4.42 per cent on U.S. Government securities.

Volume of operations. Table 10 on page 340 shows the volume of operations in the principal departments of the Federal Reserve Banks for 1963–66.

Discounts and advances were the highest in number since 1960 and the highest in dollar amount since 1959, as the number of banks borrowing rose to 1,658 against 1,157 in 1965.

The upward trend in volume of most of the other operations continued in 1966, particularly in food stamps redeemed and in the dollar amount of transfers of funds. Coin received and counted was almost back to the volume handled in 1962 before the coin shortage began.

Conversion of the check handling operation to high-speed electronic equipment, which was begun near the end of 1960, is now about completed, with the last of the 36 Federal Reserve Banks and branches scheduled to install such equipment early in 1967.

Loan guarantees for defense production. Under the Defense Production Act of 1950, the Departments of the Army, Navy, and Air Force, the Defense Supply Agency of the Department of Defense, the Departments of Commerce, Interior, and Agriculture, the General Services Administration, the National Aeronautics and Space Administration, and the Atomic Energy Commission are authorized to guarantee loans for defense production made by commercial banks and other private financing institutions. The Federal Reserve Banks act as fiscal agents of the guaranteeing agencies under the Board's Regulation V.

During 1966 the guaranteeing agencies authorized the issuance of 5 guarantee agreements covering loans totaling $9 mil-

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lion. Loan authorizations outstanding on December 31, 1966, totaled $58 million, of which $55 million represented outstanding loans and $3 million additional credit available to borrowers. Of total loans outstanding, 79 per cent on the average was guaranteed. During the year approximately $56 million was disbursed on guaranteed loans, most of which are revolving credits.

Authority for the V-loan program, unless extended, will terminate on June 30, 1968.

Table 14 (page 342) shows guarantee fees and maximum interest rates applicable to Regulation V loans. The current maximum permissible interest rate of 7½ per cent was increased from 6 per cent by the Board of Governors in September 1966, after consultation with the guaranteeing agencies, to bring the net return to financing institutions on loans under this program more in line with current lending and money market rates and thus help to assure financing from commercial sources for contractors and subcontractors engaged in defense work.

Foreign and international accounts. Assets held for foreign account at the Federal Reserve Banks declined $1,272 million in 1966. At the end of the year they amounted to $18,840 million: $10,407 million of earmarked gold; $7,036 million of U.S. Government securities (including securities payable in foreign currencies); $174 million in dollar deposits; $191 million of bankers' acceptances purchased through Federal Reserve Banks; and $1,032 million of miscellaneous assets. The latter item includes mainly dollar bonds issued by foreign countries and international organizations. Assets held for international organizations, including an IMF gold deposit, increased by $763 million to $9,517 million.

In 1966 new accounts were opened in the names of the central banks of Ethiopia, Guyana, and Tanzania. An account was opened also for the Asian Development Bank.

Gold collateral loans totaling $41 million, which were outstanding at the beginning of 1966, were repaid. New arrangements—including a standby commitment—amounted to $40

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million. All drawings during the year under the loan arrangements were repaid by the end of the year. Loans on gold are made to foreign monetary authorities to help them meet dollar requirements of a temporary nature.

The Federal Reserve Bank of New York continued to act as depositary and fiscal agent for international organizations. As fiscal agent of the United States, the Bank continued to operate the Exchange Stabilization Fund pursuant to authorization and instructions of the Secretary of the Treasury. Also on behalf of the Treasury Department, it administered foreign assets control regulations pertaining to assets in the United States of North Vietnam, Cuba, Communist China, and North Korea, and their nationals, and to transactions with those countries and their nationals.

Bank premises. During 1966 the Board authorized construction of a communications and records center for the Federal Reserve Bank of Richmond, an addition to the Federal Reserve Bank building in Kansas City, and a new building for the Denver Branch.

Table 6 on page 335 shows the cost and book value of bank premises owned and occupied by the Federal Reserve Banks and of real estate acquired for banking-house purposes.

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BOARD OF GOVERNORS

Building annex. The Board has authorized construction of an annex to its present building on property acquired as part of the original site in 1934. For this purpose it has employed Harbeson Hough Livingston and Larson, the architectural firm that is successor to Paul P. Cret, architect of the original building.

Income and expenses. The accounts of the Board for the year 1966 were audited by the public accounting firm of Haskins & Sells.

Accountants' Opinion

Board of Governors of the
Federal Reserve System:

We have examined the balance sheet of the Board of Governors of the Federal Reserve System as of December 31, 1966 and the related statement of assessments and expenditures for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying financial statements present fairly the financial position of the Board of Governors of the Federal Reserve System at December 31, 1966 and its assessments and expenditures for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Haskins & Sells

Washington, D. C.
January 27, 1967

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEET, DECEMBER 31, 1966

ASSETS

OPERATING FUND:		
Cash		$ 659,103
Miscellaneous receivables and travel advances		18,446
Stockroom and cafeteria inventories—at cost		22,697
Total operating fund		700,246
PROPERTY FUND—At cost:		
Land and improvements		792,852
Building		4,273,349
Furniture and equipment		1,405,091
Total property fund		6,471,292
TOTAL		$ 7,171,538

LIABILITIES AND FUND BALANCES

OPERATING FUND:		
Current liabilities:		
Accounts payable and accrued expenses	$ 395,211	
Income taxes withheld	275,533	
Accrued payroll	250,233	$ 920,977
Fund balance:		
Balance, January 1, 1966	(157,820)	
Excess of expenditures over assessments and special item for the year	(62,911)	(220,731)
Total operating fund		700,246
PROPERTY FUND:		
Fund balance, January 1, 1966	6,153,098	
Expenditures for additions	347,700	
Property adjustments and disposals	(29,506)	
Total property fund		6,471,292
TOTAL		$ 7,171,538

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENT OF ASSESSMENTS AND EXPENDITURES FOR THE YEAR ENDED DECEMBER 31, 1966

ASSESSMENTS LEVIED ON FEDERAL RESERVE BANKS:		
For Board expenses and additions to property		$ 9,021,600
For expenditures made on behalf of the Federal Reserve Banks		19,158,370
Total assessments		28,179,970
EXPENDITURES:		
For printing, issue and redemption of Federal Reserve notes, paid on behalf of the Federal Reserve Banks		19,158,370
For expenses of the Board:		
Salaries	$6,104,175	
Retirement and insurance contributions	976,359	
Traveling expenses	327,566	
Consumer finances surveys	45,325	
Banking markets and other economic surveys	118,172	
Legal, consultant and audit fees	66,516	
Other contractual services	155,243	
Printing and binding—net	367,173	
Equipment and other rentals	206,107	
Telephone and telegraph	136,942	
Postage and expressage	99,405	
Stationery, office and other supplies	112,820	
Heat, light and power	54,937	
Operation of cafeteria—net	60,302	
Repairs, maintenance and alterations	101,702	
Books and subscriptions	25,900	
Insurance	2,755	
System membership, Center for Latin American Monetary Studies	25,500	
Miscellaneous—net	39,369	9,026,268
For property additions		347,700
Total expenditures		28,532,338
EXCESS OF EXPENDITURES OVER ASSESSMENTS BEFORE SPECIAL ITEM		352,368
SPECIAL ITEM (See Note)		289,457
EXCESS OF EXPENDITURES OVER ASSESSMENTS AND SPECIAL ITEM FOR THE YEAR		$ 62,911

NOTE.—During 1966 payment of $289,457 was received by the Board in settlement of a court judgment in favor of the United States (on the Board's behalf) for failure by the manufacturer to deliver an electronic digital computing system under a 1956 contract.

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MONETARY POLICY, BANK RESERVES, AND INTEREST RATES

The Federal Reserve followed a monetary policy of relative ease during most of 1967, but moved toward restraint in the final months of the year. The rapid growth in bank reserves early in the year contributed to an easing of credit market conditions and to ready accommodation of the rising liquidity demands of financial institutions and the public. At the same time, the increased availability of funds helped to moderate the slowdown of the economy during the first half of the year and contributed to the strengthening of economic activity that became evident as the summer approached. Construction outlays began to expand early in the year, and this growth continued. The inventory adjustment of businesses was relatively short lived, and in the summer the rate of business inventory accumulation began to rise again. Toward the end of the year, with the Federal budget continuing to be a major stimulative force in the economy, monetary policy became more restraining in an effort to dampen the inflationary price pressures that were accompanying renewed and rapid economic growth and to encourage improvement in the U.S. balance of payments position.

Monetary policy moved vigorously to ease domestic credit conditions further in the first few months of 1967 through complementary changes in open market policy, reserve requirements, and the discount rate. The measures taken contributed to a relatively rapid growth in bank reserves that extended through most of the year. As a result, banks were able to improve liquidity positions that had been eroded during the previous year's monetary restraint.

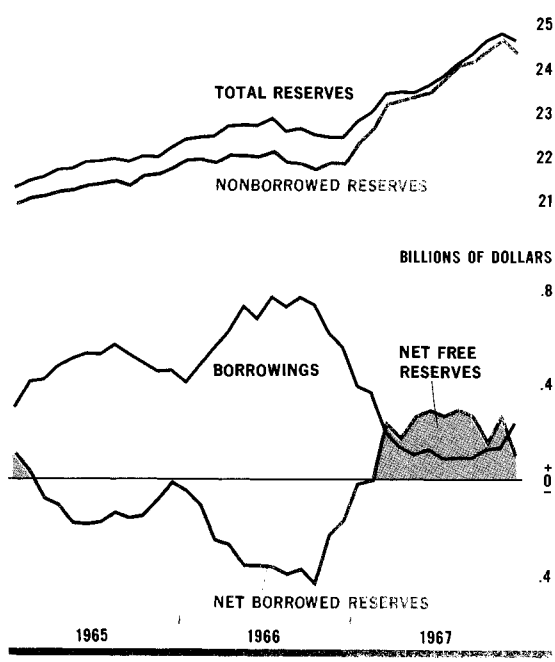
Pressures on nonbank financial intermediaries also eased considerably, until late in the year. For most of the year, the combination of reduced interest rates in short- and intermediate-term markets, the structure and level of ceiling rates permitted on time and savings accounts at banks and nonbank savings in-

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stitutions, and the increased propensity of individuals to save out of current income produced a sharp rise in inflows of savings to these institutions.

In large part because of the improved position of banks and other financial institutions, credit to businesses and consumers became more readily available than in 1966. Funds available to homebuilders increased sharply, encouraging a recovery in construction outlays. At the same time demands for credit began to

1 BANK RESERVES rise rapidly for most of '67; BORROWINGS relatively low until late in year

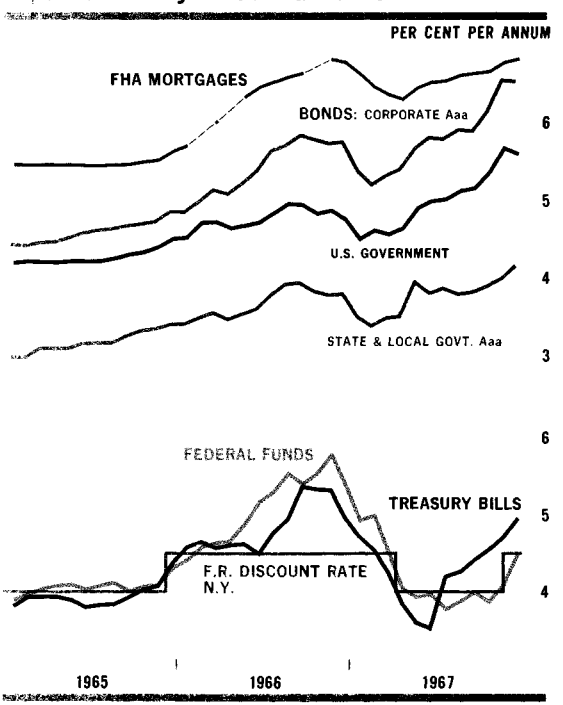


Total and nonborrowed reserves: seasonally adjusted monthly averages of daily figures for all member banks, adjusted to eliminate effects of changes in reserve requirement ratios. Series reflects current percentage requirements effective March 16, 1967. Borrowings and net borrowed and net free reserves: monthly averages of daily figures, not seasonally adjusted, for all member banks.

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build up. A drive by corporations to restore liquidity and to lengthen debt was reflected in increasing long-term market interest rates after midwinter. And short-term rates turned up in early summer despite rapid expansion in bank credit and the money supply, as large Federal demands for credit were added to the continued, very heavy demands of corporations during the second half of the year.

2 Long- and short-term INTEREST RATES rise substantially in last half of '67



Monthly averages of daily figures except for mortgages (based on quotations for 1 day each month). Yields: FHA-insured mortgages, weighted averages of private secondary market prices of certain new-house mortgages converted to annual yield; State and local Aaa—tax-equivalent, from Moody's Investors Service, adjusted to a tax-equivalent basis assuming a 36 per cent individual income tax rate; corporate Aaa new issues, calculated from bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis; U.S. Govt. bonds, market yields adjusted to constant maturity (20 years) by U.S. Treasury; U.S. Treasury bills, market yields on 3-month issues.

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During 1967, measures of fiscal restraint, including a tax increase, were proposed by the administration. As the year progressed, the need for such restraint was enhanced as increases in Federal expenditures, recovery in construction, and resumption of accumulation in business inventories led to an acceleration of economic expansion in the third quarter, accompanied by more intense and widespread price and cost pressures. However, there was no legislative action to raise taxes during the year. Meanwhile, the enlargement of the U.S. balance of payments deficit and the devaluation of the pound sterling around mid-November underscored the need to restrain the advance in costs and prices in order to achieve international as well as domestic economic objectives.

Against this background of acceleration in domestic economic expansion and of continued strains on our balance of payments—and in light of the change in the international value of the pound—the Federal Reserve in mid-November raised the discount rate back to 4½ per cent from 4 per cent, to which it had been lowered in April. And open market operations were adjusted in the direction of restraint. In late December the Board of Governors of the Federal Reserve System also announced an increase of ½ percentage point, effective in mid-January 1968, in reserves that member banks are required to maintain against demand deposits in excess of $5 million. The action raised reserve requirements on such deposits to 17 per cent at reserve city banks and 12½ per cent at other member banks.

Interest rates in long-term markets showed little reaction to these moves. Partly because many borrowers had previously obtained funds in long-term markets so as to guard against potential credit restraint in the absence of a tax increase, most bond yields had already risen to levels well above their 1966 peaks. Interest rates on mortgages, however, did not reach the previous year's peak until the last month of 1967.

Shorter-term market rates of interest did rise somewhat further in the last few weeks of the year, and yields on time and

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savings accounts of commercial banks and other financial intermediaries became less attractive to individuals and businesses, given the existing ceiling rates on such accounts. As a result, the net expansion of credit from financial institutions slowed.

While all long-term interest rates at the year-end were at or above the peaks they reached in the 1966 period of monetary stringency, short-term interest rates remained below their highs of that year. In part, the greater pressures in long-term than in short-term markets in 1967 reflected a shift in credit demands away from banks and into security markets, as borrowers restructured their debt positions because of growing expectations as the year progressed that interest rates were more likely to rise than decline in the future. While these expectations tended to raise long-term rates relative to short-term rates, the expanded growth in bank reserves, bank credit, and money over the year as a whole moderated the rise in the over-all interest rate structure, despite the greatly increased demands for credit by the Federal Government and the continued large demands of businesses and State and local governments.

In the course of 1967, total bank reserves rose by about 10 per cent, bank credit by 11 per cent, time and savings deposits at banks by 16 per cent, and the money supply by 6.5 per cent —all much more rapid rates of growth than in 1966. The rates of growth in these monetary variables slowed in the latter part of 1967, after banks and nonbank institutions—and to a degree the public generally—had rebuilt their liquidity.

MONETARY EASE AND RAPID EXPANSION OF BANK CREDIT: FIRST QUARTER OF 1967

In increasing the degree of monetary ease, Federal Reserve open market operations contributed to a quite rapid growth, 25 per cent at an annual rate, in nonborrowed reserves during the first quarter. This rate of growth, following a contraction during the last half of 1966, permitted member banks to reduce their borrowings at the Federal Reserve to near minimal levels, en-

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abled banks to begin restoring their liquidity positions, and supported a rapid expansion in bank credit, as it again became possible for banks to compete effectively for time and savings deposits. Reserves were also released to banks in March when the Board reduced reserve requirements against savings deposits and the first $5 million of other time deposits from 4 to 3 per cent.

Member bank borrowings at Federal Reserve Banks declined from an average of $557 million during December 1966 to a little less than $200 million in March 1967. Largely because of the decline, the net reserve position of banks—the difference between their excess reserves and their borrowings—moved from a net borrowed reserve average of $165 million in the last month of 1966 to a net free reserve average of around $235 million in March. With the supply of reserves to the banking system increased and with individual banks in more comfortable reserve positions, the Federal funds rate—the price at which banks with excess reserves lend reserves to other banks—declined sharply from around 5.50 per cent at the end of 1966 to about 4 per cent by early April.

As banks repaid borrowings from the Federal Reserve, the accompanying rise in banks' free reserves absorbed part of the increase in nonborrowed reserves, but the reserve expansion was still sufficient to support an annual rate of growth of more than 14 per cent in banks' total loans and investments during the first quarter. About two-thirds of the rise in outstanding bank credit was in holdings of U.S. Government securities, including Federal agency debt, and of State and local government issues, as banks rebuilt portfolios that had been reduced as a result of monetary restraint in the latter part of the previous year.

Banks obtained most of their funds for investment through a sharp expansion in time and savings deposits. These deposits grew at an annual rate of 19 per cent in the first quarter, about three times the pace of the last half of 1966. A marked decline in interest rates in the short-term market—typified by a drop in the 3-month Treasury bill rate over the first 3 months of the year

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from around 4.80 per cent to near 4 per cent—enabled banks to compete effectively for time and savings deposits.

During the first quarter of 1967 banks restored their holdings of large negotiable time certificates of deposit (CD's), which had declined markedly during the late summer and fall of 1966 when short-term interest rates moved to and above the 5½ per cent ceiling rate on such deposits. Meanwhile, banks with branches operating abroad in the Euro-dollar market effected a net reduction in the funds they obtained abroad through their foreign branches. Such borrowings in the Euro-dollar market had risen sharply in the last half of 1966 when banks' ability to compete for time deposit funds domestically was constrained by high interest rates in the market relative to the Regulation Q ceiling.

Net inflows of funds to other savings institutions—savings and loan associations and mutual savings banks—were also at exceptionally high rates early in 1967 following depressed rates of growth in 1966. Since these institutions are key lenders in mortgage markets, there was a consequent decline in interest rates on mortgages.

The increased availability of funds at banks and other financial institutions helped to reduce pressures in long-term markets generally. In the early weeks of 1967 long-term markets were also influenced by expectations of a further easing in monetary policy. As a result yields on U.S. Government, corporate, and municipal bonds declined very sharply at that time, and banks reduced their prime rate on business loans. However, market yields rose somewhat after midwinter, amid indications that corporations were likely to generate strong demands for long-term credit in security markets as they sought to improve their financial positions by lengthening their debt structure and restoring their credit lines at banks.

MONETARY DEVELOPMENTS IN THE SPRING AND SUMMER

After the winter, money market conditions, as typified by yields on day-to-day money, showed little change until late in the year.

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The discount rate was reduced from 4½ per cent to 4 per cent in early April, and Federal funds traded at rates around that level throughout the spring and summer. The 3-month Treasury bill rate, however, fluctuated rather widely. It declined further in the spring to an average of around 3.50 per cent in June. An unusually large Treasury cash surplus during the first half of the year led to a substantial, though temporary, reduction in outstanding Treasury bills in consequence of maturities of tax-anticipation bills in March, April, and June. Also, downward pressures on short-term rates were generated as the Federal home loan banks both purchased large amounts of bills and repaid their outstanding short-term debt with the proceeds of loan repayments from member savings and loan associations. After June, however, bill rates began to rise as the market focused on the unusually large Federal cash deficit in prospect for the second half of 1967. By the end of summer the 3-month Treasury bill rate had risen to around 4.50 per cent, while the Treasury was in process of raising a large amount of cash in short-term markets.

The large needs of the Federal Government for cash after mid-year, in conjunction with uncertainties about whether the tax increases recommended by the administration would become effective, also led to further increases in longer-term interest rates. Borrowing by corporations in bond markets rose to a record volume, and demands of State and local governments remained very large, as many borrowers attempted to obtain funds to hedge against the possibility that credit markets would become very tight, especially if there were no action on taxes. By late August the yields on new high-grade corporate bonds and long-term U.S. Government bonds had risen to highs—of around 6 per cent and 5.15 per cent, respectively—that were just above their 1966 peaks.

The rise in interest rates was accompanied by a considerably less rapid growth in reserves of banks during the second and third quarters of the year as compared with the first quarter.

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Nonborrowed reserves expanded at an annual rate of about 8 per cent. Borrowings from the Federal Reserve, which were already near minimal levels, declined slightly further to a daily average level of somewhat less than $100 million during the summer.

In providing reserves during the winter, the Federal Reserve had made security purchases for the System Open Market Account almost entirely in the Treasury bill area. But during the spring and summer—with pressures in bond markets increasing—the System bought a moderate amount of Treasury coupon issues with more than 1 year to maturity. However, it accomplished the bulk of its net-reserve-supplying operations through transactions in Treasury bills.

Growth in outstanding bank credit generally moderated during the six spring and summer months. But growth was quite rapid in July and August, when banks bought sizable amounts of U.S. Government securities in a period of large cash financings by the Treasury.

Banks continued to acquire time and savings deposits at a substantial rate over the 6-month period—though the pace was somewhat slower than it had been early in the year, when banks had been rebuilding such deposits after the losses suffered the year before. Private demand deposits and the money supply continued to rise strongly during the spring and summer as businesses and consumers made further efforts to restore their liquidity positions, given the drains on liquidity in the previous year and the uncertainties about the nature and extent of any future monetary restraint.

MOVES TOWARD RESTRAINT: FOURTH QUARTER OF 1967

Monetary policy became less expansive in the fourth quarter of the year in view of developments in the domestic economy and of developments affecting the international position of the dollar. In the light of the action of the British Government to reduce the parity of the pound sterling and of other measures of monetary

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and fiscal restraint in Britain, the Federal Reserve discount rate was raised from 4 to 4½ per cent in the second half of November so as to contribute to the availability of reserves to the banking system on terms and conditions that would foster sustainable economic growth domestically and a sound international position for the dollar. Open market operations became less expansive, and an increase of ½ percentage point in the reserve requirement against demand deposits in excess of $5 million was announced in late December. These moves in the direction of monetary restraint were taken in an effort to resist the domestic inflationary pressures that developed as economic activity was expanding vigorously following the pause in growth during the first half of the year.

As a result of these changes in monetary policy, member banks came under pressure to increase their borrowings from the Federal Reserve and to reduce free reserves, and short-term interest rates rose further in the last few weeks of the year. The Federal funds rate rose above the new discount rate, and the 3-month bill rate rose to about 5 per cent.

The general rise in short- and intermediate-term market rates of interest since summer had made it more and more difficult for banks and other savings institutions to attract consumer and corporate funds, in the light of the existing ceilings on rates that could be offered by such institutions. During the fourth quarter net inflows of time and savings deposits to banks declined to an annual rate of 11 per cent from 15 per cent in the third quarter. The slowdown was particularly marked in December when there was a moderate net decline, in part seasonal, of outstanding negotiable CD's and when growth in consumer-type time and savings deposits slowed further.

Not only did banks have less scope for expanding time and savings deposits in late 1967, but also the cost of the funds they obtained through branches in the Euro-dollar market rose further as a result of the increase in the British discount rate and of un-

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certainties in connection with the devaluation of sterling in mid-November. Banks' liabilities to their overseas branches, which had shown a steady rise since late spring, reached a peak of $4.9 billion in mid-November. After that these liabilities declined, although again partly for seasonal reasons.

With funds from time deposits and Euro-dollar borrowings less readily available and more costly, and with growth in reserves constrained, bank credit in the last quarter of the year expanded at a reduced annual rate, about 6 per cent, and the money supply showed relatively little growth after early November. Banks also raised their prime loan rate back to the 6 per cent level, which had prevailed from August 1966 to January 1967.

There was little reaction in long-term markets to the policy moves. In part, this was because some increase in monetary restraint had been expected and to some extent discounted in the market. As it began to appear less and less likely that a tax increase would be enacted, and with the volume of bond offerings showing no let-up until the last few weeks of the year, long-term interest rates had already risen sharply further by around mid-November. Yields on U.S. Government bonds (with 20-year maturity) rose to a peak of about 5.80 per cent toward mid-November and subsequently declined about 25 basis points by year-end. Yields on new high-grade corporate bonds showed little change from the 6.50 per cent level reached by mid-November. And average yields on State and local government securities, which banks had bought in large volume during the year, reached a peak of around 4.45 per cent in early December, about 20 basis points above their 1966 high.

Meanwhile mortgage yields continued to advance as the year drew to a close—representing in part the usual belated reaction to earlier advances in yields on market instruments. In addition, the slower net inflow of savings to thrift institutions that specialize in mortgages led to some reduced willingness on the part of these institutions to undertake mortgage commitments.

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OPERATIONS IN FOREIGN CURRENCIES

The international monetary system was subjected to greater strains during 1967 than at any time since the 1930's. Large and potentially disruptive flows of funds were generated by the crisis in the Middle East during the summer; by the recurrent weakness of the pound sterling and its devaluation in November; by speculation about possible changes in other exchange rates and in the price of gold; and by the worsening of the U.S. payments deficit. A wide variety of cooperative actions were taken by the monetary authorities of leading countries to counter the resultant pressures in gold and foreign exchange markets and in international money markets. The Federal Reserve System and the U.S. Treasury participated actively in these effects.

Early in 1967 international economic tensions appeared to be subsiding, although the underlying payments deficits of the United States and the United Kingdom and the surpluses of continental European countries, notably Germany and Italy, persisted. By the end of February the Federal Reserve had repaid the $280 million equivalent of its drawings of foreign currencies under reciprocal currency arrangements that had been outstanding at the end of 1966. The pound sterling was relatively strong early in 1967 as a result of some underlying improvement in the U.K. balance of payments, some revival of confidence, and an easing of monetary conditions elsewhere that facilitated a reflow of short-term capital into sterling. By the end of April the Bank of England had repaid all the short-term credits that it had obtained in 1966 from foreign central banks, including the Federal Reserve, and from the U.S. Treasury.

During the spring, however, foreign exchange markets again began to reflect concern about the disappointing trend of British trade figures. A deepening of the business recession in Germany and some slackening of economic activity in other European countries contributed to this trend and reinforced the payments surpluses of continental European countries.

The eruption of the crisis in the Middle East late in May and

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the outbreak of hostilities there in early June provoked very heavy selling of sterling and large flows of funds into continental European currencies, particularly the Swiss franc. Speculative buying of gold intensified briefly, and the Euro-dollar market tightened sharply.

The Bank for International Settlements (BIS) acted in early June to relieve pressures in the Euro-dollar market by placing in that market the funds drawn under its reciprocal currency arrangement with the Federal Reserve and the funds received from other central banks. The Gold Pool continued to operate to keep the price in the London market from rising above $35.20. In June and throughout the summer the Bank of England drew heavily on its credit facilities with the Federal Reserve and the U.S. Treasury and with other central banks and the BIS. Meanwhile, the Federal Reserve made extensive use of its swap lines to provide cover for the large amounts of dollars accruing to the Swiss National Bank and for the smaller gains of Belgium and the Netherlands. Beginning in September, it drew also on its facilities with Italy as that country's reserves increased much more than seasonally. German reserve gains remained small during this period, despite Germany's continuing large surplus on current and long-term capital transactions because monetary conditions in that country were easy and it was profitable for German commercial banks to add to their foreign assets.

Pressures on sterling mounted irregularly in October and early November as the figures for foreign trade and reserves continued to be disappointing—partly because of port strikes—and there were recurrent heavy flows of funds into continental currencies. On November 18 the British Government announced the devaluation of the pound by 14.3 per cent to $2.40.

No other large industrial country devalued its currency, and new standby assistance for the support of the pound was promptly arranged in the form of central bank credit lines and a $1.4 billion standby arrangement with the IMF. The British Government announced a number of new austerity measures designed to

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fortify the new rate and achieve the needed internal and external economic adjustments.

Despite these and other evidences of international solidarity in support of the new parity for sterling and of existing parities for the currencies of other leading countries, widespread uncertainty prevailed in markets for a time—as might have been expected—about both the exchange rate structure in general and the price of gold in particular. Buying of gold in the London market rose to record levels, and additional funds were shifted into some continental European currencies. Accumulating evidence that the U.S. payments deficit had been worsening added to market uncertainties, despite official assurances that the dollar price of gold would not be changed.

A number of cooperative actions were taken jointly by the monetary authorities to calm the markets: The active members of the Gold Pool reaffirmed their policy of stabilizing the London market and sold very large amounts of gold there. The Federal Reserve made further drawings on its swap lines to provide cover for some of the dollar gains of European central banks. The BIS made use of its swap facilities with the Federal Reserve to obtain dollars and place them in the Euro-dollar market, where rates had soared. At the same time, the German Federal Bank provided swaps to its commercial banks on favorable terms—selling dollars spot and buying them forward—to encourage the banks to keep funds invested in the Euro-dollar market. And the central banks of Belgium, the Netherlands, and Switzerland bought dollars forward for the account of the U.S. Treasury and the Federal Reserve.

By the year-end the markets had become calmer. In November the Bank of England repaid $300 million of the $1,350 million drawn earlier under its reciprocal currency arrangement with the Federal Reserve. But there was little opportunity for the Federal Reserve to begin repaying its large drawings under reciprocal currency arrangements. At the year-end outstanding Federal Reserve drawings totaled $1,776 million. And it was widely

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recognized that the next step must be the announcement of an effective program to halt and reverse the deterioration in the U.S. balance of payments.

The Federal Reserve's reciprocal currency arrangements with foreign central banks and the BIS were considerably enlarged during 1967. New facilities were established with the central banks of Denmark, Norway, and Mexico, and existing facilities with other central banks and the BIS were expanded. These actions brought the total swap network to $7,080 million at the end of 1967.

In addition, during 1967 the Federal Reserve continued to participate actively in international negotiations concerning a plan for the creation within the IMF of Special Drawing Rights (SDR's). The plan was adopted in outline form at the annual meeting of the IMF in September. (See pages 311-17.)

A detailed review of Federal Reserve operations in foreign currencies during 1967 is given beginning on page 276.

FOREIGN CREDIT RESTRAINT PROGRAM

During 1967 the Board continued to administer that portion of the President's balance of payments program that applied to banks and other financial institutions in accordance with guidelines issued in December 1966 and described in the ANNUAL REPORT for 1966.

Bank credit to foreigners moved seasonally during the year, with an inflow during the first quarter of 1967 partially offsetting an outflow in the fourth quarter of 1966. At the end of October 1967, the final reporting date before the announcement of a program for 1968, banks had increased their holdings of those foreign assets covered by the program by $115 million over the amount held on December 31, 1966. During the remaining 2 months of the year such holdings increased by an additional $254 million, bringing the total increase for the year to $369 million. On December 31, 1967, the banking system was $544 million

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TABLE 1

FOREIGN CREDITS OF UNITED STATES BANKS

Item	1965 Dec. 31	1966 Dec. 31	1967			
			Mar. 31	June 30	Sept. 30	Dec. 31
Number of reporting banks...	161	148	149	148	148	151
	Millions of dollars					
Total foreign credits subject to ceiling.....	9,652	9,496	9,278	9,475	9,618	9,865
Target ceiling to end of 1967	.....	10,360	10,408	10,401	10,402	10,409
Net expansion of credit since December, 1964.....	+156	−3	−222	−18	+125	+370
Net leeway for further expansion of credit within target ceiling for 1967.....	.....	864	1,130	926	784	544

NOTE.—Beginning with Dec. 31, 1966, data exclude banks with foreign credits of less than $500,000 on reporting date.

below the target ceiling established for that date by the guidelines issued in December 1966 (Table 1).

"Covered" foreign assets of nonbank financial institutions increased only $10 million during the first 9 months of 1967. Long-term credits to developed countries other than Canada and Japan increased, largely because of long-standing commitments to borrowers in these countries, but most of the increase was offset by reductions in liquid investments, short- and intermediate-term credits, and holdings of covered equities. Nevertheless, reporting institutions as a group were $58 million over their target ceiling as of September 30, 1967.

On November 16, 1967, revised guidelines for banks and nonbank financial institutions were announced by the Board of Governors for the period through 1968. The bank program retained the 1967 ceiling of 109 per cent of the end-of-1964 base for banks accounting for about 95 per cent of that ceiling. To give more equitable treatment to banks whose 1964 bases were relatively small, the guidelines provided that any reporting bank whose foreign assets were less than 2 per cent of its total assets as of December 31, 1966, might take the latter figure as its ceiling for 1968. This provision added about $650 million to the

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TABLE 2

FOREIGN ASSETS OF REPORTING NONBANK FINANCIAL INSTITUTIONS

(Amounts shown in millions of dollars)

Type of asset	Amount, Sept. 30, 1967	Change from Dec. 31, 1966 Amount	Change from Dec. 31, 1966 Per cent
SUBJECT TO GUIDELINE			
Deposits and money market instruments, all foreign countries	161	−34	−17.3
Short- and intermediate-term credits, all foreign countries [1]	424	−55	−11.5
Long-term investments, "other" developed countries: [2]			
Investment in foreign branches and subsidiaries	87	(3)	−0.5
Long-term bonds and credits	692	117	20.4
Stocks (except those acquired after Sept. 30, 1965, in U.S. markets from U.S. investors)	583	−18	−3.0
TOTAL holdings subject to guideline	1,947	10	0.5
Adjusted base-date holdings [4]	1,798	−103	−5.4
Target ceiling [5]	1,888	−108	−5.4
Leeway under ceiling (target less TOTAL above)	−58	−118	(6)
NOT SUBJECT TO GUIDELINE			
Bonds of international institutions, all maturities	1,060	34	3.3
Long-term investments in Canada, Japan, and the developing countries:			
Investment in foreign branches and subsidiaries	556	(3)	(7)
Long-term bonds and credits:			
Canada and Japan	7,843	278	3.7
Developing countries	502	36	7.7
Stocks:			
Canada and Japan	1,478	181	14.0
Developing countries	179	55	44.2
Stocks, "other" developed countries (if acquired after Sept. 30, 1965 in U.S. markets, from U.S. investors)	245	125	103.9
TOTAL holdings not subject to guideline	11,862	708	6.3

[1] Bonds and credits with final maturities of 10 years or less at date of acquisition.
[2] Developed countries other than Canada and Japan.
[3] Less than $500,000.
[4] Base-date holdings of assets subject to guideline, less equities included therein but sold to American investors during the quarter.
[5] Adjusted base-date holdings multiplied by 105 per cent.
[6] Not computed.
[7] Less than one-half of 1 per cent.

aggregate ceiling for the banking system and affected about one-half of the 150 banks reporting under the program. The leeway available under the new program approximated $1.4 billion, but the banks again were asked to limit any expansion in holdings of foreign assets during the fourth quarter of 1967 and throughout 1968 to 20 per cent per quarter, cumulative, of the difference between the new ceiling and the amount of foreign assets held on October 31, 1967.

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The new guidelines for nonbank financial institutions were substantially the same as those used during 1966, but there was a major change in the reporting requirement: only institutions holding $500,000 in covered foreign assets or $5 million in total foreign assets were asked to report. It was estimated that this provision would reduce the number of reporters from about 580 to 350 institutions.

In view of disturbed conditions in gold and foreign exchange markets after the British devaluation of sterling in November, and in view also of increasing evidence of further deterioration in the U.S. balance of payments, the President on January 1, 1968, announced a more restrictive program designed to improve the balance of payments, including mandatory controls on direct foreign investment. As part of the President's program, the Board on January 1 announced further revisions of the guidelines for banks and nonbank financial institutions, under its voluntary foreign credit restraint program, making them substantially more restrictive.

The major objective of the revised program was to produce a net capital inflow to banks and other financial institutions of at least $500 million during 1968. The program was designed to have a minimum effect on export credits or credits to meet the capital needs of developing countries; its major impact was focused on nonexport credits to developed countries of continental Western Europe.

Under the revised guidelines effective January 1, 1968, the ceilings of those banks that had remained at 109 per cent of the end-of-1964 base under the guidelines issued on November 16, 1967, were reduced to 103 per cent of that base. Banks whose ceilings had been set at 2 per cent of total assets as of December 31, 1966, were requested to reduce that ceiling to an amount equal to their 1967 ceiling plus one-third of the difference between that ceiling and 2 per cent of total assets. Banks were requested further to reduce their ceilings monthly by the amount of scheduled repayments of term loans outstanding on

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December 31, 1967, to developed countries of continental Western Europe, and further, during the course of the year, by 40 per cent of the amount of short-term credits to those countries outstanding on December 31, 1967. On the basis of foreign assets held by banks on December 31, 1967, this reduction in the ceilings reduced the immediate aggregate leeway available in 1968 to $225 million. Further reductions in the ceilings during the year were expected to bring about an actual and substantial reflow.

The banks also were requested not to make any new loans with maturities in excess of 1 year during 1968 to developed countries of continental Western Europe and not to renew loans then outstanding to those countries. The only exceptions to this general prohibition were for bona fide export credits or for legally binding commitments.

The guidelines for nonbank financial institutions requested these institutions to reduce their holdings of liquid funds abroad during 1968 to zero or to the minimum absolutely necessary for working balances. The nonbank financial institutions also were requested during 1968 to reduce their holdings of covered assets by at least 5 per cent from the amount outstanding on December 31, 1967, and to make no new loans to the developed countries of continental Western Europe except to finance bona fide export credits, or to meet legally binding commitments. The liberalized reporting requirement was retained in the revised guidelines.

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Period or announcement date	*Action*	*Purpose*
January through April	Directed that System open market operations be conducted with a view to attaining easier conditions in the money market, with provision for modification of operations depending on the course of bank credit growth.	To foster money and credit conditions, including bank credit growth, conducive to combatting the effects of weakening tendencies in the economy, while recognizing the need for progress toward reasonable equilibrium in the country's balance of payments.
February 28	Reduced from 4 to 3 per cent reserve requirements on savings deposits, Christmas and vacation club accounts, and the first $5 million of other time deposits at each member bank, in two steps: from 4 to 3½ per cent, effective March 2; and from 3½ to 3 per cent, effective March 16.	To assist in meeting developing credit needs throughout the country in a manner consistent with the Federal Reserve's policy objective of assuring adequate credit availability to provide for orderly economic growth.
April 6	Reduced discount rates at 10 Reserve Banks from 4½ to 4 per cent, effective April 7. (Reductions at the two remaining Reserve Banks were effective April 10 and April 14.)	To bring the discount rate into better alignment with market interest rates and to assure adequate credit availability to provide for orderly economic growth.
May through late November	Directed that System open market operations be conducted with a view to maintaining prevailing conditions in the money market, with provision for modification of operations if bank credit expanded significantly more than expected.	To foster financial conditions, including bank credit growth, conducive to continuing economic expansion, while recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

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November 19	Increased discount rates at 10 Reserve Banks from 4 to 4½ per cent, effective November 20. (Increases at the two remaining Reserve Banks were effective November 21 and November 27.)	To assure the continuing orderly functioning of U.S. financial markets following the devaluation of the British pound, and to maintain the availability of reserves to the banking system on terms and conditions that would foster sustainable economic growth at home and a sound international position for the dollar.
Late November through December	Directed that System open market operations be conducted with a view first to facilitating orderly market adjustments to the increase in the discount rate; and then to attaining slightly firmer conditions in the money market, with provision for modification of operations depending on the course of bank credit growth.	To foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.
December 27	Increased reserve requirements against demand deposits in excess of $5 million per bank from 16½ to 17 per cent for reserve city banks, effective January 11, 1968; and from 12 to 12½ per cent for other member banks, effective January 18, 1968.	To further the Federal Reserve's objectives of fostering financial conditions conducive to resistance of inflationary pressures and progress toward equilibrium in the U.S. balance of payments.

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DEMANDS, RESOURCE USE, AND PRICES

1967 marked the seventh consecutive year of expansion in output, employment, and incomes from the cyclical low in February 1961—the longest sustained run-up in U.S. history. But for the year as a whole the gain in real output was small and significantly less than the growth in potential. As a result, use of resources was less intense than in 1966, particularly for manufacturing capacity, and the rate of gain in productivity flagged markedly. Nevertheless, strong inflationary pressures appeared again after midyear as resumption of more rapid growth in the economy encouraged manufacturers and distributors to recoup increases in their unit labor and other costs.

The U.S. export surplus on transactions in goods and services with other countries was slightly smaller than in 1966. After a rise in the first quarter, merchandise exports were virtually stable through the summer and then fell off a little in the autumn. Imports, which had surged during 1966 in response to strong domestic demands, were at unusually high levels relative to our gross national product during 1967. Late in the year imports increased sharply.

At the outset of 1967 the economy was confronted with a sizable overhang of inventories, in part because private final demands had weakened in major areas in late 1966. These developments had induced expectations in some quarters of a recession in early 1967. But a recession did not occur. Real GNP showed no growth in the first quarter; then it resumed its advance, and in both the third and the fourth quarters it expanded at an annual rate of about 4.5 per cent. At the year-end, expansion in the economy was vigorous, the labor market was tightening, and prices were rising sharply at the industrial and consumer levels in response to both cost-push and demand-pull forces.

DEMANDS

GNP in 1967 totaled $785 billion, an increase of $42 billion, or about 5.5 per cent, from 1966. Prices as measured by the

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GNP deflator rose by 3.0 per cent, however—the largest advance in a decade—and GNP in constant dollars increased by only 2.5 per cent. This represented much the smallest advance since 1961.

Over-all developments in the first half of the year were dominated by a record reduction in inventory investment on the one hand and by substantial increases in total final sales on the other. The net result was almost no change in real GNP in the first quarter, as already noted, and then a modest rise in the spring. In the second half, real GNP advanced at a faster pace, and in the fourth quarter inventory investment accounted for a sizable portion of the growth in GNP. Final sales, however, increased less rapidly in the second half than they had earlier—and markedly less after allowance for price increases.

In the first half of the year the drastic reduction in inventory investment and relatively small declines in some other demand areas resulted in a decline of about 2.5 per cent in industrial production from its record level in December 1966. From June to December, however, it advanced by almost 4 per cent, with intervening declines in September and October caused by strikes. After major strikes had been settled, expansion was both rapid and widespread, and in December industrial production reached a new high, 1.5 per cent above a year earlier. For 1967 as a whole the Board's index averaged 158 per cent of the 1957–59 average. This too was an increase of only 1 per cent from the 1966 average and was in sharp contrast to the increase of 9 per cent in 1966.

Inventories. At the beginning of 1967, the over-all ratio of nonfarm business inventories to sales was at the highest level since the first half of 1961. But the situation was far from uniform among major industry groups. In manufacturing, stock/sales ratios were low in nondurable goods lines but high for durable goods, largely because of the build-up of work-in-process stocks associated with the preceding extended boom in business outlays for plant and equipment and with the rapid expansion

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of defense output. Distributors' inventories too were low in nondurable goods lines and high in the durable goods.

Stocks of durable goods manufacturers rose persistently in 1967 but at a much slower pace than they had in 1966. Meanwhile, stocks of durable goods at distributors—particularly retailers—declined substantially in the first half of 1967. Weakness in sales of automobiles, television sets, and appliances in late 1966 had led to curtailments in output of these goods that were extended in the opening months of 1967, and stocks of these goods were drawn down. Stocks of nondurable goods continued to rise in early 1967 and then leveled off in the spring and summer; near the end of the year they rose again.

The result of these diverse situations was a very rapid reduction in the rate of nonfarm inventory accumulation in the first half of 1967—from an annual rate of $19 billion in the fourth quarter of 1966 to little change in over-all stocks in the second quarter. But in only one month—June—did total business inventory holdings, in terms of book value, decline absolutely. At midyear, the over-all stock/sales ratio was about the same as 6 months earlier.

In the second half of the year nonfarm inventory investment increased again despite the disruptive effects of strikes in the automobile and some other industries; and in the fourth quarter accumulation reached an annual rate of over $7.5 billion. The rate of accumulation was stepped up substantially for both durable and nondurable goods but, as usual, the more pronounced movements were in the durable sector. At distributors of durable goods, there was a shift from the sizable net liquidation of the second quarter to appreciable accumulation in the fourth quarter. Dealer stocks of autos rose in the last 2 months of 1967, but at the year-end they were still well below the excessive year-earlier level. Holdings of other consumer durable goods also rose late in the year. Inventory accumulation in industries manufacturing business and defense equipment was maintained at a high level through the last half of the year, despite earlier declines

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in output of producers' durable goods and a slowing of the rate of expansion in defense production. Steel stocks were beginning to be built up late in the year as a hedge against a possible strike in the summer of 1968.

At the end of 1967, the stock/sales ratio for total nonfarm business was down slightly from the high rate of a year earlier—owing mainly to pronounced declines in the ratios for nondurable goods at both the manufacturing and retail levels, to new lows for the expansion period. For durable goods the ratio was little changed from a year earlier and well above the 1965 level, before the sharp defense build-up began.

Farm stocks increased slightly for the year, following a small decline in 1966.

Final sales. Final sales increased rapidly in the first half of 1967 and by progressively smaller amounts in the third and fourth quarters. Early in the year, when the downdrag from weakening inventory demands was heaviest, expansion in Government purchases was also at its maximum rate—accounting for more than one-half of the first-quarter rise in final sales. Thereafter, Government purchases expanded much more slowly.

Expenditures for defense bulged in the first quarter, but thereafter grew at the slowest rate since late 1965, even though the fourth quarter included a sizable increase in pay for the military as well as for Federal civilian defense workers and other employees. For the calendar year defense purchases totaled $72.5 billion, up $12 billion from 1966. Altogether, Federal expenditures on the national-income-accounts (NIA) basis—including both defense and other purchases, transfer payments, grants to State and local governments, and so forth—totaled $164 billion for the calendar year 1967, an increase of $21 billion from 1966.

A sharp rise in the Federal deficit (NIA basis) in the first half of the year reflected both the rise in expenditures and a failure of receipts to advance beyond the level reached in late 1966. Underlying the leveling off in receipts was the slowdown in economic activity, which resulted in a decline in corporate

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profits and hence in corporate tax accruals. Another influence was the unusually high level of tax refunds resulting from the establishment of a graduated schedule for withholding taxes on individual incomes effective in May 1966. The Federal deficit continued large in the second half of the year, even though receipts rose appreciably.

Needs for all sorts of State and local government services have been mounting persistently, and purchases by this sector rose by $9 billion in 1967 compared with the previous record increase of $7.5 billion in 1966. In 1967, as in earlier years, much of the increase was for wages and salaries and reflected both increases in the number of teachers and other employees and higher rates of pay.

In the private sector total final purchases increased throughout the year, but at an uneven pace. A small decline in business expenditures on fixed capital had a dampening effect on expansion in over-all output during the first half of 1967, and the subsequent increase in these outlays was moderate. For the year as a whole the increase in such spending amounted to less than 3 per cent in current dollars; after adjustment for higher prices, there was virtually no increase in real investment. The only major industry grouping that showed a significant rise in spending for the year 1967 was public utilities. Spending by other major sectors of the economy, including manufacturing, was either little changed or down.

The modest rise in business spending for fixed capital in 1967 coincided with a marked slowing in the economy's growth rate and followed sharp increases in such outlays during the 1964–66 period, when the average yearly rise amounted to about 14 per cent. Additions to capacity were substantial during this period and, indeed, continued in 1967. Manufacturing capacity was estimated to have increased more than 6 per cent in 1967, compared with a rise of close to 7 per cent in 1966. But the rate of capacity utilization in manufacturing, which had averaged over 90 per cent in 1966, declined considerably during the

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first three quarters of 1967 before edging up late in the year, and for 1967 it averaged only 85 per cent.

Another factor adversely affecting businesses' decisions to invest in fixed capital was the sharp decline in corporate profits in the first quarter, when real GNP was unchanged and output of goods declined. Profits rose sharply in the fourth quarter to a new high, and for 1967 as a whole, corporate profits after taxes totaled $47.5 billion, down $1.5 billion, or 3.5 per cent, from 1966. With dividends rising further, undistributed profits were off even more than after-tax profits, and total internal funds—undistributed profits and depreciation allowances—declined for the first time since 1960. The investment tax credit and provisions for accelerated depreciation, which had been suspended in the early autumn of 1966, were reinstated in the spring.

In 1966 a steady decline in residential construction activity had been the major offset to expansion in other sectors. In 1967, in contrast, expansion in such activity operated to offset declines in some other areas. Residential construction advanced throughout the year as housing starts moved upward from the postwar low in October of 1966. The major factor in the recovery was the increased availability of mortgage funds. Also, with housing completions at reduced levels through most of 1967 and with rental and homeowner vacancy rates declining further through the year, demands for available units were maintained even though interest rates in the mortgage market turned upward again after May.

Housing starts in the fourth quarter of 1967 were at an annual rate of 1.44 million units, the highest quarterly rate in 2 years. For the year as a whole, starts totaled about 1.3 million units—compared with less than 1.2 million in 1966 and 1.6 million in 1963. Recovery in 1967 was fairly uniform by region; it was sharper for multifamily than for single-family units. Although there were more housing starts in 1967 than in 1966 and construction costs rose further, expenditures for homebuilding were about the same in both years, and the lowest since 1961.

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While consumer spending on goods and services rose substantially in 1967, it did not keep pace with after-tax incomes. As a result, the saving rate increased to 7 per cent of after-tax income; this compared with 6 per cent or less in each of the preceding 3 years and was the highest in over a decade. This pattern of consumer behavior has been ascribed to a number of possible causes, including the build-up of stocks of consumer durable and semidurable goods in the immediately preceding years, concern over developments in Vietnam and civil disorders in many cities during the summer, resistance to steadily rising consumer prices, less confidence in prospects for increases in family incomes, and recurring expectations of a surcharge on Federal personal income taxes.

For 1967 as a whole, consumers increased their spending by about 5.5 per cent, compared with 7.5 per cent in 1966. But the rise in the physical volume of purchases was less than 3 per cent. This was only half the average increase of the preceding 3 years and was the smallest advance since 1961.

Outlays for services maintained their uninterrupted advance. The increase in current dollars was about 7.5 per cent, a little more than in 1966, but in constant dollars it was less than 4 per cent.

Purchases of nondurable goods increased at a fairly brisk pace in the first half of the year and then much more slowly. For the whole year such spending was up less than 5 per cent in current dollars and less than half of that in constant dollars. For durable goods the increase for the year was 2.5 per cent in current dollars and only 1 per cent in constant dollars. For both durable and nondurable goods the increases were far less than in 1966.

One reason for the sluggishness of consumer outlays on durable goods late in 1967 was the limited availability of new automobiles because of work stoppages in the industry. But even after allowing for this, automobile sales in 1967 were less than had been widely expected. For the year as a whole new-car sales

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totaled 8.3 million units. This number included imports, which increased sharply—in contrast to the decline for domestic cars—and accounted for an increased proportion of all sales. In 1966, 9 million autos had been sold, and in 1965 a record 9.3 million units. Sales of furniture and appliances edged up during 1967, with the modest nature of the rise attributable in part to the reduced rate of housing completions and turnover during much of the year.

Because of the slower pace of economic expansion, growth in total personal income was less in 1967 than in 1966—7 per cent compared with 8.5 per cent. For wages and salaries alone, the 1967 increase was 7.5 per cent compared with 10 per cent in 1966. Farm proprietors' incomes were down for the year, mainly because of sizable reductions in prices of farm products. Transfer payments increased twice as much as the previous record gain in 1966, but increases from late 1966 to late 1967 were far more moderate; much of the big step-up in the scale of such payments had occurred in the second half of 1966 when the medicare program was gaining momentum.

Personal income after taxes increased by 7 per cent in 1967, compared with close to 8 per cent in 1966. Consumer prices went up by about the same amount in both years, and in constant dollars the increase in income amounted to about 4.5 per cent in 1967 compared with 5 per cent in 1966.

LABOR MARKET

Demands for labor were much less expansive during most of 1967 than in 1966, primarily because of developments in the manufacturing sector. In the first half, gains in employment were curtailed by the softening in output of goods, and the manufacturing workweek was appreciably below the high level of 1966. During the summer and early autumn, strikes in the automobile industry and others curtailed growth in nonfarm employment. Late in the year, however, such employment increased sharply; the ending of major strikes was a contributing influence, but

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gains were large and widespread. In addition, the workweek in manufacturing recovered much of its earlier loss. Altogether, nonfarm employment increased by 1.9 million persons in the year ending December 1967, compared with the extraordinary rise of 2.9 million during the preceding year. On balance, all of the increase in 1967 occurred in nonmanufacturing activities.

The unemployment rate showed little sensitivity to the slowed expansion of job opportunities through the summer. During the first quarter a decline in the civilian labor force helped to keep the rate from rising above the level of late 1966. Later, the rate edged up to a high for the year of 4.3 per cent in October, dropped rapidly after that, and in December was down to 3.7 per cent, the same as a year earlier. The average unemployment rate for the year—3.8 per cent—also was the same as in 1966.

In the first half of 1967 manufacturing employment declined by 240,000, mostly in durable goods industries. Strikes interrupted the revival in employment after midyear, but the number of workers in both durable and nondurable goods industries rose in November and December. In defense-related industries employment advanced by 70,000 workers during the year, but this was only one-fourth as much as during 1966. Altogether, for the year ending December 1967, manufacturing employment declined slightly in contrast to an increase of nearly 1 million persons over the preceding year.

In nonmanufacturing activities, employment increased by 1.9 million persons during 1967, virtually the same as in 1966. Sectors with strong growth trends—particularly State and local governments, trade, and finance and service activities—all maintained their upward sweep. Despite the revival in homebuilding activity, the number of workers employed in the construction industry changed little. Federal Government civilian employment —which had expanded by more than 200,000 in 1966, largely because of the military build-up in Vietnam—continued to rise rapidly to midyear; in the autumn, however, it turned down and by December was only 50,000 above a year earlier.

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The civilian labor force increased by 1.75 million persons during 1967, somewhat more than the expected "normal" growth. But the Armed Forces expanded only slightly, compared with a rise of more than 500,000 men during 1966. As in 1966, adult women accounted for two-thirds of the growth in the civilian labor force. However, a striking development was that in 1967 the number of adult males in the civilian labor force showed the largest increase in more than a decade. This reflected the more moderate military manpower needs along with the fact that an increased number of those born during the post-World War II bulge in births had passed age 20.

While the over-all unemployment rate averaged the same in 1967 as in 1966, experience varied among major groups. For men 25 years of age and over, the rate averaged about 2 per cent —a level that reflects essentially only frictional unemployment— and was somewhat below the 1966 level. For adult females, for whom the unemployment rate is typically higher, the rate averaged 3.7 per cent compared with 3.3 per cent in 1966. For teenage workers as a group the rate averaged close to 13 per cent, little higher than in 1966. There was no significant improvement in the position of nonwhite workers in 1967, and in the fourth quarter their over-all unemployment rate—about 8 per cent—continued to be more than double that of white workers.

WAGES AND COSTS

Hourly wages in both manufacturing and nonmanufacturing activities rose more rapidly in the 12 months ending December 1967 than over the preceding year. In manufacturing, average hourly earnings of production workers increased by 5.1 per cent; over the preceding 2 years, the average increase had been 3.7 per cent. Average weekly earnings in constant dollars showed only a small increase, however, from late 1966 to late 1967, as a shorter workweek and higher consumer prices offset the sizable increase in hourly earnings. In nonmanufacturing industries,

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hourly earnings showed large increases in both the more organized industries—such as construction, railroads, and trucking—and the less well organized activities—such as trade and services.

Large increases in wages during 1967 reflected several influences: continued and prospective sharp increases in consumer prices; the direct and indirect effects of a statutory increase in minimum wages early in the year; and the negotiation of a number of new collective bargaining contracts in key industries. Contract settlements in 1967 provided increases in wages and other benefits averaging about 5.5 per cent a year, compared with 4.5 per cent in 1966.

Sharp increases in consumer prices over the past 2 years led to a shift of major emphasis in negotiations to wage rates instead of fringe benefits. This emphasis also reflected the large number of new—and younger—workers and their concern with current income rather than retirement and other deferred benefits. Furthermore, skilled workers achieved some restoration of wage differentials. Despite the rise in consumer prices, contracts negotiated during the year did not result in the introduction of many new cost-of-living escalator clauses. Indeed, in some instances—notably the automobile industry—prior escalator arrangements were restricted in the new contracts.

The rate of gain in productivity in manufacturing industries slowed sharply until late in the year because of the reduced level of output. As a result, output per manhour increased only 1 per cent in the year ending with the fourth quarter of 1967. Over the preceding year the increase had been 3 per cent, and from 1960 to 1965 gains had averaged almost 4 per cent. With hourly wage compensation continuing to increase, unit labor costs in manufacturing increased steeply until late in the year, and in the fourth quarter they were 4.7 per cent above a year earlier. During 1966 the increase had been less than 3 per cent, and from 1960 to 1965—when wage gains had been about in line with growth in productivity—unit labor costs and industrial prices had remained relatively stable. For the private nonfarm

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economy as a whole—as in manufacturing—unit labor costs also rose rapidly during most of 1967.

PRICES

The easing of private final demands in late 1966 and the sharp reduction in business inventory investment during the first half of 1967 resulted in a marked slowing of the pace of price advance. Indeed, average industrial prices were unchanged at wholesale from February to July. Moreover, considerable improvement in actual and prospective supplies brought about a sizable drop in prices of foods and foodstuffs from the early autumn of 1966 to the spring of 1967. Reflecting these developments, the wholesale price index declined in late 1966 and early 1967, and the consumer price index rose much more slowly than it had during most of 1966.

The decline in prices of foods and foodstuffs was temporarily reversed in late spring and early summer, under the influence of unusually cold, wet weather. This development coincided with a pronounced pick-up in consumer spending, sharp recovery in residential construction activity, reports of business plans to resume expansion in fixed capital outlays, and spreading expectations that the economic pause of early 1967 would give way to renewed rapid expansion. In this improved setting, businesses initiated fairly widespread, and in some cases sizable, increases in prices, in an effort to compensate for the sharp rise in unit labor costs and the narrowing of profit margins beginning around mid-1966.

After mid-July wholesale prices of industrial commodities broke out of their pattern of stability and during the last 5 months of the year increased at an annual rate of more than 3 per cent. At retail, price increases were stepped up sooner, and the consumer price index for nonfood commodities rose at an annual rate of about 3.5 per cent from early spring to the end of the year. Moreover, retail food prices, which reached a low in April, rose moderately over the remainder of the year.

The rise in average prices of industrial commodities encom-

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passed a wide variety of materials and products. Prices of sensitive industrial materials, whose sharp decline from mid-1966 to mid-1967 had been a major influence on the slowing of the rise in the over-all industrial price index over that period, by December had recovered three-fifths of their earlier decline. But a large part of this recovery reflected very sharp increases for copper and cotton—domestic supplies of which were drastically limited. Prices of most building materials rose, beginning with the recovery in residential building activity in the spring, and in the latter part of the year increases were effected for steel mill products.

Among industrial products, 1967 was marked by substantial price increases for consumer durable goods at wholesale and retail following several years of relative stability. The increase for autos—at the introduction of 1968 models—was the largest since the late 1950's. Increases were also widespread for consumer nondurable goods, with apparel showing a particularly large gain, and with household furnishings and various other nondurable products increasing by sizable amounts. Toward the end of 1967, price increases for producers' equipment, which had slowed appreciably during the first half, accelerated again to the fast 1966 pace.

Despite the sharp rise for industrial commodities, the total wholesale price index at the year-end was only a little higher than at midyear as prices of farm products and foods declined again on balance. For the entire year 1967, the total wholesale index averaged only fractionally higher than in 1966.

The consumer price index in 1967 averaged 2.8 per cent above 1966—increasing about as much as it had from 1965 to 1966. Retail food prices increased much less than in 1966. But prices of other commodities showed a rise almost double that of the preceding year, and service costs rose somewhat more, on average, than in 1966. During the closing months of 1967 the consumer price index was rising at an annual rate of more than 3.5 per cent, as fast as during the period of rapid economic expansion in late 1965 and early 1966.

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U.S. BALANCE OF PAYMENTS

The imbalance in U.S. transactions with the rest of the world became larger in 1967, and conventional measures showed a very sharp increase in the balance of payments deficit on each of two methods of calculation. Over the past 3 years the competitive position of the United States in world trade may have suffered some impairment, for advances in domestic incomes and in aggregate demand were substantially greater than the growth in real domestic product and U.S. prices rose more rapidly than they had in earlier years. In 1967, however, any adverse effects on our goods and services export surplus stemming from unfavorable international cost relationships, as well as those clearly caused by temporary slackening of demand abroad, were offset until late in the year by a pause in the growth of U.S. import demand, paralleling the pause in expansion of GNP. If the year as a whole is compared with 1966, the increase in the external deficit can be ascribed primarily to enlargement of the net outflow of capital. In the fourth quarter, however, the current-account balance again deteriorated sharply.

Capital flows reacted to a variety of forces—some tending to improve the balance, others to worsen it. In some respects the pattern of flows differed considerably from that of 1966. Thus, there was no longer a net reflux of U.S. bank credit such as that produced by the foreign credit restraint program in 1965 and by tight monetary conditions in 1966. Similarly, the net inflow of foreign funds through commercial banks abroad (including foreign branches of U.S. banks) was not so large as in 1966. For reasons not directly connected with current economic developments, there were no substantial advance repayments of debt by foreign governments, as in previous years. Net acquisitions of time deposits with maturities of more than a year and of other near-liquid assets by foreign central banks or governments and international institutions were still very large in the first half of 1967, but these dwindled after midyear. Toward the end of the year the United Kingdom liquidated a large amount of U.S.

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securities to augment its monetary reserves. Each of these developments was adverse for one or the other, or both, of the two measures of the U.S. balance of payments deficit.

The over-all deficit measured on the liquidity basis amounted to $3.6 billion, compared with $1.4 billion the year before. The alternative measure—on the basis of official reserve transactions—showed a deficit of $3.4 billion, compared with a small surplus in 1966. The narrow difference between the two measures hid substantial disparities between the two methods of computation. Acquisitions by foreign monetary authorities of certain types of claims on U.S. banks or the U.S. Treasury are treated differently in the two computations: net acquisitions of $1.3 billion of these claims in 1967 helped to reduce the liquidity deficit, while on the alternative basis they counted as official reserve transactions, financing the deficit. On the other hand, the official-reserve-transactions deficit was held down by $1.5 billion of net acquisitions of liquid assets in the United States by foreign commercial banks and private persons and international institutions—transactions that count in the liquidity balance as financing the deficit rather than reducing it.

The liabilities of the United States to foreign central banks and governments that count as financing the official-reserve-transactions deficit increased by $3.3 billion in 1967 to a total of $19.5 billion. Partly offsetting this rise in reserve liabilities, U.S. official holdings of convertible currencies increased by $1.0 billion, reflecting mainly assistance extended to the United Kingdom in support of sterling. After sterling was devalued in November, a wave of speculation arose in Europe regarding potential future increases in the price of gold in terms of dollars and other currencies. In order to quiet this speculation, the U.S. Treasury and the monetary authorities of other leading industrial countries made large sales of gold to hold the price steady in the London free market. Largely because of such sales, the gold stock of the United States decreased by $1.0 billion during the last 2 months of the year and by $1.2 billion over the year as a whole.

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At the end of 1967 the total gold stock amounted to $12.1 billion.

In view of the strains placed on the international monetary system—and in particular on the reserve asset and liability position of the United States—by 10 years of large deficits in the U.S. payments balance and by the developments in the last few weeks of 1967 described above, the President announced on January 1, 1968, a new program to reduce the balance of payments deficit. The part of the program that concerns foreign loans and investments of banks and other financial institutions is described on pages 17–21 of this REPORT.

TRANSACTIONS IN GOODS AND SERVICES

The surplus on goods and services, which totaled $5.1 billion in 1966, ran at a somewhat larger rate during most of 1967, but dropped in the fourth quarter to an annual rate of under $3 billion. For the year as a whole it fell short of $5 billion. Thus it was again far below the 1963–65 average of $7.1 billion.

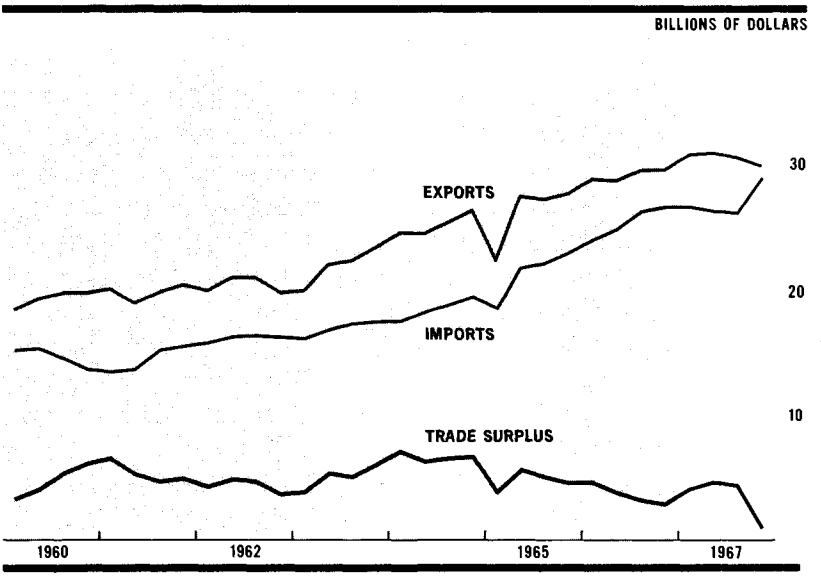
The fresh worsening in the current account of the balance of payments toward the end of 1967 resulted from a sharp rise in merchandise imports. After growing disproportionately to GNP during 1965 and most of 1966, imports leveled off in the first three quarters of 1967. Imports of industrial materials fell by 12 per cent from the peak level reached in the third quarter of 1966, but the rise in other imports only slowed. For all of 1967, as for 1966, merchandise imports were equal to 3.4 per cent of GNP, compared with 2.9 per cent in 1963 and 1964. With GNP now above $800 billion, each 0.1 per cent rise in this ratio would mean an addition of over $800 million of imports a year.

Merchandise exports increased until the spring of 1967, but from then on growth was slowed by the slackness in demand in most foreign countries—Japan, Italy, and Australia were important exceptions. Industrial output in Germany, now the leading producer of Western Europe, was 6 per cent lower in the first half of 1967 than a year earlier. At the year-end the stimulus to

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world demand provided by renewal of expansion in the United States and in Germany had not yet been sufficient to generate an upturn in U.S. exports. The trade surplus for the year was $3.5 billion, a little less than that of 1966. The rise in imports late in the year caused the export surplus in the fourth quarter to drop to an annual rate of $1.0 billion.

3 | Merchandise EXPORTS and IMPORTS both level off, but IMPORTS jump again in fourth quarter



Seasonally adjusted balance of payments data.

Income receipts from foreign investments increased substantially in 1967, and there were good gains also in receipts of fees and royalties from direct investments and for other private services. On the other hand, travel expenditures (exclusive of fares) were about $500 million greater than in 1966; this jump, nearly three times the average annual increase in the preceding 5 years, was due mainly to the attraction of Expo 67 in Canada.

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There was a further large increase—by about $600 million—in military expenditures abroad. These reached an annual rate of $4.4 billion in the second half of the year, compared with the late 1964 and early 1965 low of $2.7 billion. Deliveries to other countries under military sales contracts rose by $400 million, to nearly $1.3 billion.

UNILATERAL TRANSFERS

U.S. Government economic aid grants of $1.8 billion in 1967 were less than the average of the preceding 6 years. Government pensions and other transfers amounted to $450 million. Private remittances rose by $200 million to more than $800 million; transfers of contributions to Israel were a principal factor in this increase.

FLOWS OF U.S. CAPITAL

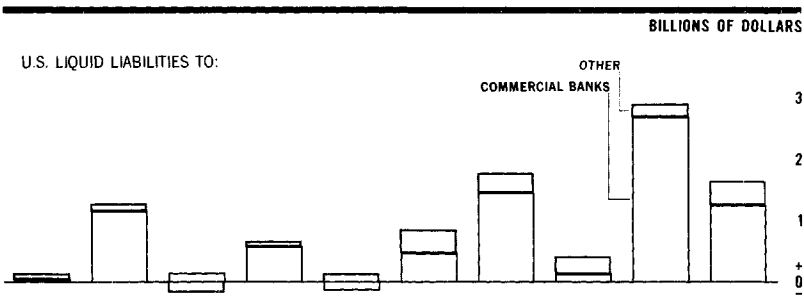
The outflow of U.S. Government credits to foreign countries and subscriptions to international agencies, net of changes in associated liabilities and after deducting loan repayments, amounted to $2.4 billion in 1967. (This does not include increases in liquid claims that count as U.S. official reserve assets.) Net disbursements rose by about $500 million, a major part of which was related to the growing stream of loans by the Export-Import Bank to finance U.S. sales of civilian jet aircraft and military equipment. Receipts of loan repayments were about $200 million less than the year before, as advance repayments—over $400 million in 1966—were negligible in 1967. The net outflow was thus about $700 million larger than in 1966.

Outflows of U.S. private capital were also appreciably larger than the year before. The largest change was a shift from about $250 million of net inflows of credits reportable by banks in 1966 to about $450 million of net outflows of such credits in 1967. Those foreign assets of U.S. banks to which the foreign credit restraint program applies increased by $370 million, which was less than the program ceilings would have allowed,

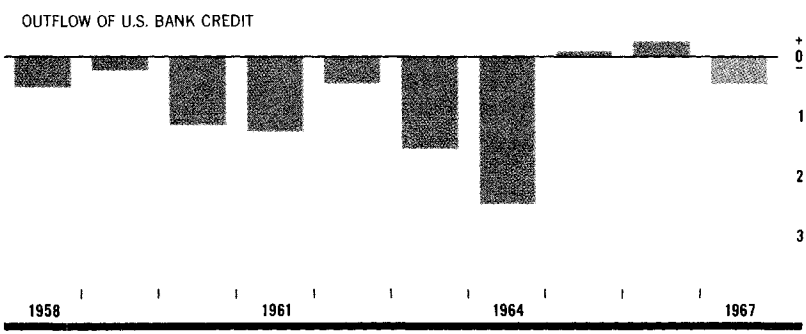
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while there were also increases in claims held for customers. This resumption of a net outflow of bank credit resulted in part from changes in monetary conditions here and abroad. In the United

4 **INFLOWS of funds through increases in U.S. liquid liabilities to commercial banks abroad and to other private foreign persons are not so large as in 1966 while . . .**



NET OUTFLOW of U.S. bank credit resumes



Balance of payments data. "U.S. bank credit" represents claims on foreigners reported by U.S. banks, including claims held for customers.

States bank liquidity was increasing and short-term market rates of interest were lower than in 1966, whereas in Japan, which is a heavy borrower from this country, short-term rates tended to rise. Outstanding U.S. bank credits in continental Western Europe

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were reduced; slackness of demand for credit in some European countries reinforced the constraining effects of the interest equalization tax (IET) and the foreign credit restraint program.

Outflows of U.S. private capital to purchase newly issued Canadian, Israeli, and World Bank bonds—all of which are exempt from the IET—increased in 1967. Also U.S. investors became net purchasers of foreign equity securities, whereas during the first 3 years that the IET was in effect they had made sizable net sales. Total U.S. net purchases of foreign securities in 1967 were about $1.3 billion, compared with $0.5 billion in 1966.

Outflows for direct investment in foreign affiliated companies by U.S. corporations and other investors were smaller than in 1966. After deducting the amounts of such investment financed through borrowings abroad by U.S.-incorporated companies, the net outflow was about $2.7 billion, compared with $3.1 billion the year before. The flow to Canada, which had been unusually large in 1965 and 1966, contracted sharply.

In total, outflows of U.S. private capital, net of U.S. sales of bonds in foreign capital markets in connection with the financing of direct investment, increased to $5.0 billion from $3.6 billion the year before.

INFLOWS OF FOREIGN CAPITAL

A new development that might, if it continued, help considerably in restoring international payments equilibrium was the large inflow in 1967 of foreign capital to buy outstanding U.S. equity securities. For the year as a whole net purchases of U.S. stocks by foreigners—other than the U.K. Government and private persons in the United Kingdom, who were net sellers—were about $0.8 billion, but in the 6 months July–December alone they were $0.7 billion. Inflows of this size were unprecedented; in the first half of 1961, for instance, total foreign net purchases of U.S. stocks were unusually large but did not reach $250 million.

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In total, the inflows of foreign private capital through these purchases of stocks, through purchases of U.S. corporate bonds, through increases in commercial and other claims against U.S. businesses other than banks, and through direct investments in U.S. subsidiaries of foreign companies amounted to about $1.5 billion, compared with $0.7 billion in 1966. Not counted in these totals are the purchases, about $450 million in 1967, of bonds issued by U.S. companies for direct investment financing, which were mentioned in the preceding section.

Another important category of foreign private capital inflow in 1967 took the form of additions to foreign holdings of liquid and near-liquid assets in the United States—such as interbank balances, bank deposits, and U.S. Treasury and Federal agency securities. Total U.S. liquid liabilities to commercial banks abroad (including foreign branches of U.S. banks) increased by about $1.3 billion. Although only about half as large as the 1966 inflow of $2.7 billion, which had been swollen by heavy bidding by U.S. banks for Euro-dollar funds through their London branches at a time when U.S. banks were under severe liquidity pressures, this was still a very large amount; in only one other year—1964—had the inflow been larger than it was in 1967. Relatively easy short-term money market conditions in Germany in 1967 and the persistent forward exchange discounts on sterling against the dollar and other currencies during a large part of the year helped to generate movements of liquid funds to the United States through the Euro-dollar market, and Canadian and Japanese banks also increased their liquid assets in the United States considerably.

Liquid liabilities of the United States to foreign private persons other than commercial banks increased in 1967, as they had in each of the preceding 6 years. The net inflow of funds in this category totaled nearly $400 million for the year, substantially more than the 1961–66 average of $250 million.

Liquid and near-liquid liabilities to international organizations (including certain regional organizations) increased by

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about $100 million in 1967, after decreasing the year before by a similar amount. Shifts by these holders from liquid assets to long-term time deposits and Federal agency securities were smaller than in 1966.

Finally, certain foreign official capital transactions had the effect of increasing the U.S. payments deficit in 1967 on either of the two methods of computation. In particular, the United Kingdom in the latter part of 1967 liquidated about $500 million of U.S. securities other than Treasury issues for the purpose of increasing its monetary reserves. Partly offsetting this outflow, there was an increase of under $100 million in U.S. liabilities to foreign governments for prepayments made on military sales contracts.

ERRORS AND OMISSIONS

The adverse balance of U.S. international payments and receipts as measured by the resulting official reserve transactions amounted to $3.4 billion in 1967, as noted above. This was substantially more than can be accounted for by the current-account transactions and capital flows that have been discussed. While some of the data are partly estimated and may eventually undergo revision, it appears that the excess of unidentifiable payments over unidentifiable receipts was only a little larger in 1967 than in the preceding years: perhaps $0.6 billion, compared with an average of $0.5 billion in the four preceding years. These "errors and omissions" may reflect statistical deficiencies in the measurement of current transactions, or they may imply that the net outflow of private capital in various forms has been larger than the available statistics and estimates have indicated.

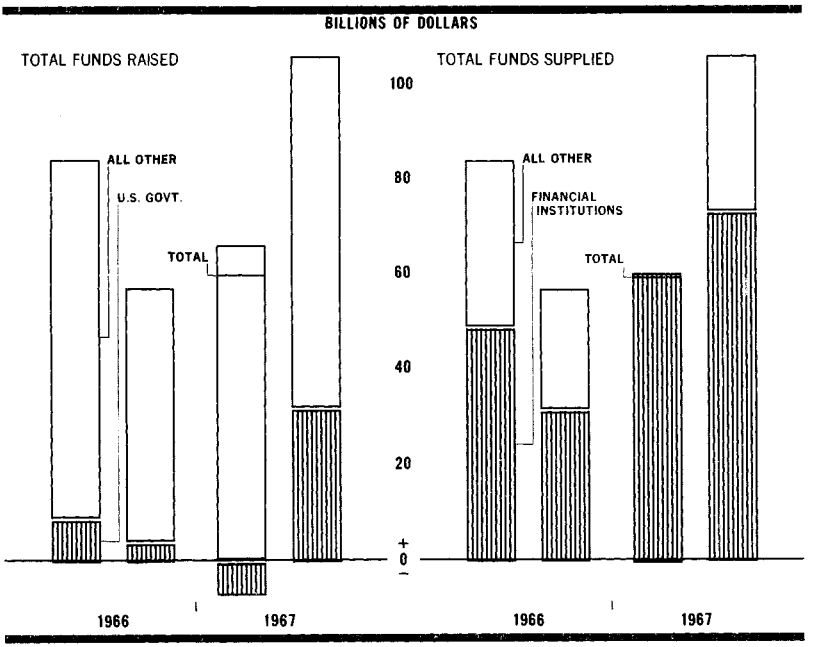
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FINANCIAL FLOWS IN 1967

The amount of funds raised in financial markets in 1967 as a whole was very large in comparison with the reduced total in 1966. Most of the increase reflected a rapid acceleration of borrowing in the second half of the year, which drove interest rates to new highs in long-term markets. Although all sectors other than consumers stepped up their credit demands in 1967, most of the expansion in borrowing stemmed from the large demands of the Federal Government for funds to finance its record deficit in the second half of the year.

Financial institutions were able to expand their lending activi-

5 | U.S. GOVT. credit demands accelerate in second half of '67; FINANCIAL INSTITUTIONS supply more funds



Flow of funds data. Half-year totals at seasonally adjusted annual rates. "All other" represents consumers, nonfinancial businesses, State and local governments, and foreigners. Data for second half of 1967 are preliminary.

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ties rapidly. Net inflows of funds to such institutions were enlarged not only by the return of more favorable spreads between market rates and rates on intermediary claims but also by the increased pace of consumer saving. However, credit flows through intermediaries moderated in the final months of the year as the public responded to the rising level of market yields by diverting a larger share of its financial asset acquisitions directly to market securities.

BORROWERS AND LENDERS

Financial markets in 1967 were dominated by the continued attempts of both borrowers and lenders to readjust financial positions following the credit market stringencies that had developed in 1966, by expectations of a return to tighter financial markets in the period ahead, and by the borrowing activities of the Federal Government. As a result, most sectors attempted to increase their holdings of liquid assets, and many borrowers made strenuous efforts to obtain large volumes of funds in long-term markets.

Federal Government. The Federal Government's financing needs dominated financial developments in 1967. Total Federal borrowing increased to about $14.5 billion—including $4.6 billion in issues of fully marketable participation certificates—or almost twice as much as the year before. In the first half of the year, accelerated tax payments and Treasury decisions to hold its cash balances at lower levels than usual permitted a more than seasonal repayment of debt—mostly of tax-anticipation bills. But after midyear, with cash balances lower than normal and with the gap between receipts and expenditures widening, total borrowing rose to record postwar levels.

Offerings of direct U.S. marketable securities alone totaled, net, about $16 billion during the second half—over $11 billion of which were Treasury bills. New issues of Treasury debt were confined to short- and intermediate-term maturities because market yields on long-term issues throughout 1967 remained above

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the statutory 4¼ per cent interest ceiling on Treasury bonds. On several occasions during the year the Treasury made offerings of issues with 5-year maturities, and in November it sold $1.7 billion of 7-year Treasury notes under new legislation. Even so, the average maturity of the Federal debt continued to decline from its recent peak reached in early 1965; by the end of 1967 it was down to 4 years and 1 month.

TABLE 3

FINANCIAL TRANSACTIONS OF U.S. GOVERNMENT

(In billions of dollars)

Item	Calendar year 1966			Calendar year 1967		
	1st H.	2nd H.	Year	1st H.	2nd H.	Year
Cash receipts	79.5	65.7	[illegible]	87.9	68.4	[illegible]
Cash payments [1]	70.8	80.1	[illegible]	75.1	88.5	[illegible]
Cash surplus or deficit (−) [1]	8.7	−14.4	[illegible]	12.9	−20.1	[illegible]
Change in cash balance	6.5	−6.5	[illegible]	2.0	−0.8	[illegible]
Total borrowing	−1.4	9.4	[illegible]	−4.8	19.1	[illegible]
Nonmarketable securities [2]	−0.8	−0.5	[illegible]	0.1	1.6	[illegible]
Marketable securities, total	−0.6	9.9	[illegible]	−4.9	17.5	[illegible]
Direct U.S.	−5.5	8.9	[illegible]	−7.4	15.8	[illegible]
Nonguaranteed Federal agency	3.5	1.6	[illegible]	−1.2	0.8	[illegible]
Participation certificates [3]	1.4	−0.6	[illegible]	3.7	0.9	[illegible]
Less: Official purchases or sales (−):						
By Govt. agencies and trust funds	0.1	2.3	[illegible]	4.2	−1.0	[illegible]
By Federal Reserve System [4]	1.7	1.5	[illegible]	3.0	2.3	[illegible]
Equals: Net Federal marketable obligations acquired by the public	−2.4	6.1	[illegible]	−12.1	16.2	[illegible]

[1] Participation certificates are included in cash payments of the Federal Government as a negative expenditure.

[2] Nonmarketable securities include the excess of cash sales over redemptions for savings bonds, and the change in outstanding savings notes, foreign series securities, depositary bonds, retirement plan bonds, and Rural Electrification Administration bonds.

[3] Includes only fully marketable participation certificates.

[4] Excludes repurchase agreements.

NOTE.—Data are not seasonally adjusted.

Borrowing in the market by Federal agencies, while large, was somewhat less than the record volume of 1966. Nonguaranteed debt of such agencies actually declined by $0.4 billion, in large part because the Federal home loan banks were able to retire substantial amounts of obligations as savings and loan associations repaid borrowings from the FHLB System. Marketable

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participation certificates, on the other hand, were issued in record volume during 1967, mostly in the first half.

The Federal Reserve Open Market Account and Treasury trust accounts absorbed a sizable volume of direct U.S. Government and Federal agency securities. Net purchases by these official accounts totaled $8.5 billion—more than two-thirds of the rise in such debt outstanding. The Federal Reserve purchased more than $5 billion of marketable U.S. Government securities (excluding purchases made under repurchase agreements). Net purchases by Treasury trust accounts and agencies totaled $3.2 billion. Although most of this amount represented direct U.S. Government debt issues, it included more than $1 billion of participation certificates. The Treasury completed all of its acquisitions in the first half; during the second half it reduced its holdings.

With the increase in official purchases, absorption of Federal debt into private portfolios during 1967 was about the same as during 1966—around $4 billion. However, there was a much sharper than usual seasonal swing from the first to the second half, and private investors had to absorb $16 billion of Federal

TABLE 4

FEDERAL LENDING

(In billions of dollars)

	1964	1965	1966	1967
Total	3.8	4.7	7.9	4.5
Mortgages	0.2	1.0	3.4	2.7
Loans, total	*3.5*	*3.7*	*4.6*	*1.8*
To savings and loan assns.	0.5	0.7	0.9	−2.5
To foreigners	1.6	1.5	1.3	2.6
To others[1]	1.4	1.5	2.4	1.7

[1] To consumers, nonfinancial businesses, and State and local governments.

NOTE.—Flow of funds data; figures for 1967 are preliminary. Components may not add to totals due to rounding.

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direct and agency securities during the July–December period. Most of these were acquired by commercial banks and other financial institutions, but takings by the nonbank public rose as interest rates moved to higher levels.

The Federal sector reduced its extension of credit to financial markets in 1967 as pressures on mortgage markets subsided. Its net purchases of mortgages, although still quite large and increasing in the second half of the year, dropped by one-fifth and, as noted earlier, a large portion of its advances to savings and loan associations through the FHLB were repaid. Outstanding loans to foreigners, however, rose sharply—reflecting larger disbursements of loans by the Export-Import Bank, as well as smaller advance repayments by foreign governments.

Nonfinancial businesses. Total funds raised by nonfinancial businesses in credit and equity markets amounted to $37 billion in 1967, one-tenth more than in 1966. Noncorporate businesses raised less, but external financing by corporations rebounded early in 1967 from the reduced volume of the second half of the previous year and remained at advanced levels thereafter. For 1967 as a whole, nonfinancial corporations raised nearly $28 billion in credit and equity markets—$4 billion more than in 1966, though somewhat below the annual rate reached in the first half of that year.

Needs to obtain external financing to fill the gap between corporations' internal funds and their capital outlays abated only moderately in 1967. While the gap was narrower than the $16 billion experienced in the second half of 1966, it was still—at $12 billion—considerably wider than in years prior to 1966. Efforts of nonfinancial corporations to rebuild liquidity and to acquire long-term funds in advance of expected sharp increases in interest rates also contributed significantly to the volume of the external financing of these corporations, and especially to the predominantly long-term nature of that financing.

Sharp curtailment in corporate spending for inventories was offset only in part by the moderate rise in outlays for plant and

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equipment and the sharp expansion in multifamily housing and commercial construction. As a result, nonfinancial corporations spent $4 billion less for fixed assets and inventories than in 1966. Funds available from internal sources also declined, for the first time since 1960, but by only $0.6 billion. Profits fell in early 1967 and remained below 1966 levels throughout the year, despite some improvement in the fourth quarter. But the continued rise in capital consumption allowances—primarily provision for depreciation—offset almost all of the $3 billion decline in retained earnings.

Corporations raised an unusually large share of the external funds they needed in 1967 in the securities market. Issues of bonds and stocks, amounting to $16.6 billion, accounted for 60 per cent of all funds raised in credit and equity markets by nonfinancial corporations, compared with 49 per cent in 1966 and an average of 44 per cent in 1961–65. Net new issues were largest in the third quarter when financing undertaken in expectation of intense credit strains in the fall swelled the total to a seasonally adjusted annual rate of $22 billion.

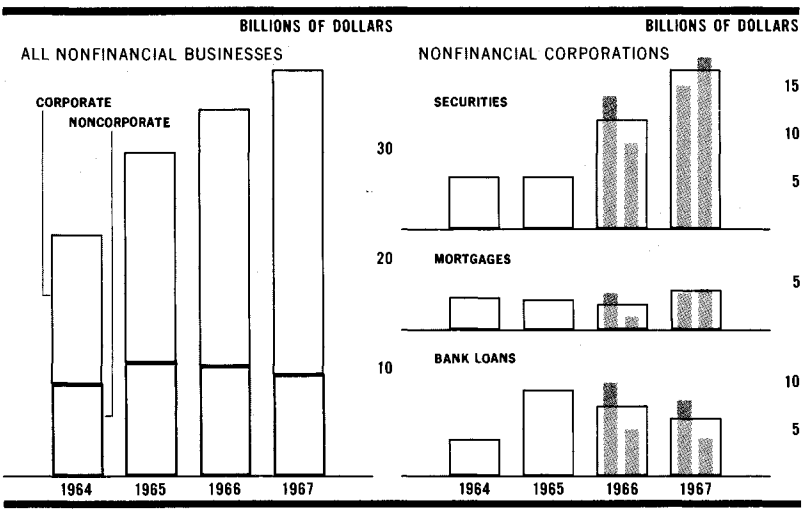
Until the closing months of the year, corporate demands centered on the public bond market, and the volume of issues offered there was more than double the previous record amount sold in 1966. Meanwhile, reflecting the constraints on new-commitment activity in 1966, the volume of issues placed privately with institutional investors was the smallest in several years. Late in the year, however, private placements increased and the pace of public offerings slowed.

In addition to raising an unprecedented volume of funds through security issues, nonfinancial corporations obtained a record amount of mortgage credit and increased the sale of their open market paper, in part to commercial banks. Even so, they obtained less financing from banks than in either of the two preceding years. Relatively large direct borrowing at banks occurred mainly around Federal income tax payment dates in the spring and near the year-end when inventory investment accelerated. But even at

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these times, such borrowing was well below the rate reached in the spring of 1966. Acceleration of Federal income tax payments caused a much larger drain on corporate funds in 1967, but to meet this drain corporations relied mostly on other sources of funds, including their own liquid assets, rather than on bank loans.

6 | CORPORATE NONFINANCIAL BUSINESSES borrow more in '67 as security issues rise to record levels



Flow of funds data. All nonfinancial businesses represent domestic corporate and noncorporate (including farm) nonfinancial businesses; total funds raised by them exclude trade debt and miscellaneous liabilities. Bank loans include bank acquisitions of commercial paper and domestic acceptances. Half-year data are at seasonally adjusted annual rates. Data for the second half of 1967 are preliminary.

The marked shift toward long-term financing in 1967 reflected, among other things, the fact that nonfinancial corporations were trying to improve their liquidity positions by reducing their dependence on short-term funds and by rebuilding liquid balances. However, despite the 80 per cent expansion in security market and mortgage financing between the second half of 1966 and the first half of 1967, liquid asset holdings were reduced and the conventional measure of corporate liquidity—the ratio of

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liquid assets to total current liabilities—continued to decline as the drop in profits in the first quarter and very large tax payments in the second put pressure on liquid funds. Thus, the only way in which corporations may be said to have improved their liquidity positions over the first half of the year was in lengthening the average maturity of their debt.

But over the second half of the year the liquidity ratio probably stabilized and may even have risen a little more than seasonally. Holdings of liquid assets increased—and by more than the reduction in the first half. For the year as a whole, liquid asset holdings of nonfinancial corporations rose by about $2 billion—a moderate amount but the largest annual increase since 1963. Increases in time deposits and holdings of open market paper were more than enough to offset reductions in demand deposits and holdings of U.S. Government securities.

State and local governments. Net borrowing by State and local governments in 1967 rose sharply from the reduced pace of the previous year—to more than $10 billion—despite postponements of substantial amounts of new issues in the final months of the year in reaction to the high level of interest rates in capital markets. With the level of interest rates high, the volume of refunding issues continued to be negligible and nearly all of the increase in borrowing by State and local governments was used for capital outlays.

Some portion of the expanded borrowing by States and their subdivisions represented issues that had been postponed in 1966 because of high interest rates and the congestion in the capital markets. The relative facility with which issues were marketed during most of 1967 reflected not only the generally increased availability of credit but also the return of commercial banks to the market for tax-exempt issues. In 1966 commercial banks had diverted their reduced supply of funds from such investments to loans to their established customers, but in 1967—with their deposit inflows expanded and loan demands relatively modest—banks purchased municipals at a record rate.

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Another factor leading to the record supply of new issues was the explosive growth in industrial revenue bonds—aggregating more than twice the already large volume of 1966. Such borrowing was accelerated in large part by expectations that the tax-exempt feature of these issues might be eliminated.

Perhaps the most important cause of rising credit demands by State and local governments was the declining adequacy of current revenues for financing their usual share of capital outlays. Cutbacks in Federal spending in 1967 sharply reduced the growth of grants-in-aid to State and local governments—such aid had been a source of increasing revenue to these units in recent years. Meanwhile these governments found that the costs of their operations were continuing to rise faster than their tax revenues. As a result, a significant portion of capital outlays normally financed from revenues had to be financed with borrowed funds. This shortfall of revenue, along with rising costs of borrowed funds and greater interest on the part of commercial banks in liquid assets, also contributed to a very large expansion in short-term borrowing by States and their political subdivisions.

State and local governments in recent years have supplied a significant volume of funds to credit markets through purchases of securities by their employee pension funds. Continuing the earlier trends to maximize income, most of the asset growth of such pension funds in 1967 took the form of higher-yielding corporate bonds. For the second consecutive year purchases of such bonds by State and local governments were larger than those by the previously dominant private insurance and pension fund sector.

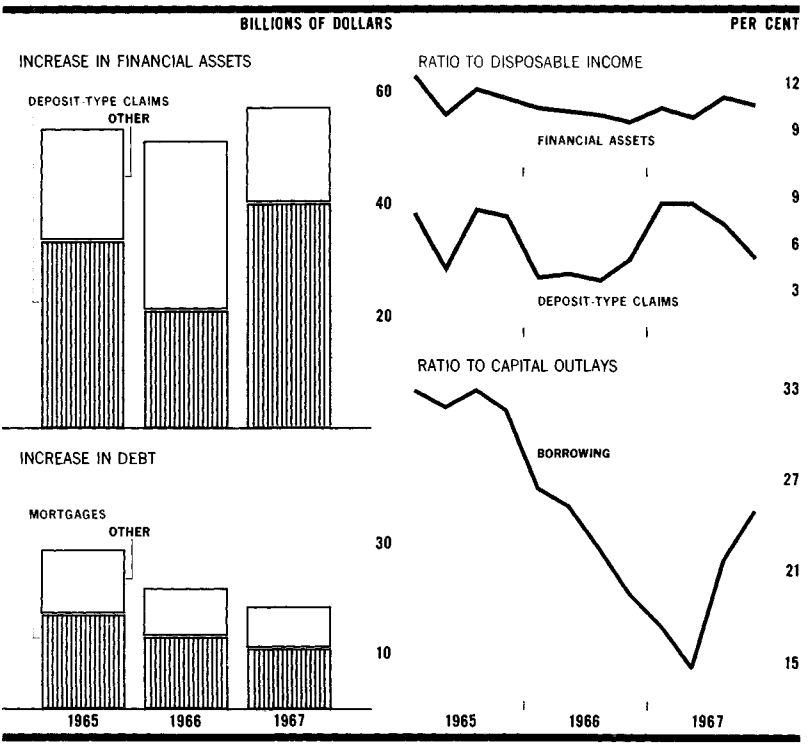
Consumers. With incomes rising at a relatively rapid rate and expenditures for housing and durable goods moderate, consumers increased their acquisitions of financial assets rapidly in 1967. In the first half of the year they liquidated market securities at a fast pace—shifting funds to the more liquid and relatively more attractive deposit-type instruments offered by financial institutions. With the renewed rise in market yields, how-

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ever, claims on financial institutions became somewhat less attractive in the final months of 1967. Consequently, consumers reduced their rate of acquisitions of such claims as they shifted to market securities.

Despite the increased availability of credit, consumers reduced their rate of net borrowing in credit markets for the third straight

7 | CONSUMERS accelerate their acquisitions of financial assets--especially deposits--and borrow less



Flow of funds data. Consumer sector includes nonprofit institutions. Increase in financial assets excludes investment in noncorporate business and is less net security credit. Deposit-type claims are demand deposits and currency and interest-bearing, deposit-type claims on commercial banks and other financial institutions. Ratios to disposable income are based on acquisitions of financial assets and changes in deposit-type claims. Borrowing/capital outlays is consumer borrowing by mortgages, consumer credit, and bank and other loans (except security credit) divided by value of residential construction, nonprofit plant and equipment outlays, and outlays for consumer durable goods. All ratios are based on quarterly totals at seasonally adjusted annual rates. Data for fourth quarter of 1967 are preliminary.

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year. This reduced borrowing reflected, to a large extent, the continued slower rate of growth in mortgage credit, particularly in the early part of 1967 when housing completions and starts were still unusually low and when turnover of existing homes had only just begun to regain momentum. However, nonmortgage borrowing by consumers also expanded at a relatively slow pace.

Consumer purchases of durable goods other than housing expanded in 1967, but the share of such purchases financed on credit was smaller than in earlier years. Indeed, while extensions of instalment credit rose rapidly after the spring, repayments also accelerated, and as a result the increase in instalment debt was the smallest in 3 years. Repayments on instalment debt in 1967 appear to have been buoyed by prepayments as consumers found their financial positions improved. Partly because an increasing share of their saving was used to repay debt, consumer acquisitions of financial assets—while large—did not rise so fast relative to income as they had in 1965 when both borrowing and acquisitions of financial assets by consumers were particularly large.

Rest of the world. Financial flows between the United States and the rest of the world increased sharply in 1967, although the net outflow did not change much.

Net outflows of U.S. private and U.S. Government loans and investments increased, as noted in the discussion of the balance of payments on pages 37–45 above. There was an increase also in the inflow of foreign private investments, partly to acquire outstanding U.S. equity securities, and partly to buy securities issued by U.S. companies to finance investments in their affiliates abroad. On the other hand, the U.K. authorities liquidated in 1967 a considerable amount of U.S. securities other than Treasury issues. Foreign purchases of more than $1 billion of gold were largely offset by a $1 billion increase in Federal Reserve and Treasury liquid claims in convertible currencies. Offsetting

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an increase from 1966 to 1967 in the net outflow balance of all the foregoing categories of capital, as well as an increase in unidentified outflows, additions to foreign holdings of liquid and near-liquid assets in the United States were about $3 billion greater in 1967 than in 1966.

Additions to the foreign holdings of such assets were about $5 billion, compared with about $2 billion the year before. Among the principal components of the 1967 inflow were an increase of more than $1 billion in U.S. banks' demand and time liabilities to foreign central banks and governments, an increase of $1.3 billion in their balances due to commercial banks abroad, and an increase of $0.4 billion in their deposit liabilities to other private persons abroad. Foreign net acquisitions of U.S. Government securities, including special issues, exceeded $2 billion. These purchases were made mainly by central banks and governments and were especially large in the fourth quarter.

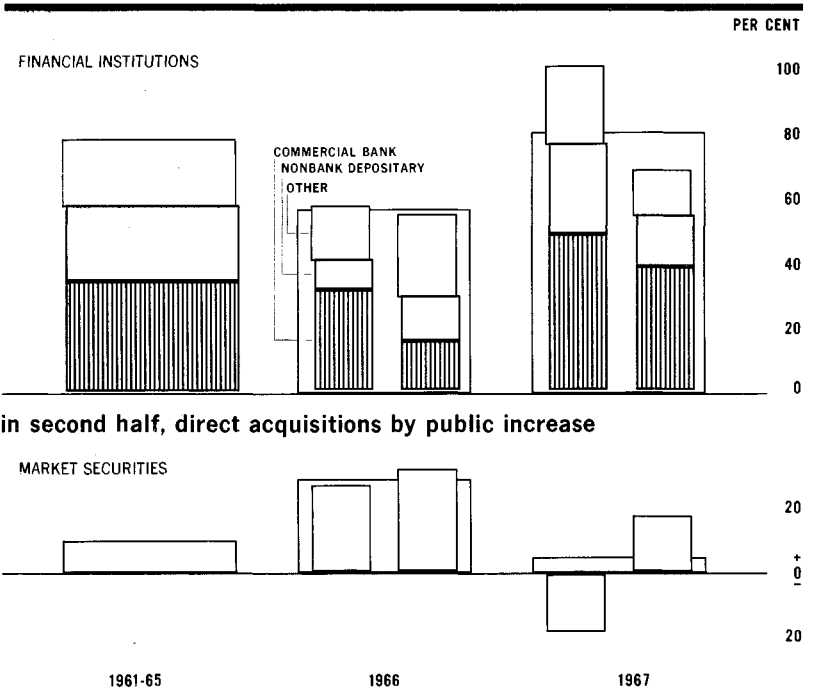
FINANCIAL INTERMEDIATION

During 1967 financial institutions as a group supplied about 80 per cent of the total funds raised in financial markets—reversing the unusually sharp decline in 1966 when institutions' share of total lending fell as the public shifted funds away from financial institutions to direct investment in market securities. In 1967 the increase in the relative attractiveness of claims on intermediaries, the public's preference for liquid assets, and the higher rate of consumer saving increased net inflows of funds to all types of financial institutions. As a group, however, these institutions allocated a large share of these inflows first to rebuilding liquidity depleted in 1966 and then—for both liquidity and yield considerations—to market securities other than mortgages.

Toward the year-end, rising yields on market securities tended to reduce the pace of inflows to financial institutions. But with short-term yields still below those of 1966, inflows of funds to these institutions as a whole remained considerably larger than during the more difficult periods of the previous year.

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8 FINANCIAL INSTITUTIONS supply larger share of total credit flows in '67, but . . .



Flow of funds data. Nonbank depositary institutions are savings and loan associations, mutual savings banks, and credit unions. Other nonbank financial institutions are made up mainly of life and other insurance companies and pension funds but also include finance companies, open-end investment companies, and miscellaneous institutions. Funds supplied directly by the public reflect acquisitions of market securities (less security credit) by domestic consumers, nonfinancial businesses, and State and local governments. Not shown are funds supplied by the F.R. System, other parts of the U.S. Govt., and foreigners. Data for half years are at seasonally adjusted annual rates and for second half of 1967 are preliminary.

Commercial banks. After relatively modest growth in 1966, loans and investments at commercial banks expanded in 1967 at a postwar record pace of 11 per cent. Credit extended by banks accounted for more than 40 per cent of total credit flows—their largest share in over a decade. The growth reflected not only the stance of monetary policy but also the increased attractiveness of bank deposits relative to alternative financial assets, and the efforts of the nonfinancial sectors to rebuild liquidity.

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Time deposits. With the decline in money market yields in late 1966, time deposits at banks again became relatively attractive instruments, and inflows of such deposits accelerated to a rate of almost 16 per cent for the full year, about twice that of 1966. All forms of interest-bearing deposits—passbook savings accounts, negotiable CD's, and other time deposits—shared in the expansion.

The most rapid increase in time deposits occurred early in the year, when banks aggressively sought to recover the funds they had lost by attrition of CD's in the late summer and fall of 1966. By maintaining relatively attractive offering rates, banks increased their outstanding negotiable CD's to a new record in the first quarter of 1967. In the spring, however, with loan demands modest, other deposit inflows strong, and substantial improvement in bank liquidity, offering rates on CD's were reduced to relatively low levels at the same time that corporate liquidity was being drawn down in order to meet accelerated tax payments. Consequently, outstanding CD's showed no growth in the second quarter. Over the first half some banks also took steps—including reductions in rates—to moderate their inflows of other forms of time deposits. But in the aggregate, growth in consumer-type time deposits remained large.

As short-term market rates of interest began to rise around midyear, some banks raised their offering rates on consumer-type deposits and on large negotiable CD's. Moreover, with growing expectations of rising interest rates and heavier demands for loans, the increase in offering rates and the aggressiveness of banks in seeking deposits were most pronounced for CD's with longer maturities. The volume of outstanding CD's expanded rapidly over the summer, and at the same time large banks increased their borrowings of Euro-dollars at the relatively low prevailing rates.

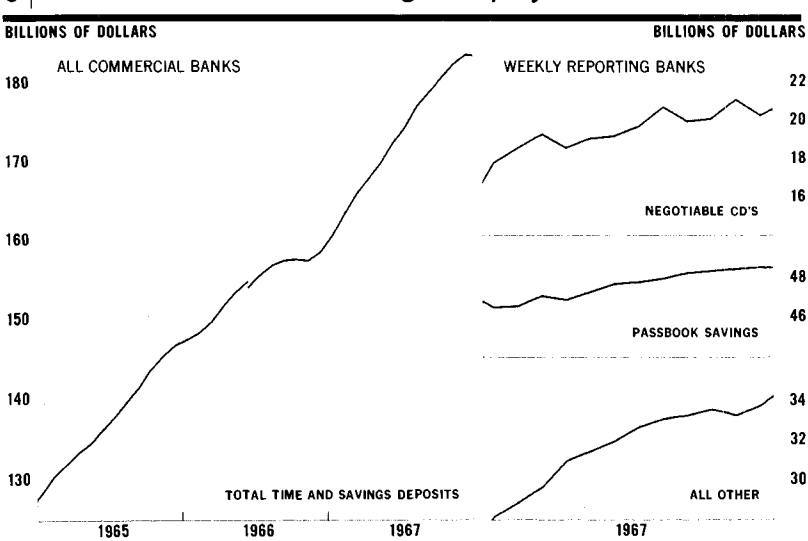
During the autumn, inflows of consumer-type deposits began to moderate as consumers shifted some funds into increasingly attractive market securities. Moreover, as short-term market in-

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terest rates continued to rise, offering rates on CD's began to approach their Regulation Q ceiling of 5½ per cent.

By late autumn longer-maturity CD's paying 5½ per cent became increasingly noncompetitive, and the average maturity of new CD's sold shortened considerably. After the devaluation of sterling and the increase in the Federal Reserve discount rate in November, offering rates of 5½ per cent on CD's became available throughout the maturity spectrum. At the year-end the average maturity of outstanding CD's at weekly reporting banks was 2.9 months, compared with 3.8 months in the spring. In addition, in the final weeks of 1967, the very large volume of CD's that were maturing and the increasing inability of banks to issue CD's in any maturities except the shortest term produced somewhat more than seasonal attrition in CD's, and inflows of other forms of time deposits continued to slacken.

9 | DEPOSITS at commercial banks grow rapidly



Total time and savings deposits are seasonally adjusted monthly averages of daily figures and exclude domestic interbank and U.S. Govt. deposits. Effective June 6, 1966, balances accumulated for payment of personal loans were reclassified for reserve purposes; such deposits are excluded thereafter. Data for weekly reporting banks are as of the last Wednesday of the month and are not seasonally adjusted.

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Demand deposits. Private demand balances were also a major source of bank funds in 1967. Such deposits had declined after the late spring of 1966, but in 1967 they expanded at a rate of nearly 7 per cent; during the spring and summer months their rise was very rapid. To a large degree, this increase reflected efforts of the public to rebuild deposits from the low levels to which they had been reduced during the period of restrictive monetary policy in 1966. It is also likely that corporations, particularly in the fall, were trying to build up their compensating balances in order to insure bank credit availability in 1968. As market yields continued to rise, however, efforts to economize on cash contributed to a cessation of growth in demand balances in the final weeks of the year.

U.S. Treasury balances, as usual, fluctuated widely during 1967. Larger expenditures by the Treasury, new patterns of tax receipts, and large cash financings contributed to fluctuations in both Government and private demand deposits. The Treasury's balances with commercial banks were drawn down to very low levels at midyear, in part as a result of the redemption of a large amount of debt in late June. After midyear, these balances were rebuilt by an unusually large volume of Treasury cash financing, which contributed to rapid expansion of bank credit through October. But by the end of 1967 Government deposits had again declined to relatively low levels, and the rate of expansion of bank credit had tapered off considerably.

Bank credit. With demands for loans small relative to deposit inflows and with banks making efforts to improve their liquidity positions, somewhat over half of the increase in bank assets during 1967 took the form of securities. Holdings of securities expanded at a record rate, whereas total loans grew at the slowest pace since 1960–61.

The expansion in total loans at commercial banks over the entire year 1967 was only a little smaller than in the previous year. However, business loans grew considerably less than in the period 1965 through the summer of 1966 as corporations increased their reliance on market financing and reduced the pace

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of inventory investment. The most rapid increase in business loans occurred in the first half of the year when the accelerated schedule of income tax payments greatly expanded the needs of corporations for funds; in the second half such loans expanded at two-thirds of their pace in the first half of the year—with some acceleration in December.

Other loans, on the other hand, expanded faster in the second half of the year than in the first. Real estate loans accelerated in the spring, and at about the same time the pace of lending to consumers increased. Loans to finance companies, which had declined from mid-1966 to the midsummer of 1967, also showed a moderate growth during the late summer and fall as the cost of market financing by these institutions began to approach the cost of bank loans; this increase, however, was halted by the increase in the bank prime rate late in November. Finally, with the shift in Treasury operations—from debt redemption in the first half to a large volume of new cash financing in the second—banks' security loans increased quite sharply in the summer and fall in contrast to net repayments earlier in the year.

In the securities segment of banks' portfolios, acquisitions of Treasury issues were the largest since 1958, and purchases of other securities were at record rates. The extent of the growth was associated with several factors, including the relatively modest demand for bank loans at a time when deposit inflows to banks were extremely large.

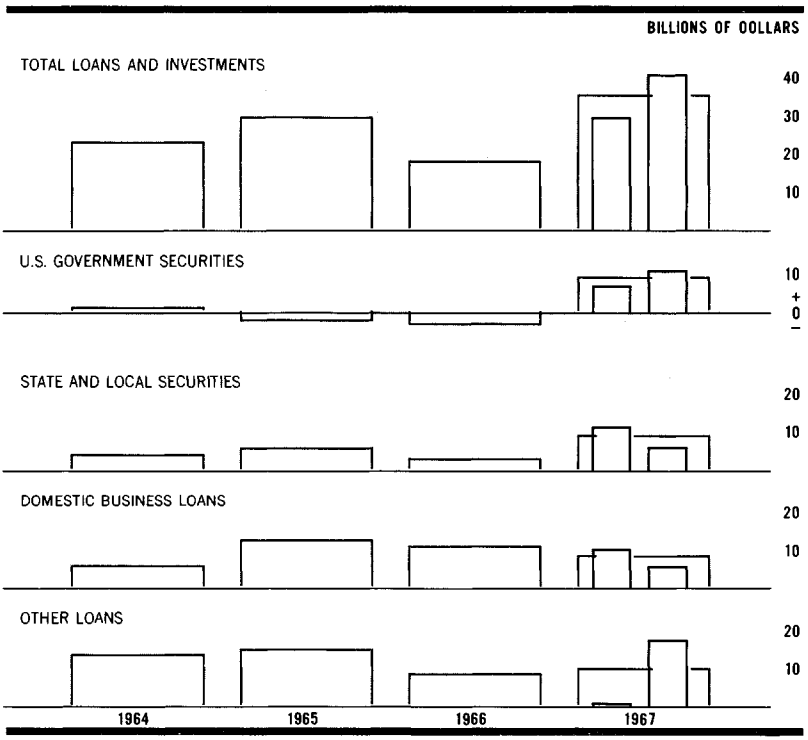
Like other financial institutions, banks had a desire to regain portfolio liquidity, which had been depleted in 1966 by heavy demands for loans at a time of restrictive monetary policy. It is difficult to quantify bank liquidity precisely, but such an indicator as the loans-to-deposits ratio fell in 1967. Moreover, banks not only increased their holdings of short-term Treasury and municipal issues but also added to their holdings of such liquid assets as acceptances and commercial and finance company paper—which are included as loans in banking statistics.

The interest of banks in accumulating liquid assets, while aimed in large part at regaining the liquidity depleted in 1966,

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was also associated with growing expectations of increased demand for loans and of greater monetary restraint as the year progressed—expectations that also strengthened banks' desires to obtain long-term time deposits. The mildness of the business

10 BANK CREDIT accelerates in '67; securities account for more than half of the increase



Flow of funds data. U.S. Govt. securities include nonguaranteed debt of the U.S. Govt. and loan participation certificates. Business loans are to all domestic nonfinancial businesses and include commercial paper and domestic acceptances. Half-year data are at seasonally adjusted annual rates; those for second half of 1967 are preliminary.

pause early in 1967, the rapidity of the recovery, the large financing needs of the Federal Government, and widespread belief that credit demands might be large in 1968, all suggested to many banks that efforts to increase liquidity constituted a prudent

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portfolio policy—particularly since they were still so conscious of their 1966 experience. Indeed, nonprice lending policies and terms were not relaxed much in 1967, despite the reduced demand for loans. The prime lending rate at banks had been reduced from 6 to 5½ per cent in the early months of 1967, but it was returned to 6 per cent after the November increase in the discount rate and a rise in the cost of bank funds from other sources.

Finally, bank demands for securities were augmented by very attractive yields on these securities—particularly on municipals. For the year as a whole, bank purchases of tax-exempt securities were equal to more than 80 per cent of the net borrowing by State and local governments. Banks also found the new issues of Treasury securities very attractively priced, and in the second half of 1967 they acquired an amount equal to more than one-third of these new issues.

Nonbank financial institutions. Financial institutions other than commercial banks also supplied an increased volume of credit in 1967. Nevertheless, their share of total credit supplied—while above that of 1966—remained less than it had been earlier in the 1960's. This reflected not only the greater relative success of commercial banks in obtaining deposits from the public but also the fact that savings and loan associations used an unusually large share of their increased inflows in early 1967 to repay loans obtained from the FHLB during the 1966 period of credit stringency.

Depositary institutions. Share accounts at savings and loan associations rose sharply in 1967, despite the general slowing of inflows toward the year-end. At the same time, net inflows of deposits to mutual savings banks—which, due to earlier upward adjustments in deposit rates, had begun to recover after mid-1966—rose to new records. As in the case of the savings and loan associations, however, rising yields on market instruments after midyear also tended to moderate inflows to these banks.

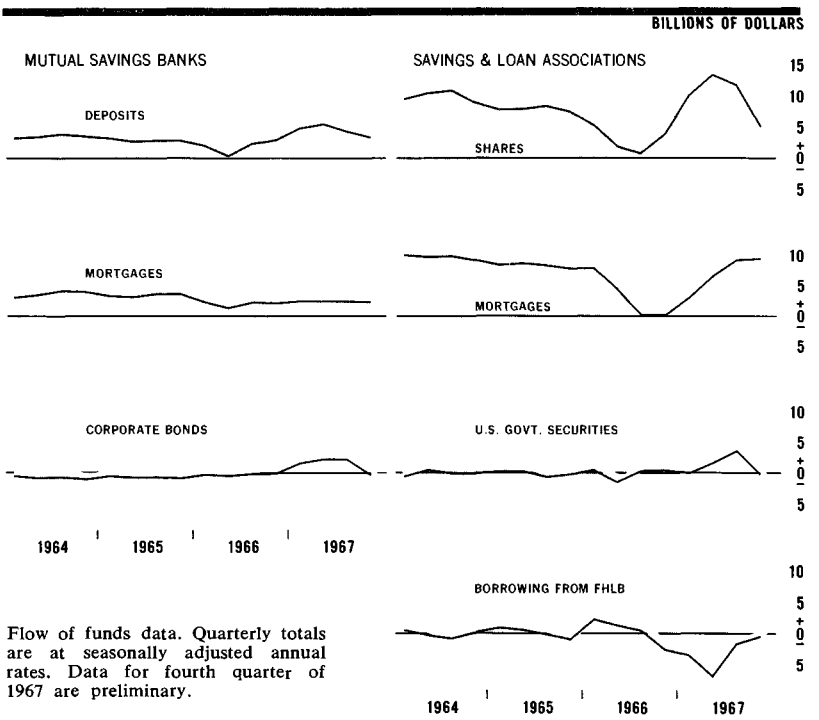
Savings and loan associations used a large proportion of their

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inflows in 1967 to rebuild their depleted liquidity. As noted above, they made large repayments to the FHLB, especially during the first half of the year, and during the year as a whole they repaid almost all of the funds they had borrowed since 1963. Moreover, during the spring and summer the associations made record acquisitions of U.S. Government securities, thereby achieving a marked improvement in their portfolio liquidity.

As a result, acquisitions of mortgages by the savings and loan associations increased much less rapidly than share inflows over most of the year. This difference in rate of growth stemmed not only from the liquidity priority of the associations but also from

11 Inflows of funds at NONBANK INSTITUTIONS accelerate in '67, but acquisitions of mortgages lag as institutions restore liquidity



Flow of funds data. Quarterly totals are at seasonally adjusted annual rates. Data for fourth quarter of 1967 are preliminary.

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the inevitably long lag between commitments and acquisitions, especially after a year such as 1966 when construction activity had lost considerable momentum and stocks of new housing units had been substantially reduced. But commitments began to rise in early 1967 and by August had returned to relatively normal levels. Indeed, with inflows higher and commitments rising, by midyear the associations had regained their dominant position in the mortgage market.

Mutual savings banks, even with record inflows of deposits during most of 1967, increased their net acquisitions of mortgages relatively little from the 1966 pace. Instead they expanded their acquisitions of corporate bonds; net purchases of these securities in the single year 1967 approached the total for the previous two decades. The interest shown by savings banks in corporate bonds was stimulated by the attractive yields on these securities, which made them increasingly competitive with mortgage investments as the year progressed. Moreover, since the bulk of the corporate bonds acquired were publicly traded, portfolio marketability of such banks was also enhanced by this shift.

Average rates paid on savings claims at both mutual savings banks and insured savings and loan associations increased in the first half of 1967 from the second half of 1966. While increases at these institutions were smaller than those during 1966, they raised rates to levels that were much more competitive with market yields, as reflected by the strength of net inflows during the first half of the year.

In July, few changes were made in offering rates by FDIC-insured mutual savings banks. Savings and loan associations, however, were affected by regulatory changes on both regular and special accounts that lowered rate ceilings by 25 basis points in 10 States. Reflecting these rate-ceiling amendments, average offering rates on both types of accounts at savings and loan associations decreased in July. At both types of institutions, however, over half of the insured members in July were offering rates below regulatory ceilings on regular accounts.

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During the remainder of 1967, there were no further changes in rate ceilings and although yields on market instruments increased significantly, offering rates changed little at both types of institutions. The special rate-control authority enacted by Congress in the fall of 1966 was extended for another year beginning September 21, 1967.

Other institutions. While the contractual nature of inflows of new funds to life insurance companies tends to insulate such inflows from immediate shifts in market pressures, the investment options of these companies are relatively broad. Consequently, investment allocation at any particular time is influenced more by considerations of comparative yield than it is at thrift institutions—particularly at savings and loan associations. Thus, in 1967 the shifting structure of yields produced further changes in the types of assets acquired by life insurance companies; similarly, the unexpected drain of lendable funds at these companies in 1966 had affected asset acquisitions in that year.

Flows of investment funds through life insurance companies in 1967 resumed the more stable pattern prevailing before 1966, although they were still being influenced by the level of market interest rates. For example, with their cost to the borrower still less than that on most other types of credit, loans to policy holders took about 9 per cent of the lendable funds of life insurance companies in 1967. While this was less than the 20 per cent of cash flows used for the same purpose in the third quarter of 1966, the share was higher than in the first half of the decade as a whole. Moreover, with interest rates high, flows of funds from prepayments of existing mortgage investments remained small. Life insurance companies, like other mortgage lenders, found not only that borrowers seemed reluctant to prepay existing mortgages but also that refinancings of existing mortgages remained quite limited under conditions of rising interest rates; turnover of used homes, though substantially improved, also continued to be relatively inhibited.

Still, the supply of funds available to life insurance companies

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for lending was somewhat larger than in 1966, and the new commitments of such companies for investments increased at an accelerating pace from the low level at the beginning of the year. However, to an even greater extent than for mutual savings banks, life insurance companies—in their quest for higher yields—shifted both their commitments and their acquisitions from home mortgages to mortgages on income properties, and from mortgages in general to corporate securities. Indeed, the largest increase in portfolios in 1967 was in holdings of domestic corporate bonds; the dollar amount of such holdings expanded more rapidly than mortgages for the first time in almost a decade. Moreover, life insurance companies increased their acquisitions of publicly offered bonds relative to privately placed issues. With the attractive yields that prevailed on quality-rated public issues during the year, gains in portfolio marketability were made at yields close to those historically available on private issues, for which quality ratings are not available.

The volume of new commitments, which had reached very low levels in late 1966 and early 1967, surged after that and carried outstanding commitments of life insurance companies to new highs by late autumn. But continuing the trend that had begun in 1966, the funds covered by more than half of the new commitments would not become available until at least 6 months after the date of the commitment—reflecting in large part the size of demands relative to cash flows. Even so, with the moderation in policy loans and the gradual build-up of new commitments, the 1967 relationship between expected cash flows and outstanding commitments was far more comfortable than it had been from late 1965 through 1966.

Other kinds of insurance companies and private pension funds made no large changes in portfolio allocations during 1967. Fire and casualty insurance companies, which are subject to higher tax rates than life insurance companies, stepped up their purchases of municipal bonds and reduced their acquisitions of corporate bonds. Pension funds used a larger proportion of their

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inflows to buy equities and reduced the proportion used to buy bonds. In view of the fact that more funds were available in the market and at other institutions, business firms reduced their debt to finance companies in the first half of the year. As a result of this and of reduced borrowings by consumers, credit granted by finance companies showed the smallest increase since 1961. Under these circumstances, finance companies not only repaid bank loans but also borrowed less in the open market.

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PART II

Records, Operations, and Organization

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RECORD OF POLICY ACTIONS OF THE BOARD OF GOVERNORS

February 28, 1967

Amendment to Regulation D, Reserves of Member Banks.

The Supplement to Regulation D was amended to reduce reserve requirements from 4 per cent to 3 per cent against savings deposits, Christmas and vacation club accounts, and the first $5 million of other time deposits at each member bank. The reduction was made in two steps: the first, from 4 to 3½ per cent, effective with the reserve computation period beginning March 2, 1967; and the second, from 3½ to 3 per cent, effective with the reserve computation period beginning March 16, 1967.

Votes for this action: Messrs. Martin, Robertson, Shepardson, Mitchell, Maisel, and Brimmer.
Votes against this action: None.

Economic and financial conditions prevailing at the time this action was taken are described in some detail in the record of policy actions of the Federal Open Market Committee, presented elsewhere in this ANNUAL REPORT. In brief, the economy had been displaying weakening tendencies since prior to the turn of the year. Production schedules were being adjusted to reduce excessive inventories, investment in new plant facilities was falling, and consumer spending for durable goods was declining.

In these circumstances the Federal Reserve moved to a more expansive monetary policy. Open market operations were undertaken to supply reserves generously, thereby permitting member banks to reduce their borrowings, enabling them to begin to restore liquidity positions, and supporting a rapid expansion of bank credit. The reduction in reserve requirements was a complementary easing action, designed to assist in meeting developing credit needs throughout the country in a manner consistent with the policy objective of assuring adequate credit availability to provide for orderly economic growth.

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The action was so structured as to achieve a greater relative reduction in reserve requirements at the many smaller member banks spread throughout the banking system. Of the total amount of reserves released by the action, approximately $500 million accrued to country member banks and the remainder—about $350 million—to reserve city banks.

March 13, 1967

Revision of Regulation M, under the title Foreign Activities of National Banks, and amendments to Regulation K, Corporations Engaged in Foreign Banking and Financing under the Federal Reserve Act.

Effective March 15, 1967, the Board adopted a revision of Regulation M and conforming amendments to Regulation K, principally to implement Section 12(b) of Public Law 89-485.

Votes for this action: Messrs. Martin, Robertson, Shepardson, Mitchell, Maisel, and Brimmer. Votes against this action: None.

The principal purpose of the revision of Regulation M was to add two new sections covering the purchase by national banks of stock of foreign banks and loans to such banks by the national banks, as permitted under an amendment to Section 25 of the Federal Reserve Act contained in Public Law 89-485, approved July 1, 1966. (Under applicable law, Regulation M generally applies also to State-chartered banks that are members of the Federal Reserve System.)

One of the new sections of the revised Regulation authorized national banks, with the permission of the Board, to acquire the stock of foreign banks. However, the total amount of such investments was limited to not more than 25 per cent of the capital and surplus of the investing U.S. bank taken together with its capital investments, if any, in so-called Edge and agreement corporations operating pursuant to Sections 25 and 25(a) of the Federal Reserve Act.

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The other new section of the revised Regulation authorized U.S. banks having a direct or indirect stock investment in foreign banks to make loans or extensions of credit to such foreign banks without regard to the provisions of Section 23A of the Federal Reserve Act.

The revision also amended Regulation M to increase to $50,000, from $20,000, the amount of credit permitted to be extended by a foreign branch of a U.S. bank to an executive officer of such branch for the purpose of acquiring or constructing living quarters for his use abroad.

The amendments to Regulation K were adopted in the interest of bringing about conformity between the two regulations.

April 6, 1967

Decrease in rates on discounts and advances by Federal Reserve Banks.

Effective April 7, 1967, the Board approved actions taken by the Boards of Directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco establishing a rate of 4 per cent (a decrease from 4½ per cent) on discounts and advances to member banks under Sections 13 and 13a of the Federal Reserve Act.

Votes for this action: Messrs. Martin, Robertson, Shepardson, Mitchell, Daane, Maisel, and Brimmer. Votes against this action: None.

Pursuant to the policy established by this action, the Board subsequently approved the same rate for the Federal Reserve Bank of Atlanta effective April 10, 1967, and for the Federal Reserve Bank of St. Louis effective April 14, 1967.

Effective the same dates the Board approved for the respective Federal Reserve Banks a rate of 4½ per cent on advances to member banks under Section 10(b) of the Federal Reserve Act. In addition, the Board approved decreases at most of the Banks in rates on advances to individuals, partnerships, and corporations other than member banks under the last paragraph of Section 13 of the Act.

(In accordance with provisions of the Federal Reserve Act, the Federal

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Reserve Banks are required to establish rates on discounts for and advances to member banks at least every 14 days and submit such rates to the Board for review and determination. Prior to this date no changes had been made in such rates since those referred to on pages 63–70 of the Board's ANNUAL REPORT for 1965. Certain proposed rate changes were disapproved by the Board in 1966, as described on pages 94–97 of the Board's ANNUAL REPORT for 1966.)

The implementation, through open market operations and a reduction of reserve requirements, of a policy of monetary ease during the early months of 1967 enabled banks to achieve more comfortable reserve positions. This was accompanied by a marked decline in interest rates, particularly in the short-term area. Over the first 3 months of the year the 3-month Treasury bill rate dropped from around 4.80 per cent to nearly 4 per cent, while the Federal funds rate declined from around 5.50 per cent to about 4 per cent.

The action to decrease the discount rate by ½ percentage point to a level of 4 per cent was taken in order to move that rate into closer alignment with the reduced level of money market rates. Moreover, in a period of hesitation in economic expansion such a reduction in the discount rate was in keeping with the general Federal Reserve policy objective of assuring adequate credit availability to provide for orderly economic growth.

April 20, 1967

Amendment to Regulation F, Securities of Member State Banks.

Effective April 20, 1967, Regulation F was amended to permit the use of a new form designed to simplify registration requirements under certain circumstances.

Votes for this action: Messrs. Martin, Shepardson, Daane, and Maisel. Votes against this action: None.

The purpose of this amendment was to authorize use of a simplified form for registration of additional classes of securities

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of a member State bank in cases where most of the information necessary for the protection of investors in securities of the bank was already publicly available.

May 15, 1967

Amendment to Regulation O, Loans to Executive Officers of Member Banks.

Effective July 1, 1967, Regulation O was amended to exclude from its coverage certain types of indebtedness of executive officers arising from the use of charge accounts and credit-card or check-credit plans.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

The purpose of the amendment was to exclude from the coverage of Section 22(g) of the Federal Reserve Act and of Regulation O certain indebtedness of an executive officer to a bank, other than his own bank, arising out of the use of charge accounts and credit-card or check-credit plans. The amendment also excluded an executive officer's indebtedness to his own bank arising from such transactions (except in the case of a particular indebtedness that would involve prior individual clearance or approval by his bank going beyond routine confirmation of the right to incur such indebtedness required of all participants in the general plan), but in no event to the extent that the aggregate amount of his indebtedness exceeded $1,000.

Because of its impersonal nature, indebtedness of the type covered by the new exclusion was not regarded as falling within the general intent of Section 22(g) of the Federal Reserve Act. However, in order to guard against possible abuse or evasion of the basic purposes of the law, certain limitations were prescribed

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in the case of indebtedness of an executive officer to his own bank.

July 20, 1967

Revision of Regulation J, under the title Collection of Checks and Other Items by Federal Reserve Banks, and revocation of Regulation G, Collection of Noncash Items.

Effective September 1, 1967, the Board adopted a revision of Regulation J and revoked Regulation G.

> Votes for this action: Messrs. Robertson, Mitchell, Maisel, Brimmer, and Sherrill. Votes against this action: None.

The new Regulation J replaced the previous Regulations G and J, which related, respectively, to the collection of noncash items and the collection of checks and other cash items. This combination had the advantage of avoiding repetition while at the same time insuring a precise interlock between the provisions relating to cash items and those relating to noncash items.

In general, the revision of Regulation J brought the regulatory provisions into closer conformity with the check collection provisions of the Uniform Commercial Code and with developments in banking practices. It also clarified and described in more precise language the terms and conditions under which checks and other items would be received and handled for collection by the Federal Reserve Banks.

In connection with the adoption of the new Regulation, the Federal Reserve Banks revised their operating circulars governing the details of collection operations, also effective September 1, 1967.

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November 13, 1967

Revision of foreign credit restraint program guidelines.

Effective November 16, 1967, the Board issued revised guidelines for banks and nonbank financial institutions cooperating with the President's program of voluntary foreign credit restraint to improve the nation's balance of payments.

Votes for this action: Messrs. Robertson, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

During 1967 the financial community had continued to cooperate effectively with the President's voluntary foreign credit restraint program. Foreign credits of commercial banks increased far less in the first three quarters of the year than would have been permitted by the program guidelines; on September 30 the banks were $783 million below the end-of-1967 target ceiling. Foreign claims of nonbank financial institutions subject to the guidelines for such institutions declined by $76 million (3.9 per cent) during the first 6 months of 1967, and at the end of June those institutions were $57 million below the target ceiling.

Nevertheless, since the U.S. balance of payments position had not improved during 1967, it was considered necessary to continue the voluntary effort to reduce the outflow of private capital. Accordingly, the Board issued revised guidelines for financial institutions.

The changes in the commercial bank guidelines were designed to tighten somewhat the over-all restraint on the flow of bank capital abroad, restrict further growth in nonexport credits to developed countries of continental Western Europe, provide more equitable treatment for banks that had small bases on December 31, 1964, and give further stimulus to export financing.

The program for nonbank financial institutions remained substantially the same as that for 1967. However, the target ceiling applicable to assets covered by the guidelines was increased somewhat for 1968, and reporting requirements were modified to reduce the number of reporting institutions.

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November 18, 1967

Increase in rates on discounts and advances by Federal Reserve Banks.

Effective November 20, 1967, the Board approved actions taken by the Boards of Directors of the Federal Reserve Banks of Boston, New York, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco establishing a rate of 4½ per cent (an increase from 4 per cent) on discounts and advances to member banks under Sections 13 and 13a of the Federal Reserve Act.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

Pursuant to the policy established by this action, the Board subsequently approved the same rate for the Federal Reserve Bank of Philadelphia effective November 21, 1967, and for the Federal Reserve Bank of St. Louis effective November 27, 1967.

Effective the same dates the Board approved for the respective Federal Reserve Banks a rate of 5 per cent (an increase from 4½ per cent) on advances to member banks under Section 10(b) of the Federal Reserve Act. In addition, the Board approved increases at all of the Banks in rates on advances to individuals, partnerships, and corporations other than member banks under the last paragraph of Section 13 of the Act.

(In accordance with provisions of the Federal Reserve Act, the Federal Reserve Banks are required to establish rates on discounts for and advances to member banks at least every 14 days and submit such rates to the Board for review and determination. Prior to this date the most recent rate changes were made in April 1967, as described on pages 74 and 75 of this ANNUAL REPORT.)

On November 18 the British Government announced a reduction in the par value of the pound sterling from $2.80 to $2.40. Later that day—against the background of growing inflationary pressures in the United States, but more specifically as a modest precautionary move in a situation of grave international uncertainties—the Board approved an increase of ½ percentage point in the discount rate to a level of 4½ per cent, effective November 20, for all Federal Reserve Banks whose directors

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had acted not later than November 19 to establish the higher rate. By the afternoon of November 19 the directors of 10 Reserve Banks had fixed the 4½ per cent rate, and the announcement made by the Board so indicated.

The action on the discount rate was undertaken, in combination with appropriate open market operations, to help assure the continued orderly functioning of U.S. financial markets and to maintain the availability of reserves to the banking system on terms and conditions that would foster sustainable economic growth at home and a sound international position for the dollar. At the same time the Board expressed its confidence in the basic economic and financial strength of the United States and pledged to do its full share in maintaining the soundness of the dollar both domestically and internationally. In addition, the Board affirmed that borrowing by member banks for purposes of making adjustments to market pressures was an appropriate use of the discount mechanism.

In the course of this action, the Board of Directors of the Federal Reserve Bank of New York at first established a rate of 5 per cent on discounts and advances under Sections 13 and 13a. However, that rate was disapproved by the Board of Governors, on the ground that a more moderate response to the existing situation was appropriate. The New York Board then acted to fix the Bank's rate at 4½ per cent, and that rate was approved by the Board of Governors.

November 29, 1967

Amendments to Regulation F, Securities of Member State Banks.

Effective December 31, 1967, Regulation F was amended to add a definition of "beneficial ownership" and a provision relating to inclusion of minority stockholder proposals in a bank's proxy soliciting material.

Votes for this action: Messrs. Robertson, Maisel, Brimmer, and Sherrill. Votes against this action: None.

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Diversity had been noted in the reporting of ownership of bank stock held by members of families of directors, officers, and principal stockholders of banks subject to Regulation F. This had occurred not only in stock-ownership reports required to be filed by such persons pursuant to Section 16(a) of the Securities Exchange Act but also in registration statements and proxy statements required to be filed by banks pursuant to Sections 12 and 14 of the Act. In the interest of uniform disclosure, the Board incorporated a definition of the term "beneficial ownership" in Regulation F.

In the light of experience gained since Regulation F was adopted in 1964, the Board also determined that it would be in the public interest to adopt requirements relating to presentation of stockholder proposals in a bank's proxy soliciting material. The new provisions were designed to promote corporate democracy and at the same time to provide reasonable rules covering relationships between bank management and minority stockholders.

December 27, 1967

Amendment to Regulation D, Reserves of Member Banks.

The Supplement to Regulation D was amended to increase reserve requirements against demand deposits in excess of $5 million at any one bank from 16½ per cent to 17 per cent for reserve city banks, effective with the reserve computation period beginning January 11, 1968, and from 12 per cent to 12½ per cent for other member banks, effective with the reserve computation period beginning January 18, 1968.

Votes for this action: Messrs. Martin, Robertson, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

In the closing months of 1967, with inflationary pressures increasing following the termination of strikes in the auto and other industries, and with pressure on the international position of the dollar intensifying after the devaluation of the pound ster-

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ling, monetary policy was shifted toward a less expansive stance. Overt Federal Reserve action initially took the form of an increase of ½ percentage point in the discount rate in November. In December, as prices continued to advance rapidly, as losses from the U.S. gold stock mounted, and as the U.S. international trade balance diminished, Federal Reserve open market operations were adjusted in support of the less expansionary monetary policy.

The December 27 action to increase member bank reserve requirements was an additional coordinated step in furtherance of the Federal Reserve's general policy objective, namely, the fostering of financial conditions conducive to the resistance of inflationary pressures and progress toward reasonable equilibrium in the U.S. balance of international payments. The action was designed to affect primarily the larger member banks—about 2,000 in number—doing the great bulk of the nation's banking business. The resulting increase in required reserves was estimated to total approximately $360 million at reserve city banks and $190 million at other member banks, bringing about a corresponding decrease in funds that might otherwise have been used for loans and investments. The effective dates for the increase in percentage requirements were selected to coincide with a period when needs for reserves would normally be declining from their pre-Christmas peak.

December 29, 1967

Revision of foreign credit restraint program guidelines.

Effective January 1, 1968, the Board adopted revised guidelines for 1968 for the use of banks and nonbank financial institutions in limiting foreign credits as part of the President's new balance of payments program.

Votes for this action: Messrs. Martin, Robertson, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

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The revised guidelines were a part of and were announced simultaneously (on January 1, 1968) with the President's new program to strengthen the U.S. balance of payments. The guidelines, substantially more restrictive than those issued on November 16, 1967, were designed to achieve a net inflow of capital of at least $500 million during 1968. The intent was to focus the major effect of the reduction in outstanding credits on the developed countries of continental Western Europe without adverse effects on credits necessary to finance U.S. exports or on credits to developing countries.

For banks whose 1968 ceilings had previously been set at 109 per cent of the amount of foreign credits they had outstanding on December 31, 1964, the ceiling for 1968 would now be 103 per cent. For other banks with smaller bases, whose ceilings had been set at 2 per cent of their total assets on December 31, 1966, the 1968 ceiling would now be an amount equal to their 1967 ceiling plus one-third of the addition to that ceiling envisaged in the original 1968 guidelines.

Banks were also asked to reduce outstanding loans with maturities of 1 year or more to developed countries of continental Western Europe by not renewing such loans at maturity, and by not relending the repayments of such loans to residents of those countries. The guidelines requested also that short-term loans to developed countries of continental Western Europe be reduced during 1968 by 40 per cent of the amount outstanding on December 31, 1967, at a rate of not less than 10 percentage points in each quarter. The ceilings of the individual banks involved would be further reduced during 1968 by the amount of repayments received on term loans to developed countries of continental Western Europe, plus an amount equal to 40 per cent of the short-term credits to such countries outstanding on December 31, 1967.

The revised guidelines for nonbank financial institutions requested that holdings of foreign assets covered by the program be reduced during 1968 by 5 per cent or more compared with

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the amount of such assets held on December 31, 1967. It was expected that holdings of deposits and money market instruments abroad would be reduced to zero, or to the minimum working balance required to conduct foreign business activities, even if that entailed a reduction of covered foreign assets by more than 5 per cent. Nonbank financial institutions were requested to refrain from making any new loans or investments in developed countries of continental Western Europe other than those judged essential for the financing of U.S. exports.

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RECORD OF POLICY ACTIONS OF THE FEDERAL OPEN MARKET COMMITTEE

The record of policy actions of the Federal Open Market Committee is presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of Section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each such action, and that it shall include in its ANNUAL REPORT to the Congress a full account of such actions.

In the pages that follow, there are entries with respect to the policy actions taken at the meetings of the Federal Open Market Committee held during the calendar year 1967, including the votes on the policy decisions made at those meetings as well as a résumé of the basis for the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings, rather than on data as they may have been revised later.

It will be noted from the record of policy actions that in some cases the decisions were by unanimous vote and that in other cases dissents were recorded. The fact that a decision in favor of a general policy was by a large majority, or even that it was by unanimous vote, does not necessarily mean that all members of the Committee were equally agreed as to the reasons for the particular decision or as to the precise operations in the open market that were called for to implement the general policy.

As noted on page 341, the Federal Open Market Committee adopted a revision of its Rules relating to the availability of information to the public, effective July 4, 1967. Under the revised rules, the policy record for each meeting is released approximately 90 days following the date of the meeting and is subse-

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quently published in the *Federal Reserve Bulletin* as well as in the Board's ANNUAL REPORT.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market activities the Federal Reserve Bank of New York operates under two separate directives from the Open Market Committee—a continuing authority directive and a current economic policy directive. In the foreign currency area it operates under an authorization for System foreign currency operations and a foreign currency directive. These four instruments are shown below in the form in which they were in effect at the beginning of 1967. Subsequent revisions in the current economic policy directive are shown in the records for each meeting held during the year. A revision in the continuing authority directive is shown in the policy record for the meeting of March 7, 1967, and revisions in the authorization for System foreign currency operations are shown in the records for the meetings of May 23, July 18, November 14, November 27, and December 12.

CONTINUING AUTHORITY DIRECTIVE WITH RESPECT TO DOMESTIC OPEN MARKET OPERATIONS
(in effect January 1, 1967)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such

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securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed $125 million or 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York;

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

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for

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the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate ¼ of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

CURRENT ECONOMIC POLICY DIRECTIVE
(in effect January 1, 1967)

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing to expand, with rising defense expenditures but with additional evidences of moderating tendencies in the private economy. While there has been some slowing in the pace of advance of most broad price measures, upward price pressures persist for many finished goods and services. Bank credit and money have shown no net expansion in recent months. Although demands on bond markets have increased, upward pressures on long-term interest rates have moderated. The balance of payments remains a serious problem. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions conducive to noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be resuming a rapid rate of expansion.

AUTHORIZATION FOR SYSTEM FOREIGN CURRENCY OPERATIONS
(in effect January 1, 1967)

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

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

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

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

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

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

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

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

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

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

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

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

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account with the following foreign banks, which are among those designated by the Board of Governors

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of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Maximum period of arrangement (months)
Austrian National Bank	100	12
National Bank of Belgium	150	12
Bank of Canada	500	12
Bank of England	1,350	12
Bank of France	100	3
German Federal Bank	400	6
Bank of Italy	600	12
Bank of Japan	450	12
Netherlands Bank	150	3
Bank of Sweden	100	12
Swiss National Bank	200	6
Bank for International Settlements:		
System drawings in Swiss francs	200	6
System drawings in authorized European currencies other than Swiss francs	200	6

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

4. It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the

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administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

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

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

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

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

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

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

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

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

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

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FOREIGN CURRENCY DIRECTIVE
(in effect January 1, 1967)

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

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

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

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

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

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

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

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

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

C. To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension, (2) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, and (3) market rumors of a character likely to stimulate speculative transactions.

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Whenever exchange market instability threatens to produce disorderly conditions, System transactions may be undertaken if the Special Manager reaches a judgment that they may help to reestablish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. In such cases, the Special Manager shall consult as soon as practicable with the Committee or, in an emergency, with the members of the Subcommittee designated for that purpose in paragraph 6 of the Authorization for System foreign currency operations; and

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

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

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

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JANUARY 10, 1967

Authority to effect transactions in System Account.

Expansionary forces in the economy were moderating as 1966 ended, and business inventory/sales ratios had risen substantially. With inventory accumulation expected to slow, a reduced rate of over-all economic growth appeared likely in the first quarter of the new year.

Gross national product was estimated to have increased substantially in the fourth quarter of 1966, but much of the advance appeared to reflect the sharp rise in inventory accumulation. Growth slackened in consumer spending for goods, in business capital outlays, and, apparently, in Federal defense expenditures. The downtrend in residential construction activity that had begun in the spring of 1966 continued in the fourth quarter, although in November housing starts recovered most of their sharp October decline. Industrial production was little changed during the quarter at about the level reached in August, as output curtailments in such industries as steel, construction materials, automobiles, and some household appliances offset continued gains in certain other industries. There had been some rise recently in claims for unemployment compensation, but labor market conditions generally remained strong in the closing months of 1966.

With respect to the outlook for the first quarter of 1967, prospective business efforts to hold down the pace of inventory accumulation appeared likely to lead to a marked slowing of the growth rate in GNP, to some decline in industrial production, and to a moderate increase in the unemployment rate from the level of around 3.8 per cent that had prevailed recently. Defense outlays were expected to remain an expansive influence, although the evidence available at the time of this meeting suggested some further slackening in the growth of such spending as well as in business capital outlays. On the other hand, the extended decline in residential construction was expected to level out in the first quarter as a result of improvement in mortgage markets. Yields

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on home mortgages touched a record high in November, the latest month for which data were available, but net inflows of funds to savings and loan associations and other major mortgage lenders had recovered recently, and there were indications of some actual or prospective easing in the supply of mortgage funds.

The pace of advance of broad price measures had slowed recently; indeed, the wholesale price index declined in November for the second successive month, to a level 2.3 per cent above a year earlier, as a further reduction in prices of foodstuffs more than offset a small increase in prices of industrial commodities. The earlier succession of substantial increases in consumer prices was broken in November, when retail food prices declined somewhat and the total index rose by only one-tenth of 1 per cent. However, unit labor costs in manufacturing had risen further in recent months, as a result both of more rapid increases in average hourly earnings and of smaller gains in productivity.

Tentative estimates indicated some deterioration in the U.S. balance of payments in the fourth quarter of 1966, as an apparent improvement in the merchandise trade surplus was more than offset by an indicated worsening on capital account. While full information was not yet available on fourth-quarter developments, it appeared that the deficit on the "liquidity" basis of calculation had increased despite substantial special receipts from Germany at the year-end, and that the balance on the "official reserve transactions" basis had reverted to deficit even though there had been large net inflows of liquid funds through foreign branches of U.S. banks during the quarter.[1] Abroad, the German

[1] The balance on the "liquidity" basis is measured by changes in U.S. reserves and in liquid U.S. liabilities to all foreigners. The balance on the "official reserve transactions" basis is measured by changes in U.S. reserves and in liquid and certain nonliquid liabilities to foreign official agencies, mainly monetary authorities. The latter balance differs from the former by (1) treating changes in liquid U.S. liabilities to foreigners other than official agencies as ordinary capital flows, and (2) treating changes in certain nonliquid liabilities to foreign monetary authorities as financing items rather than as ordinary capital flows.

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Federal Bank announced a reduction in its discount rate, from 5 per cent to 4½ per cent, effective January 6, 1967.

System open market operations since the preceding meeting had been directed at achieving somewhat easier conditions in the money market against a background of year-end seasonal churning. Net borrowed reserves of member banks fluctuated widely over the four statement weeks ending January 4, but on the average they were somewhat smaller than in the preceding 4 weeks—about $170 million, as compared with $215 million. The market yield on 3-month Treasury bills declined more than 20 basis points to 4.80 per cent in the third week of December and subsequently remained near that level. Other money market rates declined less, partly for seasonal reasons and partly because large financing needs of Government security dealers added to demands for short-term funds.

A buoyant atmosphere pervaded bond markets in recent weeks, as signs of moderating tendencies in the economy continued to appear and as it became increasingly evident to market participants that monetary policy had shifted toward less restraint—a view reinforced by the System's action on December 27, 1966, rescinding the letter of September 1 to member banks regarding lending to business and discount window administration.[2] Despite large recent and prospective offerings of corporate and municipal securities and a recent public sale of $600 million of participation certificates by the Federal National Mortgage Association, yields on Treasury, corporate, and municipal bonds all declined, with yields on long-term Treasury bonds returning to about their levels at the end of 1965, following the increase in the discount rate. Near the end of January the Treasury was expected to announce the terms on which it would refund securities maturing in mid-February, of which about $3.8 billion were held by the public.

[2] For the text of the September 1 letter, see the Federal Reserve BULLETIN for September 1966, pp. 1338-39; for the text of the December 27 announcement, see the BULLETIN for January 1967, p. 83.

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The recent declines in security yields were accompanied by resumed expansion in commercial bank credit and private deposits. Bank credit, which had declined on balance since August, increased substantially between the last Wednesdays of November and December. The increase was attributable primarily to expansion in holdings of Government securities and in short-term loans to security dealers and brokers, as banks acted to rebuild their sharply reduced liquidity positions. Business loans did not rise, apparently because of both a continuation of restrictive lending policies and some further weakening in demands for such loans.

Time and savings deposits expanded relatively fast in December following slow growth since August, when banks began to experience sizable runoffs of negotiable certificates of deposit (CD's). Although a record volume of CD's matured in December, banks were able to increase the net volume outstanding somewhat as declines in market yields on competitive instruments, particularly Treasury bills, enhanced the relative attractiveness of CD's to investors. Expansion in the money supply (private demand deposits plus currency outside of banks), which had resumed in mid-November after a period of irregular decline beginning in July, continued in December, reflecting in large part a reduction in Government deposits at commercial banks. In 1966 as a whole the money supply increased by a little less than 2 per cent, compared with a 4.7 per cent rise in 1965.

Staff projections at the time of the Committee's preceding meeting had suggested that there would be relatively little increase from November to December in daily-average deposits of member banks—the "bank credit proxy" [3]—if the then-exist-

[3] Since mid-1966 the Committee had been making increased use of daily-average statistics on total member bank deposits as a "bank credit proxy"—that is, as the best available measure, although indirect, of developing movements in bank credit. Because they can be compiled on a daily basis with a very short lag, the deposit figures are more nearly current than available bank loan and investment data. Moreover, average deposit figures for a calendar month are much less subject to the influence of single-date fluctuations than are the avail-

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ing money market conditions were maintained. But with easier conditions prevailing in the latter part of the month, these deposits increased at an annual rate of 3.4 per cent in December as a whole.

Current staff projections suggested that member bank deposit expansion would increase temporarily to an annual rate in the 7 to 9 per cent range on the average during January (largely as a result of expansion that had occurred around the turn of the year), and to a somewhat more rapid rate in that month if there were some further easing of money market conditions. All of the projected increase in January was in time and savings deposits and Government deposits; private demand deposits were expected to decline somewhat, resulting in little or no growth in the money supply.

In the Committee's discussion it was noted that appropriate monetary policy over coming months would depend importantly on the nature of Federal fiscal policies. For the immediate future, however, in light of the continued slackening of various expansionary forces in the economy and the prospect for slower overall growth in early 1967, the Committee decided that it would be desirable to relax monetary restraint somewhat further. The members agreed that the renewed expansion in bank credit and the money supply in December was appropriate; and a majority, taking note of the staff projections for the money supply and for member bank deposits, thought that somewhat easier money market conditions should be sought unless bank credit appeared to be expanding significantly faster than expected.

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able month-end data on total bank credit, which represent estimates of loans and investments at all commercial banks on one day—the last Wednesday—of each month. For statistics on daily-average member bank deposits, see the Federal Reserve BULLETIN for October 1966, p. 1478, and subsequent months. Some brief comments on the relation between the member bank deposit series and the bank credit statistics are given in the note on p. 1460 of the October 1966 BULLETIN.

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The Committee agreed that the forthcoming Treasury financing should be taken into account in the conduct of open market operations, although it was expected that the financing would be a routine one and that requirements for maintaining an "even keel" in the money market would not come into play until late in the month. Some sentiment was expressed for extending System reserve-supplying security purchases in intermediate- and longer-term Treasury securities, both to stimulate flows of funds into longer-term markets, including mortgage markets, and—for balance of payments reasons—to avoid depressing short-term interest rates unduly.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate further moderation in various expansionary forces and sharply increased inventory accumulation. The pace of advance of broad price measures has slowed, although upward price and cost pressures persist for many finished goods and services. Partly reflecting the recent modification of monetary policy, financial market conditions have become less taut than earlier and bank credit expansion has resumed. With respect to the balance of payments, trends in international transactions indicate a continuing serious problem. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions conducive to noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, and taking account of forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be expanding significantly faster than currently anticipated.

Votes for this action: Messrs. Martin, Brimmer, Clay, Daane, Hickman, Maisel, Mitchell, Robertson, and Wayne. Votes against this action: Messrs. Irons, Shepardson, and Treiber.

The members dissenting from this action thought that it would be preferable not to relax monetary restraint further at this time.

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Among the considerations they advanced were the continuing balance of payments problem and the desirability of awaiting further information on prospective Federal taxes and expenditures before changing monetary policy further. Individual dissenting members also expressed the judgments that, despite present indications of slower economic growth early in 1967, the longer-run prospects for the economy were not weak; and that the rate at which member bank deposits were expected to grow in January, given no change in money market conditions, was appropriate.

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FEBRUARY 7, 1967

Authority to effect transactions in System Account.

The pace of economic expansion continued to moderate in early 1967, according to reports at this meeting. Tentative estimates indicated that industrial production had declined somewhat in January and that, with sales of new automobiles falling further, total retail sales had failed to increase. Layoffs and short workweeks continued to be reported in the automobile industry and in some consumer appliance industries, but the labor market as a whole apparently remained strong.

Staff projections suggested that expansion in GNP would be at a sharply slower pace in the first half of 1967 than in 1966. Inventory accumulation was expected to decline markedly from its recent advanced rate, slower growth was anticipated in defense spending and business capital outlays, and only a small increase was expected in real takings of goods by consumers. On the other hand, it appeared likely that the substantial decline in residential construction would end and that State and local government outlays would continue to expand.

Projections by the Council of Economic Advisers, contained in its recent annual report, also indicated slowing of the economic advance in the first half of 1967. The Council expected expansion to accelerate in the second half of the year, when it anticipated a strong rise in residential construction, an end to the decline in the rate of inventory investment, and a rise in transfer payments (primarily as a result of a proposed increase at midyear in social security benefits). The Council foresaw a sizable stimulus from fiscal policy in the first half of the year, but the administration's budget recommendations provided for a shift in the direction of fiscal restraint at midyear in the form of a 6 per cent surcharge on income tax liabilities of individuals and corporations.

In December the wholesale price index was stable and the

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consumer price index again rose by only one-tenth of 1 per cent. Effective February 1, the minimum wage was increased and its coverage extended under the terms of legislation enacted in 1966. Unit labor costs in manufacturing were estimated to have been 2.7 per cent above their year-earlier level in the fourth quarter of 1966, and it appeared likely that such costs would continue to rise.

The deficit in the U.S. balance of payments on the "liquidity" basis of calculation was estimated to have been at an annual rate of about $2 billion in the fourth quarter of 1966, despite larger dollar receipts from various official transactions. For the full year the deficit on this basis was estimated at $1.4 billion. On the "official reserve transactions" basis there was a small deficit in the fourth quarter but a surplus of $175 million for the year. Partial data for January indicated a continued sizable deficit on both bases of calculation. Liabilities of U.S. banks to their foreign branches declined in late December and early January, but remained well above their level in the spring of 1966.

Abroad, interest rates had declined substantially from their recent peaks in the Euro-dollar market and in various national markets. The Bank of England reduced its discount rate from 7 to 6½ per cent on January 26, and subsequently the central banks of Canada, Belgium, and Sweden reduced their discount rates by varying amounts.

Open market operations since the last meeting of the Committee had been directed at attaining somewhat easier conditions in the money market. Net borrowed reserves averaged about $60 million in January and member bank borrowings about $475 million, compared with $190 million and $530 million, respectively, in December. Rates on Federal funds moved generally lower, and they fell sharply in the last week of January when float rose temporarily in the wake of a severe snowstorm in the midwest. The yield on 3-month Treasury bills declined further, from 4.80 per cent 4 weeks earlier to less than 4.50 per cent,

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although by the time of this meeting it had backed up slightly. Rates on other short-term instruments also moved significantly lower. A major New York City bank reduced its prime lending rate from 6 to 5½ per cent on January 26, and subsequently many other banks lowered their prime rates, but generally to 5¾ per cent.

Long-term security yields also had declined sharply further in recent weeks. Yields on new corporate bonds reached their lowest levels since April 1966, and those on Treasury and municipal bonds fell to levels prevailing prior to the increase in the discount rate in December 1965. Although the market atmosphere became cautious at times, mainly because of reports of a growing calendar of corporate and municipal offerings, sentiment was buoyed by various developments. These included the evidences of further easing of monetary policy; the President's statement—in his State of the Union message of January 10—that he was proposing a surcharge on income taxes and would strive to lower interest rates; and the reductions in discount rates by foreign central banks and in prime rates by domestic commercial banks. Activity in the stock market was extremely heavy, and prices of common stocks advanced virtually without interruption after the first of the year.

On January 25 the Treasury announced that it would refund securities maturing in mid-February with a cash offering of two new securities, a 15-month note and a 5-year note, both bearing 4¾ per cent coupons and priced to yield 4.85 and 4.84 per cent, respectively. With market yields declining, the new issues were heavily oversubscribed. The Treasury was expected to announce in late February or early March an offering of tax-anticipation bills due in June, and a large volume of Federal agency securities and participation certificates was expected to be marketed before midyear.

Net inflows of savings funds to depositary-type institutions increased considerably in late 1966 and early 1967, and conditions

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in markets for home mortgages appeared to have eased further recently. The rate of new mortgage commitments still appeared to be lagging, however, as many institutions used a large part of the inflows to improve their liquidity positions. Housing starts declined less than seasonally in December, but the annual rate remained relatively low.

The rate of increase in total bank credit between late December and late January was the highest since mid-1966. Banks substantially increased their holdings of municipal and Federal agency securities and their loans to businesses and security dealers. The sharp rise in business loans, following 5 months of slow net growth, was in part a reflection of a temporary concentration of corporate needs for funds to make accelerated tax payments.

Growth in time and savings deposits, which had resumed in December, accelerated in January. The increase was centered in large-denomination negotiable CD's, which became increasingly attractive to investors as yields on competitive market instruments declined. The net increase in such CD's outstanding at weekly reporting banks was at a record high in January, and in the 6 weeks after mid-December such banks recovered more than two-thirds of the runoff they had experienced in the preceding 4 months. The average maturity of new issues of CD's was lengthened significantly in January for the first time since mid-1966, and recently many banks had reduced their offering rates on CD's.

As a result of the marked increase in time deposits—together with a substantial rise in Government deposits, which was offset in part by a decline in private demand deposits—the bank credit proxy (daily-average member bank deposits) rose more from December to January than had been expected, even in the light of the easing of money market conditions that had occurred. New staff projections suggested that, if money market conditions remained unchanged, bank credit as measured by the proxy series

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would rise at an annual rate of about 9 to 11 per cent from January to February. The projections allowed for continued rapid growth in time deposits, resumed growth in private demand deposits, and some decline in Government deposits.

The Committee decided that it would be appropriate at this time to maintain the easier money market conditions achieved under the policies adopted at the three preceding meetings, unless bank credit appeared to be deviating significantly from its expected course. Various reasons were advanced by individual members against a further deliberate relaxation of monetary policy at present. These included the recent and projected growth rates of bank credit, which some members considered to be at about the upper end of a desirable range in the current circumstances; the likelihood that much of the impact on the economy of the policy actions already taken was still to come; the risk that unduly rapid easing might necessitate a sharp reversal of policy later in the year; the possibility that speculative excesses would be encouraged by continued increases in prices of fixed income securities; and concern about the implications of rising labor costs for the foreign trade balance and of declining domestic interest rates for international capital flows. The current Treasury financing also was mentioned, although "even keel" considerations were considered less important than usual in view of the market reception of the new securities.

At the same time, in light of the short-run economic outlook there was considerable sentiment for "leaning toward ease" in open market operations. In particular, the Committee agreed that efforts should be made to resist any sharp rises in interest rates but that rates should be permitted to decline if market forces worked in that direction. It was noted in this connection that the recent declines in interest rates had reflected expectational factors to an important extent, and that long-term rates were particularly vulnerable at present to a change in expectations.

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The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate further moderation in various expansionary forces, with continued large inventory accumulation. The pace of advance of broad price measures has slowed, although upward price and cost pressures persist for many goods and services. Interest rates have declined markedly, financial conditions generally are considerably easier, and bank credit expansion recently has been vigorous. While interest rates abroad have also declined, trends in international transactions indicate a continuing serious balance of payments problem. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, and taking account of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing conditions of ease in the money market, but operations shall be modified as necessary to moderate any apparently significant deviations of bank credit from current expectations.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Clay, Daane, Hickman, Irons, Maisel, Robertson, Shepardson, and Wayne. Vote against this action: Mr. Mitchell.

Mr. Mitchell dissented from this action because he favored moving somewhat further toward ease. He was inclined to give more credence to the present expectations for a weaker economic performance in the first half of the year than to those for a stronger performance in the second half, and he thought that the major economic risk for the immediate future was that a downturn in over-all economic activity might be precipitated by the expected inventory adjustment.

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MARCH 7, 1967

1. Authority to effect transactions in System Account.

Evidences of marked slowing in the pace of economic expansion were reported at this meeting. In February, according to tentative estimates, industrial production fell for the second consecutive month, sales of new automobiles decreased sharply further, and total retail sales declined from their reduced December–January level. Although the unemployment rate remained at 3.7 per cent in January, signs of easing demands for labor were beginning to appear in such sensitive indicators as the length of the workweek in manufacturing, claims for unemployment insurance, and indexes of "help wanted" advertisements. On the other hand, residential construction activity turned up in January, after 10 months of decline, as conditions in mortgage markets continued to ease.

Staff projections of GNP for the first half of 1967, which earlier had suggested a sharply reduced rate of growth, had been lowered somewhat further and now implied only moderate increases in dollar GNP and little rise in real output of goods and services. A large reduction in the rate of business inventory accumulation was still expected, although there was little evidence as yet to suggest that the adjustment had begun; in January, with retail sales sluggish, inventories of manufacturers rose sharply further despite cutbacks in production, and manufacturers' stock/sales ratios advanced to the highest levels since 1961. Defense spending was expected to continue increasing, although at a slower rate; and residential construction outlays were expected to be about the same in the first quarter as a whole as in the fourth quarter of 1966, and to rise in the second quarter. However, continuing lack of strength in consumer demands for durable goods was suggested by a Census Bureau survey taken in mid-January, which found that smaller proportions of consumers were planning to buy new cars and household durable

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goods than was the case a year earlier. It was indicated that a Department of Commerce–Securities and Exchange Commission survey, taken in February, would show that businesses planned to make outlays on new plant and equipment in the first half of 1967 at a rate no higher than that actually recorded in the fourth quarter of 1966.

The consumer price index was unchanged in January, but average wholesale prices of both industrial commodities and foodstuffs rose. Advance estimates for February suggested that average prices of industrial commodities had remained stable in that month and that prices of foodstuffs had declined somewhat. Unit labor costs in manufacturing rose sharply further in January.

With respect to balance of payments developments, capital outflows from the United States had increased relatively little recently despite the easing of domestic monetary conditions. On the other hand, revised data indicated that the surplus on U.S. merchandise trade had not improved in the fourth quarter of 1966, as had been reported earlier. Growth in imports, which previously appeared to have leveled off in late 1966, was now shown to have continued at a reduced rate through January 1967, and estimates of growth in exports in the fourth quarter had been revised downward. Prospects still favored improvement in the trade surplus over coming months, when slowing inventory accumulation was expected to reduce the demand for imports.

Abroad, economic activity had been slackening for several months in a number of industrial countries, including the United Kingdom and Germany, and monetary and fiscal policies were being relaxed somewhat. The German Federal Bank, which along with the Bank of England and a number of other central banks had reduced its discount rate earlier in the year, announced a further reduction, from 4½ to 4 per cent, on February 17. Reserve requirements of German commercial banks were lowered effective March 1.

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Conditions in domestic financial markets had passed through two distinct phases since the preceding meeting of the Committee, with a period of firmer money markets, congested bond markets, and rising long- and short-term interest rates followed by a period of easier financial conditions and declining rates. Shifts in expectations of market participants contributed importantly to these developments.

Early in the period concern developed about the viability of the levels to which interest rates had fallen, in view of a steady stream of additions to an already large calendar of corporate and municipal security issues, large inventories of securities held by underwriters, and rumors of renewed sales of FNMA participation certificates. Moreover, market participants began to reappraise the prospects for monetary policy, partly because of congressional testimony by various officials suggesting a strengthening of economic forces in the second half of the year. A belief that the trend of monetary policy toward greater ease had been halted, and perhaps reversed, was strengthened by the development of firmer conditions in the money market, as reflected by increases in rates on Treasury bills and Federal funds and advances in lending rates to Government securities dealers posted by major New York City banks. The System injected a large volume of reserves through open market operations in an effort to cope with these firming tendencies, but operations were complicated by persistent shortfalls of reserve availability from initial projections.

Subsequently, money market conditions again turned easier, earlier expectations regarding monetary policy were gradually restored, and long-term interest rates—particularly on Treasury securities—declined somewhat. These developments were initially stimulated by large-scale official purchases of Treasury securities on February 24 in conjunction with arrangements undertaken to avoid a rise in the Federal debt above the legal ceiling, and by concurrent purchases of bills for System Account to supply reserves. The view that monetary policy was still trend-

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ing toward ease was reinforced on February 28 when the Board of Governors announced a reduction in member bank reserve requirements for the purpose of meeting developing credit needs throughout the country. Reserve requirements against savings deposits and the first $5 million of other time deposits at each member bank were reduced in two successive steps: from 4 to 3½ per cent, and then to 3 per cent, effective with the reserve computation periods beginning March 2, 1967, and March 16, 1967, respectively.

By the day before this meeting the yield on 3-month Treasury bills had fallen to about 4.35 per cent, roughly 20 basis points below its level at the time of the preceding meeting, and other money market conditions in general were about as easy as they had been 4 weeks earlier. In February as a whole, member bank borrowings averaged about $365 million, compared with $475 million in January; and excess reserves exceeded borrowings by about $35 million, in contrast with a net borrowed reserve position of about $65 million in the preceding month.

Following congressional approval of legislation raising the temporary debt ceiling on March 1, the Treasury announced that $2.7 billion of tax-anticipation bills due in June would be auctioned on March 7, the day of this meeting. Treasury cash balances were expected to reach relatively low levels before the March 13 payment date for these bills, and it was possible that the Treasury would need to borrow directly from the Federal Reserve for short periods.

Bank credit expanded further between the last Wednesdays of January and February, although apparently at a rate below that of the two preceding months. Banks used the additions to their reserves mainly to improve their liquidity positions; acquisitions of securities continued heavy, but business loans increased relatively little and total loans declined. Time and savings deposits grew sharply further on the average from January to February, although the rate of expansion moderated considerably over

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the course of the latter month as large money market banks became less aggressive sellers of negotiable CD's. Private demand deposits and the total money supply rose, after declining in January, and Government deposits at commercial banks were about unchanged.

Daily-average member bank deposits—the bank credit proxy—increased at an annual rate of about 15 per cent from January to February, more than had been expected. Most of the rise occurred early in February, when time deposits were growing rapidly. New staff projections for March suggested that growth in the proxy would be at an annual rate of about 6 to 8 per cent if money market conditions were unchanged, and somewhat larger if money market conditions were eased somewhat further. It appeared unlikely that banks would resume aggressive selling of negotiable CD's in the near future, in view of their large CD sales in recent months and the uncertain outlook for loan demands following the March and April dividend and tax dates. Accordingly, time deposits were projected to expand considerably less on the average in March than in February. The projections also allowed for a substantially higher average level of private demand deposits, reflecting sharp increases late in February, and some decline in the average level of Government deposits.

The Committee agreed that somewhat easier money market conditions were desirable at present to combat the effects of weakening tendencies in the economy, and that still easier conditions should be sought if bank credit appeared to be expanding significantly less than expected. Individual members mentioned various intermediate objectives, including those of encouraging sustained growth in the money supply and further declines in long-term interest rates, of stimulating banks to relax their lending policies more rapidly than they had to date, and of confirming market interpretations that the current reduction in reserve requirements was intended to be an easing action rather than simply an alternative to open market operations as a means of

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meeting seasonal reserve needs. Some members stressed the desirability of avoiding sharp shifts in expectations regarding the near-term course of monetary policy, such as had occurred in February. Others, while sharing this position, placed equal weight on the need to avoid generating expectations that monetary policy was moving more rapidly toward ease than in fact was the case. In the course of the discussion several members expressed the view that a reduction in the discount rate might well be considered soon, although none indicated that he would favor such action immediately.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate some decline in industrial production and a marked slowing of expansion in over-all economic activity. Lack of growth in retail sales may be retarding adjustment of inventory accumulation from its recent excessive rate. Average commodity prices have changed little recently, but unit labor costs in manufacturing have risen further. Bank credit expansion has been vigorous and, after a period of rising interest rates and congested bond markets, financial conditions have again turned easier. Recent data suggest little improvement in the foreign trade surplus but also little increase in the outflow of U.S. capital. In several important countries abroad, economic activity has been softening for several months and monetary and fiscal policies have eased somewhat. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to combatting the effects of weakening tendencies in the economy, while recognizing the need for progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy against the background of the current reductions in reserve requirements, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, and to attaining still easier conditions if bank credit appears to be expanding significantly less than currently anticipated.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Shepardson, Swan, and Wayne. Votes against this action: None.

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2. Amendment of continuing authority directive.

On recommendation of the System Account Manager, Section 1(b) of the continuing authority directive to the Federal Reserve Bank of New York regarding domestic open market operations was amended to clarify the language describing the two limits specified on aggregate holdings of bankers' acceptances by the Federal Reserve Bank of New York, in accordance with the manner in which that language had always been interpreted. Specifically, the phrase "whichever is the lower" was added at the end of the paragraph, following the description of the two limits. With this change, Section 1(b) read as follows:

To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed (1) $125 million or (2) 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York, whichever is the lower.

After reviewing various amendments to the continuing authority directive that had been made during the past year, the Committee renewed the directive in its existing form (as set forth in the preface to this record of Federal Open Market Committee policy actions), except for the change resulting from this amendment.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Shepardson, Swan, and Wayne. Votes against this action: None.

3. Review of continuing authorizations.

This being the first meeting of the Federal Open Market Committee following the election of new members from the Federal

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Reserve Banks to serve for the year beginning March 1, 1967, and their assumption of duties, the Committee followed its customary practice of reviewing all of its continuing authorizations and directives. The action taken with respect to the continuing authority directive for domestic open market operations has been described in the preceding portion of the entry for this date.

The Committee reaffirmed its authorization for System foreign currency operations and its foreign currency directive, in the forms in which both were outstanding at the beginning of the year 1967, as set forth in the preface to this record of policy actions.

Votes for these actions: Messrs. Martin, Hayes, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Shepardson, Swan, and Wayne. Votes against these actions: None.

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APRIL 4, 1967

Authority to effect transactions in System Account.

Recent information supported earlier indications of a marked slowing in the pace of economic expansion and suggested that the anticipated curtailment in the rate of business inventory accumulation was under way. The latest staff projections for the first half of 1967, like those of 4 weeks earlier, implied only moderate increases in dollar GNP and little rise in real output.

Both retail sales and industrial production declined in February, as tentative estimates had suggested. In March sales of new automobiles remained close to their reduced February level, and it appeared from weekly data for most of the month that total sales continued sluggish. The production decline in February brought the capacity utilization rate in manufacturing down to 87 per cent from the 91 per cent level that had prevailed during most of 1966, and was associated with sharp reductions at factories in employment, in length of the average workweek, and in payrolls. Total nonfarm employment continued to rise, however, and the unemployment rate remained at the January level of 3.7 per cent.

With respect to inventories, accumulation by manufacturers slowed markedly in February from its earlier rapid pace. Stocks of wholesalers and retailers had not grown in January; as a result, there was a substantial reduction in that month in the over-all rate of inventory growth.

The staff projections of GNP allowed for large reductions in the rate of inventory accumulation in both the first and second quarters of 1967. Although Federal spending for defense and nondefense purposes apparently was rising somewhat more rapidly than had been expected, near-term prospects for most other broad categories of final demand did not appear strong. Growth in incomes was expected to slow in the second quarter—implying continued weakness in consumer spending for goods. Longer-

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term prospects for residential construction remained favorable, but declines in building permits and housing starts in February suggested that a strong expansion in that sector was not in immediate prospect. The results of the recent Commerce–SEC survey of business plans for plant and equipment expenditures indicated a decrease in such spending (from the fourth-quarter rate) in the first half of 1967, followed by a moderate rise in the second half. For the year as a whole, if reported plans were realized, fixed capital outlays would be 3.9 per cent above those of 1966, in contrast to increases of more than 15 per cent in each of the past 3 years. While the survey was made before the President proposed legislation to restore the tax incentives for investment that had been suspended in October 1966, it appeared unlikely that enactment of such legislation would have a significant effect on outlays until after midyear.

The consumer price index rose slightly in February; since October 1966 it had advanced at an annual rate of 1 per cent, compared with a 4 per cent rate earlier in 1966. Average wholesale prices declined in February, and according to advance estimates, they were unchanged in March at a level slightly below their peak of the preceding September. Unit labor costs continued to rise in February, and for the first quarter it appeared likely that they would average more than 4 per cent above a year earlier.

Tentative estimates of the U.S. balance of payments in the first quarter suggested that, despite some improvement in the merchandise trade surplus, the deficit was larger than in the preceding quarter on both the "liquidity" and "official reserve transactions" bases of calculation. However, it appeared that all of the increase in the liquidity deficit and part of that in the official settlements deficit was accounted for by differential effects in the two quarters of various types of special transactions. Much of the rise in the official settlements deficit reflected repayments by U.S. banks during the early weeks of the year of funds borrowed abroad through their foreign branches.

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The widespread slowdown in economic activity in Western Europe, which had begun around mid-1966, apparently continued in the first few months of 1967 although in the United Kingdom there were indications that the decline in activity might be leveling out. Since the beginning of the year monetary and fiscal policy actions had been taken in a number of countries to stimulate activity, including numerous reductions in central bank discount rates. On March 16 the Bank of England reduced its discount rate for the second time in 1967, from 6½ to 6 per cent. Discount rate reductions also were made in March by the central banks of Sweden and the Netherlands.

System open market operations since the preceding meeting of the Committee had been directed at fostering somewhat easier conditions in the money market. Growth in total and nonborrowed reserves of member banks was rapid in March, as it had been in the first 2 months of the year. Free reserves rose to an average of $165 million from about $35 million in February, member bank borrowings declined to about $200 million from $365 million, and rates on Federal funds and on bank loans to Government securities dealers moved into lower ranges. Interest rates on short-term market securities fell considerably further as a result of System operations and of other factors, including further reports of weakness in economic indicators, reductions in foreign discount rates, and widespread expectations of an early cut in the Federal Reserve discount rate. The market yield on 3-month Treasury bills declined by about 35 basis points, to slightly less than 4 per cent. On March 22 a large New York City bank lowered its prime lending rate from 5¾ per cent to 5½ per cent, and subsequently many other banks took similar action.

Long-term interest rates had also moved down somewhat in recent weeks, but they remained above the 1967 lows, which had been reached in late January and early February. The declines were limited by extremely large flotations of bonds in March, including a record volume of corporate offerings, con-

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tinued heavy sales of new municipal securities, and a sizable issue of FNMA participation certificates. The volume of offerings appeared likely to remain large in April, although not so large as in March.

The Treasury was expected to announce near the end of April the terms on which it would refund securities maturing in mid-May, of which $2.9 billion were held by the public. On Friday, March 10, the Treasury temporarily replenished its cash balances by selling a special certificate of indebtedness in the amount of $149 million to the Federal Reserve. The certificate was redeemed 3 days later.

Inflows of funds to savings and loan associations and mutual savings banks were exceptionally large in February, and growth appeared to continue in March. With supplies of mortgage funds exceeding demands, conditions in mortgage markets eased further. Depositary-type institutions used a large part of their increased inflows to repay indebtedness and to acquire marketable securities.

Commercial banks also continued to experience substantial inflows of time and savings deposits in March. Expansion in such deposits over the last 4 months—December through March—had been at an annual rate of 16 per cent, nearly twice the rate for the full year 1966. Growth in large-denomination CD's had moderated considerably since early in 1967, but passbook savings deposits began to rise sharply in mid-February after almost a year of continuous decline. Demand deposits and the money supply also expanded sharply in March. The annual rate of growth in the money supply over the December–March period was 6 per cent, compared with a rise of slightly less than 2 per cent in 1966.

Commercial banks made further sizable additions to their holdings of securities in March, and in contrast with February also expanded their loan volume substantially. A large increase in business loans was associated, in part, with the needs of businesses to finance their payments of income taxes and with-

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held individual and social security taxes. From February to March the bank credit proxy—daily-average member bank deposits—rose at an annual rate of 15 per cent, the same as from January to February and more than had been expected.

Staff projections for April suggested that the bank credit proxy would expand at an annual rate in the 10 to 13 per cent range if monetary policy remained unchanged, and somewhat more rapidly if easier money market conditions were sought. The demand for business loans was expected to be enlarged temporarily because of an unusually sharp rise in April in the volume of accelerated tax payments. The projections allowed for some slackening in growth of time and savings deposits from the exceptionally rapid pace of recent months, for a large increase in Government deposits, and for a small decline in private demand deposits. With currency holdings expected to continue rising, the money supply was projected to remain about unchanged.

There was broad agreement at this meeting that it would be desirable shortly to reduce the Federal Reserve discount rate, which had been maintained at 4½ per cent since December 1965, in order to bring it into better alignment with market interest rates. It was noted that lack of such action might result in a reversal of the recent downward trends in interest rates, which reflected in part anticipations of a reduction in the discount rate. Individual members of the Committee suggested that a lower discount rate would also help to encourage further declines in yields on long-term securities and mortgage loans; in rates paid by depositary-type institutions, which had been relatively sticky in the recent period of declining yields; and in discount rates of foreign central banks.

As to what degree of reduction in the discount rate would be most desirable, one possibility discussed was a cut of ¼ of a percentage point, with a second ¼ point reduction to be made later if it appeared warranted by unfolding developments.

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However, most of the members favored a reduction of the discount rate by ½ of a percentage point, for various reasons. A smaller reduction, they thought, was likely to be interpreted by financial market participants as a cautionary signal regarding System policy intentions, and thus might lead to a back-up in market interest rates that would be difficult to offset without very large injections of reserves. Also, a reduction of ¼ point would create uncertainties regarding the possibility of further discount rate action—an effect deemed undesirable in a period preceding a Treasury refunding operation. Moreover, a ½ point cut was viewed as likely to have significantly stronger effects than the more modest action in encouraging reductions in other interest rates domestically and abroad.

With respect to open market operations, a number of members expressed the view that recent growth rates in member bank reserves, bank credit, and the money supply—while appropriate temporarily in light of the slowing of the business expansion—were too high to be sustained for an extended period. In particular, they questioned the desirability of any policy course that might tend to accelerate growth in these financial aggregates, given the lagged effects of monetary policy and the possibility that business activity would be expanding more vigorously later in the year. These members suggested that operations might be directed toward maintaining the prevailing state of net reserve availability, or of money market conditions in general, with such modifications as might be necessary to moderate apparently significant deviations of bank credit growth in either direction from current expectations.

Other members favored open market operations consistent with the somewhat easier money market conditions that they expected would follow the anticipated reduction in the discount rate, or operations directed at attaining somewhat greater reserve availability. In general, these members thought that continued expansion in financial aggregates at rates in the neighborhood of

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those recently prevailing would be appropriate in the present economic and financial environment.

At the conclusion of the discussion the Committee agreed that open market operations should be directed at attaining somewhat easier conditions in the money market by supporting the easing expected to result from the anticipated discount rate action, but not at achieving further easing independently of that action unless bank credit appeared to be expanding significantly less than currently anticipated. With this understanding, the Committee voted to issue the following current economic policy directive to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting support earlier indications of a marked slowing of expansion in over-all economic activity. Retail sales have continued sluggish and curtailment in the rate of business inventory accumulation is in process. Average commodity prices have changed little recently, but unit labor costs in manufacturing have risen further. Bank credit expansion has remained vigorous, short-term interest rates have declined markedly further, and long-term rates have moved down somewhat despite very heavy securities market flotations. The balance of payments deficit increased in the first quarter despite some improvement in the foreign trade surplus. In several important countries abroad, monetary and fiscal policies have eased further in response to slackened economic activity. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to combatting the effects of weakening tendencies in the economy, while recognizing the need for progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, and to attaining still easier conditions if bank credit appears to be expanding significantly less than currently anticipated.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Shepardson, Swan, and Wayne. Votes against this action: None.

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MAY 2, 1967

Authority to effect transactions in System Account.

Prospects for renewed economic expansion had improved recently, according to reports at this meeting, and business confidence in the outlook had strengthened markedly. Department of Commerce figures for GNP in the first quarter confirmed earlier staff estimates that there had been no growth in real output of goods and services in that quarter. However, the official estimates—which were based in part on preliminary information for February and March—indicated that consumer expenditures had been considerably larger than anticipated, and the reduction in the rate of inventory accumulation correspondingly greater. Government outlays also appeared to have risen more than expected.

The inventory adjustments now under way were associated with both rising retail sales and a reduced level of industrial production. The retail sales estimate for February had been revised upward nearly to the January level, and the advance estimate for March showed a surprisingly large increase in that month. Although the advance estimate may have overstated the actual gain in March, weekly sales figures for the first part of April were relatively strong. Industrial output was somewhat lower in the first quarter than in the fourth quarter of 1966, and it was tentatively estimated to have fallen slightly in April. Employment in manufacturing industries declined again in March, and total nonfarm employment rose little. The unemployment rate was about unchanged in both March and April, but recent substantial increases in claims for unemployment insurance suggested weakness in some labor markets.

Continuing inventory adjustments—with a further large reduction in the accumulation rate in the second quarter and perhaps some net liquidation in the third—appeared to be in prospect. For the near term some further declines in industrial pro-

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duction and manufacturing employment seemed likely, and growth in over-all economic activity was expected to be well below the economy's potential. Nevertheless, the staff's projection for GNP in the second quarter had been revised upward moderately, in large part because of the apparent strengthening in consumer spending, and an initial projection for the third quarter suggested that activity then would be expanding at a more rapid rate. With housing starts increasing contra-seasonally in the first quarter, prospects for residential construction activity had improved. The projections assumed that total fixed investment by business would remain relatively stable at about the high first-quarter rate, that defense expenditures would continue to exceed earlier expectations, and that State and local government outlays would maintain their strong upward momentum.

The rise in the consumer price index in March was somewhat larger than the small average increase of the preceding 4 months. Contrary to earlier indications, average wholesale prices declined in March, and according to advance estimates they fell further in April. The declines in both months reflected reductions in prices of farm products and processed foods; average prices of industrial commodities were stable despite renewed weakness in prices of basic industrial materials. However, industrial prices were expected to continue under pressure from rising unit labor costs. Unit labor costs in manufacturing advanced slightly further in March, and for the first quarter as a whole they were now estimated to have been 4.7 per cent above a year earlier—the largest increase in nearly a decade.

The balance of payments deficit in the first quarter was now estimated to have been about the same as in the fourth quarter of 1966 on the "liquidity" basis of calculation, but of near record magnitude on the "official reserve transactions" basis. The liquidity deficit continued to be held down in the first quarter by various types of special transactions. First-quarter payments were affected favorably by a substantial rise in the surplus on

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merchandise trade; the nature of the factors offsetting this favorable development could not be determined as yet from the available data.

The Board of Governors approved a reduction in the Federal Reserve discount rate from 4½ to 4 per cent on April 6, and the Bank of Canada reduced its discount rate on the same day. On April 13 the German Federal Bank lowered its discount rate for the third time in 1967—to 3½ per cent—and 2 weeks later it announced its second reduction of the year in reserve requirements. Meanwhile, market interest rates in a number of major industrial countries abroad continued to decline.

Recent System open market operations had been directed at maintaining the easier money market conditions that developed after the announcement of the Federal Reserve discount rate action on April 6. That announcement had been followed promptly by reductions in rates on Federal funds, on bank loans to Government securities dealers, and on negotiable CD's and other short-term market instruments. The market rate on 3-month Treasury bills declined more than 20 basis points, and was 3.75 per cent on the day before this meeting. Large demands by private investors, as well as System purchases, contributed to the declines in bill yields.

Total and nonborrowed reserves of member banks continued to grow in April, but at a rate sharply lower than in the first quarter. Free reserves, which fluctuated widely from week to week, averaged about $210 million, compared with $170 million in March; and average member bank borrowings declined to $150 million from $200 million.

In contrast to developments in short-term markets, long-term interest rates had risen considerably since the preceding meeting of the Committee, reaching levels well above the highs of late February. These rate advances reflected both the continued heavy volume of new security flotations and the shift to more optimistic appraisals of the economic outlook by market partici-

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pants. The volume of new corporate issues offered publicly in April, while less than the March total, was a record for the month, and the calendar of offerings scheduled for May and June was already large. Municipal bond flotations continued heavy, and another sizable issue of FNMA participation certificates was expected before midyear. Market attitudes also were influenced by the prospect that the Federal Government would have substantial needs for cash in the second half of the year.

On April 26 the Treasury announced a refunding of securities maturing in May and a prerefunding of issues maturing in June and August, with settlement scheduled for May 15. In exchange for these securities, of which about $9 billion were held by the public, the Treasury offered two new issues: a 15-month, 4¼ per cent note and a 5-year, 4¾ per cent note. The 5-year note, priced at par, was offered to holders of any of the maturing issues; the 15-month note, priced to yield 4.29 per cent, was offered to holders of securities maturing in May and June.

The seasonally adjusted rate of increase in mortgage debt outstanding rose somewhat in the first quarter after three successive quarters of decline, but it remained relatively low. Downward pressure on mortgage yields was maintained in March by continuing large inflows of funds to depositary-type institutions. These institutions were continuing to use a large part of their inflows to rebuild liquidity through repayment of debt and the acquisition of marketable securities, partly because the supply of mortgages available for immediate acquisition remained limited. However, the possibility of a further increase in flows of funds into mortgage markets in coming months was suggested by an expanding volume of mortgage commitments.

Data for city banks indicated that loan demands had been moderate in the first half of April despite large corporate tax payments. Corporations apparently used part of the proceeds of recent capital market flotations and some of their CD holdings to help finance their tax payments. Beginning in late March,

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banks sharply reduced the interest rates offered on large-denomination CD's, and the volume of such CD's outstanding declined over the tax period by more than had been contemplated in staff projections. However, growth in consumer-type time deposits accelerated in April and total time and savings deposits of commercial banks continued to expand rapidly—although not so rapidly as earlier in the year. Government deposits rose substantially as a result of receipts of taxes, and private demand deposits and the money supply declined. Daily-average member bank deposits—the bank credit proxy—rose at an annual rate of 13.5 per cent from March to April, about in line with expectations and somewhat less than the rate earlier in the year.

Net business demands for bank loans were expected to be quite moderate in May; the corporate tax period was past, needs for inventory financing appeared likely to be small, and—with the continuing large volume of capital market flotations—a rise in the rate of repayments of bank loans was possible. Growth in the bank credit proxy was projected to slow considerably in May—to an annual rate in the 1 to 4 per cent range—if money market conditions were unchanged. Staff projections for the month suggested a sharp decline in Government deposits, offset only in part by a rise in private demand deposits, and a sizable increase in the money supply. Growth in time and savings deposits was expected to moderate somewhat further.

The Committee concluded that it would be appropriate at this time to maintain the prevailing conditions in the money market. While the emphasis of individual members varied, both the general economic situation and outlook and the desirability of maintaining an "even keel" in the money market during the current Treasury financing were advanced as grounds for such a policy course. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting suggest that prospects for renewed economic expansion have improved.

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The adjustment of excessive inventories is proceeding, as a result of the reduced level of industrial output and with consumer buying strengthening. Average wholesale prices have declined recently, reflecting reductions in farm and food prices and stability in prices of industrial commodities; but unit labor costs in manufacturing have risen further. Bank credit expansion has moderated in recent weeks from its earlier rapid rate. Long-term interest rates have risen considerably under the influence of heavy securities market financing and more optimistic market appraisals of the business outlook, but short-term yields have declined further following the recent reduction in Reserve Bank discount rates. Interest rates abroad have continued to decline and some further reductions have been made in foreign central bank discount rates. The balance of payments deficit has remained substantial despite some improvement in the foreign trade surplus. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to renewed economic expansion, while recognizing the need for progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing conditions in the money market.

Votes for this action: Messrs. Martin, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, Ellis, and Treiber. Votes against this action: None.

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MEETING HELD ON MAY 23, 1967

1. Authority to effect transactions in System Account.

The latest reports on recent economic developments were somewhat less favorable than earlier. Nevertheless, staff projections continued to suggest some rise in real GNP in the second quarter and a more rapid advance in the third.

Retail sales data for February had been revised downward, and figures for March revealed that the expansion in sales then had been smaller than had been indicated by the earlier advance estimate. The Commerce Department's estimate of GNP for the first quarter had been reduced somewhat, as a downward revision in consumer expenditures on nondurable goods was only partly offset by upward revisions in defense outlays and net exports. The new estimates indicated that real GNP had declined slightly in the first quarter rather than remaining stable.

In April total retail sales were about unchanged, according to the advance estimate, although sales of new automobiles rose moderately. Industrial production declined slightly, and employment in manufacturing fell further. On the other hand, housing starts in April—while moderately below the first-quarter average—were sufficiently high to suggest that the large rise in starts usual in the spring season was likely to occur this year.

The rate of business inventory accumulation, which had declined sharply in February, fell slightly further in March and for the first quarter as a whole it was only one-third the extraordinarily high rate of the fourth quarter of 1966. Staff projections now suggested the possibility of small net inventory liquidation in the second quarter and some further decumulation in the third. While inventory adjustments were retarding industrial activity currently, by the third quarter their depressant influence was expected to be considerably reduced.

Final sales had expanded substantially in the first quarter, with

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increases in outlays by Federal, State, and local governments accounting for an unusually high proportion—about half—of the rise in the total. It appeared likely that expansion in final sales would remain substantial in the second and third quarters, with defense expenditures continuing to exceed earlier estimates, State and local government outlays expanding sharply further, and consumer expenditures rising somewhat faster than earlier in the year. Prospects continued to favor expansion in residential construction but little change in fixed capital outlays by business.

Despite upward pressures on unit labor costs in manufacturing, average industrial prices had been stable since early in the year. Recent sharp reductions in prices of farm products and foods had resulted in a decline in the total wholesale price index and an appreciable slowing in the rate of increase in average consumer prices. The earlier marked expansion in output of livestock products had begun to taper off, however, and by summer or autumn supplies of many livestock products were expected to return to about their levels of a year earlier. As a result, it seemed likely that average wholesale prices of farm products and foods would stabilize or rise soon, and that retail food prices would advance more than seasonally by summer.

The deficit in the U.S. balance of payments in the first quarter was officially estimated at $540 million on the "liquidity" basis, compared with $450 million in the fourth quarter of 1966. A substantial increase in the merchandise trade surplus was more than offset by the combination of an unusually large rise in outflows of private U.S. capital into foreign securities and the absence of official debt prepayments in the first quarter. Tentative estimates suggested that the rate of deficit increased in April.

The deficit on the "official reserve transactions" basis had been enlarged in recent months as a result of repayments by U.S. banks of earlier borrowings through their foreign branches. In the first quarter the official settlements deficit was estimated at a record $1.8 billion, compared with a level close to zero in the

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fourth quarter of 1966, and it apparently continued very large in April. These high deficits had a substantial counterpart in the improved position of sterling.

On May 4 the Bank of England reduced its discount rate for the third time in 1967, to 5½ per cent, and on May 11 the German Federal Bank made the fourth such reduction, to 3 per cent. The National Bank of Belgium also had recently lowered its discount rate further.

In the recently completed Treasury refunding, $3.4 billion of publicly held securities maturing in May and June and $1.3 billion of securities maturing in August were exchanged for $2.0 billion and $2.7 billion, respectively, of the new 15-month and 5-year notes. The redemptions of May and June maturities for cash were somewhat larger than had been generally expected, but the volume of August maturities exchanged for the 5-year note also was greater than anticipated.

System open market operations since the preceding meeting of the Committee had been directed at maintaining an "even keel" in the money market during the Treasury financing. At member banks average free reserves were somewhat larger in the first 3 weeks of May than in April, and borrowings were moderately smaller. Federal funds traded in a narrow range around the 4 per cent discount rate, about the same as in April, while interest rates on most types of short-term market instruments moved lower. Demands for Treasury bills remained strong and the rate on 3-month bills declined 25 basis points further, to 3.50 per cent. On the other hand, major banks raised their offering rates on large-denomination CD's, particularly on those of longer maturity.

Yields on long-term securities continued to rise, under the influence of heavy current and prospective offerings of new issues and—despite some dampening of the earlier marked optimism—investor confidence that economic expansion would become more vigorous later in the year. Treasury, corporate, and municipal

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bond yields reached new highs for 1967, and some long-term rates were approaching the peaks recorded in the summer of 1966.

The decline in mortgage yields slowed in April despite continuing large inflows of funds to depositary-type institutions, and in early May there were scattered reports of slight rises in secondary-market yields on Federally underwritten mortgages on homes. Although interest rates on mortgages had fallen considerably since turning down in November 1966, they were still high relative to the level from which their advance had started in the summer of 1965.

At commercial banks growth in business loans had slowed markedly since the mid-April tax date. The volume of large-denomination CD's outstanding declined over the same period. As a result of further growth in other types of time and savings deposits, however, the total of such deposits was continuing to expand rapidly; new staff projections suggested that from April to May time and savings deposits would rise almost as fast as they had from March to April. As before, the projections for May allowed for a sharp decline in Government deposits and sizable increases in private demand deposits and the money supply. For total member bank deposits—the bank credit proxy —the range of expected growth in May had been narrowed somewhat, to an annual rate between 3 and 4 per cent. In June the proxy was projected to rise at an annual rate in the 4 to 7 per cent range if money market conditions were unchanged. Growth in time and savings deposits was expected to be maintained at its recent pace. Further sharp declines in Government deposits and sharp increases in private demand deposits and the money supply were anticipated.

In the course of the Committee's discussion it was noted that, while prospects favored resumption of economic expansion later in the year, the current situation was characterized by various cross currents and uncertainties. The Committee concluded that

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under these circumstances it would be desirable to maintain prevailing conditions in the money market.

A considerable amount of concern was expressed in the discussion about the recent marked increases in long-term interest rates. Some members noted that further rises might result in slowing the expected economic upturn, especially in the housing sector. The Committee concluded, although some reservations on the matter were voiced, that a constructive influence might be exercised by more extensive resort to purchases of longer-term Government securities in meeting part of the needs for bank reserves that were expected to arise in the next several weeks. In particular, it was believed that some purchases of coupon issues, if and when feasible in the course of reserve-supplying operations in the coming period, could serve to lighten somewhat the market supplies of Government securities in the maturity ranges in which such supplies were the heaviest. It was also noted that this substitution of purchases of coupon issues for bill purchases could be important for balance of payments reasons, as a means of reducing downward pressures on bill rates. The Committee members made clear that such purchases of coupon issues should not be directed at maintaining any particular level or maturity pattern of interest rates.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting suggest that renewed economic expansion later in the year is in prospect. Output is still being retarded by adjustments of excessive inventories, but growth in final demands, particularly Government, continues strong. Average wholesale prices have declined recently, but unit labor costs in manufacturing have risen further. Bank credit expansion has slowed in recent weeks from its earlier rapid rate. Long-term interest rates have continued to rise under the influence of heavy securities market financing, but short-term yields have declined further. Some further reductions have been made in foreign central bank discount rates. The balance of payments deficit has remained substantial despite some improvement in the foreign trade surplus. In this situation, it is the Federal Open Market

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Committee's policy to foster money and credit conditions, including bank credit growth, conducive to renewed economic expansion, while recognizing the need for progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing conditions in the money market, while utilizing operations in coupon issues in supplying part of reserve needs.

Votes for this action: Messrs. Martin, Brimmer, Daane, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, Wayne, and Treiber. Vote against this action: Mr. Francis.

In dissenting from this action, Mr. Francis expressed the view that monetary policy had been highly stimulative thus far in 1967, that fiscal policy was providing an increasing stimulus, and that the economy was responding relatively quickly. On the grounds that a marked increase in demands for goods and services was likely later in the year and that monetary policy actions had their main effects after some time lag, he thought some firming in the money market should be sought now to guard against the development later of excessive demands and associated inflationary pressures.

2. Ratification of amendments to authorization for System foreign currency operations.

At this meeting the Committee ratified actions taken by the members on May 12, 1967, amending paragraphs 1A and 2 of the authorization for System foreign currency operations, effective May 17, 1967. The first of these paragraphs was amended to add Danish kroner, Norwegian kroner, and Mexican pesos to the list of foreign currencies in which System operations were authorized. The second paragraph was amended to expand the list of foreign banks with which reciprocal currency (swap) arrangements were authorized to include the National Bank of

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Denmark and the Bank of Norway, with each of which standby arrangements of $100 million equivalent were authorized, and the Bank of Mexico, with which a standby arrangement of $130 million equivalent was authorized. Maximum periods of 12 months were specified for all three new swap arrangements. With these amendments, the affected paragraphs read as follows:

1A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, and with the Bank for International Settlements:

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

* * * * * * *

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

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Foreign bank	Amount of arrangement (millions of dollars equivalent)	Maximum period of arrangement (months)
Austrian National Bank	100	12
National Bank of Belgium	150	12
Bank of Canada	500	12
National Bank of Denmark	100	12
Bank of England	1,350	12
Bank of France	100	3
German Federal Bank	400	6
Bank of Italy	600	12
Bank of Japan	450	12
Bank of Mexico	130	12
Netherlands Bank	150	3
Bank of Norway	100	12
Bank of Sweden	100	12
Swiss National Bank	200	6
Bank for International Settlements:		
System drawings in Swiss francs	200	6
System drawings in authorized European currencies other than Swiss francs	200	6

Votes for ratification of these actions: Messrs. Martin, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, Wayne, and Treiber. Votes against ratification of these actions: None.

The Committee had considered the possibility of expanding the System's network of swap arrangements to include the central banks of Denmark, Norway, and Mexico at a number of recent meetings, and it had authorized the Special Manager of the System Open Market Account to hold discussions with officials of those central banks looking toward the negotiation of arrangements between their banks and the Federal Reserve. Committee members had approved the amendments to the authorization indicated above following receipt of advice from the Special Manager that the discussions had been satisfactorily completed.

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MEETING HELD ON JUNE 20, 1967

Authority to effect transaction in System Account.

Over-all economic activity was expanding at a modest pace, according to reports at this meeting, and prospects for growth later in the year had strengthened. Staff projections suggested that the current advance in real GNP, though moderate, would turn out to be higher than earlier estimates for the second quarter, and that the rate of growth would accelerate in the third quarter. The projections reflected an expectation that final sales would continue to expand rapidly in the second and third quarters, and that the effect on over-all activity of inventory adjustments—which had resulted in a slight decline in real GNP in the first quarter—would diminish progressively.

The rate of business inventory accumulation declined further in April to a low level. It appeared likely that there would be little, if any, net accumulation of inventories in the second quarter as a whole and that there would be a moderate amount of liquidation in the third quarter. Industrial production fell slightly further in May to a level about 2 per cent below the high of December 1966. Manufacturing employment declined again in May, but the reduction was less than in other recent months. The unemployment rate, at 3.8 per cent, was little changed from the April level.

Government spending remained an important source of economic stimulus, with Federal defense outlays continuing to exceed earlier estimates and State and local government expenditures rising steadily. The staff projections suggested, however, that the rate of growth in defense outlays would moderate in the second and third quarters, and that private sales would account for a larger proportion of growth in total final sales than they had in the first quarter.

Both consumer expenditures for goods and the volume of resi-

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dential construction activity appeared to have gained some momentum recently. Retail sales were now reported to have increased in April, contrary to the earlier indication that they had not changed in that month, and the advance estimate for May showed a further rise. Housing starts increased substantially in May, and various factors—including the further rise in building permits issued and the substantial increases in mortgage commitments by major groups of lenders—pointed toward higher expenditures on new housing in the months ahead.

A Commerce–SEC survey of business plans, taken in late April and May, suggested that capital spending would rise moderately in the second half of the year. The survey implied a slightly smaller rise in business outlays on plant and equipment in 1967 as a whole than had the survey taken 3 months earlier—2.9 rather than 3.9 per cent. The downward adjustment, however, was attributable mainly to a larger decline in actual outlays in the first quarter than had been implied by the plans reported earlier; for the last three quarters of the year changes in planned outlays were similar to those that had been indicated in the preceding survey.

Average wholesale prices of industrial commodities remained stable in May. Nevertheless, the over-all wholesale price index rose as prices of farm products and foods increased sharply following 7 months of nearly continuous decline. In April the consumer price index increased somewhat more than it had on the average during the winter and early spring.

With respect to the U.S. balance of payments, the surplus on merchandise trade continued to increase in April and net repayments of borrowings abroad by U.S. banks, which had enlarged the deficit on the "official reserve transactions" basis in the first 4 months of the year, were small in May. However, the available data on changes in U.S. reserves and liabilities in recent months suggested that the underlying payments deficit remained large.

Abroad, bond yields had stabilized or risen recently in a num-

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ber of industrial countries, interrupting the downward trend of interest rates that had been under way since late in 1966. Conditions in some foreign exchange markets had been unsettled as a result of the Middle-East hostilities in early June.

System open market operations since the preceding meeting of the Committee had been directed toward maintaining prevailing conditions in the money market. The System supplied reserves early in the interval and again near its close, partly through purchases of coupon-bearing Treasury securities. In the intervening period the System sold bills to offset part of the large volume of reserves supplied by declines in Treasury balances at Federal Reserve Banks. On June 15 the Treasury temporarily added to its balances by selling a special certificate of indebtedness in the amount of $87 million to the Federal Reserve. The certificate was redeemed the following day.

Growth in nonborrowed reserves of member banks had moderated further in May, and total reserves had declined slightly. In June aggregate bank reserves were rising relatively slowly. In the 3 weeks through mid-June free reserves averaged about $290 million, little changed from the average of $270 million for all of May and somewhat above the April level (revised) of $200 million. Member bank borrowings declined further to an average of about $75 million in the latest 3 weeks, from $95 million in May as a whole and $150 million in April. The Federal funds rate remained close to 4 per cent and rates on bank loans to Government securities dealers were generally stable.

Interest rates on most types of market securities had risen on balance since the preceding meeting of the Committee, with yields on Treasury securities fluctuating widely. In short-term markets yields advanced on finance company paper, bankers' acceptances, Federal agency securities, and negotiable CD's. In late May and early June the market rate on 3-month Treasury bills extended its earlier persistent decline and on June 5 it reached a low for the year of 3.37 per cent. Subsequently the rate moved up and

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was about 3.60 per cent on the day before this meeting. Yields on intermediate- and long-term Treasury bonds, which had risen to 1967 highs around mid-May, receded late in that month but then advanced sharply in the first half of June to levels above the May peaks. Corporate bond yields had drifted up further after stabilizing for a time in early June.

The recent increases in short-term interest rates appeared to have been related in part to pressures associated with the mid-June tax and dividend dates. Conditions in financial markets generally, however, were influenced by the continuing heavy volume of flotations of corporate and municipal securities, and by prospects for a very large volume of Federal debt financing in the second half of the year. Public offerings of new corporate bonds in June appeared likely to be about one-fourth larger than the previous monthly record set in March, and an unusually large volume of offerings was already scheduled for the third quarter. It appeared that the Treasury would need to raise a substantial amount of new cash later in the year, although the magnitude of the Federal deficit in the second half of 1967 would depend in large part on the course of defense spending and on the size and effective date of any increase in income taxes, all of which were uncertain at this time. The Treasury was expected to undertake a short-term cash financing in July, but the size, terms, and date of the offering had not been determined as of the date of this meeting.

In May contract interest rates on conventional mortgages on new homes advanced slightly following six consecutive months of decline, and secondary-market yields on Federally underwritten home mortgages rose fairly sharply. Inflows of funds to depositary-type institutions remained large, but the share of these funds used to expand mortgage holdings continued low. Thrift institutions reportedly were still rebuilding liquidity primarily because of a relative scarcity of mortgages available for immediate acquisition.

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At commercial banks business loans outstanding declined in May, but holdings of Treasury and municipal securities increased markedly. With offering rates on negotiable CD's rising, large city banks recovered much of the CD run-off they had experienced in April. Inflows of other time and savings deposits continued large at banks generally, and total time and savings deposits expanded almost as rapidly from April to May as they had earlier in the year. Private demand deposits and the money supply, which had declined from March to April, rose substantially in May. As a result of sharp declines in Government deposits at banks, however, daily-average member bank deposits—the bank credit proxy—increased at an annual rate of only 2 per cent.

In general, the deposit trends of May—rapid increases in time and savings and private demand deposits and sharp declines in Government deposits—appeared to be persisting in June. On balance, however, the bank credit proxy was expected to increase from May to June at an annual rate in the 7 to 8 per cent range. This was faster than from April to May, but considerably slower than in the first 3 months of the year. The probable growth rate of member bank deposits from June to July depended in large measure on the size and timing of the expected Treasury financing. On the assumption that the Treasury would sell, primarily to the banking system, about $4 billion of new securities shortly after mid-July, the bank credit proxy was projected to rise at an annual rate in the 10 to 12 per cent range if money market conditions were unchanged. Continued rapid growth was projected in private demand deposits, as were some slackening in inflows of time and savings deposits and little change in Government deposits.

The Committee decided that it would be appropriate at this time to maintain about the same conditions in the money market as had prevailed since the preceding meeting, partly because of the expected Treasury financing. Various other reasons were ad-

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vanced by individual members against seeking firmer money market conditions at present. Among these were the current pressures in capital markets, the prospect—which some members thought had been enhanced recently—that action to raise Federal income taxes might be taken soon, and the absence to date of firm evidence that the widely expected upsurge in economic activity had already begun.

While none of the members advocated seeking easier money market conditions, a number expressed concern about the continued uptrend in long-term interest rates, particularly in light of the risk that higher rates might slow the recovery in the housing industry and in the economy generally. Partly for this reason, the Committee agreed that purchases of coupon issues should continue to be utilized in meeting a portion of the needs for reserves that were expected to develop in coming weeks, although some reservations were again expressed concerning the possible adverse effects in the longer run of such purchases on the functioning of the market for coupon issues. Some members favored purchases of coupon issues on other grounds. These included considerations relating to the balance of payments, currently limited market supplies of Treasury bills, and the composition of the System's portfolio of Government securities.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting suggest that economic activity is rising modestly, and that prospects for economic expansion later in the year have strengthened. Output is still being retarded by adjustments of excessive inventories, but growth in final demands continues strong, reflecting substantial further increases in Government expenditures and also some strengthening of consumer buying. Prices of farm products have turned up recently, but average prices of industrial commodities have remained stable. The pace of bank credit expansion has increased in recent weeks, but is still well below the rapid rate of earlier in the year. Most long-term interest rates have tended to rise further under the influence of heavy securities market financing,

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and most short-term yields have also increased. The balance of payments deficit has remained substantial despite some improvement in the foreign trade surplus. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to renewed economic expansion, while recognizing the need for progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of expected Treasury financing activity, the timing and quantity of which are still uncertain, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed since the preceding meeting of the Committee, while continuing to utilize operations in coupon issues in supplying part of reserve needs.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, Wayne, and Patterson. Votes against this action: None.

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MEETING HELD ON JULY 18, 1967

1. Authority to effect transactions in System Account.

Real GNP rose modestly in the second quarter, according to preliminary Department of Commerce figures. Final expenditures expanded substantially further and the downdrag from inventory adjustments was considerably reduced. Staff projections continued to suggest that real GNP would grow at a faster rate in the third quarter, when it was expected that final sales would rise somewhat more rapidly and that the depressant influence of inventory adjustments would be reduced still more.

The private sector accounted for a much larger proportion of the expansion in final sales in the second quarter than in the first. Consumer spending contributed substantially to the expansion, with sales of automobiles especially strong. Residential construction activity increased significantly further but business outlays for fixed capital declined slightly. The rise in defense outlays was much smaller than in the first quarter, but State and local government purchases maintained their steady expansion.

Businesses accumulated inventories at a low rate in the second quarter, according to Commerce Department estimates, and the prospect appeared to be for some net liquidation in the third quarter. Industrial production again edged down in June. However, manufacturing employment advanced somewhat following 4 months of decline, and total nonfarm employment rose strongly. The unemployment rate increased to 4.0 per cent from 3.8 per cent in May, mainly because of an exceptionally large expansion in the labor force.

Prospects appeared favorable for another large increase in consumer spending in the third quarter, when rising employment was expected to result in a more rapid advance in wage incomes than in the spring quarter. Further gains in residential construction activity were suggested by a rise in building permits and a

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significant increase in lender mortgage commitments through May. Prospects for a modest advance in business spending for fixed capital were supported not only by the latest Commerce-SEC survey but also by recent increases in new orders for machinery and equipment. Little new information was available on prospective defense spending but the staff projection assumed that such spending would rise in the third quarter by about as much as it had in the second quarter.

The wholesale price index in June was officially estimated to have risen for the second consecutive month—reflecting a further increase in prices of farm products and foods. The average of industrial prices continued stable. In May the consumer price index rose again and was 2.7 per cent above a year earlier. Benefits provided in recently negotiated wage contracts suggested further upward pressure on unit labor costs in manufacturing in the months ahead.

Tentative estimates indicated that the balance of payments deficit on the "liquidity" basis of calculation was about as large in the second quarter as in the first, despite an increase in official foreign acquisitions of long-term deposits. An improvement in the trade surplus apparently was more than offset by a turn from inflow to outflow of U.S. short-term bank credit. The deficit on the "official reserve transactions" basis was much smaller in the second quarter than in the first, as repayments of borrowings by U.S. banks from their foreign branches tapered off. Abroad, economic activity remained sluggish in most industrial countries, but expansion continued in Italy and Japan.

System open market operations since the last meeting of the Committee had been directed toward maintaining about the same conditions in the money market as had prevailed during the preceding 4 weeks. A large volume of reserves was provided to meet seasonal needs, mainly through purchases of bills but partly through acquisitions of coupon securities.

Growth in nonborrowed reserves of member banks slowed

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further in June but total reserves increased moderately following the slight decline of May. Free reserves and member bank borrowings fluctuated over a wide range in the 4 weeks ending July 12, reflecting in large part seasonal patterns that regularly develop around the midyear bank statement date and the July 4 holiday. Free reserves averaged $295 million, little changed from the $285 million average of the preceding 4 weeks, and borrowings averaged about $165 million compared with about $70 million in the prior period. The Federal funds rate remained close to 4 per cent, and rates on bank loans to Government securities dealers also changed little.

Treasury bill rates rose sharply from late June to early July, and interest rates on other short-term market instruments also moved up generally, but less than did bill rates. The market rate on 3-month Treasury bills had reached a low for the year of 3.33 per cent on June 23; by July 5, the rate had advanced to a peak of 4.29 per cent. Subsequently the rate receded somewhat, but on the day before this meeting it was 4.17 per cent, almost 60 basis points higher than 4 weeks earlier. To some extent the rise reflected seasonal influences, but for the most part it was related to the large recent and prospective Treasury cash borrowing in the bill area.

Following an announcement on June 28, the Treasury auctioned $4 billion of March and April 1968 tax-anticipation bills on July 5 at average issuing rates of 4.86 and 4.90 per cent, respectively, for payment July 11. The Treasury also indicated that it would raise an additional $2.2 billion of new money by adding $100 million to each of its regular weekly and monthly bill auctions. Virtually all of the tax-anticipation bills, which carried 100 per cent tax-and-loan-account privileges, were acquired by commercial banks, and bank sales of the bills following the auction were relatively light. The Treasury was expected to announce in late July the terms on which it would

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refund coupon-bearing securities maturing in mid-August, of which the public held $3.6 billion.

A record volume of publicly offered corporate bonds and a continuing large volume of municipal bonds were issued in June, and the calendar of offerings for July and August was heavy. Yields on long-term securities generally rose further in the second half of June and early July and then declined. Before turning down, yields on intermediate- and long-term Treasury bonds had reached new highs for the year, while those on new corporate issues in some cases had exceeded their highs of August 1966. Yields on municipal issues also reached new 1967 highs and then tended to level off in the first half of July. To some extent the recent improvement in the tone of longer-term securities markets reflected both enhanced expectations of a tax increase and diminished expectations of a large further build-up of troops in Vietnam. Yields on Treasury bonds apparently also were influenced by the low volume of dealer inventories and by System purchases of coupon issues. In markets for common stocks, trading was heavy and there appeared to have been an increase in speculative activity.

In June contract rates on conventional first mortgages on homes edged up for the second consecutive month, and secondary market yields on Federally underwritten home mortgages rose further. The inflow of savings to nonbank depositary-type institutions was maintained in record volume.

At commercial banks, credit demands were heavy during the tax and dividend period in June, and business loans increased sharply during the month. Banks liquidated sizable amounts of Treasury securities and increased their holdings of municipal securities at a less rapid rate than in other recent months.

Bank offering rates on negotiable CD's rose further in June and the outstanding volume of these deposits increased moderately. Inflows of other time and savings deposits continued large and total time and savings deposits increased about as fast as in

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earlier months of the year. The money supply rose at a 13 per cent annual rate, almost as sharply as it had in May. Government deposits at banks declined somewhat less than in May, and daily-average member bank deposits—the bank credit proxy—increased at an annual rate of almost 9 per cent. In the 6 months through June, time deposits had risen at an annual rate of 17 per cent; the money supply, almost 7 per cent; and the bank credit proxy, 12 per cent.

Banks were expected to reduce their holdings of the new tax bills in July, and repayments of business loans appeared likely to result in liquidation of some private deposits. Nevertheless, the latest staff projections suggested that total bank credit, as measured by the proxy series, would rise from June to July at an annual rate in the 13 to 15 per cent range and the money supply at a rate in the 5 to 7 per cent range if money market conditions were unchanged. Government deposits were expected to increase following the declines of May and June, and time and savings deposits were projected to grow nearly as rapidly as they had in June.

In August, business loans of banks were expected to increase relatively little on balance, as a result of repayment of the tax-related borrowings of late June and early July and continued small needs for financing inventories. On the assumption that the Treasury would not raise new cash until early September, the rate of bank credit expansion was expected to be considerably slower in August than in July. For the 2 months together, the bank credit proxy was projected to grow at an annual rate in the 10 to 12 per cent range.

In the course of the Committee's discussion considerable concern was expressed about the recent high rates of growth of bank credit and the money supply, particularly in view of the prospects for more rapid economic expansion later in the year. It was generally agreed, however, that the Treasury's forthcoming financing militated against seeking a change in money market

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conditions at present. Moreover, even apart from the Treasury financing, most members felt that it would be premature to seek firmer money market conditions at a time when resumption of expansion in over-all economic activity was in a fairly early stage; and some also referred in this connection to the growing expectations that the administration would press for measures of fiscal restraint. In addition, some members expressed concern about the possibility that any significant further increases in market interest rates might reduce the flows of funds into mortgages and slow the recovery under way in residential construction activity.

The Committee concluded that it would be appropriate at present to maintain about the prevailing conditions in the money market, although the members agreed that operations should be modified, insofar as permitted by "even keel" considerations associated with the Treasury financing, if there was a tendency for bank credit and the money supply to expand more than currently expected. It was noted that the growth rates in bank credit and money currently expected rested on particular assumptions regarding the pattern of forthcoming Treasury financing activity and were subject to revision if the actual pattern differed from that assumed.

Prior to the vote on the full text of the current economic policy directive to be issued at this meeting, a preliminary vote was taken on the question of whether a reference to operations in coupon issues for supplying part of reserve needs, such as had appeared in the second paragraph of the directives issued on May 23 and June 20, 1967, should be included in today's directive.

> Votes for including such a reference: Messrs. Brimmer, Maisel, and Mitchell. Votes against: Messrs. Hayes, Robertson, Scanlon, Sherrill, Swan, Wayne, and Patterson.

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The majority favored omitting the reference in question for a number of reasons, including the imminent Treasury refunding, the small volume of net reserve needs projected for the interval up to the next meeting of the Committee, the substantial decrease in the market availability of coupon issues, and the recently more settled conditions in longer-term securities markets. It was stressed by members of the majority that operations in coupon issues from time to time were a normal part of open market operations, and that omission of the reference to them from the directive did not preclude such operations under appropriate circumstances.

Members of the minority noted that the heavy calendar of prospective corporate issues could result in renewed upward pressures on long-term yields, with possibly adverse effects on mortgage markets. They expressed the view that recent operations in coupon issues had had some moderating effect on long-term rates by affecting both market supplies and expectations of market participants, and that such operations could continue to serve a constructive purpose in dealing selectively with capital market pressures. Mr. Maisel thought that there remained a broad demand for liquidity in the economy, and that helping to meet that demand by purchases of coupon issues represented an appropriate System portfolio policy.

Mr. Brimmer observed that appropriate circumstances for coupon operations might not arise in the coming period, and along with Messrs. Maisel and Mitchell he agreed that omission of the reference from the directive would not preclude them if the need arose. Nevertheless, these members felt that the reference should be retained in the present directive to clarify the Committee's intent.

The Committee then voted to issue the following current economic policy directive to the Federal Reserve Bank of New York:

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The economic and financial developments reviewed at this meeting indicate that economic activity has been rising modestly and that prospects are for further expansion. Output is still being retarded by adjustments of excessive inventories, but growth in final demands continues strong, reflecting some strengthening in consumer expenditures for durable goods and housing, and also further increases in Government outlays. The over-all indexes of both wholesale and retail prices have risen further, although wholesale prices of industrial commodities have remained stable. Bank credit expansion has been large in recent weeks. Most short- and long-term interest rates, after reaching advanced levels under the influence of heavy public and private securities market financing, have declined somewhat recently. The balance of payments deficit has remained substantial despite some improvement in the foreign trade surplus. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to continuing economic expansion, while recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

To implement this policy, while taking account of forthcoming Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified insofar as the Treasury financing permits to moderate any apparent tendency for bank credit and money to expand more than currently expected.

Votes for this action: Messrs. Hayes, Brimmer, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, Wayne, and Patterson. Votes against this action: None.

2. Amendments to authorization for System foreign currency operations.

At this meeting the Committee ratified an action taken by members on June 29, 1967, effective June 30, 1967, amending paragraph 2 of the Committee's authorization for System foreign currency operations to change the maximum period authorized

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for the reciprocal currency (swap) arrangement with the Netherlands Bank from 3 to 6 months.

Votes for ratification of this action: Messrs. Hayes, Brimmer, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, Wayne, and Patterson. Votes against ratification of this action: None.

Subsequently in the course of the meeting the Committee amended paragraph 2 of the authorization in certain other respects. In the text of the paragraph the phrase "for periods up to a maximum of 12 months" was added following the direction to the Federal Reserve Bank of New York to maintain swap arrangements with indicated foreign banks; and the column in the table contained in the paragraph that specified a maximum maturity for each of the existing arrangements—12 months in 10 cases and 3 or 6 months in the others—was deleted. These changes, which were in line with the Committee's interest in moving toward 12-month maturities for swap arrangements where agreeable with the foreign bank concerned, eliminated the necessity for amending the authorization each time the maturity of an arrangement was changed.

In addition, the paragraph was amended to reflect approval of increases (a) from $200 million to $250 million in the swap arrangement with the Swiss National Bank, (b) from $200 million to $250 million in the arrangement with the Bank for International Settlements covering System drawings in Swiss francs, and (c) from $200 million to $300 million in the arrangement with the Bank for International Settlements covering System drawings in authorized European currencies other than Swiss francs. These increases were considered desirable to provide broader margins of safety to deal wth unforeseeable contingencies.

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Votes for these actions: Messrs. Hayes, Brimmer, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, Wayne, and Patterson. Votes against these actions: None.

Reflecting these amendments, paragraph 2 of the authorization for System foreign currency operations read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	150
Bank of Canada	500
National Bank of Denmark	100
Bank of England	1,350
Bank of France	100
German Federal Bank	400
Bank of Italy	600
Bank of Japan	450
Bank of Mexico	130
Netherlands Bank	150
Bank of Norway	100
Bank of Sweden	100
Swiss National Bank	250
Bank for International Settlements:	
System drawings in Swiss francs	250
System drawings in authorized European currencies other than Swiss francs	300

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MEETING HELD ON AUGUST 15, 1967

Authority to effect transactions in System Account.

Economic activity had been expanding more rapidly in recent weeks, according to reports at this meeting. The latest business developments lent support to the expectation that the rate of growth in real GNP would accelerate in the third quarter, when it was anticipated that final sales would continue to increase rapidly and that the depressant influence of inventory adjustments would wane.

In July industrial production turned up after declining irregularly over the first half of the year, nonfarm employment rose further, and the unemployment rate edged down to 3.9 per cent from 4.0 per cent in June. According to the advance estimate, retail sales increased in July from a June level that had been revised upward substantially. Housing starts declined somewhat in June after rising sharply in May, but they remained above their reduced year-earlier level. Following the sharp contraction in the rate of accumulation earlier in the year, business inventories declined substantially in June, and in many industries stocks were moving into better relation with sales.

In a message to Congress on August 3 the President proposed a new fiscal program, the main element of which was a 10 per cent surcharge on Federal income taxes, to be effective October 1, 1967, for individuals, and to be retroactive to July 1, 1967, for corporations. A staff projection suggested that, even if the President's fiscal program was enacted promptly in the form recommended, the growth rate in real GNP in the fourth quarter would be slightly higher than that expected in the third. It was anticipated that the tax increases, if enacted, would moderate the pace of expansion in final spending—particularly by consumers. However, it was thought likely that this effect would be about offset in terms of the rise in total GNP by a shift from

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small decumulation of inventories in the third quarter to moderate accumulation in the fourth. Among the uncertainties affecting the projections for the second half of the year was the possibility of a strike in the automobile industry in early September when existing wage contracts would expire.

The rise in the wholesale price index slowed in July, according to the advance estimate, as prices of farm products and foods increased only moderately further. However, average industrial prices apparently edged up after 4 months of stability, and increases for a number of industrial commodities had been announced following the mid-July date to which the index applied. In June, as in May, the consumer price index rose at a faster rate than in the first quarter. Unit labor costs in manufacturing advanced further in June, and for the second quarter as a whole they were estimated—after upward revisions in the data for some months—to be 5.5 per cent higher than a year earlier.

Recent data on the U.S. balance of payments supported earlier estimates indicating that the deficit on the "liquidity" basis of calculation was about as large in the second quarter as in the first and that it was considerably above the 1966 rate. Although the merchandise trade surplus increased somewhat in the second quarter as a whole, there was no improvement after April, partly because industrial activity continued sluggish in important industrial countries abroad. The liquidity deficit apparently remained large in July, and there seemed to be little reason to expect it to decline substantially during the second half of the year.

The deficit on the "official reserve transactions" basis was quite large in the second quarter, although only about half the record high of the first quarter. The balance on this basis had fluctuated widely over the past year as a result of marked swings in the indebtedness of U.S. banks to their foreign branches.

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Banks had borrowed heavily through their branches abroad from about the middle of 1966 until late in the year, had repaid a large amount of this debt over the ensuing period until mid-May 1967, and then had resumed such borrowing at a substantial rate.

The President's tax message was followed by a rally in the Government securities market, but this response was short-lived. Subsequently, yields on most coupon-bearing Treasury issues advanced to levels about equal to their previous 1967 highs, as market participants focused on the uncertainties of the congressional reaction to the President's recommendations and on the volume of Federal financing in prospect for the rest of the calendar year even if the tax program was enacted in the form recommended. Yields on municipal securities moved lower, however—mainly because the volume of new offerings had abated somewhat recently, but apparently also because the proposed tax increase enhanced the attractiveness of tax-exempt issues to investors. Markets for corporate bonds continued to be dominated by the heavy flow of new issues, and yields remained close to the highs reached in late June. The volume of new corporate bonds offered publicly in July was more than four times that of a year earlier and was at a new record level; and the calendar for August was large, although not so large as in July.

With a Treasury refunding under way in August, System open market operations since the preceding meeting of the Committee had been directed toward maintaining steady conditions in the money market. The market operations needed for this purpose proved to be relatively limited and were reflected in a small rise in System holdings of Treasury bills. Free reserves of member banks averaged about $265 million in the 4 weeks ending August 9, compared with $285 million in the preceding 4 weeks, and member bank borrowings continued light. Interest rates on Fed-

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eral funds and on bank loans to Government securities dealers had remained relatively stable since the preceding meeting of the Committee, and the market rate on 3-month Treasury bills was about unchanged on balance. However, rates on a variety of short-term market instruments, including 9- and 12-month Treasury bills, had risen somewhat further.

In its refunding operation the Treasury redeemed securities maturing in mid-August with the proceeds of a sale of a 5¼ per cent, 15-month note (priced to yield 5.30 per cent), and it also raised $300 million of new cash. The Treasury was expected to raise an additional $2 billion to $2.5 billion of new cash later in August by the sale of another new issue, but the specific terms had not yet been decided upon.

Secondary-market yields on Federally underwritten home mortgages, which had turned up in May, apparently rose little further in July, when inflows of funds to savings and loan associations and mutual savings banks were unusually large for that time of the year. The pace of mortgage lending by such institutions had accelerated in June—bringing the net increase in outstanding mortgages on homes in the second quarter as a whole to the highest rate since early 1966.

Commercial bank credit expanded markedly in July, partly because of bank acquisitions of tax-anticipation bills auctioned by the Treasury. Also, business loans at banks, which had risen seasonally in June in connection with midmonth corporate income tax payments, failed to show their usual decline in July; as compared with the pattern in other recent years, loan repayments tended to lag, not appearing in volume until late July and early August. This development, which probably was related to the acceleration in the schedule on which businesses pay to the Treasury the taxes they withhold on individual incomes, resulted in a sharp rise in business loans after seasonal adjustment on the basis of past patterns. Daily-average member bank

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deposits—the bank credit proxy—increased at an annual rate of about 15 per cent from June to July, reflecting a marked expanson in private demand deposits and the money supply, a rise in U.S. Government deposits, and continued rapid growth in time and savings deposits. The volume of negotiable CD's outstanding continued to increase as banks raised their offering rates on these deposits somewhat further.

With business loan repayments becoming large, it appeared likely that growth in bank credit and money would slow over the course of August. For July and August together, however, the bank credit proxy was now projected to rise at an annual rate in the range of 14 to 16 per cent. This was somewhat higher than the range previously expected, partly because of differences between the emerging pattern of Treasury financing and the pattern that had been anticipated earlier.

Staff projections suggested a slower rate of increase in the bank credit proxy from August to September—in the range of 7 to 9 per cent, annual rate—if money market conditions were unchanged. The money supply, which appeared likely to increase much less in August than in July, was projected to decline somewhat in September as Government deposits rose, and growth in time and savings deposits was expected to be somewhat slower. It was recognized that a strike in the automobile industry in September, should one develop, could alter the outlook for bank credit and for demand and time deposits, since it would affect corporate cash flows, personal income, and credit demands.

In the course of the Committee's discussion the members agreed that the fiscal program recommended by the President would, if enacted, make a substantial contribution to balanced economic growth. They also agreed that the continuing substantial deficit in the U.S. balance of payments represented a serious national problem, and some members suggested that a

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strengthening of elements of the voluntary programs for limiting capital outflows might be desirable.

A number of members expressed the judgment that both the impending Treasury financing and uncertainties about the outcome with respect to the fiscal program now under active consideration by Congress militated against a change in monetary policy at present. At the same time, most members were of the view that recent rates of growth in bank credit were higher than should be sustained in light of the current economic outlook. The Committee concluded that open market operations should be directed at maintaining about the prevailing conditions in the money market, but that operations should be modified, insofar as the Treasury financing permitted, to moderate any apparent tendency for bank credit to expand more than currently expected.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that economic activity has been expanding more rapidly in recent weeks. With strengthening of private demands for final products and further curtailment of inventory investment, a better balance between inventories and sales is emerging. Upward pressures on costs persist and the over-all indexes of both wholesale and consumer prices have risen further. The balance of payments deficit has remained substantial and is a serious national problem. Bank credit expansion has continued large, while most short- and long-term interest rates have fluctuated close to their highs of the year, under the combined pressure of heavy private security market financing and of current and prospective Federal financing. A new fiscal program has been proposed by the President, including a sizable increase in income taxes, which would make a substantial contribution to balanced economic growth. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to continuing eco-

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nomic expansion, while recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

To implement this policy, while taking account of expected Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified, insofar as Treasury financing permits, to moderate any apparent tendency for bank credit to expand more than currently expected.

Votes for this action: Messrs. Robertson, Brimmer, Daane, Maisel, Mitchell, Scanlon, Sherrill, Swan, Ellis, Patterson, and Treiber. Votes against this action: None.

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MEETING HELD ON SEPTEMBER 12, 1967

Authority to effect transactions in System Account.

Economic activity had strengthened recently and the prospect was for more rapid growth in coming months. It appeared that industrial production had advanced in August at about the July rate and since June had recovered much of the decline experienced earlier in the year. Nonfarm employment also rose further in August, and the unemployment rate again edged down—to 3.8 per cent from 3.9 per cent in July. Housing starts, which had fallen slightly in June, rebounded in July. Real GNP was expected to rise at a substantial rate in the third quarter as a whole, despite a strike that began in early September at a major automobile producer.

It appeared likely that growth in real GNP would accelerate further in the fourth quarter to a rate that would reinforce existing upward pressures on costs and prices. This expectation was premised on the assumptions—which were necessarily uncertain —that work stoppages in the automobile industry would be of relatively short duration and limited extent, and that a surcharge on Federal income taxes, which was now under consideration by Congress, would not go into effect before the end of the year. With growth in personal incomes accelerating as a result of more rapid increases in both employment and wage rates, consumer spending was expected to rise substantially, accounting for about half of the large advance in GNP foreseen for the fourth quarter. Also anticipated were continued sizable increases in Federal and State and local government spending, a moderate further rise in residential construction outlays, and some net growth in business inventories following the small decline expected for the third quarter. A Commerce–SEC survey taken in August indicated that businesses planned slightly smaller expenditures on plant and equipment during 1967 than had been reported in April and

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May, but the latest survey still suggested that such outlays would be slightly higher in the second half of the year than in the first half.

Prices of industrial commodities increased appreciably from mid-July to mid-August, according to preliminary estimates, although the total wholesale price index declined because of a downturn in prices of farm products and foods following 3 months of advance. Price increases were being announced for a wide variety of industrial materials and products as producers sought to pass on, at a time of strengthening demands, the increases in costs they had incurred earlier. The rise in industrial prices from July to August represented a departure from the pattern of stability that had prevailed over the preceding 5 months, when a downdrift in prices of materials had offset moderate advances in prices of industrial products. The consumer price index rose substantially further in July, partly because of seasonal increases in food prices.

With respect to the balance of payments, U.S. banks borrowed heavily through foreign branches during July and August, a period in which rates on Euro-dollar deposits were unusually low relative to rates offered by U.S. banks on domestic CD's. As a result, a substantial surplus developed after midyear in the payments balance on the "official reserve transactions" basis of calculation.

Tentative data suggested that the payments deficit on the "liquidity" basis was at a somewhat lower rate in July and August than in the first half of 1967, but that it was still undesirably large. The surplus on merchandise trade was about unchanged in July at a level below the average for the first 5 months of the year. Thus far in 1967 imports had remained unexpectedly high and exports had shown no tendency to grow, in part because of continued stagnation of business activity in most industrial countries abroad. Moderately stimulative monetary and fiscal measures had been taken in some countries; the most recent of these

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measures was a further reducton in Germany of minimum reserve requirements of commercial banks, effective September 1. However, the use of expansionary public policies had been restrained in many countries by concern over actual or prospective inflationary pressures or, as in the United Kingdom, by balance of payments problems.

On August 17, shortly after completing its mid-August refunding, the Treasury announced an offering of a 3½ year, 5⅜ per cent note (priced to yield 5.40 per cent), to raise $2.5 billion of new money. The payment date for the note, which carried full tax-and-loan-account privileges, was August 30. It was reported that the Treasury was tentatively planning to obtain part of the new cash it would require in the fourth quarter by auctioning about $4.5 billion of tax-anticipation bills in early October. On Friday, September 8, the Treasury replenished its balances by selling a special certificate of indebtedness in the amount of $153 million to the Federal Reserve. The certificate was redeemed 3 days later.

Recent System open market operations had been directed at maintaining generally steady conditions in the money market while the Treasury's note financing was under way. In the 4 weeks ending September 6 free reserves of member banks averaged about $285 million and member bank borrowings about $75 million, both little changed from the averages of the previous 4 weeks. In the latter part of August the interest rate on Federal funds fell to a level generally below the 4 per cent discount rate, and rates on bank loans to Government securities dealers also frequently dropped below the discount rate. In early September, however, rates of both types moved back to 4 per cent and above. Market rates on Treasury bills had fluctuated rather widely since the preceding meeting of the Committee, with the rate on 3-month bills rising 18 basis points on balance to 4.34 per cent on the day before this meeting. Yields on most other types of short-term securities fluctuated near their highs for the year.

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Capital markets remained under pressure in the latter part of August as a result of continued heavy corporate bond flotations and Treasury financing activity, and longer-term yields advanced to levels near or above the peaks reached earlier in the summer. The atmosphere in markets for U.S. Government notes and bonds and corporate securities subsequently improved, however, as the volume of publicly offered corporate bonds appeared to be moderating. In contrast, pressures persisted in markets for municipal securities, where the volume of new offerings in prospect for September was considerably above the reduced August level.

Business loans outstanding at commercial banks, which had risen sharply in July, declined by nearly as much in August. These changes probably were related in large part to delays in loan repayments relative to the usual seasonal pattern, because of the need in July of this year to finance accelerated payments to the Treasury of taxes withheld on individual incomes. Despite the contraction in business loans, total bank credit expanded rapidly in August, as it had in July. Banks again acquired a substantial volume of newly issued Treasury securities and they increased their loans to Government securities dealers considerably further. According to preliminary estimates the bank credit proxy—daily-average deposits of member banks—rose at an annual rate of 17 per cent from July to August, slightly more than had been anticipated. Most of this increase in the proxy series occurred in late July and early August; growth slackened markedly in the last 3 weeks of August.

Among deposit categories, total time and savings deposits continued to grow rapidly from July to August as the volume of outstanding negotiable CD's increased sharply further and inflows of other time and savings deposits remained large. Private demand deposits—and the money supply—again rose substantially on average, although growth ceased in the latter part of August when credit demands abated. U.S. Government deposits increased somewhat.

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Staff projections now suggested that the bank credit proxy would rise at an annual rate in the range of 9 to 12 per cent from August to September if money market conditions were unchanged. Loan demands appeared likely to be relatively moderate in September, and with U.S. Government deposits expected to rise slightly on average, it was anticipated that there would be little or no growth in private demand deposits and in the money supply. The rate of expansion in total time and savings deposits was expected to slacken considerably, primarily because banks were expected to become less aggressive in issuing negotiable CD's.

Considerable concern was expressed in the course of the Committee's discussion about the evidences of developing inflationary pressures in the economy and the prospects for overly rapid growth in aggregate demands later in the year. The members agreed that congressional enactment of the surcharge on income taxes recommended by the President would make a needed contribution to balanced economic growth.

Many members also indicated that they were disturbed by the rapid rates of increase in bank credit and the money supply in recent months. The Committee was divided, however, with regard to the appropriate course for monetary policy under current circumstances. The majority concluded that open market operations should be directed at maintaining prevailing conditions in the money market, with the proviso that operations should be modified as necessary to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

Members of the majority advanced various reasons in support of this course, including the desirability of waiting for firmer indications of the likely nature of action by Congress with regard to the President's tax proposals. Other considerations cited were the risks that under present conditions in financial markets even a modest move toward greater monetary restraint at this time might have an exaggerated impact on market expectations and result in sharp further increases in interest rates, with attendant

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adverse effects on depositary-type financial intermediaries and on the position of sterling in foreign exchange markets. Also noted were existing uncertainties with respect to the extent, duration, and ultimate economic effects of the strike in the automobile industry.

At the conclusion of the discussion the following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that economic activity has strengthened and, despite the strike in the automobile industry, that prospects favor more rapid growth later in the year. Upward pressures on costs persist and average prices of industrial commodities have turned up following several months of stability. While there recently have been large inflows of liquid funds from abroad, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large, while most short- and long-term interest rates have fluctuated close to their highs of the year, under the combined pressure of heavy private security market financing and of recent and prospective Federal financing. The President's new fiscal program calling for a sizable increase in income taxes, which would make a substantial contribution to balanced economic growth, is now before Congress. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified as necessary to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

Votes for this action: Messrs. Martin, Brimmer, Daane, Maisel, Mitchell, Robertson, Sherrill, Swan, and Wayne. Votes against this action: Messrs. Hayes, Francis, and Scanlon.

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Messrs. Hayes, Francis, and Scanlon dissented from this action because they thought that greater monetary restraint was required in light of recent rates of growth in bank credit, present and prospective inflationary pressures, and the unsatisfactory balance of payments situation. They considered it particularly important to modify monetary policy at this time because they felt that Treasury financing operations would limit the opportunities for such action later in the year. The dissenting members differed, however, with respect to the degree of restraint they thought was appropriate under present circumstances.

Mr. Francis favored seeking significantly firmer money market conditions, and firming still further if growth in bank credit did not moderate substantially. In his judgment, both monetary policy and fiscal policy were characterized by excessive ease at present, the lagged effects of which would magnify the pressures on the economy expected in the months ahead. He observed that fiscal policy was likely to remain extraordinarily stimulative even if the President's tax proposals were enacted in the form recommended. He expressed the view that the limitation by appropriate monetary action of excessive demand, inflation, speculation, and further deterioration in the U.S. balance of payments appeared to be more crucial than any temporary hardships on the Treasury, financial intermediaries, and long-term borrowers resulting from higher interest rates.

Messrs. Hayes and Scanlon, on the other hand, agreed with members of the majority that there were risks in moving toward firmer money market conditions at present. In their judgment, however, those risks argued not for maintaining prevailing money market conditions but for exercising caution in probing toward moderately less easy conditions.

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MEETING HELD ON OCTOBER 3, 1967

Authority to effect transactions in System Account.

Reports at this meeting indicated that underlying economic conditions had strengthened and that prospects were for more rapid growth later in the year, apart from the effects of the strike at a major automobile producer that was now in its fourth week. More complete data confirmed earlier indications that industrial production had increased further in August, and while output had probably declined in September, it appeared likely that growth would resume when the automobile industry returned to full production. Retail sales had continued to rise rapidly in August, according to the advance estimate, and housing starts had edged up. Price increases for industrial commodities continued to be widespread.

The latest information tended to support earlier expectations of a substantial increase in real GNP in the third quarter. Also, an acceleration in growth still appeared in prospect for the fourth quarter, when it was expected that final sales would rise considerably further and that business inventories would increase modestly. As before, the expectations for the fourth quarter were based on the assumptions that work stoppages in the automobile industry would be of relatively short duration and limited extent, and that a surcharge on Federal income taxes—which was still pending before Congress—would not go into effect before the end of the year.

Average prices of industrial commodities again increased appreciably from mid-August to mid-September, according to preliminary estimates, and the number of announced increases that were to become effective after the latter date suggested that the average would advance further in the following month. The consumer price index, which since March had been rising more rapidly than earlier, increased at a sizable rate in August. Unit labor costs in manufacturing were expected to remain under up-

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ward pressure in coming months, when it appeared likely that wage increases would more than offset gains in productivity.

The large deficit in the U.S. balance of payments on the "official reserve transactions" basis in the second quarter was followed by a large surplus in the third quarter as a result of heavy inflows of liquid funds, particularly in July and August, through foreign branches of U.S. banks. The deficit on the "liquidity" basis was estimated to have increased somewhat in the third quarter, although a decline would have been recorded had it not been for certain types of official transactions that had held down the second-quarter deficit. The merchandise trade surplus increased in August as a result of a reduction in imports. Prospects for renewed strength in exports had been enhanced by recent signs of industrial recovery in Germany and Britain, but imports also were expected to rise with expansion in U.S. business activity.

In Britain the improvement in exports and in the basic payments balance that had been hoped for in 1967 had not materialized thus far, in part because of the slowdown in economic activity on the continent and the balance of payments costs of the Middle East crisis, and sterling remained under pressure in foreign exchange markets. The Bank of Canada had raised its discount rate from 4½ to 5 per cent on September 27. This action was generally interpreted as a technical adjustment to the sharp increases in market interest rates that had occurred in Canada over the preceding 6 months.

On September 22 the U.S. Treasury announced that it would auction $4.5 billion of April and June tax-anticipation bills on October 3, the date of this meeting, for payment on October 9. The Treasury also indicated that it would add $100 million to each of its weekly bill offerings for 13 weeks beginning with the auction of October 9. Since early July the Treasury had raised about $10 billion of new cash through sales of bills—including today's offering of tax-anticipation bills—and nearly $3 billion through sales of coupon-bearing securities, and it appeared that

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the Treasury would need to raise substantial further amounts of cash in the remaining months of 1967. An announcement was expected in late October of the terms for refunding U.S. Government securities maturing in mid-November, of which $2.6 billion were held by the public.

System open market operations since the preceding meeting of the Committee had been directed at maintaining steady conditions in the money market. In the 3 weeks ending September 27 free reserves of member banks had averaged about $270 million and member bank borrowings about $85 million, both within the ranges prevailing recently, and the Federal funds rate had averaged about 4 per cent, slightly higher than in July and August. After the preceding meeting of the Committee the market rate on 3-month Treasury bills had risen sharply—reaching 4.60 per cent on September 22—chiefly as a result of market anticipations of additional Treasury bill financing. The bill rate had subsequently declined, however, and on the day before this meeting it was 4.40 per cent, only 6 basis points above its level 3 weeks earlier. Rates on other short-term market instruments increased further or remained at advanced levels.

In capital markets the volume of new securities offered to the public had moderated recently. Although flotations by State and local governments in September and those in prospect for October were considerably above their reduced August level, the presently estimated volume of new corporate offerings in September and October was only about half the extraordinarily large volume of July and August. Nevertheless, bond yields were subject to renewed upward pressures, with yields on long-term Treasury bonds rising to levels above their 1966 highs. In part, the pressures in capital markets reflected apprehension over the large cash needs of the Treasury in prospect for the near term. They also reflected concern about developing inflationary pressures, growing doubts about the prospects for congressional enactment of the proposed income tax surcharge, and accompany-

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ing uncertainties concerning the course of monetary policy.

In August interest rates on conventional mortgages on new homes edged up, and secondary-market yields on Federally underwritten mortgages increased. Inflows of funds to nonbank depositary-type institutions remained large—although not quite so large in August, after seasonal adjustment, as in the spring and early summer.

Demands for business loans at commercial banks were relatively light in early September but they appeared to have picked up around the midmonth tax-payment period. Growth in total time and savings deposits moderated considerably, mainly because of a sizable reduction in the volume of negotiable CD's outstanding. Private demand deposits and the money supply changed little, but U.S. Government demand deposits increased further from their June low. According to preliminary estimates, daily-average member bank deposits—the bank credit proxy—rose at an annual rate of 9.5 per cent from August to September, well below the rate of more than 15 per cent earlier in the summer.

Staff projections suggested that if money market conditions remained unchanged the bank credit proxy would rise at an annual rate in the 10 to 13 per cent range from September to October. About half of the expansion was expected to be in U.S. Government deposits, as a result of heavy borrowing by the Treasury during October. Growth in time and savings deposits appeared likely to be at a somewhat more rapid rate than in the preceding month, but less rapid than the average rate earlier in the year. Private demand deposits—and the money supply—were expected to rise only slightly.

Many members of the Committee thought that current and prospective inflationary pressures and the rapid rate of bank credit growth in recent months offered strong grounds for seeking somewhat greater monetary restraint at this time. Some members also pointed to the unsatisfactory balance of payments situ-

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ation as arguing for a firming of monetary policy. The majority believed, however, that these considerations were outweighed by others militating against a change in policy at present. The latter included the desirability of awaiting firmer indications of the probable actions by Congress with respect to Federal taxes and expenditures; the uncertainties regarding the extent and duration of the automobile industry strike; and the risk that under present financial market conditions any firming action at this time would lead to sharply higher interest rates, with possible undesired effects on financial intermediaries domestically and on the position of sterling in foreign exchange markets. The Treasury's current bill financing and, more importantly, the November refunding soon to follow also were cited as considerations arguing against a change in monetary policy at this juncture.

The Committee concluded that open market operations should be directed at maintaining about the prevailing conditions in the money market, but that operations should be modified, to the extent permitted by Treasury financing, to moderate any apparent tendency for bank credit to expand more than currently expected. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that, apart from the effects of the strike in the automobile industry, underlying economic conditions have strengthened and prospects favor more rapid growth later in the year. Upward pressures on costs persist, average prices of industrial commodities have risen further, and the rate of increase in consumer prices remains high. While there recently have been large inflows of liquid funds from abroad through foreign branches of U.S. banks, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large, although there was some moderation in September from the rapid July–August rate. The volume of corporate bond flotations has slackened, but Federal and State and local government financing demands remain large and most interest rates have on balance moved up somewhat further. The President's new fiscal program is still pending before Congress. In this situa-

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tion, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified, to the extent permitted by Treasury financing, to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

Votes for this action: Messrs. Hayes, Brimmer, Daane, Maisel, Mitchell, Robertson, Sherrill, Swan, and Wayne. Votes against this action: Messrs. Francis and Scanlon.

Messrs. Francis and Scanlon dissented from this action because they assessed the balance of considerations at issue differently from the majority and favored seeking greater monetary restraint. In their judgment, in view of the prospects for further price inflation the risks in not acting at this time to moderate the rapid growth of bank credit outweighed the various considerations seen as militating against a firmer monetary policy.

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MEETING HELD ON OCTOBER 24, 1967

Authority to effect transactions in System Account.

Underlying economic conditions continued strong despite recent weakness in some key measures of activity resulting from strikes in the automobile and other industries. In the third quarter, according to preliminary Commerce Department figures, real GNP rose substantially and average prices—as measured by the GNP "deflator"—increased more rapidly than they had earlier in the year. It appeared likely that the rate of growth in real output would step up in the fourth quarter if major work stoppages were limited in duration and extent and that inflationary pressures would continue. Expectations had diminished that a surcharge on Federal income taxes, as recommended by the President, would be enacted before the year-end.

Both nonfarm employment and industrial production declined in September, largely as a result of strikes. The unemployment rate rose to 4.1 per cent from 3.8 per cent in August, mainly because of an unusually large increase in the number of women in the labor force. However, continued tightness in over-all labor market conditions was indicated by other evidence, including a decline in the unemployment rate for adult men to an extremely low level and a rise in the index of help-wanted advertising. Against the background of tight labor markets and recent rapid increases in consumer prices, it appeared likely that settlements in current wage negotiations would be of a nature to maintain upward pressures on costs.

In the fourth quarter business inventories were expected to increase modestly—as they had in the third quarter—and further advances were anticipated in most major categories of final demand. Growth in consumer expenditures had been smaller than expected in the third quarter; estimates of retail sales for July and August, particularly at nondurable goods stores, had been

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revised downward sharply, and the advance estimate for September showed little improvement. However, it appeared likely that consumer spending would increase considerably in the fourth quarter, when the rate of growth in disposable income was expected to rise further unless retarded by extended major strikes or restrained by enactment of a tax increase. Further advances also seemed to be in prospect for residential construction, which had risen substantially in the third quarter, and for business fixed investment, which had turned up after declining moderately in the first half of the year. Growth in defense spending had slowed markedly after midyear, but a sharp rise in total Federal outlays was anticipated in the final quarter largely because of expected increases in civilian and military pay.

With respect to the U.S. balance of payments, substantial deficits had been recorded in each of the first three quarters of 1967 on the "liquidity" basis of calculation, and another such deficit appeared likely in the fourth quarter. The balance on the "official reserve transactions" basis had swung widely in recent quarters as a result of wide fluctuations in liabilities of U.S. banks to their foreign branches, but for the first three quarters of 1967 as a whole there had been a sizable deficit on this basis also. Sterling continued under pressure in foreign exchange markets, and on October 19 the Bank of England raised its discount rate from 5½ to 6 per cent.

On October 3 the Treasury auctioned $1.5 billion of tax-anticipation bills maturing in April and $3.0 billion maturing in June at average issuing rates of 4.93 and 5.11 per cent, respectively. Commercial banks initially absorbed almost all of the new issues, which carried 75 per cent tax-and-loan-account privileges. Bids for the June tax bills exceeded the amount offered by an unusually small margin. An announcement was anticipated on the day following this meeting of the terms on which the Treasury would refund securities maturing in mid-November, of which

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$2.6 billion were held by the public. The Treasury was expected to raise some new cash in connection with that refunding.

System open market operations since the preceding meeting of the Committee had continued to be directed at maintaining steady conditions in the money market. Free reserves of member banks fluctuated widely in the 3 weeks ending October 18, but their average of about $265 million was little changed from that of the preceding 3 weeks. Both excess reserves and borrowings of member banks increased; borrowings averaged about $170 million, compared with $85 million in the preceding period. Rates on Federal funds and on bank loans to Government securities dealers rose somewhat in the first half of October, but after that they moved down again.

Interest rates on most short-term market instruments had advanced further since the preceding meeting of the Committee. The market rate on 3-month Treasury bills, at 4.58 per cent on the day before this meeting, was 18 basis points higher than 3 weeks earlier. In part this increase reflected the shift in the maturity dates of 3-month bills to January from the December dates that are attractive to many investors. It also reflected the increased bill supplies resulting from the Treasury's tax-anticipation bill offering in early October and the continued $100 million additions to the weekly bill offerings.

Bond yields had risen significantly further in recent weeks; yields on municipal bonds had advanced to their highest levels since the early 1930's, and those on corporate and long-term Treasury bonds to levels not reached since the early 1920's. These developments reflected diminishing confidence in financial markets that a tax increase would be enacted and a related heightening of expectations that monetary policy would become firmer. In this atmosphere investors were becoming more reluctant to acquire long-term securities and borrowers were increasingly tending to anticipate later needs. The volume of new corporate securities offered publicly in October was now expected

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to be considerably larger than the reduced offerings of September, and the November calendar was growing rapidly. Flotations of municipal securities were expected to decline in October—partly because a number of issues had been postponed or reduced in size—but it appeared likely that the volume of such issues would increase again in November.

Interest rates on conventional mortgages on new homes remained at their advanced August level in September, and secondary-market yields on Federally underwritten mortgages rose for the fifth consecutive month. Although inflows of funds to nonbank depositary institutions continued large, in the third quarter as a whole they were below the record volume of the second quarter, after allowance for seasonal influences.

At commercial banks, loans on securities and loans to nonbank financial institutions increased markedly in September and apparently also in early October. Growth in business loans appeared to have stepped up somewhat in recent weeks from its earlier slow pace, but to a large extent the increased demands for such loans probably reflected needs to finance payments to the Treasury of corporate income taxes in September and of withheld taxes in early October. As to total bank credit, estimates of recent and current growth rates had been revised upward somewhat since the preceding meeting of the Committee. The bank credit proxy—daily-average member bank deposits—now was estimated to have risen at about a 10½ per cent annual rate from August to September and was projected to rise at a rate in the range of 12 to 15 per cent from September to October. The money supply, which earlier had been expected to grow relatively little in October, was now projected to rise in that month at an annual rate in the 7 to 9 per cent range.

Growth in both the bank credit proxy and the money supply was expected to moderate somewhat in November—to annual rates in the ranges of 7 to 10 per cent and 4 to 6 per cent, respectively—if money market conditions were unchanged. Al-

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though the outlook for business loan demands was particularly uncertain at present, on balance such demands appeared likely to remain moderate in both November and December.

The Committee decided that the forthcoming Treasury financing precluded any change in monetary policy at this time. Some members favored no policy change on other grounds also, including the continuing uncertainties regarding the probable outcome of the current congressional debate on fiscal policy measures. Also cited in this connection was the judgment that a considerable degree of restraint was already being imposed on potential borrowing and spending by the high levels to which long-term interest rates had risen. In addition, it was noted that further increases in market interest rates at this time might well have undesired effects on flows of funds to financial intermediaries and on the position of sterling in foreign exchange markets.

Other members indicated that in the absence of Treasury financing activity they would have been inclined to advocate some firming of monetary policy in an effort to slow the rapid growth of bank credit and the money supply. In their judgment, current and prospective inflationary pressures and the continued large deficits in the balance of payments argued strongly for such a course.

At the conclusion of the discussion the following current economic policy directive was issued to the Federal Reserve Bank of New York:

The economic and financial developments reviewed at this meeting indicate that, apart from the effects of strikes in the automobile and other industries, underlying economic conditions continue strong and prospects favor more rapid growth in the months ahead. Upward pressures on costs persist, average prices of industrial commodities have risen further, and the rate of increase in consumer prices remains high. While there recently have been large inflows of liquid funds from abroad through foreign branches of U.S. banks, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large. The volume of new security issues is expanding again and interest rates

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have risen further, reflecting in part increased uncertainties in financial markets concerning enactment of the President's fiscal program. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

To implement this policy, while taking account of forthcoming Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified, to the extent permitted by Treasury financing, to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

Votes for this action: Messrs. Martin, Brimmer, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, Wayne, and Treiber. Vote against this action: Mr. Francis.

Mr. Francis dissented from this action because he favored seeking whatever degree of firming in money market conditions would be required to moderate substantially the growth in bank credit and the money supply by the end of the year. He agreed that Treasury financing operations would have to be taken into account to some extent in implementing such a policy. Nevertheless, he thought that the national interest called for greater monetary restraint now to curb inflationary pressures and to protect the foreign trade component of the U.S. balance of payments.

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MEETING HELD ON NOVEMBER 14, 1967

1. Authority to effect transactions in System Account.

Although strikes recently had been retarding activity in some areas of the economy, real GNP was expected to increase more rapidly in the current quarter than it had in the third quarter. A still higher rate of economic growth and continued upward pressures on prices and costs appeared to be in prospect for early 1968, particularly if an income tax surcharge as proposed by the President were not enacted.

Recent weakness in various broad measures of business activity was largely a consequence, directly or indirectly, of work stoppages in the automobile industry and in some other industries. Industrial production was estimated to have declined slightly further in October. Retail sales decreased appreciably, according to the advance estimate, mainly because of a sharp reduction in automobile sales attributable to the limited availability of new cars. Total nonfarm employment rose relatively little; the net increase in manufacturing employment was held down by strikes, and Federal Government employment declined slightly because of a curb on hiring. With the labor force increasing more rapidly than usual, the unemployment rate rose further, to 4.3 per cent from 4.1 per cent in September. Residential construction activity, however, continued to rise strongly in October.

It appeared likely that final sales to both the private and Government sectors of the economy would increase more rapidly in the fourth quarter than in the third, but that the rate of business inventory accumulation would remain low. Growth in output, employment, and incomes was expected to be quickened in the early months of 1968 by business efforts to rebuild inventories depleted by strikes and by efforts of steel users to accumulate stocks as a hedge against a possible steel strike in the summer.

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Moreover, it appeared that consumer spending would be stimulated in early 1968 by liberalization of social security benefits and by a Federal employee pay raise, as well as by continued sizable advances in industrial wage rates—including increases resulting from the rise in minimum wage rates on February 1, 1968, as provided by existing legislation.

Wholesale prices of industrial commodities increased further from mid-September to mid-October, according to preliminary estimates, but prices of farm products and foods declined, and the total wholesale price index edged down. The consumer price index rose somewhat less in September than it had in other recent months as food prices declined.

Further information confirmed earlier estimates that the deficit in the U.S. balance of payments on the "liquidity" basis of calculation was at a rate somewhat higher in the third quarter than in the first half of the year, and another large deficit appeared to be in prospect for the fourth quarter. The merchandise trade surplus declined in September from the high August rate, as imports increased while exports fell; in the third quarter as a whole the trade surplus was about the same as in the second quarter. On the "official reserve transactions" basis, a sizable surplus was recorded in the third quarter following substantial deficits in the first half of the year. This surplus was due primarily to large inflows of liquid funds to U.S. banks through their foreign branches. Net inflows of such funds continued after the end of September. Sterling was under heavy pressure in foreign exchange markets and on November 9, for the second time in 3 weeks, the Bank of England raised its discount rate by ½ of a percentage point, to 6½ per cent.

In its November financing—for which subscription books were open October 30—the Treasury refunded securities maturing November 15, including $2.6 billion held by the public, and raised $2.2 billion of new money. Two issues were offered—a 15-month, 5⅝ per cent note, and a 7-year, 5¾ per cent note—

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of which private investors were allotted $3.2 billion and $1.6 billion, respectively. While the two notes were well-received initially—with the longer maturity, in particular, heavily oversubscribed—selling pressures developed soon after the books had closed and on the day before this meeting prices of both were quoted at discounts. It was announced on November 10 that $650 million of participation certificates of the Federal National Mortgage Association would be offered to the public on November 28. Apart from the continuing addition of $100 million to each weekly and monthly bill auction, this was expected to be the Government's last new cash financing in the calendar year 1967.

Open market operations since the preceding meeting of the Committee had continued to be directed at maintaining steady conditions in the money market. Net free reserves of member banks averaged about $200 million during the 3 weeks ending November 8, compared with a revised figure of about $240 million for the preceding 3 weeks. Excess reserves of member banks declined, particularly at country banks; borrowings also declined, to an average of $90 million from about $170 million in the preceding period. Average rates on Federal funds and on bank loans to Government securities dealers were a little lower than in September and the early weeks of October. Interest rates on short-term market instruments remained generally unchanged or rose slightly from their levels at the time of the preceding meeting of the Committee. The market rate on 3-month Treasury bills was 4.62 per cent on the day before this meeting, up 4 basis points from its level 3 weeks earlier.

After a brief interruption in late October, bond yields resumed their advance in all sectors of the capital market. Yields on long-term Government bonds at the time of this meeting were significantly above both the levels prevailing 3 weeks earlier and the highs reached in 1966, and those on intermediate-term Government issues were up sharply. Yields on new corporate and

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municipal issues also advanced, the former to levels exceeding the previous peaks reached in mid-October. The renewal of upward pressures on bond yields reflected in part a heavy prospective volume of new offerings of corporate and municipal securities in November and anticipations of the large FNMA offering. Also contributing to the pressures were prospects of inflationary developments and growing expectations in financial markets that a tax increase would not be enacted this year and that monetary policy would become firmer. On the day before this meeting, a major corporate bond offering was postponed as a result of congestion and uncertainties in the capital market.

The incomplete data available suggested that secondary-market yields on Federally underwritten mortgages rose further in October—approaching the record level reached toward the end of 1966. It appeared that net inflows of funds to nonbank depositary institutions continued to moderate in October on a seasonally adjusted basis. By the end of September outstanding mortgage commitments of private lenders were virtually back to the postwar high of January 1966, but in recent weeks some individual lenders were reported to have reduced their new commitments.

Commercial bank holdings of Treasury and other securities rose considerably in October. Security loans and loans to nonbank financial institutions also increased relatively fast, but the advance in business loans was again quite moderate. The bank credit proxy—daily-average member bank deposits—increased at an annual rate of 12 per cent, a little faster than in the preceding month. Time and savings deposits expanded at an annual rate of 13 per cent in October, slightly above the September rate but well below the average rate of more than 17 per cent for the first 8 months of the year. The money supply, which had been virtually unchanged in September, increased at an annual rate of about 6.5 per cent in October.

The rate of expansion in bank credit was expected to slow in the last 2 months of the year if prevailing money market con-

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ditions were maintained. It appeared likely that demands for business loans would remain moderate in view of prospects that changes in business spending on inventories and fixed capital would be small. The bank credit proxy was still projected to rise at an annual rate in the 7 to 10 per cent range in November, and a somewhat lower growth rate was anticipated for December. In November the money supply was expected to increase at an annual rate in the range of 6 to 8 per cent and time and savings deposits in the range of 9 to 11 per cent.

At this meeting the Committee heard reports on negotiations relating to international credit assistance to the United Kingdom in addition to reviewing conditions and prospects with respect to the domestic economy, the U.S. balance of payments, and the foreign exchange markets. After discussion the Committee agreed that no change should be made in monetary policy at this time, in view of the sensitive state of conditions in foreign exchange markets and of the international negotiations now under way. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that, while the direct and indirect effects of strikes have been retarding activity in some areas of the economy, prospects still favor more rapid economic growth in the months ahead. Although prices of farm products and foods have declined recently, upward pressures persist on industrial prices and costs. While there recently have been further inflows of liquid funds from abroad through foreign branches of U.S. banks, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large. The volume of new private security issues has expanded further and interest rates remain under upward pressure, reflecting in part increased doubts in financial markets concerning enactment of the President's fiscal program. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

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To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market, but operations shall be modified as necessary to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, and Wayne. Votes against this action: None.

2. Amendment to authorization for System foreign currency operations.

The Committee amended paragraphs 1B(3) and 1C(1) of the authorization for System foreign currency operations, in each case effective as of the date of a determination by Chairman Martin that such action was in accordance with the position of the United States in the current international negotiations concerning credit assistance to the United Kingdom. In the amendment to paragraph 1B(3) the limit on authorized System Account holdings of sterling purchased on a covered or guaranteed basis was increased from $200 million to $300 million equivalent. In the amendment to paragraph 1C(1) the limit on outstanding forward commitments to deliver foreign currencies to the Stabilization Fund was increased from $200 million to $350 million equivalent, and language restricting the foreign currencies covered by the paragraph to currencies "in which the U.S. Treasury has outstanding indebtedness" was deleted.

Chairman Martin made the indicated determination on November 21, 1967, for the amendment to paragraph 1B(3) and on November 22, 1967, for the amendment to paragraph 1C(1). Accordingly, the respective amendments became effective on those dates. With these two amendments, the first paragraph of the authorization read as follows:

The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account,

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to the extent necessary to carry out the Committee's foreign currency directive:

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

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

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

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

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

(3) Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $300 million equivalent.

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

(1) Commitments to deliver foreign currencies to the Stabilization Fund, up to $350 million equivalent;

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

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

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

Votes for this action: Messsr. Martin, Hayes, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, and Wayne. Votes against this action: None.

In his report on the negotiations now in process concerning international credit assistance to the United Kingdom, the Special Manager for foreign currency operations noted that one possible form of U.S. participation in such assistance was an undertaking by U.S. monetary authorities to acquire additional sterling. The previous authority to acquire sterling, including the authorization to acquire up to $200 million for System Account, had proved useful at times in the past in market operations undertaken by the Special Manager for purposes specified in the Committee's foreign currency directive. The Special Manager indicated that in his judgment an increase of $100 million in the limit on such holdings by the System was justified in light of possible future needs for similar market operations. Accordingly, he recommended that if in the current negotiations the United States were to undertake to acquire additional sterling, $100 million should be acquired for System account and the remainder for Stabilization Fund account.

The Special Manager also indicated that if the arrangements were concluded on the basis he had suggested the resources of the Stabilization Fund might be inadequate to meet all demands upon them from time to time in the future. Accordingly, he recommended the amendments to paragraph 1C(1) of the authori-

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zation described above to enable the System Account to "warehouse" part of the Treasury's holdings of sterling if that should prove desirable. Past operations undertaken under the terms of paragraph 1C(1) had been limited to the purpose of facilitating repayment by the Treasury of maturing bonded debt denominated in foreign currencies.

After discussion, the Committee concurred in the recommendations of the Special Manager and took the actions indicated.

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MEETING HELD ON NOVEMBER 27, 1967

1. Authority to effect transactions in System Account.

On Saturday, November 18, 1967, the par value of the pound sterling was reduced by 14.3 per cent, from $2.80 to $2.40. The British authorities simultaneously announced a broad series of measures designed to reduce domestic demands and in general to facilitate the economic adjustments required to achieve a substantial improvement in the balance of payments of the United Kingdom. These measures included an increase in the discount rate of the Bank of England from 6½ to 8 per cent, its highest level in 53 years. On November 19 the Federal Reserve announced an increase in its discount rate from 4 to 4½ per cent, effective the next day. Today's meeting had been called for the purposes of reviewing the latest developments and making such revisions in the Open Market Committee's policy instruments as were needed in the light of recent events.

Following the British devaluation, all of the other major industrial countries comprising the "Group of Ten" announced promptly that the par values of their currencies would not be changed. The announcement for the United States took the form of a statement on November 18 by President Johnson, unequivocally reaffirming the U.S. commitment to the existing price of $35 per ounce for gold. Some countries did devalue after the British action, but together they accounted in 1966 for only about 6 per cent of world trade, less than Britain alone. Among the countries devaluing, Spain, Ireland, and Israel reduced the par values of their currencies by the same percentage as Britain had; New Zealand by more; and Denmark and Hong Kong by less.

Conditions in markets for foreign exchange and gold had been turbulent since the Committee's preceding meeting on November 14. Pressures on sterling had increased after publication that day

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of British foreign trade figures for October, which indicated that a deficit of record proportions had been incurred. The pressures eased over most of the next 2 days, when there were rumors regarding negotiations for foreign central bank credit assistance to the United Kingdom, but they resumed late on Thursday, November 16. On Friday there were press reports that a devaluation of the pound was imminent, and the markets were flooded by offers of sterling. Demands for gold in the London market and other foreign centers increased substantially, and some central banks in continental Europe acquired sizable amounts of dollar reserves as a result of shifts by market participants from sterling into continental European currencies.

The British authorities declared a bank holiday for the Monday following devaluation. When foreign exchange trading resumed in London on Tuesday, November 21, spot sterling was quoted at its new ceiling rate of $2.42, where it remained for the rest of the week. Market demands for gold continued to mount, however, and reached unprecedented levels during the week. Continental central banks experienced only small changes in their dollar reserves during most of the week, but made sizable acquisitions on Friday.

On Sunday, November 26, the following statement was issued in Washington:

The Secretary of the Treasury and the Chairman of the Federal Reserve Board made available a communique issued in Frankfurt, Germany, today which reads as follows:

> The Governors of the Central Banks of Belgium, Germany, Italy, Netherlands, Switzerland, United Kingdom and the United States convened in Frankfurt on November 26, 1967.
>
> They noted that the President of the United States has stated:
>
> "I reaffirm unequivocally the commitment of the United States to buy and sell gold at the existing price of $35 per ounce."
>
> They took decisions on specific measures to ensure by coordinated action orderly conditions in the exchange markets and to support the

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present pattern of exchange rates based on the fixed price of $35 per ounce of gold.

They concluded that the volume of gold and foreign exchange reserves at their disposal guarantees the success of these actions; at the same time they indicated that they would welcome the participation of other central banks.

On the following day—the day of this Committee meeting—the market demand for gold was considerably below its levels during the preceding week.

In domestic financial markets both short- and long-term interest rates had fluctuated widely since the Committee's November 14 meeting. Yields initially declined, following the postponement of a large bond issue by a major U.S. corporation and the reports concerning negotiations for credit assistance to Britain. They advanced on Friday, November 17, however, in the wake of the mounting pressures on sterling and rumors of imminent devaluation. On Monday, November 20, both short- and long-term interest rates rose sharply in the initial reaction to the events of the preceding weekend. A large commercial bank increased its prime lending rate from 5½ to 6 per cent that day, and various other banks followed shortly.

The securities markets began to rally on Monday afternoon, and they strengthened further on the following 2 days. Factors underlying the rally included large-scale purchases of Government securities by the System, the postponement of a number of corporate and municipal bond issues, and an announcement that the House Ways and Means Committee would reopen hearings shortly on the administration's proposals for increased fiscal restraint.

Market interest rates rose sharply again on Friday, November 24, however, when uncertainties were increasing in foreign exchange and gold markets. Yields on municipal and seasoned corporate bonds advanced to new record levels, but yields on intermediate- and long-term Government securities did not re-

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attain the highs they had reached on the day before the Committee's preceding meeting. Most short-term yields had increased considerably, on balance, since that time; the market rate on 3-month Treasury bills, at about 4.90 per cent, was up approximately 30 basis points over the period. Major banks raised their offering rates on large-denomination CD's, and rates on CD's maturing in 3 months or more were now generally at the 5½ per cent ceiling established by Regulation Q.

The System conducted large-scale open market operations on the Monday after the devaluation of sterling and the announcement of the increase in Federal Reserve discount rates, with a view to facilitating orderly adjustments to the new circumstances brought about by these events. Early in the day the System placed bids with Government securities dealers for a substantial volume of securities maturing in more than 1 year. After purchasing $186 million of such securities it also bought $427 million of Treasury bills. These operations absorbed some of the overhanging supply of securities that might otherwise have been pressed onto an unreceptive market; and as sentiment improved, market conditions quickly became relatively normal. No further System operations were carried out in the market during the rest of the week, although on Friday $191 million of Treasury bills were purchased directly from foreign accounts.

Free reserves of member banks were at the relatively low level of about $90 million in the statement week ending November 22, despite the large volume of reserves provided by both the System's security purchases on Monday and by various international transactions. Interest rates on Federal funds and on bank loans to Government securities dealers, like other market rates, had fluctuated widely in recent weeks. By the Friday before this meeting, however, money market rates had moved into closer alignment with the new level of the discount rate; the effective rate on Federal funds that day, at 4½ per cent, was equal to the discount rate, and dealer loan rates also had risen.

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In considering the domestic open market policy to be followed in the period until its next meeting, the Committee took note of the various crosscurrents that were likely to be at work as a consequence of the increase in Federal Reserve discount rates and of recent events abroad, and of the continuing uncertainties with respect to international developments and their possible impact on domestic financial markets. At the conclusion of the discussion the following current economic policy directive was issued to the Federal Reserve Bank of New York:

System open market operations until the next meeting of the Committee shall be conducted with a view to facilitating orderly market adjustments to the increase in Federal Reserve discount rates; but operations may be modified as needed to moderate any unusual pressures stemming from international financial uncertainties.

Votes for this action: Messrs. Martin, Brimmer, Francis, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, and Ellis. Votes against this action: None.

2. Amendments to authorization for System foreign currency operations.

At this meeting the Committee amended its authorization for System foreign currency operations in a number of respects, against the background of the discussions by the central bank governors at their meeting in Frankfurt. The amendments included an increase in the limit, specified in paragraph 1C(3) of the authorization, on forward commitments by the System Account to deliver foreign currencies; and enlargements of the swap arrangements, specified in paragraph 2, with a number of central banks and the Bank for International Settlements. In a further action, related to the change approved in the size of the swap arrangement with the Bank of England, the limit on authorized System Account holdings of sterling purchased on a covered or guaranteed basis, specified in paragraph 1B(3), was reduced to the level prevailing prior to the amendment to that paragraph that was approved on November 14, 1967.

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With respect to the first of these actions, one of the agreements reached at the Frankfurt meeting was that the foreign central banks represented there, in collaboration with U.S. monetary authorities, would undertake coordinated operations in forward markets. In these operations the central banks would sell their own currencies forward against dollars, to discourage further large accruals of dollar reserves such as had occurred on the Fridays before and after the sterling devaluation and, if possible, to encourage some reflows from European currencies to the Eurodollar market. The U.S. Treasury had agreed to cooperate in this program, and forward operations in certain currencies had already begun, with the System Account participating on the basis of the authority contained in paragraph 1C(3) of the authorization for System foreign currency operations. It was noted that the existing authority to undertake forward commitments up to $275 million equivalent might well prove adequate to the System's needs in this connection. However, the Committee concurred in the recommendation of the Account Management that the limit contained in paragraph 1C(3) be doubled, to $550 million equivalent, to provide against the possibility of larger needs.

The increases in a number of System swap arrangements, which were for the purpose of providing a broader margin of safety for the stability of the international monetary system, were approved on the understanding that enlargements of certain additional swap arrangements might be proposed subsequently. Paragraph 2 of the authorization was amended to change the size of the reciprocal currency arrangements with (1) the National Bank of Belgium, from $150 million to $225 million equivalent; (2) the Bank of Italy, from $600 million to $750 million equivalent; (3) the Netherlands Bank, from $150 million to $225 million equivalent; (4) the Bank of Sweden, from $100 million to $200 million equivalent; (5) the Bank for International Settlements (the arrangement providing for System drawings in

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authorized European currencies other than Swiss francs), from $300 million to $600 million equivalent; (6) the Bank of England, from $1,350 million to $1,500 million equivalent; (7) the Bank of Japan, from $450 million to $750 million equivalent; and (8) the German Federal Bank, from $400 million to $750 million equivalent. On advice that negotiations looking toward the indicated increases had already been conducted with the first five foreign banks listed above, the corresponding changes in the authorization were approved effective immediately. The changes relating to the swap arrangements with the central banks of England, Japan, and Germany were approved on the basis that they would become effective upon a determination by Chairman Martin that preliminary negotiations had been satisfactorily completed. The Chairman made such a determination with regard to the swap arrangements with the central banks of England and Japan on November 28, and with regard to the arrangement with the German Federal Bank on November 30.

With respect to the amendment to paragraph 1B(3), an increase in the limit specified there on System holdings of sterling had been approved at the preceding meeting of the Committee, at a time when it appeared that the United Kingdom might find it possible to maintain the par value of the pound at $2.80. In light of the subsequent devaluation, the Committee concluded that any expansion of credit facilities between the Federal Reserve and the Bank of England would more appropriately take the form of an increase in the size of the swap arrangement between the two central banks. Accordingly, the language of the affected paragraph was restored to the form in effect before the November 14 action.

Votes for these actions: Messrs. Martin, Brimmer, Francis, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, and Wayne. Votes against these actions: None.

Subsequent to this meeting, on November 30, the Special Manager recommended that paragraph 2 of the authorization for

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System foreign currency operations be further amended to change the size of the swap arrangement with the Bank of Canada from $500 million to $750 million equivalent. This recommendation was unanimously approved by available members of the Committee, namely, Messrs. Martin, Hayes, Brimmer, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, and Wayne.

As a result of these several actions, the first two paragraphs of the authorization for System foreign currency operations read as follows:

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

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

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

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

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

(2) Additional currencies held spot or purchased forward, up to the

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amount necessary for System operations to exert a market influence but not exceeding $150 million equivalent; and

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

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

(1) Commitments to deliver foreign currencies to the Stabilization Fund, up to $350 million equivalent;

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

(3) Other forward commitments to deliver foreign currencies, up to $550 million equivalent.

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

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	225
Bank of Canada	750
National Bank of Denmark	100
Bank of England	1,500
Bank of France	100
German Federal Bank	750

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Italy	750
Bank of Japan	750
Bank of Mexico	130
Netherlands Bank	225
Bank of Norway	100
Bank of Sweden	200
Swiss National Bank	250
Bank for International Settlements:	
System drawings in Swiss francs	250
System drawings in authorized European currencies other than Swiss francs	600

At this meeting the Committee also reviewed certain transactions in sterling that had been made during the preceding week by the Federal Reserve Bank of New York with a number of U.S. commercial banks. Specifically, the New York Bank had sold sterling from System Account holdings to the U.S. commercial banks, for delivery on Tuesday, November 21, and had concurrently repurchased forward an equivalent amount of sterling from each bank for delivery on Friday, November 24. Similar transactions were conducted for Treasury account, with sales for delivery on Wednesday and repurchases for delivery on Friday.

These transactions were carried out to enable the U.S. commercial banks to make deliveries of sterling on Tuesday and Wednesday, under contracts they had made on Friday, November 17. The commercial banks involved had originally entered into those contracts in order to balance their positions in sterling, in accordance with their customary practice, after accommodating commercial customers and correspondent banks that had desired to sell sterling forward. At the time they made the spot contracts, the commercial banks had expected to acquire the necessary ster-

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ling in the market on Monday, November 20, but were unable to do so because the British authorities had declared that day to be a bank holiday.

The New York Bank took measures to insure that such transactions did not provide relief to any commercial bank to the extent that it was short sterling as a result of operations on its own initiative. In cases where the banks had over-all short positions in sterling as of Friday, November 17, an amount equal to that short position was deducted from the amount made available by the New York Bank, except where the short position could be explicitly justified by the bank in question.

The broad purpose of these transactions, from the System's point of view, was to avoid the disorder in the foreign exchange market that might have resulted from widespread defaults on foreign exchange contracts. The transactions were carried out with the concurrence of a majority of the Subcommittee authorized, under the terms of paragraph 6 of the authorization for System foreign currency operations, to act on behalf of the Federal Open Market Committee when necessary to enable the New York Bank to engage in foreign currency operations before the Committee could be consulted. After discussion at this meeting, the Committee unanimously approved, ratified, and confirmed these transactions, along with other System transactions in foreign currencies since the previous meeting.

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MEETING HELD ON DECEMBER 12, 1967

1. Authority to effect transactions in System Account.

Evidence was accumulating of a resurgence in economic activity following settlement of strikes in the automobile industry and in other industries. It now appeared highly probable that growth in over-all activity would accelerate in early 1968 and that upward pressures on prices would persist as the effects of higher costs were reinforced by those of rapidly expanding demands.

Preliminary indications were that industrial output had rebounded in November, that employment had risen sharply in both manufacturing and other areas, and that the unemployment rate had declined to less than 4 per cent from 4.3 per cent in October. Retail sales had increased significantly, according to the advance estimate, and residential construction activity had continued to expand. Average prices of industrial commodities had advanced further from mid-October to mid-November, and numerous increases were announced in subsequent weeks. A sizable rise in the consumer price index in October brought its increase since March to an annual rate of over 3.5 per cent.

The business outlook for early 1968 appeared strong despite an anticipated slowing of the advance in Federal expenditures, including defense outlays. Consumer spending was expected to rise in pace with rapidly growing incomes. Although the latest Commerce–SEC survey of business capital spending plans indicated a slightly lower level of outlays in the second half of 1967 than that shown by earlier surveys, it suggested that plant and equipment expenditures would rise considerably in the first half of 1968. The rate of business inventory accumulation also was expected to increase substantially after the turn of the year, both because of the heightened pace of over-all activity and because of efforts to rebuild strike-depleted stocks of autos and to accumulate steel against the possibility of a strike in that industry. Outlays for residential construction appeared likely to continue

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upward for a time, although the pace and duration of the advance was in doubt because of uncertainties regarding prospective supplies and costs of mortgage funds.

With respect to the U.S. balance of payments, available data for October and November suggested that in the fourth quarter the deficit on the "liquidity" basis of calculation would be larger than in the third quarter and that the balance on the "official reserve transactions" basis would revert to deficit from the surplus recorded in the third quarter. Part of the deterioration reflected the conversion in October and November of official British holdings of U.S. securities to assets of more liquid form. Part, however, reflected other factors, including a further weakening of the U.S. merchandise trade surplus in October. Continued large deficits seemed to be in prospect for early 1968.

Gold holdings of the U.S. Treasury were reduced by $475 million in the week ending December 6, mainly to settle the U.S. share of sales made by the gold pool in London during the first 2 weeks after the devaluation of sterling on November 18 and to cover U.S. sales to foreign central banks. Foreign demand for gold subsequently dropped sharply, but it turned up again on the day before this meeting following press reports that possible measures to restrict access to the London gold market were under discussion.

In foreign exchange markets spot sterling remained at its new ceiling rate of $2.42 until early December, when the rate weakened following a labor dispute involving British railway workers. Subsequently the sterling exchange rate fluctuated below the ceiling. Forward operations by some continental central banks, undertaken in cooperation with U.S. monetary authorities, had helped to minimize speculative movements into continental currencies and to stimulate short-term investment outflows from them.

System open market operations since the preceding meeting of the Committee had been directed at facilitating continuing

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orderly adjustments to the increase in Federal Reserve discount rates, against the background of the massive international flows of funds that followed the devaluation of sterling. Operations were complicated by the need to offset the effects on member bank reserves of those flows and of the large reduction in the Treasury's gold stock. Money market conditions remained relatively stable, however, with the Federal funds rate fluctuating around the 4½ per cent discount rate. In the 2 weeks ending December 6 free reserves averaged about $240 million and member bank borrowings about $105 million, compared with averages of $210 million and $125 million, respectively, in the preceding 4 weeks.

Interest rates on most types of market securities had risen after the increase in Federal Reserve discount rates and the devaluation of sterling. Most recently, many rates had advanced further as the waning likelihood that a tax increase would be enacted this year strengthened market expectations of greater monetary restraint. Since the preceding meeting of the Committee interest rates had increased on such short-term instruments as bankers' acceptances, finance company paper, and CD's; some banks were now offering the 5½ per cent ceiling rate on CD's of relatively short maturity. In early December the market rate on 3-month Treasury bills reached 5.01 per cent—its highest level in 1967—but it subsequently declined and on the day before this meeting was 4.90 per cent, about the same as 2 weeks earlier.

In the capital markets yields on intermediate- and long-term Treasury securities had moved irregularly lower in recent weeks, but those on municipal and corporate bonds, particularly the former, had risen further. The rise in corporate bond yields was moderated by postponements and cutbacks of scheduled new issues, which reduced the November volume of public offerings to little more than half the total expected earlier. Upward interest rate pressures appeared to be persisting on home mortgages.

Commercial bank credit increased less rapidly in November

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than in other recent months, with bank acquisitions of municipal and Federal agency issues accounting for much of the rise. Holdings of Treasury securities and loans on securities both declined, and growth in business loans, while somewhat faster than in the two preceding months, was still moderate. The bank credit proxy —daily-average member bank deposits—increased at an annual rate of about 8.5 per cent in November, compared with average annual rates of 11 per cent in September and October together and 13.5 per cent in the first 8 months of the year. Growth in total time and savings deposits was maintained in November at the 12 per cent average annual rate of the two preceding months by substantial bank sales of short-maturity CD's; expansion in other time and savings deposits moderated further. The pace of growth in private demand deposits and the money supply increased somewhat—the latter to an annual rate of about 7.5 per cent—as Government deposits declined.

With continued expansion in over-all economic activity in prospect, demands for business loans were expected to strengthen in December and January. However, growth in total bank credit was expected to slow further in December; it was anticipated that the funds available to banks would be limited by run-offs of CD's, a large volume of which matured around the midmonth tax date. The bank credit proxy was projected to rise at an annual rate in the range of 2 to 5 per cent in December if prevailing money market conditions were maintained. Faster growth appeared likely in January, when it was anticipated that banks would be the initial purchasers of a large proportion of the tax-anticipation bills the Treasury was expected to issue then. It was thought likely that a slight firming of money market conditions would have relatively little effect on bank credit growth in December, but that it would reduce the growth rate in January from what would otherwise be expected, in part by causing some further attrition in outstanding CD's.

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The Committee decided that open market operations in the period until its next meeting should be directed at moving slightly beyond the firmer conditions that had developed in the money market partly as a result of the increase in Federal Reserve discount rates. The Committee also agreed that operations should be modified if necessary to moderate any significant deviation of bank credit from current expectations, particularly in an upward direction, or any unusual liquidity pressures that might develop in financial markets.

It was noted in the discussion that events of recent weeks had shifted the balance of conflicting considerations in favor of a firming of monetary policy. Efforts to achieve a measure of fiscal restraint through enactment of a surcharge on income taxes had proved unavailing in the 1967 session of Congress. Prospects for accelerated growth in economic activity and for the continuation of inflationary pressures had heightened following the settlement of major strikes. The balance of payments situation had deteriorated further and pressures on the U.S. gold stock had increased. At the same time, the constraint on monetary policy resulting from the pressures on sterling in foreign exchange markets had been relaxed, although not completely removed, by the devaluation of the pound; and the constraint imposed from time to time by Treasury financing activity was absent for the time being.

It was for these reasons that the Committee decided to seek firmer money market conditions at present. The decisions to move toward only slightly firmer conditions—and to provide for modification of operations in the event that unusual liquidity pressures developed—reflected in part continuing concerns about possible adverse effects of higher interest rates on financial intermediaries, especially around the year-end dividend- and interest-crediting periods when such institutions were particularly exposed to withdrawals of funds. Various other considerations were cited as grounds for caution in increasing monetary restraint at this

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time. These included the fact that the growth rate of bank credit had moderated in November and was expected to decline further in December; the judgment that the current high levels of interest rates were already imposing a considerable degree of restraint on borrowing and spending; and the fact that pressures on sterling had not completely dissipated following the devaluation.

In the course of the Committee's discussion a number of members expressed the view that serious consideration should be given to an increase at an early date in member bank reserve requirements against demand deposits, as a further step in a gradual and orderly firming of monetary policy. At the conclusion of the discussion the following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that industrial output and employment have rebounded following strike settlements in the automobile and other industries, and that prospects have heightened for more rapid expansion of over-all economic activity in the months ahead. Both industrial and consumer prices have continued to rise at a substantial rate. The imbalance in U.S. international transactions has worsened, partly because of weakening in the export surplus since midyear. Foreign purchases of gold have been large following the devaluation of the pound sterling. Bank credit expansion has lessened, with diminished bank buying of Government securities and continued moderate loan growth. Most interest rates have risen further in reaction to the British devaluation and Bank rate increase, the rise in Federal Reserve discount rates, and waning expectations of enactment of the President's fiscal program. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to moving slightly beyond the firmer conditions that have developed in money markets partly as a result of the increase in Federal Reserve discount rates; provided, however, that operations shall be modified as needed to moderate any apparently significant deviations of bank credit from current expectations or any unusual liquidity pressures.

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Votes for this action: Messrs. Martin, Hayes, Brimmer, Francis, Mitchell, Robertson, Scanlon, Sherrill, Swan, and Wayne. Vote against this action: Mr. Maisel.

Mr. Maisel dissented from this action in part because he thought the directive was susceptible to an interpretation under which growth in member bank reserves and bank deposits would be slowed too abruptly, and perhaps succeeded by contraction. He favored seeking growth rates in reserves, deposits, and bank credit considerably below the average rates thus far in 1967, but still high enough to facilitate expansion in GNP at a somewhat faster rate than had prevailed on average in the first three quarters of the year. He noted that whether or not interest rates would rise further under the course he advocated would depend upon the strength of market demands for funds in relation to the supplies that would be available under such a Committee policy.

Mr. Maisel also thought that the statement of the Committee's general policy stance contained in today's directive had far too narrow a focus; in particular, he objected to the omission of reference to the basic policy goal of facilitating sustainable economic expansion. This omission resulted from the substitution of language stating that it was the Committee's policy "to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments" for the language of other recent directives stating that it was the Committee's policy "to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes."

2. Amendments to authorization for System foreign currency operations.

At this meeting the Committee ratified the action taken by mem-

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bers on November 30, amending paragraph 2 of the authorization for System foreign currency operations to change the size of the swap arrangement with the Bank of Canada from $500 million to $750 million equivalent.

Votes for ratification of this action: Messrs. Martin, Hayes, Brimmer, Francis, Maisel, Mitchell, Robertson, Scanlon, Swan, and Wayne. Votes against ratification of this action: None.

Subsequent to this meeting, on December 14, 1967, the Special Manager recommended that paragraph 2 of the authorization be further amended to change (1) the size of the swap arrangement with the Bank for International Settlements providing for System drawings in Swiss francs, and (2) the size of the arrangement with the Swiss National Bank, each from $250 million to $400 million equivalent, effective immediately, to supplement the enlargements of the System's swap network that had been approved on November 27 and November 30. The recommendation was unanimously approved by available members of the Committee, namely, Messrs. Martin, Hayes, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Swan, and Wayne. (This action was ratified by the Committee at its following meeting, on January 9, 1968.)

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OPERATIONS OF THE SYSTEM OPEN MARKET ACCOUNT

The following two reports describe the actions taken during 1967 to carry out the policy directives of the Federal Open Market Committee.

The report on operations in domestic securities was prepared by Alan R. Holmes, Manager of the System Open Market Account, who supervises these operations. It is written from the vantage point of the Trading Desk at the Federal Reserve Bank of New York, where operations in these securities are effected to carry out the policy directives of the Federal Open Market Committee. The report outlines the factors that the Manager takes into account in the day-to-day provision of bank reserves.

The report on foreign currency operations was prepared by Charles A. Coombs, Special Manager of the System Open Market Account, who supervises the Federal Reserve's operations in such currencies. The Federal Reserve has been buying and selling foreign currencies since early 1962 as part of the efforts to defend the dollar and strengthen the world payments system. All of these operations for the System Account are carried out, under the authorization of the Federal Open Market Committee, by the Federal Reserve Bank of New York, which also handles foreign currency transactions for the U.S. Treasury.

The report on operations in foreign currencies begins on page 276.

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REVIEW OF OPEN MARKET OPERATIONS IN DOMESTIC SECURITIES IN 1967

Open market operations in domestic securities during 1967 were aimed at implementing three consecutive phases of monetary policy:

—a step-up of monetary stimulation during the opening months of the year when the over-all business situation was weakening;

—the maintenance of generally steady conditions in the money market from spring until late fall, while the economy gradually strengthened, liquidity continued to be rebuilt, and interest rates in the capital markets rose sharply; and finally

—a moderate move toward monetary restraint in the final weeks of the year to resist growing inflationary pressures and protect the dollar internationally.

The first phase covered the period from the beginning of the year through May 1. Open market operations, a reduction in member bank reserve requirements, and a cut in the Federal Reserve discount rate all were used hand in hand during this interval to ease money market conditions. This easing, and the accompanying growth in bank credit, helped to combat the effects of weakening tendencies present in the economy. There were, of course, various shadings around this general stance. Indeed, during the final month of the interval open market operations were directed more at ratifying the easier conditions that came to the money market with a cut in the discount rate announced on April 6 than at independently inducing still further ease.

For purposes of exposition, the second policy phase is divided into two parts or subperiods: one covering the period May 2 through September 11, and the other September 12 through November 13. About the same money market condi-

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tions were maintained through the two subperiods. In the first subperiod these conditions were accompanied by increasing signs of renewed economic expansion, very heavy demands for funds in the capital markets as corporations and others continued to rebuild depleted liquidity positions, and a rapid expansion of bank credit. As this subperiod wore on, price increases became more numerous.

By early September, when the second subperiod began, there was considerable sentiment in the Federal Open Market Committee that the weight of economic evidence called for some move toward monetary restraint. For a variety of reasons, however, policy was unchanged for a while longer. These reasons included the uncertainties associated with the strike in the automobile industry and congressional deliberations over the administration's proposed tax surcharge, as well as the threats to financial intermediaries and to the weakening position of the pound sterling posed by the already high rates of interest prevailing in the open market. Even-keel considerations associated with Treasury financing operations in early and late October contributed to the no-change posture.

The final phase covers the interval November 14 through December 31. The beginning of this period marked roughly the onset of the tremendously increased pressures and uncertainties that beset the foreign exchange and gold markets late in the year. Within a week, over the November 18-19 weekend, sterling had been devalued, and the Federal Reserve had increased the discount rate in defense of the dollar. Open market operations sought to facilitate orderly market adjustments to the new discount rate through the first 4 weeks of the period, and then sought somewhat firmer conditions in the market after the December 12 meeting of the Committee. A few weeks later the Federal Reserve took still further steps to resist inflationary pressures and defend the dollar by raising reserve requirements of member banks. Then on January 1, 1968, the President announced an extensive balance of payments program, including

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a tightening of the System's guidelines for voluntary restraints on international financial flows.

Viewed as a whole, open market operations during 1967 were conducted in a somewhat less strained domestic financial environment than in 1966. The former year had been marked by major shifts of funds among financial sectors and by strains in financial markets as interest rates reached levels not seen in a generation. Long-term interest rates rose even higher in 1967; but over-all, the markets performed very well in handling a record demand for capital funds. As in 1966, the nervousness that continued to exist was related mostly to insufficient fiscal restraint—with bond prices tending to rise or fall as prospects for the tax surcharge waxed or waned. Short-term interest rates rose sharply in the second half of the year, and at the year-end they were at levels that raised questions about banks' ability to compete for funds under existing Regulation Q ceilings.

Although the general financial environment was less strained in 1967 than in 1966, a wide variety of domestic and international developments over the year had profound effects on market expectations and psychology. These developments in turn affected contingency planning in the Federal Reserve System and actual day-to-day operations in the market. During the year the markets were affected not only by recurrent shifts in sentiment regarding the likelihood of congressional action on the tax bill but also by uncertainties over congressional action on the Treasury debt ceiling.

Treasury debt management operations were also important. Such operations involved not only the four regular quarterly refundings but also four operations to raise new cash, several increases in the amounts of regular weekly and monthly bill auctions, and wide swings in Treasury balances at the Reserve Banks. Government trust accounts also engaged in quite extensive market transactions. Finally, there were the operations for foreign accounts. Foreign transactions had major effects on domestic reserve availability, the Treasury's cash position, and the

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U.S. securities markets. Coordination of the System's operations with these transactions in the period following the devaluation of sterling required especially close cooperation among the Open Market Account and the foreign account operations of the New York Reserve Bank and the operations of the debt management and foreign divisions of the Treasury Department.

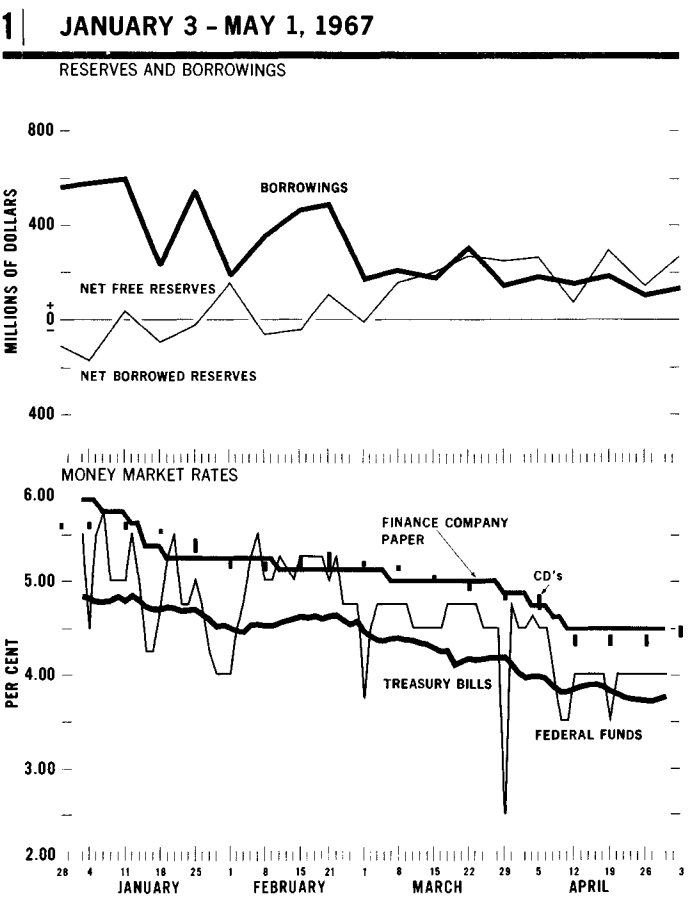
January 1-May 1: Monetary Policy Eases to Combat Emerging Weakness in the Economy

Federal Reserve policy during the first 4 months of 1967 was directed at combating the effects of weakening tendencies in the economy. The pace of business expansion was already moderating when the year began, though in view of prospects for a sharp increase in fiscal stimulus in the months ahead, most forecasts looked for renewed economic vigor by midyear. In anticipation of such a strengthening, the President in his State of the Union Message on January 10 proposed enactment of a 6 per cent income tax surcharge for individuals and corporations to become effective on July 1. But meanwhile, what had appeared at first to be only slowdowns in many business indicators turned into actual declines as the first quarter progressed, reflecting for the most part the effects of a sharp drop in the rate of inventory accumulation.

To counter the effects of economic weakening, the Federal Reserve quickly stepped up monetary stimulation through a combination of actions that brought a rapid extension of the easing of System policy that had begun in late 1966. To be sure, there was a pause for a generally even-keel posture for a time in February while the Treasury's quarterly financing operation was under way, and another financing was in process as the period closed. In addition, some unexpected shortfalls in nationwide net reserve availability around mid-February and mid-March temporarily generated some unintended firmness in money market conditions.

But over the first 4 months as a whole, open market opera-

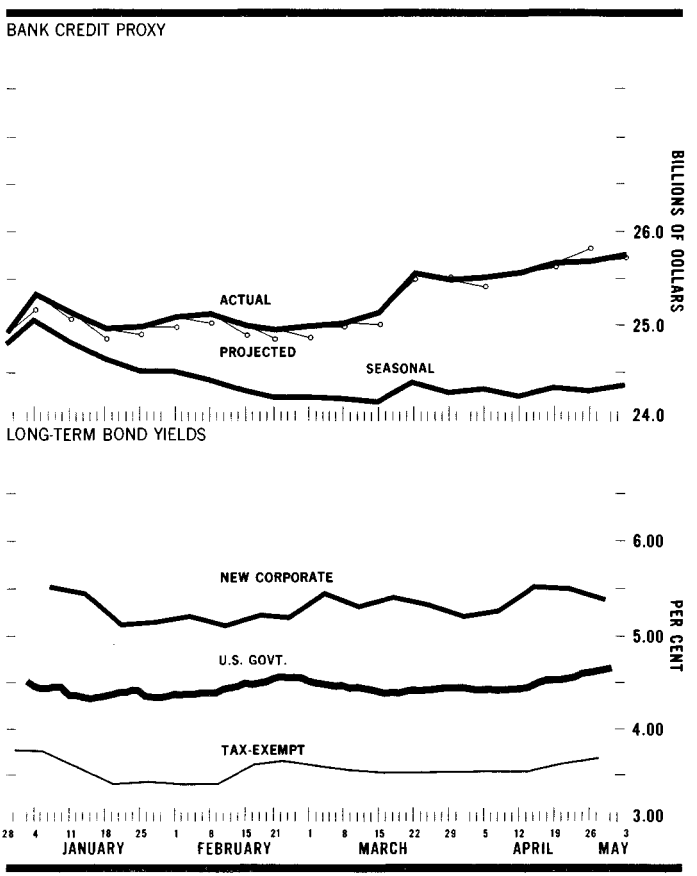
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Finance company paper, 90-day, offering rate. Treasury bills, 3-month issues, daily bid rate. Federal funds, effective rate. New corporate issues, Aaa

tions provided about $1.4 billion (net) of reserves to the banking system, more than offsetting reserve drains caused by movements in various factors. In addition, on February 28, the Board of Governors announced a forthcoming reduction in reserve requirements against savings deposits and certain types of time deposits. This action released about $850 million of reserves to the banking system in two steps in March. Then on April 6,

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basis. CD's, 3-month, secondary market rate. Tax-exempt bonds, rate on 20-year issues.

after short-term interest rates in the open market had fallen substantially, 10 of the Federal Reserve Banks announced reductions in their discount rates from 4½ to 4 per cent. (The other two Federal Reserve Banks took similar action shortly thereafter.) During the period the administration also requested action by the Congress to restore two special inducements to business investment—one, the 7 per cent investment tax credit and two, permis-

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sion to use accelerated depreciation schedules—that had been suspended in late 1966.

Under the stimulative thrust of the open market operations, nationwide net reserve availability in the banking system expanded from net borrowed reserves averaging $165 million in December 1966 to about zero in the first 2 months of 1967 and then to free reserves averaging in the $100 million to $300 million range by early May. (See top left-hand panel of Chart 1.) While the distribution of these added reserves within the banking system was somewhat uneven, a ready flow of funds through the Federal funds market quickly rechanneled the reserves to banks that needed them and at generally declining rates. Major money market banks thus had increasingly less difficulty in covering their deep basic reserve deficits that persisted throughout the period, partly because of heavy lending to securities dealers. The Federal funds rate dropped, with a few interruptions, from around 5½ per cent in late 1966 to 4½ per cent toward the end of March, and then to 4 per cent following the reduction of the discount rate in early April. Member bank borrowing from the Reserve Banks fell fairly steadily over the period, from an average of about $560 million in December 1966 to around $100 million by early May.

There were also extensive flows of savings into financial institutions during the period. Time and savings deposits at commercial and mutual savings banks and shareholdings at savings and loan associations increased by nearly $15.1 billion over the first 4 months of the year. The increase included a net rise of $2.9 billion in negotiable certificates of deposit at reporting commercial banks; this brought outstanding CD's back to the peak reached in mid-August 1966.

These and other flows had quick and pervasive effects throughout the financial system. In particular, they facilitated (and reflected) a massive rebuilding of liquidity in all sectors of the economy from the depleted levels reached during the monetary squeeze of 1966. Savings and loan associations, for example,

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used a good part of the increase in their savings capital to repay nearly $2.2 billion (net) of borrowings from the Federal home loan banks, and they also replenished their holdings of cash and Treasury bills.

The ready availability of funds for investment in large denomination CD's led commercial banks to reduce steadily their offering rates on new CD's and also to make large repayments of funds that had been borrowed in the Euro-dollar market during the second half of 1966 when the 5½ per cent Regulation Q ceiling had made it difficult for banks to compete for domestic funds. By early May offering rates on CD's were well down from the 5½ per cent ceiling available on all maturities at the beginning of the year to a range of 4 to 4½ per cent. Meanwhile, aggregate balances due to foreign branches of the major banks fell by almost $1.2 billion from the level on the last Wednesday of 1966.

There was also a rapid expansion of credit during the period, especially at commercial banks. Loans and investments at all commercial banks rose by $13 billion (seasonally adjusted) during the first 4 months of the year. The pace of bank credit expansion rose to an annual rate of nearly 15 per cent in the first quarter before abating in April. More than half of this expansion represented purchases by banks of Government and other securities, which helped to rebuild their liquidity. Furthermore, the banks maintained very sizable portfolios of short-term loans to Government securities dealers. Loans to nonfinancial businesses increased somewhat over the period, partly under the impetus of the continuing acceleration of payment schedules for corporate income and social security taxes. But the really heavy borrowing by businesses during this period—and throughout the year—was through the capital markets. Indeed, many corporations used the funds they obtained in the market to repay bank loans.

Finally, along with the already mentioned decline in rates on CD's, there was a fairly steady and mutually reinforcing down-

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trend in all short-term interest rates during the period; the only major hesitation occurred in February. Rates posted by the major New York City banks on call loans to U.S. Government securities dealers dropped very sharply, from a range of 6–6¾ per cent in early January to 4–4¾ per cent at the end of the period. Rates on finance company and commercial paper and bankers' acceptances fell, in steps, by a total of about 1¼ percentage points. During the second half of March expectations of further declines in Treasury bill rates were so strong that a downward-sloping yield curve emerged in the bill market, and rates on 6- and 12-month bills fell by as much as 9 and 17 basis points below the rate on 3-month maturities.

Along with these declines in market rates, and in light of the not-overly exuberant demand for bank loans, major banks across the country lowered the rate on "prime" business loans from 6 to 5½ per cent during the period. One large bank moved to the lower rate on January 26, in the wake of the initial steps toward monetary ease in the opening weeks of the year. Most others, however, moved first to 5¾ per cent and did not reduce their rates to 5½ per cent until around March 22, after the easing in Federal Reserve policy had proceeded further.

Only in the longer-term markets were the effects of the easing of monetary policy outweighed by other forces. In these markets yields had already fallen considerably during the final months of 1966, and this trend was extended for a time during the early weeks of the new year. But with demands for capital, both current and in prospect, mounting sharply, upward yield pressures soon returned. By the end of the period yields on corporate and municipal bonds were up about 8 to 25 basis points from their late-January lows, and in some cases they were even a little higher than those prevailing at the start of the year.

Open market operations. Implementing the easing in System policy involved extensive open market operations during the January 1–May 1 interval. Operations sought in general to inject reserves into the banking system a little ahead of expected

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needs. They were often complicated, however, by shortfalls of reserves below projected levels—frequently because the rapid expansion of bank credit persistently caused member bank required reserves to rise faster than expected; in addition, float occasionally fell to unusually low levels.

Reserve shortfalls were particularly marked on the first several days of the year, again in mid-February and mid-March, and in the statement weeks ending April 12 and 26. On each of these occasions the System repeatedly used repurchase agreements to counter the unintended firmness developing in the money market. In fact, repurchase agreements were arranged on 41 of the 83 business days of the interval under review, and on several days they were arranged twice when the reserve injection from the first round proved to be insufficient to relax conditions in the money market. The System also made sizable outright purchases of Treasury bills, and in March and April it bought Treasury coupon-bearing issues. Purchases of Treasury bills toward the middle and the end of April helped to preserve comfortable conditions in the money market and eased some of the nervousness that emerged in the securities markets during the period.

Reserve bulges resulting from swings in float and from other factors had to be absorbed at regular intervals, but most of these absorptions were accomplished without substantial sales of securities by the System. The scheduled maturity of outstanding repurchase agreements provided an automatic means of absorbing reserves when needs had run their course, and in a number of regular Treasury bill auctions the System arranged in advance for some reserve absorption a few days later through the redemption of part of its holdings of maturing bills.

Cash transactions to absorb reserves were undertaken on only five occasions during the period. Two of these involved the use of matched sale–purchase transactions—a technique initiated during 1966 to absorb reserves temporarily—and two others involved sales of a moderate amount of Treasury bills to foreign accounts. The only outright sale of bills by the System in the

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open market occurred on April 11, when a bulge in reserves was causing particularly easy conditions in the money market.

In total, the System purchased $10.8 billion of Treasury and Federal agency securities under repurchase agreements during the period, and $11.2 billion of such agreements were terminated, as shown in the table. Repurchase agreements against

SYSTEM OPERATIONS IN GOVERNMENT SECURITIES DURING 1967

(In millions of dollars)

Type of operation	Jan. 1–May 1	May 2–Sept. 11	Sept. 12–Nov. 13	Nov. 14–Dec. 31	Total
Outright purchases:					
Treasury bills:					
From market	[1] 3,624	[1] 2,795	[1] 1,674	601	[1] 8,694
From foreign accounts	607	1,022	270	897	2,796
Coupon issues	218	611	139	186	1,154
Special certificates of indebtedness	149	240	.....	.....	389
Outright sales:					
Treasury bills:					
To market	[1] 701	[1] 1,775	[1] 270	.....	[1] 2,746
To foreign accounts	161	648	26	.....	835
Coupon issues	.....	.....	.....	.....	.....
Redemptions:					
Treasury bills	1,864	1,129	329	416	3,738
Special certificates of indebtedness	149	240	.....	.....	389
Repurchase agreements:					
Government securities:					
Purchases	10,362	3,090	2,097	1,243	16,792
Sales	10,699	3,380	1,901	1,307	17,287
Federal agency obligations:					
Purchases	466	80	89	79	714
Sales	493	87	84	46	710
Net change	+1,359	+579	+1,659	+1,237	+4,834
Matched sale-purchase transactions:					
Sales	495	635	170	.....	1,300
Purchases	495	635	170	.....	1,300

[1] See "Memorandum" item at bottom of table for amounts of matched sale-and-purchase transactions included in this total.

NOTE.—All figures are as of date of delivery.

bankers' acceptances were often a helpful supplement to these operations, and nearly $1 billion of such agreements were arranged and terminated over the period as a whole. On an outright basis the System purchased more than $4.2 billion of Treasury bills over the period, including about $600 million directly from foreign accounts, while sales and redemptions of maturing

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bills totaled $2.7 billion. Included in these total outright transactions in Treasury bills were $495 million of matched sale–purchase transactions.

Finally, the four operations in Treasury coupon issues during the period resulted in total purchases of $218 million of such securities, of which $79 million were issues maturing after 5 years. These operations marked the beginning of a somewhat more active role played by the System in the coupon sector during the year, following the reduced activity in 1966. In addition to providing a portion of the reserve needs of the banking system, these purchases of coupon issues helped investors switch into corporate or municipal securities, or mortgages, and thus facilitated the large flows of funds that were needed to meet the heavy demands placed on the capital markets during the year.

The pattern of prompt, and at times rather extensive, reserve injections to offset reserve shortfalls and counter persisting tautness in the money market was established in the first few days of the year. Inventories of Government securities dealers had climbed to more than $5 billion, and heavy borrowing by dealers to finance these positions was adding to pressures on reserve positions of major money market banks. Rates on loans to dealers at banks in New York City rose as high as 6¾ per cent, and many major banks were bidding aggressively for Federal funds to cover their needs. When the flow of Federal funds proved somewhat limited, even at rates of 5½ to 5¾ per cent, banks turned to the Federal Reserve discount window and borrowed there in large volume.

In combating this tautness in the money market, the System injected a total of $1.5 billion of reserves on the first four business days of the year, January 3–6. The operations involved mostly the use of repurchase agreements, with a total of $991 million of Treasury and Federal agency securities and $135 million of bankers' acceptances purchased under such agreements.

Open market operations were more limited during the rest of January. Nationwide net reserve availability expanded as cur-

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rency outside banks and member banks' required reserves dropped following their year-end bulges, and Federal funds were generally in good supply at rates of about 5 per cent. Even lower rates emerged toward the end of the month, when float and free reserves bulged in the wake of a blizzard in the Chicago area that closed a number of banks and interrupted the normal schedule of check collections. Securities dealers maintained sizable positions, but they had little difficulty in securing credit from banks, and member bank borrowings from the Federal Reserve averaged somewhat less than in earlier weeks.

Termination of most of the repurchase agreements outstanding on January 9 and 10 absorbed part of the early influx of reserves. Additional absorptions during the month were accomplished by redemptions of $439 million of maturing Treasury bills, by two operations involving matched sale–purchase transactions, and by outright sales of some bills to foreign accounts. Interspersed among these absorptions were a few temporary injections of reserves through repurchase agreements, and also some outright purchases of bills, to relieve occasional stresses that emerged in the money market. One of these occurred on January 18 when a large money market bank with a sizable reserve deficiency asked securities dealers that had loans on its books to seek financing elsewhere. On that day the System arranged $289 million of overnight repurchase agreements to facilitate the relocation of financing, and the dealers eventually met the rest of their needs at other money market banks.

Operations became more extensive again in February, as the System often found it necessary to counter unintended firmness in the money market arising out of renewed shortfalls of reserves below expectations. Adding to the complications affecting its operations was the persistently uneven distribution of reserves within the banking system and the interruptions to normal flows and bank behavior in the money market around the time of the February holidays. The major money market banks were still in deep basic reserve deficit, as they continued their extensive

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lending to Government securities dealers and also built up their investment portfolios. Banks outside the money centers, on the other hand, were in fairly comfortable reserve positions, but they tended to be cautious in managing their reserves and in the statement weeks ended February 15 and 22 held large amounts of excess reserves.

The needed injections of reserves proceeded fairly smoothly in the opening days of February as the System made some outright purchases of Treasury bills and then arranged some repurchase agreements on February 6 and 7. A bulge in float caused by a severe snowstorm in the Northeast also added to reserve availability. By its operations the System preserved a generally even keel in the money market while the Treasury's refunding was in process. Rates on Federal funds did rise as high as 5½ per cent on February 6 and 7 and borrowings from the Reserve Banks expanded, but the Federal funds market eased over the next several days, with trading mostly at 5 per cent.

The System arranged further repurchase agreements on February 10 to run over the ensuing partial holiday weekend. This raised estimated free reserves for that statement week to a seemingly satisfactory level. The Federal funds market tightened after the long weekend, however, as reserves fell short of expected levels, and Federal funds traded as high as 5¾ per cent. To head off further firming in the money market, the System moved early on Wednesday, February 15, to purchase $550 million of Treasury and Federal agency issues under overnight repurchase agreements. But firmness in the money market persisted, and later that morning the System made additional repurchase agreements totaling $241 million.

Further, though somewhat less massive, injections of reserves through repurchase agreements and through some outright purchases were made on each of the next six business days, as Federal funds trading consistently opened at a 5¼ per cent rate. After each of these operations, projections pointed to relatively high levels of free reserves, and conditions in the Federal funds

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market tended to ease for a time. Actual reserve availability fell persistently short of the projections, however, and as each day wore on, the money market generally firmed again, and at the end of the day member banks turned to Federal Reserve discount windows to borrow large amounts of reserves.

The shortfalls in reserves from estimated levels during this period were generally quite large, ranging to more than $700 million on 2 days. In addition to continuing strength in required reserves, these shortfalls reflected considerably lower than normal levels of float, which tended to follow a somewhat erratic pattern around the February holidays. Predicting the level of float became even more hazardous for a short time after the change on February 20 in check-clearing procedures—a change that reduced float on Mondays to levels more than $1 billion below previously normal amounts.

In total, over the February 15–24 period, the System bought nearly $2.8 billion of Treasury and Federal agency securities and bankers' acceptances under repurchase agreements, while terminations of such contracts amounted to only about $2.3 billion. Toward the end of this interval, outright purchases of Treasury bills from foreign accounts and in the market about offset redemptions of maturing bills. Despite these operations, the persistently firm conditions prevailing in the money market led some participants to fear that the trend toward further monetary ease had run its course. These fears were dispelled later in the month, however, when the System made no effort to counter the relatively easy conditions that finally emerged in the money market.

By that time, dealers' financing needs had declined sharply in the wake of extensive sales of securities to the System and other official accounts, and pressures on reserve positions of banks in the money centers had eased. Meanwhile, excess reserves accumulated by country banks spilled into the money market, and Federal funds traded at progressively lower rates. The announcement by the Board of Governors on February 28 about

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the reduction in reserve requirements against savings deposits and the first $5 million of time deposits at member banks reinforced the view that monetary policy was likely to maintain a relatively easy posture.

Open market operations during March were also fairly frequent and sizable. In seeking to maintain generally comfortable conditions in the money market, the System injected reserves either through repurchase agreements or outright purchases, or both, on 13 of the 16 business days in the March 2–23 period. On three occasions during this interval it arranged repurchase agreements twice on the same day. Over-all, these injections provided $786 million (net) of reserves during this interval.

A sharp decline in the Treasury's balances at the Reserve Banks around mid-March also supplied a large amount of reserves to the banking system during this period. Uncertainties surrounding the projections of the Treasury's balance tended to complicate somewhat the conduct of System operations, but the use of repurchase agreements to make temporary injections of reserves provided the flexibility needed to deal with the situation. On Friday, March 10, the System facilitated management of the Government's cash balances through a seasonal low by purchasing directly from the Treasury a special certificate of indebtedness in the amount of $149 million. The certificate was redeemed 3 days later on Monday, March 13. System purchases of $101 million of Treasury coupon issues on March 3 and 22 also provided reserves during this period.

Free reserves expanded to an average of about $235 million in March, and member banks reduced their borrowings from the Reserve Banks to a daily average of about $200 million. The general increase in net reserve availability and the timeliness of System actions enabled the money market to accommodate without difficulty the heavy demands placed upon it during March. These included the churning that occurs around the corporate dividend and tax payment dates, the settlement on March 13 of a cash offering of $2.7 billion of Treasury tax-anticipation

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bills, and settlements throughout the month on a large volume of corporate and municipal offerings. Federal funds traded generally at 4½ to 4¾ per cent during March, and call loans at banks in New York City were usually available to Government securities dealers at rates of 5 to 5½ per cent. Meanwhile, other short-term interest rates were generally declining. Treasury bill rates, for example, fell by about 45 to 70 basis points from the previous month's highs—on February 23—to the end of March.

Open market operations were reduced in scale for a brief period in the latter part of March, when a spillover of previously accumulated excess reserves eased conditions in the money market. But another round of reserve injections occurred over the March 30–April 5 interval. These injections, which involved both outright purchases and short-term repurchase agreements, offset the end-of-month decline in float and helped to preserve comfortable conditions in the money market amid the churning around the quarterly statement publishing date and the April 1 property tax date in Cook County, Illinois. Included in these injections were further purchases, in two operations, of $117 million of Treasury coupon issues, which were the last System purchases in the coupon sector until after the Treasury had completed its May refunding.

Following the reduction in the discount rate announced on April 6, trading in Federal funds immediately adjusted to a 4 per cent rate and remained there—or occasionally below—over the rest of the interval under review here. Dealer loan rates posted by the New York City banks declined to a range of 4–4¾ per cent, and other short-term rates also continued to decline during April.

Open market operations in the weeks immediately following the cut in the discount rate sought to promote conditions in the money market that would validate the new structure of interest rates. The first several days after the rate reduction saw a few quick reversals of direction in operations. Some temporary reserve needs were met on Friday, April 7, through the use of re-

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purchase agreements that would mature after the weekend. When money market conditions threatened to become easier than desired on April 10 and 11, however, the System allowed these and other outstanding repurchase agreements to mature without replacement, and on the latter day it sold $206 million of Treasury bills in the market. As it turned out, reserves fell short of expectations, and on Wednesday, April 12, the Account Manager injected $289 million of reserves through overnight repurchase agreements.

Operations over the remainder of the period provided a net of $756 million of reserves, with needs met generally as they arose. Outright purchases of $697 million of Treasury bills on 3 days around mid-April not only helped to preserve a comfortable tone in the money market but also helped to stem some nervousness that had arisen in the securities market in the wake of the continued heavy calendar of new issues.

In the final weeks of the interval, operations were affected by even-keel considerations as market participants turned their attention to the Treasury's May refunding, the terms of which were announced on April 26. Repurchase agreements arranged that day countered the firmness in the money market that had arisen in the wake of another shortfall of reserves. Further repurchase agreements and some outright purchases of Treasury bills on the final 3 days of the interval preserved this comfortable tone in the money market and helped to allay some of the nervousness in the securities markets. Part of the repurchase agreements arranged on May 1 were against "rights" issues involved in the Treasury refunding—contributing to a reasonable availability of financing for such issues taken by the nonbank dealers until the issues were exchanged on May 15.

Securities markets. As noted earlier, developments in the securities markets followed divergent patterns during the period, with short-term interest rates generally declining by a percentage point or more while long-term yields were under upward pressure after the end of January. Sharp swings in expectations and

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general market psychology—developments that were to assume increasing significance as the year wore on—accentuated movements in prices and yields within the period. The more basic factors shaping the general trends, however, were the very heavy demands for funds that were pressed on the longer-term markets and the sizable flows of some of these and other funds into short-term investments. While motives for such developments varied among borrowers and investors, the outcome represented a considerable rebuilding of liquidity throughout the financial system.

Flotations of new issues by corporations and by State and local governments in the capital market totaled nearly $12.7 billion during the January–April period, 18 per cent more than the record volume in the corresponding months of 1966. A good part of these funds were absorbed rather quickly in meeting current needs. Corporations, for example, had to make particularly heavy payments for taxes as well as for dividends and plant and equipment. However, by borrowing in the capital market, corporations were able to make these payments without further depleting their liquidity, and many of them had sufficient funds left over to repay bank loans and to rebuild holdings of liquid assets. Similarly, State and local governments invested—at least temporarily—a sizable portion of their tax receipts and the proceeds from their capital issues in Treasury bills and other short-term instruments.

Financing activities of the Federal Government also had differential effects on the demands and supplies in the long- and short-term sectors of the market. During the January–April period Federal agencies sold to the public a total of $3.4 billion of new issues with maturities of more than a year; of this amount nearly $2.3 billion represented participation certificates sold by the Federal National Mortgage Association and the Export-Import Bank. Meanwhile, the supply of short-term Federal agency paper was being reduced, as savings and loan associations repaid their borrowings from the Federal home loan banks and these banks in turn redeemed, without replacement, about $1.8 billion of

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maturing notes. Finally, redemptions of maturing Treasury tax-anticipation bills in March and April more than offset increases in other bill issues; hence the supply of outstanding Treasury bills decreased by $600 million over the period.

The combination of heavy demand for Treasury bills—including buying by the System, banks, corporations, and public funds—and the eventual shrinkage in the supply of bills produced a good tone in the bill market through most of the period. The general downtrend in bill rates was interrupted for a time in February, when firmer money market conditions and worries about the course of Federal Reserve policy prompted some aggressive professional selling. Demand expanded as rates moved higher, however, and as easier money market conditions reappeared toward the end of the month, bill rates resumed their earlier downtrend. Banks bid aggressively for the $2.7 billion of June tax-anticipation bills auctioned on March 7, and they held a considerable portion of their awards well beyond the March 13 payment date. Dealers too were aggressive bidders in most of the regular weekly and monthly auctions during March and April as they sought to replenish their positions in the face of the continuing demand.

By early April the rate on 3-month bills had fallen below 4 per cent, or more than ½ percentage point below the then current discount rate. Following the April 7 cut in the discount rate, bill rates initially moved down by another 10 to 25 basis points. Emerging nervousness in the longer-term markets spread temporarily to the bill sector around mid-April, but a better tone was soon restored following a general increase in demand, including sizable purchases by the System to meet reserve needs. At the end of the period, 3-month bills were auctioned at an average rate of 3.777 per cent, 105 basis points lower than in the last weekly auction of 1966. The average issuing rate on new 6-month bills, at 3.907 per cent, was also a full percentage point less than that in the final auction of 1966.

In the capital markets, yields generally declined in January,

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rose in February, and then edged a little lower in March before climbing toward new highs in April. The buoyancy prevailing in these markets at the beginning of the year reflected a number of factors. Initially, the most important element was the evident trend toward an easier monetary policy. The Board of Governors' announcement on December 27, 1966, rescinding its letter of September 1 regarding accommodation at the discount window was taken as confirmation of this trend. To this was added an optimistic response to the President's State of the Union Message on January 10, with its proposal for a 6 per cent surcharge on corporate and individual income taxes. Market sentiment was further strengthened on January 26 in the wake of a reduction in the discount rate of the Bank of England from 7 to 6½ per cent and a cut in the prime lending rate of major U.S. banks.

Under these various influences, prices of securities rose and their yields declined sharply during most of January. An exceptionally large volume of new corporate, municipal, and Federal agency issues came to market during the month—setting the trend that was to follow over the months ahead—but most of the offerings were enthusiastically received by investors at generally declining yields. Included in the Federal agency issues sold to the public were three issues, totaling $600 million, of participation certificates offered by the FNMA on January 5. (An additional $500 million of these issues were sold to Government trust accounts.) These were the first such certificates to be issued since June 1966, and the offering marked the end of the administration's temporary suspension of such sales in effect since the period of monetary pressure in August 1966. Each of the three issues, maturing in 5, 10, and 15 years, respectively, was well received at a yield of 5.20 per cent.

At the end of January the Treasury successfully refunded $7.5 billion of coupon issues maturing on February 15. It offered for cash $5.5 billion of 15-month notes and $2.0 billion of 5-year notes, both priced to yield about 4.85 per cent. The buoyancy prevailing in the markets after the cuts in the British discount

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rate and the prime rate of U.S. banks carried through the opening of the books for the Treasury financing on January 30, and the offerings were heavily oversubscribed. Large subscriptions for the short notes received only 10 per cent allotments, and allotments for the longer issue amounted to only 7 per cent, the lowest allotment ratios in a Treasury financing in some time.

Market sentiment changed rather sharply over the next several days, as fears arose that yields had fallen about as far as they would, in view of the heavy financing calendar of prospective corporate, municipal, and Federal agency issues and predictions of a pick-up in economic activity later in the year. The unintended firmness that emerged in the money market around this time despite the System's aggressive injections of reserves added to these worries. An offering of $500 million of participation certificates by the Export-Import Bank on February 7 showed the effects of the general deterioration. Interest in both the 4- and 15-year maturities of these certificates was restrained, and prices of the issues soon declined.

In this atmosphere a number of corporate and municipal borrowers rushed to add their issues to the calendar of offerings before yields rose much further. This, along with some outright selling of outstanding issues, added to upward pressures on yields, and the markets became congested for a time. Inventories of corporate and municipal bond dealers expanded, with the Blue List of advertised tax-exempt issues rising to more than $650 million by mid-February. In the Government sector dealers became fairly aggressive sellers in order to pare inventories that had just been swelled by awards of the Treasury's new notes. By mid-February dealers' positions in Treasury notes and bonds had declined to about $1 billion, roughly the same as the level prevailing before the refunding.

The atmosphere in the securities markets improved around the end of February, with the return of easier money market conditions—later augmented by the reduction in reserve requirements against savings deposits and certain time deposits,

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announced on February 28. In the meantime, there had been a sharp improvement in the technical position of the market following extensive Treasury operations on February 24 in connection with efforts to keep the Federal debt from exceeding its legal ceiling. These operations, which were undertaken while legislation to raise the statutory debt ceiling was moving slowly through the Congress, involved switching the investments of several Government trust funds and a Federal agency out of special Treasury issues and into outstanding marketable Treasury securities. The special issues were then redeemed by drawing down the Treasury's cash balances—thus lowering the total national debt subject to the debt ceiling. The market purchases that were executed through the System's Trading Desk involved the buying of nearly $500 million of bills and coupon issues; additional amounts of bills were purchased directly by one of the Federal agencies.

The more buoyant atmosphere in the capital markets was sustained throughout March by a succession of developments, most of which led market participants to expect further easing in credit conditions. These included further reductions in the Dutch and British discount rates; the cut from 5¾ to 5½ per cent in the prime rate of most commercial banks—matching the rate established by one major bank in January; higher levels of free reserves; generally comfortable money market conditions; widespread declines in short-term interest rates; and reports of further weakness in many economic indicators.

In this environment record amounts of new corporate and tax-exempt public offerings—together with large offerings of the International Bank for Reconstruction and Development and of FNMA participation certificates—were generally well received in March. The participation certificates (of which $750 million were offered to the public and $150 million issued to Government trust funds) were sold on March 22 at yields that were 10 to 20 basis points below those in the January offering. Yields on Treasury issues and tax-exempt bonds declined over

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the course of the month, although investors' resistance increased as municipal yields declined. Indeed, the Blue List of advertised tax-exempt offerings climbed by more than $150 million during March to nearly $800 million. In the corporate market bond yields showed little tendency to change during March, despite the record volume of new public offerings. Part of the absorption of this volume reflected takedowns of the new issues by dealers in the hopes of being able to sell them at higher prices later. Thus, as in the municipal market, there were fairly large inventories of corporate bonds on dealers' shelves as March drew to a close.

The reduction in the Federal Reserve discount rate in early April was greeted enthusiastically in the capital markets. Immediately following that action, underwriters of both corporate and tax-exempt bonds made good progress in distributing the unsold balances of recent offerings. The demand was not sustained, however, and the markets became heavy again for a time around mid-April. As the calendar of new offerings continued to mount and signs of renewed strength in economic activity multiplied, market participants again began to think that monetary policy was not likely to ease much further. Investors were selective, and many new corporate and municipal offerings encountered resistance. In the market for Federal agency issues, on the other hand, an excellent reception was accorded the offering on April 19 of $400 million of Export-Import Bank participation certificates. This offering consisted of a 3-year issue yielding 4.80 per cent and a 7-year issue yielding 5⅛ per cent.

Toward the end of April prices of Government securities began to adjust downward in expectation that the Treasury's operation to refund the May maturities might involve a pre-refunding of other issues as well. In that refunding, the terms of which were announced on April 26, holders of issues maturing in May and June were offered the opportunity to exchange into either 15-month notes yielding 4.29 per cent or 5-year notes yielding 4.75 per cent, and holders of August maturities were permitted

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to exchange only into the longer notes. The announcement of the refunding terms was followed by a sharp, further downward adjustment of prices, but a generally improved tone had emerged by the time the subscription books opened on May 1.

The upward pressure on capital market yields in the closing weeks of the period brought the level of such yields well above the lows reached around the end of January, and in many cases to levels even above those prevailing at the end of 1966. Thus the average yield on long-term Treasury bonds on May 1 was 4.66 per cent, 32 basis points above the year's low in the second half of January. New Aa-rated utility bond issues with 5 years of call protection were trading to yield 5.70 per cent after release from syndicate pricing restrictions at the beginning of May; this compared with a yield of 5.54 per cent offered on a similar issue when it was sold in early January and 5.05 per cent on one sold near the end of January. And finally, the Bond Buyer's index of yields on 20 tax-exempt bonds was up to 3.79 per cent in the first week of May; this compares with the January–February low of 3.40 per cent and 3.77 per cent at the end of December 1966.

May 2-November 13: Steady Conditions Maintained in the Money Market While Economic Expansion Resumes and Interest Rates Rise Sharply

Stimulated by both monetary and fiscal policies, prospects for renewed business expansion seemed to be improving toward the end of April. Against this background, open market operations, in carrying out Federal Reserve policy, did not seek any further easing of money market conditions. Rather, generally steady money market conditions were maintained throughout the succeeding 6½ months, a period in which large demands for credit were reflected in rising interest rates. For purposes of exposition, this period is broken down into two subperiods.

ECONOMIC RECOVERY (May 2–September 11)

Signs that the economy was expanding more rapidly multiplied over the summer months, and by late July price increases were becoming more numerous. The U.S. balance of payments re-

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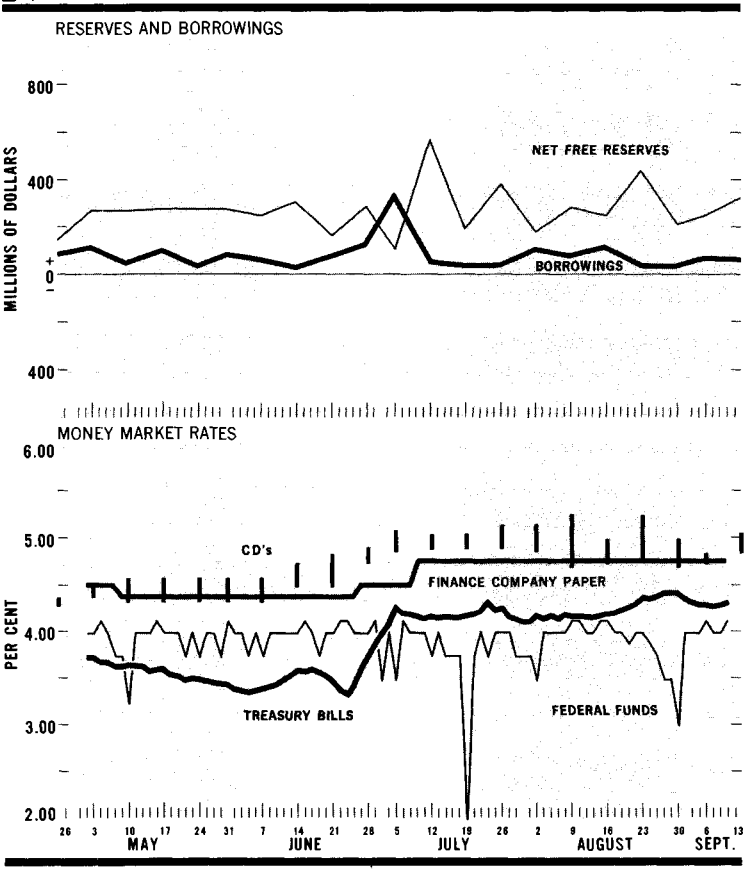
mained in substantial deficit, and the pound sterling came under renewed pressure following the outbreak of hostilities in the Middle East on June 5. In domestic financial markets corporations and State and local governments continued their unprecedented rush for capital funds, with consequent further upward pressures on long-term interest rates. At midyear, short-term interest rates moved up very sharply as the Treasury's net redemption of maturing debt came to an end and the Treasury began to borrow large amounts of funds to finance the Federal deficit.

As the summer wore on, there was growing evidence of the need for a tax increase to restrain inflationary pressures, reduce the Treasury's need to borrow, and prevent the recurrence of money market pressures like those in the summer of 1966. On August 3 an administration message to the Congress formally requested enactment of a 10 per cent tax surcharge effective October 1 for individuals and retroactive to July 1 for corporations. The proposed tax increase, which exceeded the 6 per cent surcharge called for in the State of the Union Message in January, was favorably received throughout the financial community. Buoyancy in the securities markets was cut short, however, by the reappearance of concern about the size of the Treasury's cash needs—even with the surcharge—and by growing uncertainties about congressional passage of the bill. Hearings on the proposed tax began in mid-August, but action on the tax bill remained uncertain through the rest of the period.

Conditions in the money market were generally steady and comfortable during the May to mid-September period. Federal funds traded generally in a narrow band around the 4 per cent discount rate—though more often below that rate than above it. Member bank borrowings from the Reserve Banks were nominal on most days and for the period averaged about $100 million. Free reserves averaged around $280 million daily over the interval. But there was considerable variation in the week-to-week averages of free reserves after mid-June as shown in top left panel of Chart 2—reflecting unusually wide swings in country

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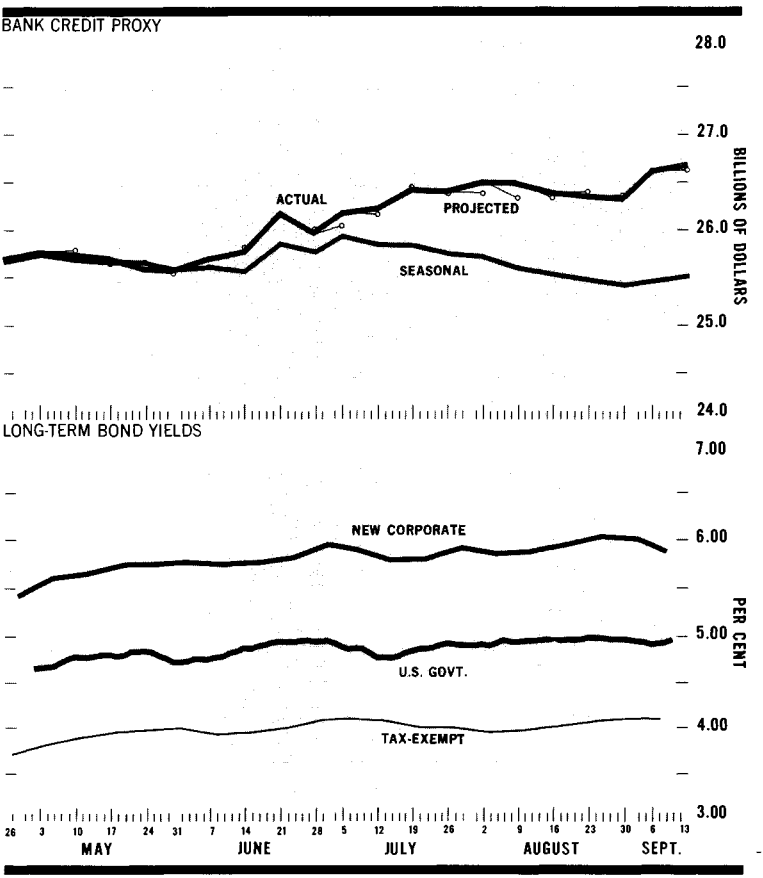
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For notes see pp. 212-13.

bank holdings of excess reserves. Over the 12 weeks from mid-June through early September, free reserves averaged about $375 million in the first half of each biweekly reserve-settlement period for country banks and about $185 million in the second half of those periods. Money center banks generally remained in deep basic reserve deficits through midyear, but their reserve positions eased considerably in succeeding months as deposit growth and a renewed build-up of Euro-dollar balances outstripped growth in bank credit.

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The steady conditions in the money market helped to facilitate a continued substantial flow of credit and deposits through financial intermediaries and credit markets during the period, though not without rising interest rates in the face of the heavy demand for funds. Further efforts to rebuild liquidity continued to motivate, and to lay claim to a part of, these flows.

While the very heavy flow of corporate bond issues met the bulk of business borrowing needs over the period, demand for bank loans did pick up for a while around mid-June. Moreover,

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such loans remained outstanding somewhat longer into July than in past years—reflecting largely the further acceleration of payment schedules for corporate income taxes. Meanwhile, banks continued to build up their holdings of attractive-yielding tax-exempt bonds, and after midyear they played a major role in underwriting new Treasury offerings. Holdings of Government securities by all commercial banks rose by $4.9 billion during July and August combined. These acquisitions, along with the delay in loan repayments mentioned above, pushed the expansion in total bank credit to a seasonally adjusted annual rate of more than 20 per cent during the 2-month period. This was considerably above the moderate pace prevailing during the spring.

Partly in anticipation of the demands for credit around mid-June, banks began to bid a little more aggressively for CD's at the very start of the period under review here and then increased their rates on CD's sharply further amid the general upward pressures on short-term rates after mid-June. By mid-September major banks were reportedly paying 5⅜ per cent or more on longer-term deposits. Outstanding CD's rose by more than $2 billion from early May through the end of August, before a sizable net run-off occurred in early September. Major money center banks also began bidding more aggressively for Eurodollar balances after mid-June, and total liabilities due by head offices of U.S. banks to their foreign branches rose by more than $1 billion from mid-June to late August before falling off slightly in early September.

Operating considerations. Open market operations were considerably more limited in volume in the May to mid-September period than they had been earlier in the year and were especially light after the middle of July. Complications arising out of unexpected shortfalls of reserves occurred less often than in preceding months, and fluctuations in the various factors affecting the supply of and demand for bank reserves seldom caused any marked disturbance in the over-all balance of forces already prevailing in the money market. Day-to-day operations tended to

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focus on keeping the Federal funds rate around 4 per cent and borrowing from the Reserve Banks at nominal levels. After mid-June free reserves were allowed to fluctuate in a wide range from week to week to accommodate the sharply increased fluctuations in excess reserves.

While conditions in the money market were the immediate focus of day-to-day operations, two somewhat broader considerations also influenced operations. One consideration was related to the heavy atmosphere often prevailing in the securities markets. On several occasions when the market was particularly unsettled, operations were tailored so as to avoid adding to existing pressures on securities prices and interest rates. In addition, purchases of coupon-bearing issues were made to meet part of the emerging needs for reserves, in line with instructions included in the Open Market Committee's policy directives issued on May 23 and June 20.

These purchases—in addition to supplying reserves—helped to relieve persistent upward pressures on long-term interest rates, which it was feared might slow the economic upturn, especially in the housing sector. In carrying out such operations, no effort was made to establish any particular pattern of yields. In all, $611 million of Treasury coupon-bearing issues were purchased during the interval. Of this amount $180 million represented issues due in 5 to 10 years; and $85 million, issues maturing in more than 10 years. However, there were no purchases of coupon issues for fairly extended periods when the need to supply reserves was temporarily absent, when the availability of such issues diminished, or when a financing by the Treasury was in process.

The other broader consideration influencing open market operations involved concern within the Open Market Committee over the acceleration in the growth of bank credit and the money supply around midyear following the relatively moderate expansion in the spring. While even-keel considerations were predominant at the time, the Committee voted at its July 18 meeting to

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restore a "proviso" clause to the current policy directive, instructing the Account Manager to modify open market operations—insofar as Treasury financing activities would permit—to moderate any apparent tendency for bank credit and money to expand more than expected.

Proviso clauses, of varying form, had been included in each current policy directive voted by the Committee from the spring of 1966 through the first four Committee meetings of 1967. They had proved very helpful in facilitating a prompt easing in System policy late in 1966 amid the first signs of the slowing in economic activity. When the Committee voted at its meeting on May 2, 1967, to adopt a generally steady policy stance, the proviso was dropped and was not introduced again until July. As it turned out, deviations from the expectations subsumed in subsequent proviso clauses were generally not of a magnitude to call for implementing the clauses. Even so, the presence of the proviso clause provided a useful focal point for assessing credit developments as they unfolded.

Open market operations. Over the period as a whole, System operations supplied $579 million of reserves, net, to meet additional needs for required reserves and to offset the modest net drains of reserves stemming from movements in other factors. Outright purchases of marketable Treasury issues totaled more than $4.4 billion, including $611 million of coupon-bearing securities, while sales and redemptions of Treasury bills were nearly $3.6 billion. Matched sale–purchase transactions accounted for $635 million of the outright sales and purchases during the period. Some $3.2 billion of repurchase agreements against Treasury and Federal agency securities were made, and $3.5 billion of these and other contracts matured or were terminated during the period. In June and September the System again purchased special certificates of indebtedness from the Treasury—for overnight or over a weekend—to facilitate management of the Treasury's cash balances at their seasonal low.

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The period under review here began while the Treasury's May refinancing was in progress. Open market operations during the first 2 weeks of May were conditioned by the weakness in the markets for coupon securities as the Treasury's new issues were being subscribed for and then absorbed. Against this background, operations sought to counter quickly the firming tendencies in the money market at the beginning and again around the middle of May, with a cautious absorption of a redundancy of reserves in the easy money market that emerged in between. Most of the reserve injections involved use of repurchase agreements to counter pressures caused by increases in financing needs of Government securities dealers; two rounds of such agreements were arranged on May 3 when firmness in their money market persisted. Outright operations to absorb the redundancy of reserves were limited to sales of $107 million of Treasury bills, mostly to foreign accounts; in addition, some maturing bills were redeemed, and some outstanding repurchase agreements matured.

After the injections on May 15 and 16, most of the immediate reserve needs of the banking system were satisfied, and money market conditions began to ease. Projections pointed to further needs over the period ahead, however, and the System began a series of outright operations that ultimately supplied a net of $604 million of reserves over the following 3 weeks—through June 7. Four operations in coupon issues provided a little more than half of the over-all net reserve injection during this period. Operations on June 5, the day hostilities broke out in the Middle East, helped to moderate price declines in the nervous atmosphere prevailing in the securities markets.

The System made intermittent purchases of Treasury bills in the market and from foreign accounts, and at the end of May it bought some Government securities under short-term repurchase agreements to meet temporary needs around the Memorial Day holiday. Money market conditions remained quite steady, with Federal funds consistently trading in a narrow range around

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4 per cent; and member bank borrowings from the Federal Reserve Banks were nominal on every day except the day after the holiday.

The operations in coupon-bearing issues following the May 23 Committee meeting took place in somewhat unsettled markets. There was some speculation in the press, following this meeting, that the System would be seeking to buy a substantial amount of coupon securities in the weeks immediately ahead, possibly with some kind of rate objective in view. But as purchases of bills and coupon issues proceeded roughly hand in hand, market participants gradually came to realize that the operations were designed primarily to meet seasonal reserve needs, with purchases of various maturities coincidentally reducing the overhang of intermediate- and longer-term Government issues in the market, and thus facilitating flows of funds in the capital markets.

For the period under review here operations were largest between mid-June and mid-July, when the System first provided for seasonal reserve needs and subsequently absorbed a reflux of reserves after the July 4 holiday. This period also marked the beginning of the sharply increased variations in demands for excess reserves by country banks. The complications for operations stemming from these shifts were at times accentuated by unexpected shortfalls or bulges in nationwide reserve availability and by the interruptions in normal reserve flows around the quarterly statement date, June 30, and the Independence Day holiday. Accumulations of reserve needs did lead to some pressures in the money market and to heavy borrowings from the Reserve Banks on June 29 (the day before the statement date) and on July 3 (before the holiday), but a comfortable atmosphere prevailed over most of the remainder of this time period.

The major reserve-supplying operations during the interval began on Friday, June 16, when the System conducted go-arounds of the market to purchase sizable amounts of bills and coupon issues. Reserves fell below expectations, however, and by

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the end of the statement week some firmness was threatening to emerge in the money market. A redeposit by the Treasury of $1 billion into tax and loan accounts of its large depositaries, or "C" banks, on Wednesday, June 21, and System purchases of $472 million of Government securities under 1- and 2-day repurchase agreements met a good part of the accumulated reserve needs, but even so, member bank borrowings from the Reserve Banks rose that night to $411 million.

Three operations in coupon issues and large purchases of bills in the market and from foreign accounts supplied $1.4 billion of reserves, net, over the June 22–July 7 period. These injections were supplemented on occasion by use of repurchase agreements against Government securities and bankers' acceptances. The large amounts of bills available from foreign accounts were particularly helpful in meeting these substantial reserve needs at a time when dealers' positions were becoming depleted. On July 5, when dealers' inventories were very low, the Account Manager sought to broaden the avenues of reserve injection by offering to arrange repurchase agreements against any Government securities that dealers either already had in position or might acquire under repurchase agreements with investors. Buying by the System during this period helped to moderate pressures in the Treasury bill market as bill rates shot upward in anticipation of heavy Treasury borrowing in the weeks ahead.

This wave of reserve injections was completed by Friday, July 7, and after an unexpected bulge in nationwide reserve availability over the ensuing weekend, the System reversed direction and on July 10 began to absorb the emerging redundancy of reserves in a gradually easing money market. Bill rates had stopped rising by that time, but some nervousness persisted in the securities markets. At first, therefore, the System confined its operations to sales of a small amount of bills to foreign accounts. Then, as the bill market remained steady and reserve excesses became evident, the System sold $590 million of bills outright in the market on July 12 and 14, and on the following Monday

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it sold $295 million of bills under matched sale–purchase transactions. Even though average free reserves declined in the July 19 statement week, Federal funds traded at progressively lower rates, as previously accumulated excess reserves at country banks spilled into the money centers.

Operations were extremely limited over the rest of the period. The System supplied some reserves through outright purchases of Treasury bills during the period July 18–24, but over the following month its only actions involved two reserve injections —through repurchase agreements—and periodic reserve absorptions through redemptions of maturing Treasury bills totaling $450 million. Conditions in the money market remained fairly steady through this period. Federal funds traded generally at 3¾ or 4 per cent, and borrowings from the Reserve Banks were nominal, while average free reserves continued to fluctuate from week to week in line with shifts in country banks' excess reserves.

The money market did show somewhat more than usual ease in the final weeks of August as the basic reserve positions of money center banks improved and nationwide reserve availability bulged beyond expectations. Some of the redundant reserves were absorbed through use of matched sale–purchase transactions on August 25 and 29 and sales of maturing bills on the latter date. But in view of the considerable nervousness that prevailed in the securities markets while new Treasury notes issued in the August refunding and in a cash financing in late August were still being digested, no further actions were undertaken. Federal funds traded at rates as low as 2 per cent during the final week of August, but most trading was at higher rates.

Seasonal reserve needs immediately surrounding the Labor Day weekend were met initially through outright purchases of Treasury bills and coupon issues; these were supplemented a few days later by use of repurchase agreements. Then, as currency flowed back into banks after the holiday and float bulged, the System allowed the outstanding repurchase agreements to mature and also sold $353 million of Treasury bills in the market and to

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foreign accounts on the final 3 days of the period. The money market had taken on a somewhat firmer tone following the undue ease at the end of August, but Federal funds traded in good volume at rates around 4 per cent and member bank borrowings from the Reserve Banks remained nominal.

Capital markets. Interest rates moved substantially higher on balance over the May 2–September 11 period. Short-term rates showed the sharpest net increases—reflecting the large volume of Treasury borrowing in the short-term area after midyear, following sizable redemptions of Treasury debt in preceding months. In the long-term markets yields rose by 30 to 50 basis points net over the interval, with the dominant force being an unprecedented demand for funds by corporations in the summer. Under this pressure yields on new Aa-rated utilities with 5 years of call protection rose from 5.70 per cent at the beginning of May to a peak of 6.20 per cent at the end of August, before edging a few basis points lower in early September. Borrowings by State and local governments were also quite heavy over the period, and the Bond Buyer's index of yields on 20 tax-exempt bonds rose from 3.79 to 4.07 per cent. Yields on long-term Government bonds rose from 4.66 to 4.96 per cent.

The effects of the heavy volume of new offerings in the capital markets were compounded by the steady stream of announcements of forthcoming new issues that were being added to an already heavy calendar. In all, $13.3 billion of new corporate and tax-exempt bond issues were floated during the 4½ months under review here, compared with the previous record volume of $9 billion for the similar period in 1966. Offerings of new corporate bonds averaged more than $2.2 billion a month over the summer, with public offerings accounting for more than half of the total. Offerings of new tax-exempt issues slackened a little in July and August, but still totaled $4.7 billion for the interval as a whole.

Included in the tax-exempt total were more than $250 million of industrial revenue bonds, as more and more municipalities

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used this type of financing to attract new industry. During 1967 as a whole more than $1.3 billion of industrial revenue bonds were sold, compared with only $500 million of such issues in 1966. This type of financing accounted for almost 10 per cent of all tax-exempt offerings during the year, compared with less than 5 per cent a year earlier. The relative impact on long-term tax-exempt financing was even greater because the industrial revenue issues were largely of a long-term character.

In the face of the continuously heavy calendar, most of the new corporate and tax-exempt offerings met with mediocre or poor initial response on the part of investors. Even as yields rose, investors generally saw little reason to hurry to commit funds. Meanwhile, underwriters were under some pressure to keep their inventories cleared out so as to be prepared for the next wave of new issues. Hence underwriting syndicates were often terminated quickly, and price and yield adjustments were often quite large. On some issues they ranged up to 40 basis points.

Because of this readiness to adjust prices flexibly, markets never became really congested with huge amounts of unsold inventories on dealers' shelves. Indeed, the Blue List of advertised tax-exempt issues declined rather steadily over the period, from the year's high of more than $800 million at the end of April to around $600 million during June and only $400 million during August and early September. The corporate market reportedly showed a similar trend, but comparable data on dealer inventories are not available.

There were, of course, some temporary respites from the general upward pressure on yields during the period. One such breather occurred around the end of May, when investor demand was sparked by speculation, as noted earlier, that the System was about to embark on extensive operations to buy Treasury coupon issues with a view to twisting the yield curve. Strong demand reappeared in July, amid rumors that the administration was about to propose a tax increase and that any further build-up of troops in Vietnam might be smaller than had been expected. The

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actual proposal of the tax surcharge on August 3, also noted earlier, sparked a brief rally in the markets, but it was short lived. Finally, there was some improvement in the markets around the end of August, amid discussion of possible peace feelers following the election in Vietnam and a reassessment of the economic outlook in view of a possible strike in the automobile industry.

For the most part, however, these improvements in the markets tended to reflect somewhat exaggerated reactions to each of the successive sparks. When the initial fire died, market participants returned to their previous worries about the course of the war in Vietnam and its implications for the economy and for Treasury borrowing needs, along with the discouraging uncertainties about prospects for fiscal restraint even after the formal proposal of the tax surcharge. Tensions in the Middle East in early June were another source of worry for a while.

Most long-term yields by the end of June were either close to or above their peaks of August 1966. After a brief decline in early July, yields on corporate bonds moved to successive new highs throughout August, and Treasury bond yields gradually returned to their peaks. Yields on tax-exempt issues declined from early July through early August as the new-issue calendar lightened somewhat; they then rose only gradually amid the general pressures in August—reflecting in part an increased relative attractiveness of tax-exempt bonds in the wake of the administration's proposal for a tax surcharge. At the end of the period yields throughout the long-term markets were generally 10 to 15 basis points higher than at their peaks in August 1966.

Treasury finance. The turnaround in Treasury debt operations after midyear was quite sharp. In the first 6 months of 1967 the Treasury had retired nearly $7.4 billion, net, of marketable debt; its last action during that period was to redeem $5.5 billion of maturing tax-anticipation bills in June. Then over the next 2½ months, through the end of the period reviewed here, the Treasury borrowed more than $7.7 billion of new money; two-thirds of this total matured in 15 months or less. (Additional borrowing

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within the calendar year totaled $8.6 billion of direct Treasury debt, plus the sale to the public of $650 million of participation certificates by the FNMA).

Before the onset of this heavy borrowing program, a continuing demand for Treasury bills from a wide variety of investors who were rebuilding liquidity or seeking a temporary haven for their funds, combined with increasing scarcities of bills, had pushed rates on short-term bills down fairly sharply. Bill rates moved up somewhat in early June, as corporations sold bills to meet their quarterly dividend and tax payments. But the decline soon resumed under the weight of sizable reinvestment demand from holders redeeming the maturing tax bills and from commercial banks preparing for their midyear statements. By June 23 the rate on 3-month bills was down to 3.33 per cent bid, its low for the year. Meanwhile, rates on longer-term bills had already begun to rise in expectation of future pressure. On June 23 there was a spread of 50 basis points between rates on 3- and 6-month bills. This was the widest spread since September 1966.

Bill rates shot upward in the days that followed as heavy dealer offerings were pressed on the market in anticipation of an imminent financing announcement. By June 28, when the Treasury announced the first step in its borrowing program, the rate on 3-month bills had already risen 43 basis points from its low point, and it rose another 60 basis points through the morning of July 5 when the actual financing began. Rates on longer bills also increased—by about a percentage point—over this 10-day interval.

The Treasury announcement outlined plans to raise $6.2 billion of new money in the bill market over a period of time. The program included sale of $4 billion of new tax-anticipation bills on July 5, along with additions of $100 million to each regular weekly auction of 3-month bills and to the monthly auctions of 1-year bills. The higher rate levels reached by the time of the tax-anticipation bill auction proved attractive, and the bidding for these bills and for bills in several succeeding weekly auctions was fairly strong.

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Bill rates fluctuated around their higher levels for a while, rose further in August amid a heavy atmosphere in the coupon sector, and after a brief decline around the first of September were moving upward again at the close of the period. In the auction on September 11, 3-month bills were sold at an average rate of 4.360 per cent, 59 basis points higher than at the beginning of the interval and more than a full percentage point above the low reached in late June. The rate on 6-month bills was up to 4.951 per cent on September 11, more than a percentage point higher than at the start of the period.

The Treasury conducted three coupon financing operations during the period, and Federal agencies sold to the public $1.7 billion of issues maturing in more than a year, including $650 million of new participation certificates by the Federal National Mortgage Association. While each of the Treasury's issues and the FNMA certificates were fairly well subscribed for, they all weakened in secondary markets, amid a general deterioration in over-all market sentiment.

In the May financing, for example, which was in process as the period under review here began, public subscriptions totaled more than $4.7 billion, including $2.7 billion for the 5-year, 4¾ per cent notes. The large amount of August maturities turned in by the public was taken as an encouraging sign, because the operation reduced the size of that month's refinancing to more manageable proportions.

But conditions in the market soon began to deteriorate as apprehensions grew over anticipated Treasury financing needs, especially in the light of reports of the possibility of further escalation of the Vietnam war. Dealers became restive with their enlarged holdings, and as they pressed offerings on the market, prices of new and outstanding issues fell. Purchases of coupon issues by Government investment accounts on May 8 and 9, and by the System on May 17 in the course of meeting banks' seasonal needs for reserves, absorbed some of the heavy supply of securities overhanging the market, but prices continued to decline through May 23.

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One of the factors contributing to the nervousness in the coupon sector around this time was the Treasury's request at hearings on the Federal debt limit on May 15 for two revisions in the legislation affecting the 4¼ per cent interest rate ceiling on long-term Treasury issues. Specifically, the Treasury requested (1) a redefinition of Treasury notes—to which the interest ceiling does not apply—extending their maximum maturity from 5 to 10 years and (2) authority to sell up to $2 billion of bonds without regard to the interest ceiling.

As was the case with the debt limit legislation enacted in February, debate on the new debt limit and interest ceiling bill extended almost until the last minute before the expiration of the existing debt limit on June 30. Passage of the new debt ceiling saved financial markets from severe dislocations that might have ensued had the Treasury been required to reduce its outstanding debt by paying off maturing issues in cash as they came due. As finally approved, the legislation set the maximum maturity of notes at 7 (rather than 10) years, but it included no provision for sales of bonds outside the interest ceiling.

The FNMA offering of participation certificates on June 15 consisted of $350 million of 5¼ per cent, 27-month certificates and $300 million of 5½ per cent, 5-year certificates, both priced at par. (Treasury trust accounts took an additional $250 million of the two issues.) The yields—in both cases 50 basis points higher than those offered on certificates in March—seemed initially to have attracted a fairly good interest on the part of investors. When the certificates were released from syndicate pricing restrictions on June 20, however, their prices dropped sharply below par. In fact, the 5-year certificates immediately began to trade at a discount to yield 5.70 per cent.

In its August refunding the Treasury offered for cash $9.6 billion of new 15-month, 5¼ per cent notes discounted to yield 5.30 per cent. (Through over-allotments, the Treasury actually acquired $300 million of new money in this operation as well as the amount needed to redeem maturing issues.) The offering attracted a routine interest, and larger public subscriptions re-

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ceived 35 per cent allotments, about in line with market expectations. The new issue traded briefly at its original offering price during the period of short-lived buoyancy in the markets following the President's tax message on August 3, but by the payment date, August 15, it was trading at a discount of $^{3}/_{64}$ from the offering price.

The final Treasury borrowing during the interval, announced on August 17, was a cash offering of $2.5 billion of new 5⅜ per cent, 3½-year notes discounted to yield 5.40 per cent. Subscription books were open on August 22, and payment was made on August 30. Commercial banks were permitted to pay for the issue by credits to Treasury tax and loan accounts. Many market participants had hoped that the Treasury would offer a higher-yielding note in the 5- to 7-year area. As in the refunding earlier in the month, interest proved routine, and larger public subscriptions received 38 per cent allotments. Prices of outstanding intermediate-term issues had adjusted lower immediately after the terms of the new offering were announced, and they continued to drift somewhat lower over the next week in a generally dull market environment. By payment date the new issue was trading at a discount of $^{5}/_{64}$ from the offering price.

MOUNTING INFLATIONARY PRESSURES (September 12–November 13)

In some ways the autumn was a time of transition both for the economy and for views on monetary policy. Whereas a number of business indicators showed weakness during September and October as a result of strikes in the automobile industry and elsewhere, underlying economic conditions apart from the strikes strengthened. The heavy demand for credit resulted in a sharp further rise in interest rates during the period, as the securities markets responded to evidence of mounting inflationary pressures and the seemingly dim prospects for early enactment of the proposed income tax surcharge. Credit expansion slowed from the rapid pace of the summer, but it was still large. Meanwhile, the underlying U.S. balance of payments situation worsened.

Federal Reserve policy continued to be aimed at maintaining

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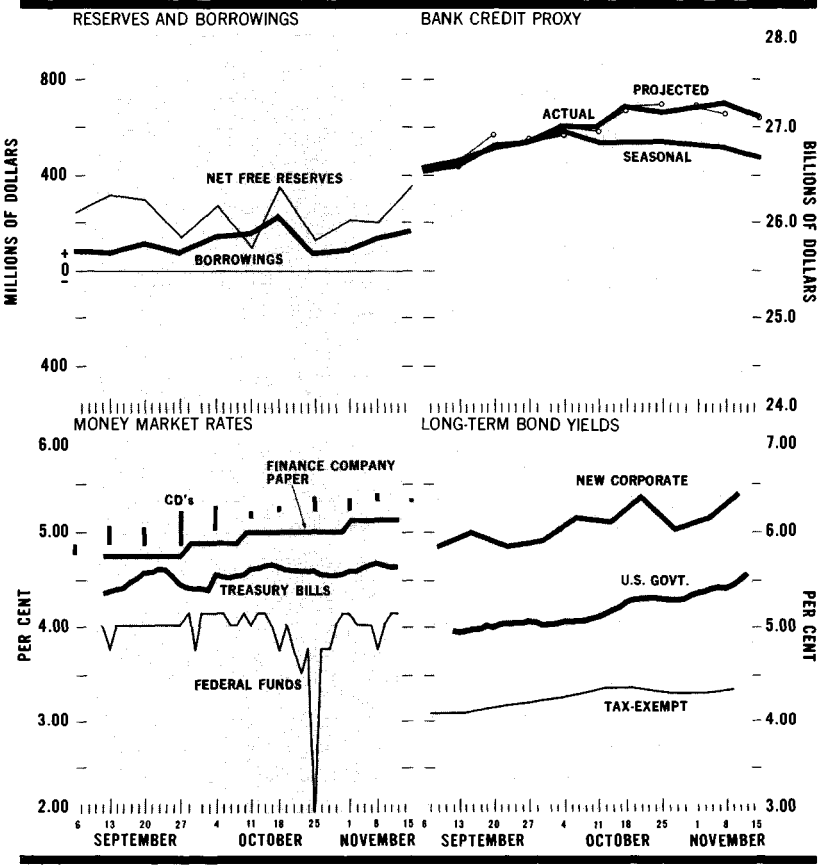
generally steady conditions in the money market over this period. There was growing concern in the Open Market Committee over evidences of inflationary pressures, the recent rapid rates of growth in money and credit, and continued large deficits in the U.S. balance of payments. However, the uncertain effects and duration of the strikes, continuing hope for action on the tax proposal, and concern about the effects of rising interest rates on domestic financial intermediaries and on the position of sterling in foreign exchange markets were seen as arguing against a policy shift. "Even keel" considerations came into play for a time in early October, when the Treasury auctioned $4.5 billion of tax-anticipation bills, and then again in the final weeks of the interval, when the Treasury carried on a sizable cash financing to refund securities maturing on November 15 and to raise additional new money.

Day-to-day conditions in the money market continued to fluctuate during this period in the same general range as during the summer. The variations reflected largely shifts in the distribution of reserves between money center banks and those in outlying areas. The effects of these shifts were accentuated somewhat during October by unexpected shortfalls, and also bulges, in nationwide net reserve availability. Federal funds traded generally around 4 per cent during the period. The funds rate was a little above this level in early October when reserve availability repeatedly fell short of expectations, but it was somewhat lower later in the month when accumulated excess reserves spilled into the money centers. Member bank borrowings from the Reserve Banks averaged about $125 million over the period, well within the range of earlier variation, while the average level of free reserves declined a little, reflecting a somewhat more efficient use of reserves by the banking system (upper left panel of Chart 3).

As in the preceding several months, developments in the securities markets during the period were in sharp contrast with these generally comfortable conditions in the money market. Long-term yields rose with little interruption from their already

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high level by a total of more than ½ of a percentage point—in some cases to the highest levels in about a century. Short-term interest rates increased by ⅛ to ⅜ of a percentage point. By mid-November rates for CD's due in 9 months or longer had reached the 5½ per cent ceiling, as banks sought to maintain their outstanding CD's in the face of heavy maturities. Banks also added to their borrowings of Euro-dollars following losses of such funds in late August and early September. By mid-

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November, balances due to foreign branches of the major banks had risen to a new record of $4.6 billion, about $600 million above the August peak.

The bidding for CD's and Euro-dollars was related more to expectations of future developments than to a need to meet a heavy current demand for bank credit. Indeed, loan demand at banks over the September dividend and tax payment dates was a little weaker than bankers had expected. In fact, demand remained on a generally moderate level over the rest of the period under review here as corporations continued to tap the capital markets for a good part of their financing needs. Against this background, banks tended to hold for a somewhat longer period than usual the large amounts of tax bills won in the auction in early October, and they also built up their holdings of other securities. Thus, even though expansion of total bank credit slowed to about half of the very rapid pace experienced during the summer, the annual rate of growth was more than 8.5 per cent over the September–November period.

Open market operations. The day-to-day implementation of open market policy proceeded fairly smoothly over the period. As it turned out, the Committee's instructions to the Manager to moderate any tendency for bank credit to expand significantly faster than expected did not require any change in the general stance of maintaining steady money market conditions, because the pace of credit expansion proceeded about as expected. The only large-scale operations came around mid-October, when the System again made extensive use of repurchase agreements to counter the effects of repeated shortfalls of reserves below expectations. Outright purchases of Treasury bills in the market and from foreign accounts around the end of October met the month-end reserve needs of banks and helped to moderate heavy pressures that had suddenly reappeared in the securities markets after the close of subscription books for the Treasury's November refunding.

In its efforts to accommodate biweekly variations in demands

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for excess reserves by country banks, the System continued to permit fairly wide week-to-week fluctuations in average free reserves. During the interval free reserves of these banks tended, on the average, to drop by about $160 million from the first to the second week of a reserve settlement period for country banks, before rising again in the first week of the next settlement period. The absorption of reserves from the first to the second week of these periods was often accomplished by timely movements in market factors; hence the System's actions over this interval too were weighted mostly on the purchase side of the ledger.

Over the period as a whole, the Federal Reserve injected nearly $1.7 billion of reserves, net, into the banking system. This amount roughly met the reserve need stemming from increased required reserves and offset the reserve drains caused by increases in currency in circulation, gold outflow, and the restoration of Treasury balances at the Reserve Banks from a seasonal low to more normal levels. The injections proceeded in essentially three waves: in late September; temporarily around mid-October; and from late October through the end of the period.

Operations were fairly limited during the first week and a half of the interval, as the money market readily accommodated on its own the churning that occurred around the corporate dividend and tax payment dates. Some reserves were absorbed in the temporarily easy money market at the very start of the period through sales of maturing Treasury bills and the use of matched sale–purchase transactions, but no further operations were necessary for a week. Pressures on reserve positions of money center banks were less than many had expected, despite the banks' losses of CD's and some expansion of bank credit. The moderate deficits that developed were easily covered in the Federal funds market at rates around 4 per cent.

In the last third of September the Account Manager proceeded in fairly routine fashion to provide reserves through outright purchases of Treasury bills and coupon issues along with repurchase agreements against bankers' acceptances. These injections, which

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totaled more than $1 billion over the September 21–29 interval, offset the drains in reserves caused by a rise in Treasury balances at the Reserve Banks after the September tax payment date. Money market conditions remained generally steady through the month-end.

The money market firmed somewhat on subsequent days, however, following a reserve shortfall over the last weekend in September. No undue strains were apparent initially, in part because major banks in New York City had already stockpiled enough reserves to cover most of their moderate needs for the statement week. Interest in the Treasury's auction of $4.5 billion of tax-anticipation bills on October 3, moreover, seemed generally satisfactory, although as it turned out, bidding for the bills maturing in June 1968 was more restrained than had been expected.

But by Wednesday, October 4, retention of excess reserves by country banks, combined with the cumulative effects of earlier reserve shortfalls, threatened to produce additional firmness in the money market. To head off this pressure, the Treasury permitted its balances with the Reserve Banks to decline, and the System injected more than $400 million of reserves through outright purchases of Treasury bills and through purchases of bankers' acceptances under repurchase agreements.

Further injections of reserves through repurchase agreements against Government securities and bankers' acceptances were undertaken on six of the following seven business days in an effort to counter the persisting firmness in the money market. This firmness, and a general rise in interest rates in domestic short-term markets, was accompanied by a little more aggressive bidding for funds in the Euro-dollar market by some major U.S. banks, with consequent repercussions on the already weakening position of the pound sterling. By mid-October, balances due to foreign branches of U.S. banks had risen by more than $200 million from their end-of-September level. (The British discount rate was raised from 5½ to 6 per cent on October 19 and then

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to 6½ per cent on November 9.) In all, operations to counter this money market firmness involved the purchase of more than $1.5 billion of obligations under repurchase agreements over the October 5–16 interval. But reserves repeatedly fell short of expectations, and trading in Federal funds generally remained at rates around 4⅛ per cent.

The accumulated effects of the earlier reserve injections and of the heavy borrowings from the Reserve Banks finally began to cause an easing in the Federal funds market by Tuesday, October 17, and over the next week the funds rate was persistently below 4 per cent. In view of the earlier firmness in the money market and of the nervousness in the securities markets as the Treasury's November refunding drew near, the System took no overt action to head off the easing. Instead, the System sold a few Treasury bills to foreign accounts, terminated maturing repurchase agreements without replacement, and redeemed some maturing Treasury bills.

Meanwhile, with country banks' excess reserves falling sharply, average free reserves dropped to the lower end of the range of recent fluctuation, but conditions in the Federal funds market remained quite comfortable. Short-term interest rates declined a little during this period, and banks began to acquire domestic funds through CD's—thus easing a little of the pressure in the Euro-dollar market. The more comfortable money market environment also helped to dispel fears that had arisen among some market participants that a change in Federal Reserve policy was already under way and contributed to the better atmosphere that was also emerging in the securities markets.

Needs for additional reserves reappeared around the end of October. Meanwhile, a weak atmosphere had developed throughout the securities markets on October 31. This considerably undermined interest in the Treasury financing, for which the subscription books had been opened on the previous day. To meet banks' needs for reserves and to moderate the heavy pressures in the securities markets, the System bought about $110 million of

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Treasury bills from foreign accounts over the October 30–November 2 interval, and it purchased $491 million of bills in go-arounds of the market.

Further injections of reserves from November 2 through the end of the period involved the purchase of $703 million of Government securities under short-term repurchase agreements. While unexpected shortfalls of reserves on several days reduced nationwide net reserve availability to levels a little below those initially anticipated, the money market remained generally comfortable, and most of the trading in Federal funds was at rates around 4 per cent.

Securities markets. A weak atmosphere pervaded the securities markets during almost all of the period under review here. This reflected largely the increasing discouragement among market participants about prospects for any significant fiscal action to restrain inflationary pressures and to reduce Treasury borrowing needs. Early in the period more and more market participants began to think that the Federal deficit would probably be large even if the proposed tax surcharge were enacted by the Congress. By the end of the period, most remaining hopes for the proposal itself had been undercut by two developments—one, the announcement of the House Ways and Means Committee on October 3 that it was setting aside further deliberations on the tax surcharge until some agreement could be reached on reductions in expenditures; and two, reports over the final weekend in October that the Congress would soon adjourn without passing the tax surcharge.

Given the dimming prospects for fiscal restraint, market participants came increasingly to believe that monetary policy would begin to tighten soon. Discouragement over the lack of any signs of peace in Vietnam contributed to the weak market atmosphere, and as the period wore on, there was also growing concern about the worsening position of the pound sterling.

Against this background, borrowers tended to accelerate their financing schedules, and investors tended to wait to buy

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new issues in the secondary market until initial offering prices had been cut and yields raised. Yields on longer-term issues ratchetted upward at a rate of about 5 to 10 basis points a week during the period. The only major interruption to this general trend occurred for a time near the end of October when yields finally reached a level that did attract some investment demand. Although renewed deterioration in the markets had occurred by October 31 and had continued into November, some signs of hope emerged late on November 13, the final day of the period, following rumors of a possible brightening of prospects for peace and the cancellation of a large corporate issue scheduled for the following day.

Government financing activities during the period contributed to, and were affected by, the heavy market atmosphere. Rates on bills maturing within 3 months moved up by about 15 to 25 basis points over the first week and a half of the interval—reflecting in part the growing apprehension over the possibility of a very large offering of new tax-anticipation bills in the near future. On Friday, September 22, the Treasury announced an offering of $4.5 billion of such bills in early October and also indicated that it would continue to add $100 million to the weekly bill auctions for another 13 weeks. As a result, the size of each weekly auction rose to $1.5 billion for 3-month bills, but for 6-month bills remained at $1 billion. Bill rates rose further on the following Monday in reaction to the announcements, but little selling pressure was apparent. And as demand expanded toward the end of the month—in part from banks that were preparing to publish their quarterly statements and in part from the System Open Market Account—rates declined toward the levels prevailing at the start of the period.

In the auction of the new tax-anticipation bills on October 3, bidding was fairly strong for the $1.5 billion issue due in April 1968 as banks sought to capture tax and loan credits that they could use to pay for their purchases. On the other hand, bidders showed much less interest in the $3 billion issue due in June

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1968, and tenders for it totaled only $3.3 billion, one of the narrowest "covers" in an auction in some time. The average issuing rate on the June issue, at 5.108 per cent, was somewhat above expectations in the market, and some tenders were accepted at rates as much as 10 basis points higher to cover the issue.

Despite the weak interest in the auction, rates on outstanding bills remained fairly steady for a time before moving higher around mid-October when several short-term issues of Federal agencies were poorly received and some selling of bills appeared. By October 16 the weekly auction rates for 3- and 6-month bills had reached 4.676 and 5.165 per cent, respectively. Rates fluctuated a little below these levels over the next several weeks, but by the end of the period they had risen again. In the auction of November 13, 3- and 6-month bills were sold at average issuing rates of 4.648 and 5.155 per cent, about 29 and 20 basis points, respectively, above the rates prevailing at the end of the preceding period.

Almost $3.4 billion of new Federal agency issues came to market during the period at generally rising yields. Within a few days after these issues had been sold, most of them—even those accorded fairly good initial receptions—were being traded at discounts from their original offering prices. Two Federal land bank issues—one maturing in 27 months and the other in 5 years—had particularly poor secondary market performances. The issues were priced on October 10 to yield 5.75 and 5.88 per cent, respectively, 11 basis points above yields available on similar maturities in the secondary market the day before.

By the time the issues came to market a day later, even these yields were considered relatively unattractive. Initial trading in both issues in the secondary market took place at discounts of ⅜ of a point below original offering prices. This in turn reinforced the poor market sentiment, and in particular it discouraged investor interest in two other short-term issues offered by the Federal home loan banks 2 days later. In early November the FNMA

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revealed plans for a public offering of $650 million of new participation certificates later in the month (with an additional $350 million to be sold to Government trust accounts). While this addition to an already heavy calendar of offerings caused some apprehension in the markets, the announcement was fairly well received for two reasons—one, that it was accompanied by an indication that this would be the last Government financing of the year; and two, that the public portion of the offering was smaller than many market participants had expected.

The one period of major relief in the capital markets during the interval occurred just before and during the early stages of the Treasury's November refunding operation. The increasing caution and lack of demand that was apparent before this improvement set in had led some market participants to worry about the capacity of the markets to accept anything but a short-term obligation in the financing. As demand for capital market issues finally did emerge, however, and the general atmosphere improved, the Treasury took the opportunity—in addition to refunding its November maturities—to raise $2 billion of new cash and also to seek some significant extension in debt maturity. The terms of the financing, announced on October 25, offered for cash about $10.7 billion of 5⅝ per cent notes due in 15 months and about $1.5 billion of 5¾ per cent notes due in 7 years. The 7-year issue was the first to be offered under the more liberal definition of notes contained in legislation that had been passed by the Congress in late June.

The long note attracted real enthusiasm among market participants and was heavily oversubscribed when the books were opened on October 30. Larger subscriptions received allotments of only 7.5 per cent. Interest in the 15-month notes was routine, and large subscriptions were allotted at a 36 per cent rate. In these circumstances most participants expected that both notes would be traded at slight premiums in the secondary market.

As it turned out, conditions in the market deteriorated rather abruptly the day after the books for the refunding had closed.

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There were several reasons for this. On October 30, while the books for the new Treasury notes were still open, a major steel company had announced plans to sell a large bond issue in the near future, and similar announcements by other would-be borrowers followed quickly. Meanwhile, participants became increasingly discouraged about prospects for enactment of the proposed tax surcharge following reports that Congress might adjourn soon. The Treasury's two new issues did begin to trade at small premiums when the market opened on October 31, but later in the day investors and dealers who had subscribed for the long-term notes just the day before began to sell these notes in large amounts. As this selling pressure persisted, the price of the new 7-year notes eventually fell to a discount of more than half a point on November 13, raising its yield to 5.85 per cent.

This performance added to the factors that were weighing on the market, and prices of most Treasury issues fell sharply and rather steadily over the rest of the period. By the close of the markets on November 13, yields on 3- to 5-year Government securities averaged 5.89 per cent—49 basis points higher than at the start of the period—and the average yield on long-term Treasury bonds had risen by 59 basis points to 5.55 per cent.

In the corporate bond market about $3.7 billion of new issues (including private placements) were offered during the mid-September to mid-November period. While this was a third less than the extremely large volume of new offerings during the summer, it was still heavy by any other standard. The calendar was kept full, for new offerings were added to the schedule as fast as already scheduled offerings actually came onto the market. The upward ratcheting of corporate yields during the period is illustrated in the experience of several new Aa-rated utility issues, all with 5 years of special call protection. At the beginning of the period, an issue of this type came to market yielding 6.10 per cent. By early October an issue yielding 6.20 per cent

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was accorded only a fair reception, and 2 weeks later an issue yielding 6.375 per cent was accorded an even poorer reception.

Demand finally emerged for an issue yielding 6.44 per cent, which was sold on October 18. As the whole market improved over the next several weeks, yields declined somewhat and unsold balances in older accounts were pared. By the end of the period, however, after the market atmosphere had deteriorated again, new Aa-rated electric utility issues were being offered at yields around 6.55 per cent. By way of comparison, at the peak of interest rates during the credit squeeze of 1966, such issues were offered at yields no higher than 6.05 per cent.

The market for convertible corporate bonds was affected during the period by the Board of Governors' announcement on October 20 of a number of proposals governing the use of credit in securities transactions, including the extension of margin requirements to loans for purchasing convertible bonds. Offerings of such bonds had become very sizable in recent months. In fact, they amounted to 27 per cent of total corporate debt offerings in the third quarter compared with only 12 per cent for all of 1966.

In the wake of the Board's announcement, many scheduled offerings of convertible issues were postponed, some were reduced in size, and prices of some bonds already outstanding dropped as much as 13 points in secondary market trading. Other markets were not affected particularly by the announcement, and by the end of the period many of the convertible issues postponed earlier had come to market or were back on the calendar, albeit under somewhat more generous terms than would have been given earlier.

Offerings of tax-exempt bonds totaled a little more than $2 billion over the period. This pace of financing was a little higher than that in the late summer. Initial receptions were generally poor, and subsequent adjustments in yields tended to be quite sharp. On the whole, however, the adjustments were sufficient to attract buyers, for dealers' inventories remained moderate

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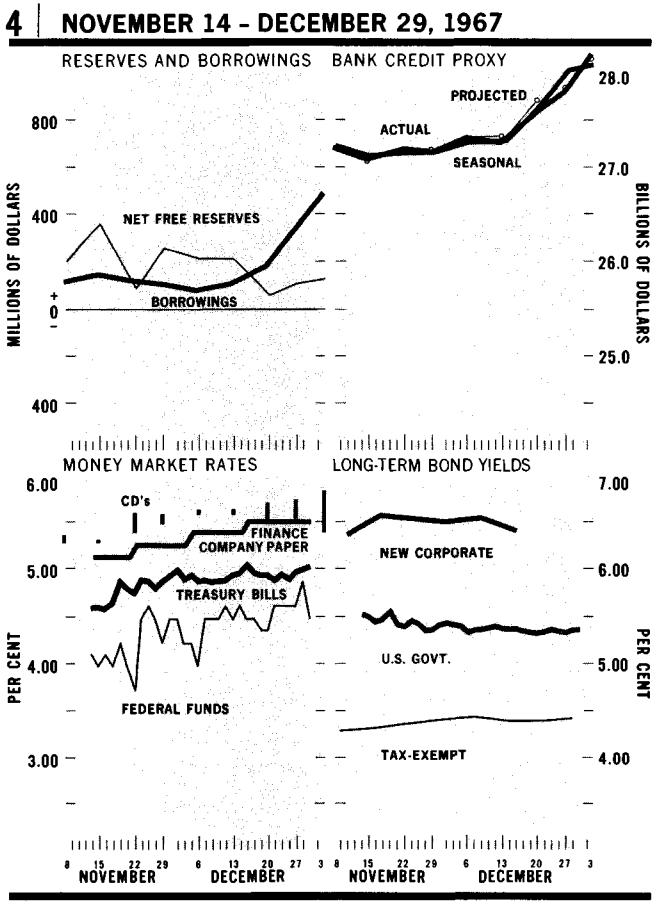
throughout the period. By the end of the interval the Bond Buyer's index of yields on 20 tax-exempt bonds was up to 4.31 per cent, 24 basis points higher than in mid-September and 7 basis points above the 1966 high.

November 14–December 31: Monetary Policy Firms to Defend the Dollar and Resist Inflationary Pressures

Connections among financial markets at home and abroad came into sharp focus in the final 6 weeks of 1967 as sterling, gold, and the dollar alternately felt waves of pressure that generated considerable nervousness in domestic securities markets. Tremendous uncertainties pervaded all markets on the days immediately surrounding the devaluation of sterling and related British actions on November 18 and the increase in the Federal Reserve discount rate from 4 to 4½ per cent announced the following day. Extensive open market operations in Government securities early on Monday morning, November 20, helped to preserve the orderly functioning of the domestic securities markets that day. New uncertainties over succeeding days were handled by the markets without unusual difficulty.

Around mid-December open market operations were aimed at moving slightly beyond the firmer money market conditions that had developed following the increase in the discount rate. Then on December 27 the Board of Governors announced an increase in reserve requirements against certain demand deposits to become effective around the middle of January 1968. These steps were taken to resist the resurgence of inflationary pressures and contribute toward achievement of reasonable equilibrium in the country's balance of payments. In the meantime, Congress adjourned without enacting the proposed tax surcharge, and business activity was picking up following settlement of strikes that had affected output earlier in the fall. Prices were rising at a substantial rate. Deterioration in the U.S. export surplus since

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For notes see pp. 212-13.

midyear had contributed to a considerable worsening of the balance of payments situation.

Federal funds traded in good volume around the 4 per cent discount rate during the first 4 days of the interval, and mostly at 4½ per cent or below for a time thereafter. Member bank borrowings from the Reserve Banks averaged around $100 million, about the same as in preceding weeks, while average free

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reserves continued to fluctuate in a range of $100 million to $300 million. In the final 2 weeks of the year, however, rates on Federal funds were more often around 4⅝ per cent, and member bank borrowings averaged around $200 million. Free reserves dropped to about $100 million on the average (upper left panel of Chart 4).

The remarkable performance of the domestic securities markets over the period, in the face of all the unsettlements from international and domestic events, was a strong testimony to their underlying vitality. In addition to the nervousness stemming from pressures in the exchange markets, from the rise in the discount rate, and from the moderate tightening in open market policy, participants in the markets faced the fact that prospects for early enactment of the proposed tax surcharge and for general fiscal restraint had become increasingly dim. Meanwhile, the volume of new security issues remained substantial until a seasonal lull began in mid-December, and additional large financings by the Treasury were expected after the end of the year.

Even though there were some fairly sharp gyrations in securities prices on individual days, markets as a whole remained quite orderly. Short-term interest rates showed a net increase for the period, but most of the rise occurred immediately after the increase in the discount rate. Many long-term yields, on the other hand, declined on balance over the period. Indeed, as the period wore on, considerable sentiment began to develop that the heaviest pressures on the markets had passed, and investors began to put more of their funds into issues with longer maturities to obtain the high yields available on such issues.

The rise in short-term market yields during the period reduced further the ability of banks to compete for funds under the 5½ per cent interest rate ceiling for time and savings deposits. Moreover, market rates appeared to be moving into critical areas in relation to ceiling rates on savings accounts. Inflows of funds to savings and loan associations and mutual savings banks were

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at a reduced pace in the final weeks of the year, but these institutions did not lose funds net.

Commercial banks raised their offering rates on new CD's soon after the increase in the discount rate, and as the period progressed, the 5½ per cent ceiling became available on CD's of any maturity. At the higher rates banks were able to build up their outstanding CD's during the latter part of November, but during the corporate dividend and tax payment period in mid-December they experienced heavy net runoffs. Over the period as a whole, outstanding CD's were about unchanged.

Banks also built up their Euro-dollar balances early in the period under review here to a new peak of more than $4.8 billion on November 22. As rates in the Euro-dollar market reached higher levels, however, the banks withdrew from bidding for longer maturities, and by the last Wednesday of the year their total outstanding balances due to foreign branches were down to $4.2 billion.

On Monday, November 20, in the wake of the increase in the discount rate, a large commercial bank in Chicago raised its lending rate to prime business borrowers from 5½ to 6 per cent, and most other banks soon followed. Loan demand at the banks was fairly heavy around mid-December as corporations borrowed to finance their dividend and tax payments, but banks met most of these demands by selling Government securities. As a result, total bank credit remained largely unchanged over the period. Even so, the expansion over the year as a whole amounted to $35 billion, or 11 per cent, almost double the rate in 1966.

Days around the devaluation. Rumors that a large credit package was being arranged to assist the British in their continued defense of the pound had considerable calming effect on domestic and international markets on the opening days of the period under review here. Indeed, these rumors, along with postponement of a large issue of industrial bonds scheduled for offering on November 14 and renewed hopes for peace negotiations in Vietnam, generated one of the sharpest rallies of the year in

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prices of long-term securities during the first 3 days of the interval. Most unsold corporate issues still in syndicate were quickly taken up, a large volume of tax-exempt offerings was quickly distributed, and dealers' inventories of Treasury issues maturing in more than a year were sharply reduced. Prices of some Treasury issues rose by nearly 2 points over the first 3 days of the period—that is, through Thursday, November 16—and Treasury bill rates moved down by as much as 10 basis points. This atmosphere evaporated on Friday, November 17, however, when pressures on sterling increased sharply amid talk of possible devaluation over the weekend. Prices of some U.S. Treasury bonds fell by more than ⅝ of a point that day, prices of corporate and tax-exempt bonds also eased, and rates on Treasury bills rose by as much as 7 basis points.

With generally comfortable conditions prevailing in the money market during this period, open market operations were limited. The System did purchase $225 million of Treasury and Federal agency securities under repurchase agreements on Thursday, November 16, when large demands by dealers for financing exerted pressure on reserve positions of major money center banks. But this did little more than offset terminations of outstanding agreements over the 4 days November 14–17.

Following the devaluation of sterling, the Board of Governors announced on Sunday, November 19, an increase in the Federal Reserve discount rate. The announcement indicated that the System "had taken actions to assure the continued orderly functioning of U.S. financial markets and to maintain the availability of reserves to the banking system on terms and conditions that will foster sustainable economic growth at home and a sound international position for the dollar."

The Account Manager and some of his associates met that same afternoon—November 19—to work out detailed operating plans to forestall the emergence of disorderly conditions in the Government securities markets that might develop if offerings of dealers and investors inundated the market when trading resumed

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the following morning. Prior to this time broad contingency plans to deal with situations of this type had been discussed among Treasury and Federal Reserve officials. Operations followed the general outline of plans presented earlier to the Federal Open Market Committee.

Dealers' aggregate positions were not unduly large at the time, although a number of dealers still held notes acquired in the Treasury's November financing. It was recognized that dealers with net long positions would probably try to preserve their capital by withdrawing from the "buy" side of the market and that they might well push their own inventories on the market before prices fell too far—thereby aggravating the price decline and adding to the potential disruption of the market. Government securities dealers were contacted during that afternoon and were read the full text of the Board of Governors' announcement of the increase in the discount rate.

Open market operations began early on Monday morning, November 20. In line with the plans that had been worked out, the System at 9:15 a.m. placed bids with Government securities dealers for a sizable part of their coupon issues due in more than a year at prices that were somewhat below the average of dealers' bid prices at the close of the market the preceding Friday. Most of the bids were accepted, and the System purchased $121 million of issues due in 1 to 5 years and $65 million of issues due in more than 5 years.

After this operation had been completed, the System initiated a regular go-around asking dealers for offerings of all Treasury bills. In this operation the dealers offered about $1.2 billion of bills to the System at rates ranging generally from 20 to 30 basis points above those prevailing at Friday's close. The System's purchases totaled $427 million, mostly in issues due in more than 3 months. The bills were purchased for delivery on Tuesday, November 21, and delivery of the coupon issues was scheduled for the following day in order to minimize the immediate impact of the operations on member bank reserves.

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Prices of Treasury coupon issues did drop sharply when the market officially opened, and by 11 a.m. some intermediate-term Treasury issues were down by as much as ⅞ of a point from the close on the preceding Friday. Some longer-term issues were off by as much as 1⅝ points. Meanwhile, a number of corporate and municipal issues scheduled for offering over the next several days were postponed. A recently offered Aa-rated corporate issue was released from pricing restrictions and its price dropped more than 3 points, raising its yield from 6.55 to 6.83 per cent.

The Dow-Jones index of industrial stock prices fell by 14.96 points on heavy volume in the first half hour of trading, and around 11:30 a.m. a major bank raised its prime lending rate from 5½ to 6 per cent. In short-term markets, in addition to the upward adjustments that were made in Treasury bill rates, dealers in bankers' acceptances raised their rates by generally ¼ percentage point during the morning, and some major banks reportedly paid 5½ per cent on new CD's maturing just beyond the year-end.

Most of these price declines and rate increases were defensive, however, for trading was light, except in the stock market. Dealers in Treasury issues, with their positions pared by the System's operations, were able and willing to absorb the moderate amount of securities offered by other customers. In this generally constructive atmosphere, prices began to stabilize late in the morning and during the afternoon moved well up from their lows. The postponement of $300 million of scheduled corporate and tax-exempt offerings contributed to the turnaround in prices of Government securities. Prices of some long-term Treasury bonds recovered about ¾ of a point in this rally, and coupon issues generally recouped about half of their early morning losses. The markets for corporate and tax-exempt bonds and the stock market also rallied from their lows.

In the bill market, the quick stabilizing of bill rates paved the way for a very good interest in the regular weekly auction

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of 3- and 6-month bills held that afternoon. Average issuing rates on these issues were set at 4.989 and 5.517 per cent, respectively, up 34 and 36 basis points from those set in the auction the preceding week but within the range of offering rates on similar bills in the System's go-around conducted early in the morning.

After trading activity in the market had become generally routine, with prices well up from their lows, reports reached the market late on that Monday afternoon that the House Ways and Means Committee would soon reopen hearings on the administration's proposed tax surcharge. In this environment, and with the markets in a strong technical position, prices rallied sharply on the next 2 days. Some long-term Treasury issues recorded gains of as much as 2 points, and by the close on Wednesday, November 22, a few were at their highest levels since the end of October. The yield on the Aa-rated corporate issue, referred to above, declined from its peak of 6.83 per cent to 6.61 per cent. Meanwhile, in some cases, rates on Treasury bills fell by more than 20 basis points from their Monday highs.

In view of the quick and orderly adjustment of the markets to the changed circumstances brought by devaluation and the rise in the Federal Reserve discount rate, and then of the rally amid the renewed hopes for a tax increase, the System took no further action for several days after its two operations early on Monday. With the reserve injections stemming from those operations, and with the effects on reserves of sizable foreign transactions, money market conditions were generally comfortable, and Federal funds traded at progressively lower rates.

Sharply increased pressures in the gold markets on the Friday after Thanksgiving Day brought renewed caution in the U.S. securities markets. Prices of Treasury coupon issues fell again, by as much as 1¼ points, and bill rates rose by as much as 15 basis points. Meanwhile money market conditions were generally comfortable, with Federal funds trading in a good volume at rates around 4½ per cent. But estimates of reserve availability

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were very uncertain in view of potentially large swings in transactions by foreign accounts as a result of their activity in the foreign exchange and gold markets. As the morning wore on, orders from foreign accounts to sell Treasury bills accumulated to a total of $191 million. Rather than press these bills on an unreceptive market, the Manager purchased them directly for the System Account.

The Federal Open Market Committee met on the following Monday, November 27. After reviewing developments over the preceding 2 weeks, the Committee directed that open market operations "be conducted with a view to facilitating orderly market adjustments to the increase in Federal Reserve discount rates; but operations may be modified as needed to moderate any unusual pressures stemming from international financial uncertainties." Operations over succeeding days continued to be complicated by considerable uncertainty surrounding the magnitude, timing, and direction of transactions in gold, foreign exchange, and securities accompanying massive international flows of funds. Many of these transactions had sizable effects on Treasury cash balances and domestic reserve availability. As it turned out, however, pursuit of the Committee's objective proved consistent with maintenance of net reserve availability and member bank borrowings in the range of recent experience.

Repurchase agreements against Government securities were used twice in late November to inject reserves to counter special pressures in the money market. In addition, in view of the continuing nervous state of the Treasury bill market, the System bought $502 million of bills being sold by foreign accounts in the period from November 27 through December 5. The System then withdrew for a time, and the money market remained comfortable.

An outflow of $475 million of gold on December 5 and the effects of various other foreign transactions drained reserves in volume around this time, but these were offset by a rise in float and a decline in Treasury balances at the Reserve Banks. In

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the case of the Treasury balances, however, the decline was not so large as in other periods prior to the receipt of corporate tax payments, since a part of the continuing flow of dollars to foreign central banks was placed in special Treasury issues. By November 29, Treasury obligations held at the Federal Reserve Bank of New York in custody for foreign accounts had risen to $9.4 billion, up $1.4 billion from the level in mid-November. Federal funds trading during this period was mostly at rates of 4½ per cent or less, and member bank borrowings from the Reserve Banks were minimal on most days. Free reserves in the 2 weeks ended December 13 averaged $208 million.

In the securities markets, worries about international developments gradually faded after the pressure in the gold markets on November 24 subsided. Hopes for a tax increase were buoyed further on Monday, November 27, in the wake of an administration proposal to cut expenditures, but they were dashed soon afterward when the Chairman of the House Ways and Means Committee indicated that a tax increase would not be passed during 1967. Meanwhile, rumors of a possible further rise in the Federal Reserve discount rate to reduce the differential between U.S. and foreign rates added to nervousness in short-term markets around the first of December.

Against this background, the rate on 3-month Treasury bills reached 5.01 per cent on December 1, then edged lower through December 8 in the face of broad demand and dwindling market supplies. A strong technical position in the longer-term area of the Treasury market and the large volume of "tax-swapping" activity tended to overshadow psychological developments, and prices of coupon issues moved up fairly steadily after the nervousness that developed on November 24 had died down. Meanwhile, an excellent reception was accorded the public offering on November 28 of $650 million of participation certificates by the FNMA. Both the 26-month issue yielding 6.35 per cent and the 20-year issue yielding 6.40 per cent sold out quickly and moved to premium prices. The corporate and tax-exempt markets also

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experienced a gradual improvement in tone as the holiday lull drew near, though yields in both markets continued to edge higher, in contrast to developments in the Treasury coupon market.

Operations to implement firmer policy. Open market operations over the last 3 weeks of December sought to bring about slightly firmer conditions in the money market as directed by the Federal Open Market Committee at its meeting on December 12. In the process of offsetting seasonal drains and of avoiding undue strains in the money market, the System provided reserves somewhat sparingly, and its injections did not meet fully the increase in seasonal demand for excess reserves. Free reserves were permitted to contract to an average of around $100 million in the final weeks of the year. Partly reflecting year-end churning, member bank borrowings from the Reserve Banks rose to an average of about $340 million. Rates on Federal funds moved up from around 4½ per cent in the first half of December to around 4⅝ per cent after December 21.

No further open market operations were undertaken until December 20. An outflow of currency from the banks and a rise in required reserves in the wake of the credit demands around the dividend and tax payment dates drained reserves. Meanwhile major banks continued to lose CD's, and they also experienced a decline in their Euro-dollar balances. Nevertheless, the money market remained fairly comfortable as the reserves that were available tended to be concentrated at money center banks.

Beginning on December 20, the System undertook a series of operations that injected $541 million of reserves, net, into the banking system during the remainder of the year. It purchased some Treasury bills from foreign accounts, and on December 26 it bought bills in the market. It supplemented these injections by gross purchases of $588 million of Government and Federal agency securities under repurchase agreements on 3 days of the interval to relieve temporary deficiencies amid typical year-end

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churning. Some $90 million of reserves were also injected through repurchase agreements with dealers in bankers' acceptances.

Additional reserves were provided for a while in the week between the Christmas and New Year holidays by permitting the Treasury's balances at the Reserve Banks to decline to a low level. These various reserve injections, however, offset only part of the further reserve drains during the period, including the effect of a $450 million gold loss on December 28, when the United States made settlement for its share of net sales by the London Gold Pool in December.

Money center banks moved into a deeper basic reserve deficit during this period, as they normally do, and the continuing lower level of nationwide net reserve availability imparted the additional degree of firmness sought in the money market. The money market became quite firm on Thursday, December 28. Federal funds were traded that day at rates as high as 5 per cent, and borrowings from the Reserve Banks rose to $1.8 billion as many banks sought to acquire in advance the reserves they expected to need over the year-end statement publishing date in order to eliminate or minimize the need to show "bills payable" on their statements. The following day, however, which was the final business day of the year, the money market was more comfortable in somewhat curtailed activity, and member bank borrowings dropped back to about $140 million.

Securities markets at year-end. Short-term interest rates fluctuated in a fairly narrow range over the final weeks of the year. Treasury bill rates moved upward around the middle of December when some concern reemerged over international developments, but rates then declined for a while amid strong year-end demand from banks, corporations, and foreign accounts. Evidence of tightening in System policy and the prospect of the sale by the Treasury of a large amount of tax-anticipation bills in early January resulted in a somewhat cautious atmosphere in the bill market on the closing days of the year.

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Rates on outstanding bills showed little change, but the caution did affect bidding in the final auction of the year, which had been advanced to Friday, December 29, because the following Monday was the New Year holiday. Bills with 3- and 6-month maturities were sold in that auction at average rates of 5.103 and 5.593 per cent, respectively. These rates were a little below the highs reached in mid-December but were 11 and 8 basis points above the rates in the auction immediately after the devaluation of sterling. Over the year as a whole, the 3- and 6-month bill rates showed increases of 28 and 68 basis points, respectively.

In the capital markets the shift in investor sentiment that seemed to be emerging in the early weeks of December developed further as the year drew to a close. There was an increased willingness to commit funds at high current interest rates rather than wait out the numerous domestic and international uncertainties that had weighed on the market in earlier months. Indeed, concern over the international position of the dollar, the absence of congressional tax action, and increasing evidence of a shift in monetary policy tended to be relegated to the background. The pick-up in activity in the Treasury market reflected in part year-end switching operations for tax purposes—much of which extended maturities—and a fair amount of outright demand. In the corporate and tax-exempt markets the seasonally light calendar contributed to the better tone, but reports of sizable direct placements with life insurance companies suggested that a more basic desire to buy at current yields was also at work.

In this general atmosphere, prices of Treasury notes and bonds continued to move upward in the final weeks of the year. At the year-end yields on 3- to 5-year issues and on long-term Treasury bonds were down to 5.80 and 5.36 per cent, respectively. These were about 10 and 20 basis points below their levels in mid-November, but still were 95 and 87 basis points above the levels at the end of 1966. Meanwhile the 20-year issue of FNMA participation certificates that had been sold on November 28 at

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a yield of 6.40 per cent advanced to a premium bid of 2 points by the end of the year—reducing its yield to 6.23 per cent.

In the corporate and municipal markets, new-issue activity was very light, and prices of outstanding issues rose in line with the improvement in the Treasury sector. After the turn of the year, an issue of Aa-rated utility bonds with 5 years of call protection sold out immediately at a yield of 6.50 per cent, in comparison with the 6.80 per cent yield available on two smaller issues in early December. This was 96 basis points higher than had been offered on such issues in early January 1967. The Bond Buyer's index of yields on 20 tax-exempt bonds closed the year at 4.44 per cent, a little below its early December high, but still up 67 basis points from the level prevailing at the beginning of the year.

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REVIEW OF OPEN MARKET OPERATIONS IN FOREIGN CURRENCIES

The foreign exchange and gold markets were subjected to unprecedented stresses in 1967. The crisis in the Middle East beginning in late spring, the persistent weakness of sterling that culminated in the devaluation of the British pound on November 18, the subsequent speculative rush into gold through the London market, and the worsening of the deficit in the U.S. balance of payments generated massive movements of funds across the exchanges and in the Euro-dollar market. These disturbances posed a serious threat to the stability of the international monetary system, and they were contained only through sustained and concerted cooperation among the major world monetary authorities.

To help meet these pressures, the Federal Reserve and the U.S. Treasury expanded their foreign exchange operations and related transactions. Operations were undertaken with the Bank for International Settlements (BIS) to ease pressures in the Euro-dollar market through placement of official funds during the crisis in the Middle East, and again later in the year. At the height of the Middle East crisis, the Federal Reserve also operated to ease pressures in the sterling market and made substantial use of its swap facilities to deal with the large precautionary flows of funds into Switzerland and other continental centers.

Following the devaluation of the pound sterling in November, the focus of speculation shifted toward gold and against the dollar. Speculation took the form of record buying of gold in London and shifts of funds into continental currencies. The United States unequivocally reaffirmed its commitment to maintain the official price of gold at $35 an ounce, and acting jointly with other members of the Gold Pool, it continued to stabilize the market price through sales of gold in the London market. At the same time, to deal with speculative demand for continental cur-

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rencies, a number of continental central banks offered their currencies forward—for their own account or on behalf of U.S. authorities—to reinforce confidence in existing parities.

Despite the shock to the international financial system caused by Britain's decision to devalue, the repercussions were lessened by the readiness of other countries to support the new sterling parity and to continue to cooperate in the gold and exchange markets. No other major industrial nation devalued its currency. Moreover, more than $1.5 billion of new international credits were made available to the United Kingdom in addition to the $1.4 billion standby that Britain had obtained from the International Monetary Fund (IMF), as that country embarked on a new austerity program to strengthen its basic international position. The U.S. Treasury and the Federal Reserve participated in these new credits, just as they had provided support for the pound prior to devaluation.

A number of important steps were taken in 1967 to strengthen the ability of the international monetary system to deal with speculative shifts of funds and flows generated by swings in countries' international payments. In May the Federal Reserve negotiated new reciprocal currency arrangements with the central banks of Denmark, Mexico, and Norway. In July, against the background of the Middle East conflict, the System increased its existing Swiss franc swap facilities with the Swiss National Bank and with the BIS and also increased its facility with the BIS under which resources have been provided for BIS operations in the Euro-dollar market.

At the end of November, after the devaluation of sterling had touched off heavy speculation, the Federal Reserve announced an increase of $1.75 billion in its swap lines with eight central banks and the BIS, and before the year ended it had arranged a further increase totaling $300 million in its Swiss franc swap facilities with the Swiss National Bank and the BIS. This broadening and enlargement of the reciprocal currency arrangements brought the total swap network to $7.08 billion, an increase of

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TABLE 1
FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Other party to arrangement	Amount of facility (in millions of dollars equivalent)	
	Dec. 31, 1966	Dec. 31, 1967
Austrian National Bank	100	100
National Bank of Belgium	150	225
Bank of Canada	500	750
National Bank of Denmark	.....	100
Bank of England	1,350	1,500
Bank of France	100	100
German Federal Bank	400	750
Bank of Italy	600	750
Bank of Japan	450	750
Bank of Mexico	.....	130
Netherlands Bank	150	225
Bank of Norway	.....	100
Bank of Sweden	100	200
Swiss National Bank	200	400
Bank for International Settlements:		
Dollars/Swiss francs	200	400
Dollars/authorized European currencies other than Swiss francs	200	600
Total	4,500	7,080

more than $2.5 billion during the year. In addition to this strengthening by central banks of short-run defenses against disequilibrating capital movements, the basis was laid for the longer-term provision of liquidity when the members of the IMF at their annual meeting agreed in principle on a plan for creating Special Drawing Rights (SDR's) in the Fund.

Early in 1967 the dominant feature in the foreign exchange markets was the strong recovery of the pound. Aside from favorable seasonal influences, the strengthening reflected underlying improvement in the U.K. balance of payments. The recovery was further bolstered by inflows into sterling from the Euro-dollar market following a substantial easing of U.S. monetary policy.

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Moreover, with economic activity somewhat sluggish in most major continental European countries with payments surpluses—notably in Germany—monetary authorities in those countries eased their policies considerably to provide domestic liquidity conditions favorable to renewed business expansion. In the process they stimulated further short-term outflows of funds. These outflows from the Continent not only reinforced the move into sterling but also helped to limit the increase in official dollar holdings that might otherwise have resulted from the large deficit in the U.S. balance of payments.

Early in the year the Federal Reserve acquired sufficient foreign exchange in the market, from central banks, and through third-currency swaps to repay fully the $280 million equivalent of swap drawings outstanding at the end of 1966 in Dutch guilders, German marks, Italian lire, and Swiss francs. Thus by February all of the Federal Reserve's credit lines under the swap facilities reverted fully to a standby basis. The Bank of England also reduced its commitments under the Federal Reserve swap line and liquidated other sizable special credits from the Federal Reserve and the U.S. Treasury, as well as credits from other central banks. By early March it had repaid the last of its swap drawings from the Federal Reserve.

During May, however, the market for sterling began to weaken as the U.K. trade position deteriorated. The subsequent outbreak of hostilities in the Middle East brought sterling under heavy pressure. Precautionary withdrawals from the Euro-dollar market added to the strains normally associated with midyear window-dressing by continental commercial banks. These dual pressures were immediately countered by coordinated action by central banks. In early June the U.S. authorities, in consultation with the Bank of England, initiated purchases of spot sterling in New York on a short-term swap basis—buying pounds spot against forward sales. By June 5 they had purchased a total of $113 million. In addition, by June 7 the BIS had drawn a total of $143 million from the Federal Reserve to place in the Euro-dollar market, thereby relieving pressures in that sector.

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Nevertheless, the jolt to confidence from the Middle East crisis and the adverse impact on the U.K. balance of payments of the closing of the Suez Canal left the pound in a seriously weakened position. A succession of progressively larger trade deficits—reaching extreme levels by October as a result of a strike on the British docks—had a demoralizing effect on the market, and confidence in the pound deteriorated. With discounts on forward sterling widening, the pull of interest rates in the Euro-dollar market added to the drain on U.K. reserves. In June and during the remainder of the year the Bank of England relied heavily on international credit facilities—including those with the Federal Reserve and the U.S. Treasury, the Basle group of central banks, and the BIS—to bolster its reserve position prior to the devaluation, and then subsequently to reinforce the new exchange parity.

The continuing U.S. payments deficit and sizable transfers of funds among countries as a result of international tensions and of the backwash of intensifying pressure on sterling led the Federal Reserve to reactivate some of its central bank credit facilities beginning in May. It initiated drawings in Belgian francs that month and drew further amounts subsequently as inflows into Belgium continued intermittently through November. In June and July the System made large drawings in Swiss francs in order to absorb $390 million that poured into the Swiss National Bank during May and June during the Middle East crisis. The swap line with the Netherlands Bank was reactivated in July with a small Federal Reserve drawing. During the autumn the System made additional drawings on the Netherlands Bank and also drawings on the central banks of Germany, Italy, and Switzerland to cover dollars that moved into their reserves during the sterling crisis and during the period of speculation against the dollar that followed in the wake of devaluation.

By December 27 Federal Reserve commitments under the swap lines had risen to $1.8 billion equivalent. Although some

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progress was made in reacquiring foreign exchange near the end of the year, when the earlier, heavy speculative flows into Germany and Belgium were partially reversed, commitments at the year-end still exceeded $1.7 billion. In addition, the U.S. Treasury at the end of the year had a sizable commitment in guilders under special swaps arranged with the Netherlands Bank in November.

During the year the U.S. Treasury also increased its total indebtedness in securities denominated in Swiss francs and Belgian francs. In addition, its liabilities in the form of foreign-currency-denominated securities were increased substantially by the issuance in July and October of the first two of four quarterly instalments of $125 million equivalent each of special nonliquid securities scheduled to be sold to the German Federal Bank in conjunction with the German Federal Government agreement to offset part of the costs of stationing U.S. troops in Germany.

Apart from those obligations, U.S. authorities by the end of the year had accumulated forward commitments to the market in Swiss francs, Netherlands guilders, and Belgian francs totaling $115 million as a result of operations conducted on their behalf through the central banks concerned. These forward obligations were incurred as part of coordinated central bank operations during November and December, when speculative pressures were acute. At the same time, the German Federal Bank sold a very large amount of dollars on the basis of market swaps with its commercial banks in late November and December—thus helping to ease pressures in the Euro-dollar market. The BIS reinforced this operation at the end of November by placing in the Euro-dollar market $38 million drawn from the Federal Reserve; this raised total placements in November to $106 million. In December the BIS drew an additional $240 million from the Federal Reserve for placement in the Euro-dollar market. As a result, dislocations and pressures in the Euro-dollar market were held to a minimum during this period of unusual stress and uncertainty.

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TABLE 2

FOREIGN CURRENCY TRANSACTIONS OF THE FEDERAL RESERVE, 1967

(In millions of dollars equivalent)

Currency	Transactions under swap lines					Third-currency swaps		Other transactions			
				Acquisitions of funds for repaying swaps				With U.S. Treasury		With others[1]	
	Drawings	Repayments	Disbursements of swap-acquired balances	From U.S. Treasury	From others	Purchases and reacquisitions	Sales and repayments	Purchases	Sales	Purchases	Sales
Operations initiated by the System:											
Belgian franc	211.2	105.4	211.2	60.4	45.0	.....	.....	.....	.....	10.0	21.9
Pound sterling	.....	.....	.....	.....	.....	37.3	37.3	.....	50.0	147.1	195.6
German mark	350.0	140.0	307.3	.....	107.3	.....	.....	.....	.....	20.1	.....
Italian lira	500.0	15.0	500.0	.....	13.4	.....	.....	.....	.....	.....	.....
Dutch guilder	170.0	35.0	170.0	.....	34.8	.....	.....	.....	.....	.....	18.8
Swiss franc	830.0	270.0	830.0	37.3	195.4	[2] 37.3	37.3	36.1	.....	.....	32.8
Total	**2,061.2**	**565.4**	**2,018.5**	**97.7**	**395.9**	**74.6**	**74.6**	**36.1**	**50.0**	**177.2**	**269.1**
Swap operations initiated by others:											
Pound sterling	1,650.0	950.0	.....	.....	.....	.....	.....	.....	.....	.....	.....
German mark (by BIS)	837.0	691.0	.....	.....	.....	.....	.....	.....	.....	.....	.....
Total	**2,487.0**	**1,641.0**	.....	.....	.....	.....	.....	.....	.....	.....	.....

[1] Includes forward as well as spot transactions; excludes Italian lira forward operations.
[2] Used to repay swap drawing.

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The remainder of this report gives a detailed review of Federal Reserve operations in sterling, German marks, Italian lire, Swiss francs, Netherlands guilders, and Belgian francs.

Sterling. During the first quarter of 1967 there was a relatively strong demand for sterling. Confidence improved as a result of some underlying improvement in the U.K. balance of payments. Seasonal factors were favorable, and for the first time in a year there was a significant covered incentive in favor of U.K. local authority sterling deposits over comparable investments in the Euro-dollar market. The reversal of year-end repatriations of funds to the Continent and progressive relaxation of monetary policy in the United States, Germany, and other countries produced reflows of funds into sterling from the Euro-dollar market where interest rates on short-term funds had been reduced sharply.

With inflationary pressures on the British economy considerably reduced, and with interest rates declining in major international markets, the Bank of England reduced its discount rate on January 26 from 7 per cent to 6½ per cent, in line with objectives expressed jointly by Treasury officials of major industrial nations at a meeting the previous weekend. Nevertheless, with the discount on forward sterling well under 1 per cent per annum, British interest rates remained relatively attractive to short-term investment funds on a covered basis. Under these circumstances, pounds were being bought in very substantial volume, and the spot rate rose to $2.7960 by February 1, its highest level since mid-March 1966.

As confidence in sterling improved and the sizable adverse payments leads and lags that had built up in 1966 began to unwind, the Bank of England gained a very large amount of dollars. It used the bulk of these dollars to repay short-term indebtedness to central banks; by early March it had liquidated all its commitments under swap drawings on the Federal Reserve and had repaid other special credits from the U.S. Treasury and the Federal Reserve. At their peak in August 1966 these credits

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had totaled $750 million, but by the end of 1966 they had been reduced to $510 million, of which $350 million was outstanding under the Federal Reserve swap line. Announcement in early March that these credits had been repaid, and also of substantial repayments of short-term credits to other central banks, confirmed to the market the degree of recovery that had already taken place and triggered further buying of pounds that persisted through the end of the month.

During March, official word of renewal of the credit lines with nine central banks and the BIS contributed to a surge of short covering that was reinforced by unexpectedly good fourth-quarter figures on the balance of payments, a cut in the Bank of England's discount rate from 6½ per cent to 6 per cent, and the British Government's decision to continue to restrain price and wage increases for another year after the lapse of the wage freeze in June. As an exceptional amount of dollars flowed in, the Bank of England continued its practice of using such receipts to repay debt to other central banks, and by the end of March it had liquidated all of its short-term debts except for a small amount of credits linked to changes in overseas sterling balances. In early April the U.K. authorities reported that after such repayments Britain's official reserves had increased by $90 million in March, to $3,259 million. For the first time in several months the market responded positively to a reserve announcement, and the Bank of England continued to gain substantial amounts of dollars.

By April 11 sterling had moved up to $2.7990, following the discount rate reductions in the United States and Canada and a further decline in yields on dollar investments. Moreover, the absence of tax concessions in the British Government's budget reduced market fears that that Government was moving toward a more expansionary economic policy. The market was also impressed by Chancellor Callaghan's reiteration that Britain would repay its $818 million debt to the IMF due at the end of the year under the 1964 drawing, and also $80 million owed to

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Switzerland as a result of credit extended that same year. The continuing demand for pounds boosted the spot rate above par for the first time in over a year, and the Bank of England was able to announce a reserve increase of $146 million in April.

As early as April, however, renewed concern had begun to be felt in some quarters over the trend in the U.K. foreign trade position. Moreover, by early May the covered interest rate incentive began to turn against short-term sterling investments. Shortly after the May 4 announcement by the Bank of England of the third cut of ½ percentage point in its discount rate, to 5½ per cent, Euro-dollar rates began to firm—despite cuts in discount rates in Belgium and Germany and an easier monetary policy in France. On May 11 it was anounced that Britain's seasonally adjusted trade deficit had increased to $115 million equivalent in April, as exports showed signs of leveling while imports remained relatively high. This imbalance followed a trade deficit of $36 million equivalent in March, after virtual balance the month before. A few days later the market was confronted by President de Gaulle's sharply negative, press conference remarks regarding Britain's application to join the Common Market. The riots in Hong Kong were also disturbing to the market.

The cumulative effect of these events produced the first significant net selling of sterling in 1967—requiring sizable support by the Bank of England as spot sterling declined to less than $2.7960 near the end of May. Nevertheless, the British authorities proceeded with their plans to prepay $405 million to the IMF on May 25 and to repay fully the Swiss debt incurred in 1964.

On June 1 market expectations of an imminent outbreak of hostilities in the Middle East sparked a burst of selling of pounds. Apprehension of war affected the pound both directly and through the Euro-dollar market, where precautionary withdrawals of funds and the usual pressures that are associated with midyear window-dressing created a sudden squeeze and a sharp rise in interest rates. These dual pressures were immediately met by coordinated central bank actions in both the foreign exchange

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and Euro-currency markets. On June 1 the U.S. authorities purchased a total of $92.9 million equivalent of pounds in the New York market on a swap basis (buying spot against forward sales), with purchases distributed evenly between System and Treasury accounts. That same day the BIS began to place in the Euro-dollar market funds drawn under its swap arrangement with the Federal Reserve.

Pressures on sterling stepped up sharply in early June with the outbreak of fighting between Israel and Egypt, the closing of the Suez Canal, and the Arab countries' interruption of the flow of oil to Britain and the United States. The Bank of England provided substantial support in the forward market to avoid the tendency toward wider forward discounts and to forestall spot sales, thereby limiting spot exchange losses. Moreover, in New York on June 5 the U.S. authorities again bid for sterling on a 1-month swap basis and purchased an additional $20 million equivalent.

At the same time interest rates in the Euro-dollar market began to rise sharply—by as much as ½ percentage point per annum in less than a week. The BIS met these pressures through continued placements of funds drawn under the swap line with the Federal Reserve. By June 7, when a cease-fire resolution by the United Nations served to reduce tensions somewhat, the BIS had placed a total of $143 million of funds drawn from the System, together with funds received from other central banks. These operations produced a definite easing in Euro-dollar rates, and with the cessation of actual hostilities, market covering of short positions in sterling boosted the spot rate for sterling by some 30 points to $2.7932, and the Bank of England recouped its losses of the preceding few days.

As June progressed, however, market anxieties were revived by rumors of major withdrawals from sterling by Arab countries, and by midmonth the pound had declined to $2.7912. Moreover, the market became concerned over the probable adverse consequences of the Middle East crisis for the U.K. balance of

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payments. Reports of additional shifts of Arab-held sterling balances to Paris triggered heavy selling, and the Bank of England extended substantial support in holding the rate at just under $2.7900 in the latter part of June.

The early July announcement by the Bank of England of a $120.4 million decline in reserves in June, to $2,834 million, met with some disappointment in the market. The decline would have been larger if the Bank of England had not reactivated its swap line with the Federal Reserve by drawing $225 million. As the summer wore on, market doubts about the future of sterling increased and there were bursts of heavy selling. The Bank of England sustained very large losses of reserves around mid-July, following the announcement of a large increase in the trade deficit for June, and by the end of July spot sterling had declined to $2.7858.

A favorable reaction to the report in mid-August of a sharp swing in the U.K. trade balance in July—to a small surplus from the large deficit in June—provided a brief respite from the continuing pressures on the pound. Moreover, market tensions associated with discussions of proposals to increase international liquidity were relaxed somewhat after it was announced on August 26 that an agreement along general lines had been reached by the Group of Ten and that a plan to strengthen the international monetary system was ready for submission to the IMF at its annual meeting in September. Nevertheless, the U.K. reserve position underwent further erosion during August as a result of market support operations early in the month, and again at the end of the month when the market reacted adversely to reflationary measures announced by the Government.

News that Arab leaders had agreed to allow the resumption of oil shipments to the West provided a more favorable background for the announcement in early September that the reserve loss in August had been small. The announcement was well received by the market. Nevertheless, there was some further selling of sterling, and the continuing pull of interest rates in the

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Euro-dollar market drew funds out of sterling investments. To cushion the reserve impact of these losses, the Bank of England drew further on the Federal Reserve during the third quarter—bringing its commitments under the swap line to $650 million. It also made use of its credit arrangements with other central banks.

There was a sharp escalation in the pressure on sterling in October as market confidence deteriorated further, particularly after doubts about the viability of the $2.80 parity were expressed in a report by the European Economic Community (EEC) on the British application to join the Common Market. Moreover, market sentiment was not bolstered by the announcement of a $103 million equivalent Swiss franc loan extended to the U.K. Government by several Swiss commercial banks.

As a result the pound was vulnerable to the news that Britain's trade balance had deteriorated sharply in September; the seasonally adjusted deficit of $146 million was the largest in 15 months. As expected, the closing of the Suez Canal had raised the cost of imports of fuel oil, and exports had been hurt by the dock strike in Britain in the latter part of September. But the figures appeared to confirm a weakening trend in exports. In the heavy selling of sterling that ensued, the Bank of England sustained very large losses, in both the spot and forward markets, in defending the spot rate, which by October 12 had dropped to $2.7824.

Faced with mounting speculative pressures in the market and a sizable covered incentive in favor of Euro-dollars, the Bank of England raised its discount rate by ½ percentage point to 6 per cent on October 19. In a coordinated move to prevent a rise in Euro-dollar rates from offsetting the increase in British interest rates, the BIS, after consultation with the Federal Reserve, made modest placements in the Euro-dollar market of funds drawn under its swap facility. However, the increase in the discount rate disappointed many observers, who had been expecting

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an increase of a full percentage point, and heavy sales of sterling in the market resumed—requiring very substantial support by the Bank of England in both spot and forward markets.

In an effort to stabilize quotations for spot sterling in New York, the U.S. Treasury initiated purchases of sterling on October 19 at rates just under $2.7830 and continued to buy through Monday, October 23. In these operations it bought a total of $47.1 million equivalent of pounds. The evidence of strong official support calmed the market, and the spot rate firmed during the last week of October. Nevertheless, an undercurrent of uneasiness remained, and there was a fairly steady flow of offerings of forward pounds, which the Bank of England met.

The announcement on November 2 of a $75.6 million equivalent reserve gain in October, after the $103 million equivalent Swiss loan had been taken into the reserves, had little additional impact on a market in which funds had begun to move out of sterling. The next day rumors of an impending devaluation of sterling dramatically increased the selling pressure in pre-weekend trading. A very gloomy atmosphere continued after the weekend, and with growing pressures in the forward market, on November 9 the Bank of England, for the second time in 3 weeks, raised its discount rate by ½ percentage point—to 6½ per cent. Again the BIS backed up the move with operations in the Eurodollar market by making additional drawings on the Federal Reserve swap line. But the market was unimpressed and sales of sterling continued large, with many sectors increasingly ready to believe the rumors of an impending devaluation of the pound.

The announcement on November 14 that the trade deficit in October had amounted to $300 million equivalent, the largest ever recorded, further undermined the pound and indicated, indirectly, how difficult it would be to strengthen the pound from its then-current level. In this highly charged atmosphere the market reacted favorably to rumors that negotiations were in progress for a new $1 billion loan from central banks to tide the

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United Kingdom over its difficulties. Traders anticipated confirmation of the rumors, and on November 16 their short covering pushed the sterling rate up to $2.7848.

That afternoon, however, Chancellor Callaghan refused in Parliament to confirm or deny that negotiations were in progress. Thereupon, the market immediately began to suspect that the rumored negotiations were not progressing smoothly and that new credit would not be forthcoming. By the next day financial markets throughout the world had concluded that devaluation was not only inevitable but also imminent, and the market was inundated as holders of sterling rushed to sell before the weekend.

On Saturday, November 18, Chancellor Callaghan announced the British Government's decision to devalue the pound by 14.3 per cent to $2.40. The next day, in an address to the nation Prime Minister Wilson explained his government's decision as a move designed to permit the United Kingdom to solve its basic balance of payments problem without unnecessarily constricting domestic economic growth. He stressed that:

> It would have been possible to ride out this present tide of foreign speculation against the pound by borrowing from central banks and governments abroad—banks and governments to whom I pay tribute for their help and cooperation over these past years.
>
> In our view it would have been irresponsible to go on dealing with these successive waves of speculation by borrowing for short periods at a time, without attacking the root cause of the speculation.

In order to stiffen the defense of the new parity, the Bank of England raised its discount rate to 8 per cent per annum (the highest level in 53 years) and redirected bank credit toward exports, while the government announced curbs on consumer instalment credit and programmed cuts in government spending and an increase in the corporation tax. Prime Minister Wilson set as the target of his government's policy a very significant improve-

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ment in the country's balance of payments designed to bring the external accounts into substantial surplus by the second half of 1968. A $1.4 billion standby drawing on the IMF was formally requested. In addition, the U.K. Government reported that negotiations for an additional $1.5 billion of credit facilities with foreign monetary authorities were in progress.

When markets in London reopened on Tuesday, after a special bank holiday, trading was hectic as banks and commercial interests scrambled to purchase or borrow sterling to meet immediate and near-term requirements, including maturing forward sales undertaken earlier. The demand for pounds held sterling firmly against its new upper limit ($2.4200), and the Bank of England made large dollar gains. The severe market stresses reflecting demand to meet cash commitments soon faded, however, and activity began to reflect a more normal pattern of dealing. The Bank of England continued to purchase dollars, although on a more moderate scale.

As in earlier periods of reserve recovery the Bank of England used its gains to reduce its short-term debts. After a repayment of $300 million to the Federal Reserve, its commitments under the $1,350 million swap line, which had been fully utilized to help meet pressures prior to devaluation, were reduced to $1,050 million. On November 30 the Federal Reserve increased to $1.5 billion its reciprocal currency arrangement with the Bank of England, along with the other increases in its swap network.

Market atmosphere changed abruptly in early December—in view of a British railway labor dispute and higher U.S. interest rates—and the spot rate for sterling declined sharply. The market took no special notice of the announcement of a $127.2 million reserve gain during November, achieved after incorporation of the $490 million remainder of the U.K. dollar portfolio. The authorities also announced that the last $250 million outstanding on Britain's 1964 drawing from the IMF had been repaid; the impact of this payment on reserves was offset by a new credit from foreign central banks and the U.S. Treasury.

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Despite subsequent mediation of the railway difficulties, the market remained uneasy, and by December 7 the spot rate for sterling had moved below $2.4100. Before Christmas, however, the market quieted and sterling firmed. After the Christmas holiday, reports that the British Government was planning massive cuts in welfare and defense spending programs to backstop its devaluation package—with details scheduled for release in mid-January 1968—triggered short covering and the spot rate advanced to $2.4070, to close the year on a firm note.

At the end of December the United Kingdom paid $220 million of principal and interest on postwar debts to the United States and Canada. After these transactions, British reserves totaled $2,695 million, $240 million less than on November 30 and $400 million less than at the end of 1966.

To bolster its reserves during the last quarter of 1967, the Bank of England had made net drawings of $400 million on the Federal Reserve swap, bringing the amount outstanding to $1,050 million, and had also made use of other credit facilities during the quarter. On the other hand, Britain's repayments to the IMF during 1967 and drawings of sterling from the Fund by other Fund members had increased Britain's unused drawing rights on the Fund to $1.4 billion, and this amount was available to the United Kingdom at the year-end under a standby arrangement. And in case of need, substantial additional amounts of credit were available through credit facilities of central banks.

German mark. The reduced pace of economic activity in Germany during most of 1967 increased the German trade surplus, as imports declined and exports advanced. The trade surplus expanded very sharply during the first half and remained large during the second; for the full year it exceeded $4 billion (compared with $1.9 billion in 1966) while the current-account surplus reached $2.4 billion. Primarily to stimulate the flagging domestic economy, the German authorities during the first 5 months of 1967 reduced the central bank discount rate on four

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occasions, by ½ percentage point each; by May 11 the rate was 3 per cent.

In addition, the authorities substantially lowered commercial banks' reserve requirements during the first half of the year. This considerable easing of monetary policy permitted German banks to invest heavily in short-term foreign assets. Consequently, the trade surplus was not reflected in official reserve gains and did not cause strains in international money markets or in the foreign exchanges.

At the beginning of the year there was the usual seasonal outflow of funds from Germany, and the German Federal Bank replenished the losses it had sustained in market support operations by purchasing $45 million from the Federal Reserve. In addition, the Federal Reserve purchased $35.7 million equivalent of marks in New York and took delivery of $17.5 million that had been purchased forward in market swaps during December 1966. By mid-February it had used these marks, together with $25.1 million equivalent acquired in a special transaction and marks held in balances, to repay the entire $140 million drawn on the swap line with the German Federal Bank in December 1966.

Because of the underlying strength in the German balance of payments, the mark generally held close to its upper limit during the winter and early spring of 1967, although the authorities did not add significantly to their reserves. By mid-May, however, the cumulative effects of the easing of monetary policy were inducing heavy outflows of commercial bank funds to the Euro-dollar market, while German commercial firms began to repay sizable amounts of credits previously obtained abroad. Consequently, the spot rate for marks began to decline.

To encourage retention in Germany of newly released bank liquidity, the German Federal Bank altered its pattern of exchange market activity during the summer. For several months the bank had been concerned that its active easing of monetary policy had been more successful in stimulating outflows of funds

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from Germany than in lowering domestic interest rates. By widening the spread between its announced buying and selling rates and permitting a rapid fall in the spot rate, the central bank sought to increase the degree of uncertainty about future rate movements, particularly for those who were investing abroad at very short-term on an uncovered basis. When the spot rate dropped sharply in early July to just below par, investors immediately began to purchase forward cover to avoid the risk of a future rise in the rate. The cost of such cover back into marks jumped from about ¾ per cent per annum for 3-month maturity, for example, to more than 1¾ per cent and remained close to 1½ per cent through August.

There was some refinancing in German marks of maturing Euro-dollar credits during the early fall, but the principal result of the easier monetary conditions in Germany continued to be further placements of funds abroad by commercial banks. The spot mark therefore traded narrowly on either side of $0.2498 through October. With the mark below par, the Federal Reserve took advantage of occasional offerings of spot marks in New York to build up its balances in anticipation of possible future requirements. During the period from August through early November it purchased a total of $20.1 million equivalent of marks.

On November 3 the growing uneasiness in the market for sterling suddenly resulted in a sharp strengthening in spot quotations for marks as German interests repatriated funds from sterling and began to prepare for their year-end needs. A tightening in the German money market contributed to the incentive to move funds into Germany. Upward pressure on the mark intensified on November 7 as growing speculation in the gold and foreign exchange markets spawned wide-ranging rumors of changes in currency parities, including an imminent upward revaluation of the mark.

In the ensuing heavy buying of marks the German Federal Bank purchased a total of $57 million while permitting the spot rate to advance to $0.2512½ in order to discourage further in-

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flows. A flat denial of revaluation plans by the German authorities led some speculators to cover their positions, and by November 8 the spot mark had eased slightly. Speculation lingered in the forward market, however, and the premium on 3-month forward marks remained about 1.60 per cent per annum.

Very heavy buying of German marks developed in the massive speculation against sterling on November 17 and again on November 24 when the focus of speculative interest shifted against the dollar; on those 2 days the German Federal Bank purchased nearly $300 million. The demand for marks let up abruptly, however, with the temporary calm that followed the November 26 meeting of the active members of the Gold Pool in Frankfurt and the subsequent official communique pledging concerted support of the existing parities based on the $35 gold price.

As the exchange markets settled down to more normal dealings, the German Federal Bank took action (1) to prevent the earlier heavy withdrawals of funds from the Euro-dollar market from producing unwanted stringency in that market and (2) to cut the incentive for moving additional funds out of dollars that stemmed from the wide premium being quoted on the forward mark (nearly 3 per cent per annum for 3-month maturity, by November 24). To accomplish these purposes, the German authorities began to induce the return of dollars to the Euro-dollar market on a swap basis, selling them spot to German commercial banks for repurchase at a later date at rates representing premiums on the forward mark of 1¾ per cent per annum; these rates provided an incentive of close to 1 per cent per annum to switch funds into Euro-dollar investments. By November 30 about $600 million had been swapped at premiums on the mark ranging up to 2¼ per cent. Euro-dollar rates responded immediately by moving sharply lower. The Federal Reserve subsequently participated in this operation by drawing $300 million equivalent of German marks on its swap line with the German Federal Bank—to that extent providing cover for a part of the dollars purchased forward by that bank.

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Meanwhile, at the end of November the Federal Reserve had drawn $50 million equivalent of marks under the swap line and was holding the marks for possible intervention related to market uncertainties and expected year-end pressures. (On November 30, as part of a general strengthening of the swap network, the swap facility with the German Federal Bank was increased by $350 million to $750 million.) These pressures began to assert themselves strongly on December 13, when the German Federal Bank gained dollars on a substantial scale, and the spot mark strengthened to $0.2513¼. The German Federal Bank bought a particularly large amount of dollars on Friday, December 15, in the backwash of the week's extremely heavy speculative activity in the gold markets, and in New York the Federal Reserve sold a total of $7.3 million equivalent of marks for its own account.

The heavy inflows into marks resulting from market uncertainties provided considerably more mark liquidity than necessary to meet German commercial banks' usual year-end needs, in good part because the German Federal Bank had assisted the banks in arranging for mark liquidity in advance by selling them a large amount of money market paper scheduled to mature in mid-December. By December 21, with the German money market quite liquid and a more normal atmosphere being restored in foreign exchange markets, funds began to flow back into Eurodollar investments.

As German commercial banks bid strongly for dollars on a covered basis, the German Federal Bank sold an additional $250 million on a swap basis, before raising the swap rates it offered to the banks to the equivalent of premiums on the forward mark of up to 3½ per cent per annum (an increase of ½ percentage point). In addition, to moderate the pressure, the German authorities permitted the spot rate for the mark to move lower rather quickly. By the end of the year, outflows from Germany had offset the German Federal Bank's intake earlier in December. The spot rate had slipped still lower in the last few trading days of the year, and with the market ready to sell marks, the

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Federal Reserve made a start toward covering its swap commitments in German marks.

Early in 1967 there were discussions between Germany and the United States, together with the United Kingdom, concerning military forces in NATO and the balance of payments consequences of deployment of U.S. and U.K. troops in Germany. In early May the U.S. authorities released an exchange of letters growing out of these discussions between the President of the German Federal Bank, Karl Blessing, and the Chairman of the Board of Governors of the Federal Reserve System, William McChesney Martin, Jr., in which the former indicated that the Federal Bank intended to continue its practice of not converting dollars into gold as part of a policy of international monetary cooperation. This statement was made with the agreement of the German Federal Government, which at the same time took note of the Federal Bank's intention to purchase $500 million equivalent of U.S. Government medium-term securities denominated in marks, in four equal quarterly instalments beginning in July. The first $125 million equivalent security was issued on July 3, and the second on October 2.

Italian lira. The deficit that had emerged in Italy's balance of payments in late 1966 continued during the first 2 months of 1967, reflecting seasonal factors and intensified import demand associated with an expanding economy. In addition, there were sizable exports of capital, partly in anticipation of changes in the Italian tax laws. Early in 1967 the Federal Reserve paid off the final $15 million of lira commitments that had been outstanding at the end of 1966 under the reciprocal currency arrangement with the Bank of Italy.

In March Italy's balance of payments began to strengthen, although the re-emerging surplus was considerably less than that for the comparable period a year earlier, as import demand expanded further and exports of capital continued. As economic expansion generated mounting financial requirements on the part of Italian residents for both foreign exchange and local currency,

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Italian banks reduced their net claims on foreigners by nearly $275 million during the first 6 months of the year. During the same period Italian official reserves, including Italy's position in the IMF, increased by $50 million.

About midyear the Italian payments position moved into the period of seasonal strength and the demand for lire intensified. The Italian authorities began to acquire substantial amounts of dollars. It appeared at first that the reserve gains were developing on a smaller scale than in former years. But demand for lire strengthened considerably during the summer, and counter to the seasonal expectation the payments surplus persisted into October and early November; as a result Italian reserve gains during the second half of the year came to about $500 million.

Underlying the unusual strength in Italy's external accounts during most of the latter part of 1967 was a better performance on trade than was anticipated in view of the strong internal demand in Italy and of the earlier slowdown of economic activity in Italy's major trading partners. Moreover, Italian investments in the Euro-dollar and Euro-bond markets fell to more normal proportions following the heavy outflows during the first half of the year. Added to these factors was the growing uneasiness in the sterling market, which stimulated sizable repatriations of funds from sterling.

In order to absorb the Italian authorities' large dollar gains, the Federal Reserve reactivated its swap line with the Bank of Italy, and between September 19 and November 30 it drew a total of $500 million on that bank. (With the $600 million facility almost fully utilized, the System and the Bank of Italy agreed in late November to increase their swap arrangement by $150 million, to $750 million.) After the British devaluation, the lira softened noticeably and was generally weak through the end of the year as the normal seasonal deterioration in the Italian balance of payments set in; nevertheless, the System was not able to repay any of its commitments in lire. In December Italy purchased $85 million in gold from the United States.

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Federal Reserve and U.S. Treasury technical forward commitments in Italian lire were rolled over periodically during 1967, and during the year the Treasury added to its technical forward obligations. The Treasury's longer-term indebtedness in Italian lire remained unchanged during the year at $125 million equivalent—all in the form of medium-term instruments issued to the Bank of Italy.

Swiss franc. During the first half of 1967 interest rates in Switzerland declined less rapidly than rates outside Switzerland. Indeed, during much of this period the Swiss credit market remained relatively tight, and there was more incentive for foreigners to pay off their borrowings in Swiss francs than for Swiss residents to place new funds abroad. Even in the early months of the year, the reflux to foreign markets of funds repatriated by Swiss residents at the year-end was less than might have been expected in terms of the usual seasonal pattern. As a result, the Federal Reserve was able to acquire only enough francs to pay off the $15 million of drawings outstanding under its swap line with the Swiss National Bank; and a total of $75 million was still due to the BIS.

To liquidate this residual obligation in Swiss francs, the U.S. authorities in February used $75 million equivalent of sterling balances to acquire Swiss francs from the BIS on a temporary swap basis. Subsequently, when the Swiss National Bank released to Swiss commercial banks part of the deposits of those banks that had been blocked since 1961, the banks bought Swiss franc-denominated promissory notes from the BIS in the amount of $60.2 million equivalent. The BIS placed these francs at the disposal of the U.S. Treasury, which in exchange issued certificates of indebtedness denominated in Swiss francs. The Swiss francs thus obtained were used in April to pay off the System's commitment of $37.3 million under the sterling/Swiss franc swap and in May to reduce the Treasury's commitment to $14.3 million equivalent.

Meanwhile, in order to forestall a rapid rise in the Swiss franc

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rate during March, when Swiss banks were repatriating funds to meet domestic liquidity requirements, the Swiss National Bank announced early in the month that it would provide Swiss francs against dollars for end-of-quarter needs through short-term market swaps. This was the first time that the Swiss authorities had offered this facility other than at midyear and at the year-end. During the final weeks of March the central bank took in $221 million on this basis and immediately reinvested the funds in the Euro-dollar market—thus helping to moderate pressures in that market.

After the first quarter, short-term interest rates outside of Switzerland continued to decline, while the unwinding of the Swiss National Bank swaps with its commercial banks tended to tighten the Swiss market again. Foreigners, particularly Italians, began to bid for Swiss francs to repay Swiss franc indebtedness and started to shift their borrowing into currencies that were being lent more cheaply, notably German marks. As a result, the spot rate for the franc moved up from $0.2307½ at the beginning of April to the effective ceiling of $0.2317½ by April 26, at which point the Swiss National Bank began buying dollars. With credit conditions remaining tight and with some nervousness developing about sterling and the prospects of a clash in the Middle East, the rate for the franc held at or close to the effective ceiling through most of May, and the Swiss National Bank added some $180 million to its reserves through market operations. In addition prepayment by the Bank of England in May of the $80 million equivalent Swiss franc credit extended to it in December 1964 resulted in an equivalent dollar gain by the Swiss National Bank.

During the first days of June the rumor, and then the actual outbreak, of hostilities in the Middle East precipitated a heavy flow of funds into Switzerland. The dollar holdings of the Swiss National Bank, already swollen by the inflows in May, jumped by $212 million in the first week of June. In order to absorb these dollar flows, on June 2 and June 8 the Federal Reserve drew a

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total of $370 million equivalent of Swiss francs in equal amounts under its swap arrangements with the Swiss National Bank and the BIS; in addition, the Swiss National Bank purchased $30 million of gold from the U.S. Treasury.

Although only a part of the funds shifted to Switzerland during this period represented transfers directly out of sterling, the Swiss authorities and the Swiss commercial banks were prepared to cooperate with the Bank of England in countering the effects of such shifts. One byproduct of this cooperation was the acquisition by the Federal Reserve of $28 million equivalent of Swiss francs that were used on June 16 to repay an equivalent amount of drawings on the Swiss National Bank.

Following the cease-fire in the Middle East, the demand for francs abated, only to pick up again on a moderate scale just before midyear. Once again, the Federal Reserve drew on its swap arrangements to absorb these inflows; it added $33 million to its drawings on the Swiss central bank and $15 million to its drawings on the BIS; this brought the total Swiss franc drawings outstanding on July 3 to the equivalent of $390 million, out of credit lines then totaling $400 million. The drawing on the Swiss National Bank was reduced on July 28 from $190 million to $180 million, when the Swiss National Bank purchased $10 million from the Federal Reserve against Swiss francs to meet Swiss official requirements. In view of continuing uncertainties in financial markets and the unsettled conditions in the Middle East during the summer, it was agreed in mid-July that the Federal Reserve swap facilities in Swiss francs with the Swiss National Bank and the BIS should be expanded by $50 million each, to a new combined total of $500 million.

The capital inflows in May and June led to increased liquidity in Switzerland and eliminated the need for any special measures, such as short-term swaps, to meet midyear needs; in fact, there was some easing in Swiss interest rates. In order to reinforce this trend, the Swiss National Bank on July 10 reduced its discount rate from 3½ per cent to 3 per cent—explaining that the move

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was "likely to facilitate the reestablishment of interest rate differences existing normally between Switzerland and foreign countries and thus also the reflux abroad of the excess liquidity registered in the past two months." Following this move, some shifting of funds out of Switzerland into the Euro-dollar market began to develop, and by late August the exchange rate for the franc had eased considerably.

Outflows of short-term funds from Switzerland to the Euro-dollar market continued through early November and kept the spot rate for the Swiss franc close to the low for the year ($0.2301½) reached on September 12. Nevertheless, there were no sizable dollar losses by the Swiss National Bank. The Federal Reserve was able to make some progress in liquidating its Swiss franc swap commitments, however, as Swiss official agencies required a substantial amount of dollars during the autumn. To replenish dollar balances sold to the Swiss Government, the National Bank purchased a total of $57.0 million from the System. The Federal Reserve used the franc proceeds to reduce its outstanding swap commitment to the Swiss National Bank to $123 million equivalent in November.

The growing pressures on sterling in early November were reflected in an increase in the rate for spot francs. In addition, the Swiss money market was tightened by the payment of the 450 million Swiss franc loan granted to the U.K. Government by three large Swiss commercial banks. With continuing international uncertainties and the approach of the year-end, the franc rate advanced further. Despite the turbulence in the exchanges in connection with the devaluation of the pound on November 18, the Swiss National Bank purchased only a small amount of dollars in market intervention during the remainder of the month. As a consequence of the unrest in the exchange market, however, the premium on the forward Swiss franc grew wider. Following the Frankfurt meeting of the active Gold Pool members, the Swiss National Bank, as part of the general cooperative effort agreed to at that meeting, indicated to the market its willingness to sell

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forward francs. This action helped to restore a calmer atmosphere. The forward premium on 3-month Swiss francs dropped substantially below 2 per cent per annum, the premium prevailing just before the Swiss National Bank's action.

Although these uncertainties precluded any further acquisition of Swiss francs in the market by the Federal Reserve, the System purchased from the Bank of England $80.1 million equivalent of the Swiss franc proceeds of the 1-year loan from Swiss commercial banks. (The U.S. Treasury also purchased $14.3 million equivalent of the loan proceeds and used the francs to pay off the remainder of its outstanding sterling/Swiss franc swap with the BIS.) These francs, together with a small amount in balances and $4 million equivalent purchased from the National Bank in connection with Swiss Government dollar needs, were used to reduce Federal Reserve Swiss franc credits drawn from the BIS to $115 million by November 30. At that time total Federal Reserve commitments under its Swiss franc swap lines thus were reduced to $238 million.

Heavy inflows of dollars into Switzerland resumed on December 1, and the Swiss National Bank purchased very substantial amounts as the Swiss financial community prepared for its year-end liquidity needs. In past years these inflows had been accommodated on a swap basis by the National Bank, but in view of the tense international monetary situation, the banks were not willing to enter into swap transactions at this time. Hence, the spot franc was in demand, and the premium on the forward franc again widened, especially during the flare-up in the gold market.

To deal with this pressure, on December 14 the Swiss National Bank initiated forward sales of Swiss francs jointly for Federal Reserve and Treasury accounts. A total of $65.5 million equivalent of forward francs had been sold by December 19, before the market responded to this evidence of official reassurance and the demand for both spot and forward francs eased. Thereafter a more normal trading pattern emerged, and Swiss commercial banks—instead of resuming spot sales of dollars—began to make

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use of the usual year-end swap facilities offered by the Swiss National Bank to obtain needed Swiss franc liquidity.

In order to increase its capacity to deal with the heavy inflows into the Swiss National Bank, the Federal Reserve, after discussions with the Swiss National Bank and the BIS, increased each of its Swiss franc swap facilities by $150 million equivalent on December 15, bringing each credit line up to $400 million. The Federal Reserve subsequently drew $127 million on the Swiss National Bank; this raised its Swiss franc commitments to that institution to $250 million equivalent. Also, during the third week of December it drew $285 million on the BIS, thus utilizing the full $400 million Swiss franc credit line with BIS.

Netherlands guilder. Early in 1967 seasonal weakness in the Netherlands balance of payments, a flow of funds into sterling, and the conversion into dollars of the guilder portion of a multicurrency drawing from the IMF by Spain enabled the Federal Reserve to repay in full the $35 million equivalent in guilders that was still outstanding at the end of 1966.

Economic activity in the Netherlands—as in most of Europe—showed some signs of slowing during the first quarter of 1967, and with interest rates declining abroad, the Dutch authorities acted to ease the tight domestic monetary policy that had been in force during 1966 to restrain an overheated economy. On March 14 the Netherlands Bank announced a reduction in its discount rate to 4½ per cent per annum, from the 5 per cent in effect since May 1966, and it also removed the penalty-deposit-requirements for banks that exceeded the credit ceilings in effect.

Despite the easing in monetary policy, however, the Dutch money market remained tighter than markets abroad, and during the spring Dutch banks repatriated funds from overseas. By the end of April the spot guilder began to strengthen quite noticeably, and early in May it reached $0.2774⅝. Under the circumstances the Dutch authorities relied increasingly on swap transactions with the foreign exchange market as a regular method of relieving money market pressures. As banks repatriated funds from abroad, the Netherlands Bank bought dollars on a swap basis (that is,

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spot purchase against forward sale) in order to supply domestic liquidity on a temporary basis and, correspondingly, to avoid a build-up in its uncovered dollar holdings. These operations became fairly substantial in May and rose to a peak of $150 million in early June.

The backwash of the hostilities in the Middle East and renewed pressures on sterling subsequently produced further demand for guilders. As funds flowed into the Netherlands, the spot rate for the guilder rose sharply and the Netherlands Bank took in dollars both outright and on a swap basis. The Federal Reserve reactivated its swap facility with the Netherlands Bank in July and drew $20 million equivalent of guilders in order to absorb some of that bank's dollar gains.

Inflows into guilders continued intermittently through the autumn—reflecting firmness in the Amsterdam money market, an improvement in the Dutch balance of payments, and repatriations of funds in view of uncertainties about sterling. The Federal Reserve drew further on its swap facility and by November 13 had used the full $150 million.

The exchange market turbulence associated with the flight from sterling and the subsequent speculation against the dollar produced further heavy inflows of funds into guilders. These speculative influences began to be reflected in widening quotations for forward guilders, which moved to a premium of nearly 2 per cent per annum for 3-month maturity. In order to dampen these pressures, the Netherlands Bank on November 23 initiated forward sales of guilders, jointly for the Federal Reserve and the U.S. Treasury, as part of a concerted central bank effort to exert a calming influence in the exchanges. Most of the forward sales were part of swap transactions designed to return dollars to the market and at the same time limit the tendency for the wide forward premium on guilders to pull further funds out of dollars. By November 29 a total of $37.5 million equivalent of forward guilders had been sold before speculative pressure eased sufficiently for operations to be discontinued.

Meanwhile, in order to absorb the heavy inflows into the Neth-

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erlands Bank during November, the Federal Reserve Bank of New York, acting for the account of the U.S. Treasury, undertook swaps with the Netherlands Bank similar to those concluded for the Federal Reserve. By the end of November Treasury commitments under those ad hoc arrangements stood at $126 million. On November 30, as part of the more general increase in the Federal Reserve reciprocal currency arrangements, the System's facility with the Netherlands Bank was increased by $75 million to $225 million.

Buying of guilders was small and sporadic during early December, but a tightening of the money market in Amsterdam in the latter part of the month produced a larger inflow. Just before the year-end, commercial demand for guilders boosted the spot rate to $0.2782¼, and the Netherlands Bank purchased a further sizable amount of dollars. The Federal Reserve drew on its expanded credit line with the Netherlands Bank to absorb these inflows and thereby raised its obligations in guilders under that credit line to $170 million equivalent at the year-end.

Belgian franc. The Belgian franc moved above par in January as a slower pace of economic activity in Belgium contributed to a more than seasonal drop in imports and the current account shifted from deficit to surplus during the winter. Most of the demand for francs was met in the exchange market, however, so official holdings of gold and foreign exchange were little changed through the first quarter.

In April the franc began to strengthen further as the current account continued in surplus, and from May on it held at or near its upper intervention point. The Belgian central bank eased its monetary policy somewhat, cutting its discount rate three time during the first half of the year. But an inflow of short-term capital took place nevertheless. In order to absorb the inflow, the Federal Reserve reactivated its swap line with the Belgian National Bank in May, and by early June it had made a series of drawings that totaled $37.5 million.

Shortly afterward, however, the Belgian National Bank pur-

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chased dollars from the Federal Reserve in order to meet current needs, and the System used the francs to reduce commitments under the swap line to $27.5 million equivalent. (In an unrelated transaction, the U.S. Treasury during May repaid two maturing Belgian-franc-denominated bonds totaling $30.2 million that had been originally issued in 1963; it used francs it had acquired for this purpose in late 1966 when the dollar was in demand in Belgium. The Treasury's bond indebtedness denominated in Belgian francs was thereby fully liquidated.)

Demand for francs intensified in July and August, partly as a consequence of the continuing Middle East crisis and the growing pressure on sterling. In order to absorb dollars purchased by the National Bank through early September, the Federal Reserve drew a further $97.5 million equivalent of francs under its swap facility; this brought its commitments in Belgian francs to $125 million equivalent. Later the Belgian National Bank purchased dollars for government needs, thus enabling the Federal Reserve to reduce its swap commitments in Belgian francs to $115 million equivalent by the end of the month.

The Belgian balance of payments strengthened on current account in October. In addition the money market tightened, following the flotation of a large government bond issue. The resulting demand for francs pushed the spot rate to the ceiling, and the National Bank purchased more dollars. The surplus on current payments persisted in November as the Belgian economy remained sluggish. During these 2 months the Federal Reserve continued to use its swap facility with the Belgian National Bank and by November 13 the entire $150 million line had been utilized.

During the period immediately preceding the British devaluation and in the period of heavy speculative activity afterward, the Belgian authorities took in further substantial amounts of dollars. Belgian Government requirements for dollars absorbed some of those inflows. With the Federal Reserve swap line fully employed, the U.S. Treasury on November 24 issued a $60.4 million equiva-

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lent 24-month Treasury note denominated in Belgian francs. The Federal Reserve purchased these francs and used them to repay $60 million of outstanding Federal Reserve swap drawings. Then at the month-end the System absorbed $41.2 million of the Belgian National Bank's dollar gains by drawing once again on the swap line. Thus, Federal Reserve commitments in Belgian francs under the credit line with the Belgian National Bank stood at $130.8 million equivalent at the end of November. (On November 30, as part of a general strengthening in the swap network, total credits available under that swap line were raised by $75 million to $225 million equivalent.)

In addition to meeting pressures in the spot market, the Belgian National Bank, in cooperation with U.S. authorities, took action to keep the forward market calm. On December 4 it initiated forward sales of Belgian francs—divided equally between System and Treasury accounts—to reduce the large premium on forward francs and discourage further shifts of funds from dollars. Pressures subsided almost immediately, and few additional forward sales were necessary through the end of December. These operations were the first conducted in forward Belgian francs and involved a modest commitment of $11.8 million equivalent in forward franc sales.

The spot Belgian franc eased somewhat below its ceiling during December, and the Belgian National Bank lost a moderate amount of dollars in market support operations as the Belgian economy showed signs of reviving and import demand picked up. The Federal Reserve therefore was able to acquire Belgian francs as the Belgian authorities required dollar balances to meet market needs; the System also obtained some francs from conversion of part of the proceeds of a drawing by an IMF member. These francs were used to reduce Federal Reserve commitments under the swap line with the Belgian National Bank to $105.8 million equivalent by the year-end.

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SPECIAL STUDIES BY THE FEDERAL RESERVE SYSTEM

From time to time the Federal Reserve System has undertaken extensive economic studies to reappraise the workings of its various instruments of monetary and regulatory policy. The broad aim of these studies has been to keep Federal Reserve policy and action adapted to the changing economic and financial scene. The status of each of the four studies under way is described below.

Reappraisal of the Federal Reserve discount mechanism. The fundamental reappraisal of the Federal Reserve discount mechanism, announced in the Board's ANNUAL REPORT for 1965, is approaching a conclusion. Most of the numerous research projects commissioned as part of the study have been completed, and the results have undergone extensive analysis and evaluation. A concrete proposal for redesign of the discount window is emerging from these efforts, and it is expected that—after further discussion, analysis, and refinement within the System—documents embodying this proposal will be made available to the public.

U.S. Government securities market study. Meetings of the Joint Treasury–Federal Reserve Steering Committee were held during the year to consider the various policy aspects of evidence from staff studies, from the earlier consultations with U.S. Government securities dealers, and from the answers to questionnaires sent to major market participants. The completed staff studies are in the process of being reviewed for publication, and the final report of the Committee is in preparation.

Foreign operations of member banks. Work on the study of the foreign operations of member banks, which was undertaken to provide additional knowledge and perspective on the expanded international operations of U.S. commercial banks, continued in 1967. The study involves a broad-scale examination of the evolution and nature of the international lending and other credit activities at banking offices in this country, operations at foreign branches, and the affiliations that have been established with foreign banks and other financial institutions. The marked

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changes in each of these three interrelated areas of activity, as they bear on the monetary and supervisory responsibilities of the Federal Reserve, form the principal focus of the study. A report containing the study's findings was nearing completion at the year-end.

Effects of monetary policy on economic activity. Much progress was made during 1967 on the large econometric project involving economists on the Board's staff and a group of university economists led jointly by Professor Modigliani of the Massachusetts Institute of Technology and Professor Ando of the University of Pennsylvania. A preliminary version of the model was completed and was tested against recent data. This preliminary version was discussed at the annual meetings of the American Economic Association and the American Statistical Association. A description of it was published in the Federal Reserve *Bulletin* for January 1968.

The results of the preliminary version suggest that both monetary and fiscal policies have powerful effects on the economy, though the time lag between a policy change and its economic effects is longer for monetary policy than for fiscal policy. The response of money income to changes in both monetary and fiscal policies is stronger in this model than in a number of earlier ones.

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INTERNATIONAL LIQUIDITY

In 1967 a major event in international monetary evolution occurred when agreement was reached on a plan for the creation of a supplement to existing international reserve assets. Prepared by the Deputies of the Group of Ten major trading countries and the Executive Directors of the International Monetary Fund, the plan, after acceptance by the Finance Ministers and Central Bank Governors of the Group of Ten, was agreed upon by the Board of Governors of the International Monetary Fund at its annual meeting, held in Rio de Janeiro in September. The decision to proceed to establish, within the Fund, machinery for the creation of what will be known as Special Drawing Rights (SDR's) marks the culmination of 4 years of work on the problem—2 years of thorough study, followed by 2 years of intensive negotiations—in which the Federal Reserve participated with the Treasury Department.

In recent years the need for a means by which existing international reserve assets could be supplemented regularly, through the periodic creation of international liquidity of a kind that nations would accept as reserves and could use in international settlements, has become increasingly evident. But in view of two developments since last September, the agreement reached at Rio de Janeiro was particularly timely. First, since the beginning of this year the United States has intensified its efforts to improve the U.S. balance of payments position. To the extent that these efforts are successful, the growth of world reserves via increases in reserve-currency holdings will be further slowed. Second, on March 17, 1968, the central-bank Governors of the then-existing Gold Pool countries concluded that the stock of monetary gold is sufficient in view of the prospective establishment of the facility for SDR's; they no longer felt it necessary therefore to buy gold from the market. A large number of other countries subsequently announced their intentions to cooperate with the policies decided upon on March 17 by the central-bank Gov-

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ernors of the Gold Pool group. These decisions regarding gold, which were based in part upon the prospective establishment of the SDR facility, obviously reinforce the need for its establishment.

Implementation of the Rio agreement will assure that the international monetary system can be provided with an adequate growth of reserves at the existing price of gold.

The Outline Plan (as the plan agreed upon at Rio de Janeiro is called) is a statement of the principles that will govern the creation, distribution, and use of SDR's. Since September 1967 the Executive Directors of the Fund, in accordance with a Resolution adopted by the Governors of the Fund at the Rio de Janeiro meeting, have prepared the draft amendment of the Fund Articles of Agreement and By-Laws that will be needed in order to give effect to the Outline Plan. After approval by that Board, and submission by the Fund to member countries, the amendment will come into force when three-fifths of the members, having four-fifths of the total voting power, have accepted it.

The Resolution referred to above also requested the Executive Directors to submit a report proposing such amendments to the Fund Articles and By-Laws as would be required to give effect to possible improvements in the present rules and practices of the Fund. Some proposals for changes in these rules and practices had been made, particularly by the member countries of the European Economic Community; and the Fund's Board of Governors decided that work should go forward on this subject, as well as on the SDR plan.

The texts of both the Resolution which has been referred to and the Outline Plan for SDR's were reproduced in the Federal Reserve *Bulletin* for November 1967 (pages 1877-82).

The following observations and comments on the SDR plan are intended to summarize the main features of the plan and some of its underlying principles.

Rational control of reserve-asset supply. Adoption of the SDR plan means that there exists for the first time an international

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agreement that the world supply of international reserve assets can, should, and will be subjected to deliberate international regulation. This means that the supply of international reserve assets is likely to grow in the future at a controlled rate reasonably related to the need for reserves, rather than at a rate determined primarily, as in the past, either by the vagaries of gold production and of gold flows into or out of monetary use, or by the rate of increase in foreign official holdings of reserve currencies.

Universalist approach. The Outline Plan is based upon an approach that may best be described as universalist, because all member countries of the IMF will be on the same footing with respect to the distribution of SDR's. The universalist approach shows up in several ways. First, any country that is a member of the IMF may participate in the reserve-creating system if it wishes to do so. Second, all participating countries will receive the same kind of created reserves: SDR's. Third, the amounts of SDR's created periodically will be distributed among all participating countries in proportion to their quotas in the Fund. Acceptance of the universalist approach was not assured from the beginning. Under some proposals put forward in the early stages of the negotiations, there would have been differentiation among countries in respect of one, two, or all three of the aspects just listed.

Nature of the facility: absence of currency "backing." Unlike the existing IMF, which holds a pool of currencies provided out of quota-subscription payments by member countries, the SDR system will entail no holding of currencies by the Fund. As member countries use SDR's, they will transfer them directly to other members in exchange for currency. The role of the Fund itself, aside from the function of keeping the central record of holdings of and transactions in SDR's (and aside from its acceptance and use of SDR's in transactions), has been likened to that of a traffic policeman, guiding the flow of SDR's among members according to principles to be noted presently.

Each participating country's initial holdings of SDR's will be acquired through allocation by the Fund, and each country's

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holdings will be strengthened by periodic allocations. Countries will be entitled to use SDR's to finance balance of payments deficits, and SDR's will thus shift back and forth among countries as their payments positions fluctuate.

The "backing" of SDR's—the feature that assures their acceptability—is the obligation of each participant to receive SDR's from other members up to the point where its holdings are equal to three times its cumulative allocations, inclusive of those allocations.

Attractiveness of SDR's. The attractiveness of SDR's to the monetary authorities of participating countries will be enhanced by a gold-value guaranty and an interest yield. It is expected that the rate of interest paid to SDR holders (such payments to be financed by payments to the Fund by each country on its cumulative allocations) will be significantly below the rate obtainable on reserve-currency holdings. Switching from reserve-currency holdings to SDR's will be further discouraged by a provision in the Outline Plan that a participant will be expected not to use SDR's "for the sole purpose of changing the composition of its reserves."

Creation of SDR's. Allocations of new SDR's will be proposed as and when they are deemed necessary in view of aggregate world reserve needs and availabilities. They will not be proposed with a view to the balance of payments positions of individual participating countries. The United States supported this principle from the beginning. As Secretary Fowler said to the Subcommittee on International Exchange and Payments of the Joint Economic Committee on September 14, 1967: "Throughout the course of these negotiations I have done my best to make it very clear—as I note the subcommittee report did 2 years ago —that the United States was fixing its eyes on the global needs for reserves and did not expect that the plan for reserve creation would solve the United States balance of payments problem. That is a matter which I associate with the general subject of the adjustment process. At an early date in the negotiations there was a complete and full understanding that negotiations

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with regard to a supplementary reserve were to deal with global needs and not with the problems of the balance of payments of individual countries."

Another aspect of the allocation procedure should be mentioned, if only because it was one of the main issues in the negotiations during 1967. This is the provision that for any decision on the basic period for, timing of, amount, and rate of allocation of SDR's, an 85 per cent majority of the voting power of participants will be required. The effect of this provision is to give a veto over such decisions to the United States, and also to the group of countries in the European Economic Community—as well as, of course, to any other group of countries controlling more than 15 per cent of the total voting power of participants.

Use of SDR's. Principles governing the use of SDR's are:

1. *Automaticity.* The use of SDR's by participating countries will not be subject to prior challenge. However, the Fund may make representations to any participant that, in the Fund's judgment, has failed to observe the understanding as to appropriate use, and it may direct drawings to such participant to the extent of such failure. (Regarding "directed" or guided drawings, see 4 below.)

2. *The "needs" test.* Each participating country will normally be expected to use SDR's "only for balance of payments needs or in the light of developments in its total reserves," and not, as already noted above, for the sole purpose of changing the composition of its reserves.

3. *Use of SDR's to redeem own currency.* Normally countries using SDR's will wish to receive convertible currencies that they can use on their exchange markets. A participant may also use SDR's to purchase balances of its currency held by another participant. It may do so if (a) it meets the "needs" test for use of SDR's (see 2 above), and (b) the other participant agrees to the transaction. Obviously this provision is of special interest to the United States, as a reserve-currency country.

4. *Principles of guidance.* The Fund's selection of participants from whom currencies may be drawn in exchange for SDR's

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will normally be based upon the following principles (plus any others the Fund may adopt):

(a) "Normally, currencies will be acquired from participants that have a sufficiently strong balance of payments and reserve position, but this will not preclude the possibility that currency will be acquired from participants with strong reserve positions even though they have moderate balance of payments deficits."

(b) As stated in the Outline Plan, "The Fund's primary criterion will be to seek to approach over time equality, among the participants indicated from time to time by the criteria in (a) above, in the ratios of their holdings of special drawing rights, or such holdings in excess of net cumulative allocations thereof, to total reserves." It was subsequently decided—and the draft amendment of the Fund Articles of Agreement so provides—that the guidance principle during the first basic period will be that of equality, over time, in the ratios of SDR holdings in excess of net cumulative allocations to official holdings of gold and foreign exchange. Because initially these ratios will be zero for all participants, the amendment also provides that guidance will be in proportion to official holdings of gold and foreign exchange when the ratios of excess holdings of SDR's are equal.

5. *Reconstitution.* Reconstitution of SDR holdings by participating countries was one of the main issues of the negotiations during 1967, which it proved possible to settle only in the final stages of the negotiations leading up to Group of Ten acceptance of the Outline Plan. The compromise agreed upon for the first 5-year period after the SDR system has been activated is that a participating country's average net utilization of SDR's during the period as a whole must not exceed 70 per cent of its average net cumulative allocation during the period. This does not mean that average net utilization may not exceed 70 per cent during part of the period; it means only that if there is such an excess, reconstitution, to the extent necessary, must take place before the end of the period. It should also be noted that the "average net use" phraseology means that the

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duration of use during the period, as well as the amount used, is relevant to whether reconstitution is or is not necessary. Moreover, the language of the reconstitution section of the Outline Plan indicates specifically that the calculation of average net use shall take account of any holdings of SDR's above net cumulative allocations during the period, as well as of use of SDR's below such allocations.

Activation. Ratification of the SDR amendment to the Fund Articles, while essential, will not by itself bring the plan into operation. In order to bring it into operation, an allocation must be made; and this can be done only after a decision by the Fund's Board of Governors, on the basis of a proposal by the Managing Director concurred in by the Executive Directors. Before formulating a proposal, the Managing Director must satisfy himself that certain conditions have been met and must "conduct such consultations as will enable him to ascertain that there is broad support among participants for the allocation of special drawing rights . . ."

★ ★ ★

The foregoing summary of the main features of the SDR plan, and of some of its underlying principles, indicates the general principles that have been devised to govern the creation, distribution, holding, and use of SDR's. It is reasonable to assume that the SDR system, like most economic and financial systems, will evolve over time. While it is possible, of course, that unanticipated problems will arise that will require the formulation of additional principles and understandings, it seems likely that the evolution of the system will be mainly in the direction of greater flexibility, as familiarity with and confidence in the new asset grows. Meanwhile, the Outline Plan agreed upon at Rio provides the essential basis for a workable system of international reserve-asset creation.

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BANK SUPERVISION BY THE FEDERAL RESERVE SYSTEM

Examination of Federal Reserve Banks. The Board's Division of Examinations examined the 12 Federal Reserve Banks and their 24 branches during the year, as required by Section 21 of the Federal Reserve Act. In conjunction with the examination of the Federal Reserve Bank of New York, the Board's examiners also audited the accounts and holdings related to the System Open Market Account and foreign currency operations conducted by that Bank in accordance with policies formulated by the Federal Open Market Committee, and rendered reports thereon to the Committee. The procedures followed by the Board's examiners were surveyed and appraised by a private firm of certified public accountants, pursuant to the policy of having such reviews made on an annual basis.

Examination of member banks. National banks, all of which are members of the Federal Reserve System, are subject to examination by direction of the Board of Governors or the Federal Reserve Banks. However, as a matter of practice they are not examined by either, because the law charges the Comptroller of the Currency directly with that responsibility. The Comptroller provides reports of examinations of national banks to the Board of Governors upon request, and each Federal Reserve Bank purchases from the Comptroller copies of reports of examination of national banks in its district.

State member banks are subject to examinations made by direction of the Federal Reserve Bank of the district in which they are located by examiners selected or approved by the Board. The established policy is to conduct at least one regular examination of each State member bank, including its trust department, during each calendar year, with additional examinations if considered desirable. In most States joint examinations are made in cooperation with the State banking authorities, while in others alternate

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independent examinations are made. All but 33 of the 1,313 State member banks were examined during 1967.

The Board of Governors makes its reports of examination of State member banks available to the Federal Deposit Insurance Corporation, and the Corporation in turn makes its reports of insured nonmember State banks available to the Board upon request. Also, upon request, reports of examination of State member banks are made available to the Comptroller of the Currency.

In its supervision of State member banks, the Board receives, reviews, and analyzes reports of examination of State member banks and coordinates and evaluates the examination and supervisory functions of the System. It passes on applications for admission of State banks to membership in the System; administers the disclosure requirements of the Securities Exchange Act of 1934 with respect to equity securities of banks within its jurisdiction that are registered under the provisions of the 1934 Act; and under provisions of the Federal Reserve Act and other statutes, passes on applications for permission, among other things, to (1) merge banks, (2) form or expand bank holding companies, (3) establish domestic and foreign branches, (4) exercise expanded powers to create bank acceptances, (5) establish foreign banking and financing corporations, and (6) invest in bank premises an amount in excess of 100 per cent of a bank's capital stock.

By Act of Congress approved September 12, 1964 (Public Law 88-593), insured banks are required to inform the appropriate Federal banking agency of any changes in control of management of such banks and of any loans by them secured by 25 per cent or more of the voting stock of any insured bank. In 1967, 30 instances of changes in ownership of the outstanding voting stock of State member banks were reported to the Reserve Banks as changes in control of such member banks. In addition, reports of 18 loans secured by 25 per cent or more of the stock of a State member bank were forwarded to the System. Arrangements continue among the three Federal supervisory agencies for appro-

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priate exchanges of reports received by them pursuant to the Act. The Reserve Banks send copies of all the reports they receive to the appropriate district office of the Federal Deposit Insurance Corporation, the regional Comptroller of the Currency, and the State bank supervisor.

Upon receipt of reports involving changes in control of State member banks, the Reserve Banks are under instructions to forward such reports promptly to the Board, together with a statement (1) that the new owner and management are known and acceptable to the Reserve Bank or (2) that they are not known and that an investigation is being made. The findings of any investigation and the Reserve Bank's conclusions based on such findings are forwarded to the Board.

By Act of Congress approved July 3, 1967 (Public Law 90-44), each member bank of the Federal Reserve System is required to include with (but not as part of) each report of condition and copy thereof a report of all loans to its executive officers since the date of submission of its previous report of condition. Since enactment of this legislation, member banks have submitted two condition reports, dated October 4, 1967, and December 30, 1967, respectively. With the report for October 4, 1967, member banks reported 9,095 loans to their executive officers during the approximate 3-month period covered since June 30, 1967, the date of the last condition report submitted before enactment of the new law. These loans aggregated $14,203,372 and were made at rates ranging from 2 per cent to 18 per cent.[1] Compilation of similar information with respect to the call report for December 30, 1967, has not been completed.

Federal Reserve membership. As of December 31, 1967, member banks accounted for 44 per cent of the number of all commercial banks in the United States and for 63 per cent of all commercial banking offices, and they held approximately 84 per cent of the total deposits in such banks. State member banks ac-

[1] The rate of 18 per cent reflects the inclusion of rates of 1½ per cent per month charged on credit-card and check-credit plans.

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counted for 14 per cent of the number of all State commercial banks and 30 per cent of the banking offices, and they held 60 per cent of total deposits in State commercial banks.

Of the 6,071 banks that were members of the Federal Reserve System at the end of 1967, 4,758 were national banks and 1,313 were State banks. During the year there were net declines of 41 national and 38 State member banks. The decline in the number of national banks reflected 53 conversions to branches incident to mergers and absorptions and 5 conversions to nonmember banks, which was partly offset by the organization of 18 new national banks and the conversion of 7 nonmember banks to national banks. The decrease in State member banks reflected mainly 12 conversions to branches incident to mergers and absorptions and 21 withdrawals from membership.

At the end of 1967 member banks were operating 13,649 branches, 749 more than at the close of 1966; this included 708 de novo establishments.

Detailed figures on changes in the banking structure during 1967 are shown in Table 19, pages 370 and 371.

Bank mergers. Under Section 18(c) of the Federal Deposit Insurance Act (12 U.S.C. 1828(c)), the prior written consent of the Board of Governors of the Federal Reserve System must be obtained before a bank may merge, consolidate, or acquire the assets and assume the liabilities of another bank if the acquiring, assuming, or resulting bank is to be a State member bank.

In deciding whether to approve an application, the Board is required by Section 18(c) to consider the impact of the proposed transaction on competition, the financial and managerial resources and prospects of the existing and proposed institution, and the convenience and needs of the community to be served. The Board is precluded from approving "any proposed merger transaction which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States." A proposed transaction "whose effect in any

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section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade," may be approved only if the Board is able to find that the anticompetitive effects of the transaction would be clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

Before acting on each application the Board must request reports from the Attorney General, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on the competitive factors involved in each transaction. The Board in turn responds to requests by the Comptroller or the Corporation for reports on competitive factors involved when the acquiring, assuming, or resulting bank is to be a national bank or an insured nonmember State bank.

During 1967 the Board disapproved 2 and approved 13 applications, and it submitted 76 reports on competitive factors to the Comptroller of the Currency and 48 to the Federal Deposit Insurance Corporation. As required by Section 18(c) of the Federal Deposit Insurance Act, a description of each of the 13 applications acted on and approved by the Board, together with other pertinent information, is shown in Table 21 on pages 374 through 393.

Statements and orders of the Board with respect to all bank merger applications, whether approved or disapproved, are released immediately to the press and the public and are published in the Federal Reserve *Bulletin*. These statements and orders set forth the factors considered, the conclusions reached, and the vote of each Board member present.

Bank holding companies. During 1967, pursuant to Section 3 (a)(1) of the Act, the Board approved 10 applications for prior approval to become a bank holding company and denied one application. Pursuant to Section 3(a)(3) of the Act, the Board approved applications by 11 bank holding companies, involving acquisition of shares in 16 banks, and denied two applications. Two

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of the approved acquisitions involved two affiliated bank holding companies, both of which were required to file applications. To provide necessary current information, annual reports for 1966 were obtained from all registered bank holding companies pursuant to the provisions of Section 5(c) of the Act.

Statements and orders of the Board with respect to applications to form or to expand bank holding companies, whether approved or disapproved, are released immediately to the press and the public and are published in the Federal Reserve *Bulletin*. These statements and orders set forth the factors considered, the conclusions reached, and the vote of each Board member present.

Foreign branches of member banks. At the end of 1967, 15 member banks had in active operation a total of 295 branches in 54 foreign countries and overseas areas of the United States; eight national banks were operating 280 of these branches, and seven State member banks were operating 15 such branches. The number and location of these foreign branches were as shown in the accompanying tabulation.

Under the provisions of the Federal Reserve Act (Section 25 as to national banks and Sections 9 and 25 as to State member banks), the Board of Governors during the year 1967 approved 62 applications made by member banks for permission to establish branches in foreign countries and overseas areas of the United States.

During the year member banks opened branches in foreign countries as follows: one branch in Cordoba, Flores, and Rosario, Argentina; La Paz, Bolivia; Melipilla and Vina del Mar, Chile; Guayaquil, Ecuador; San Pedro Sula, Honduras; Managua, Nicaragua; La Chorrera and Panama City, Panama; Lima, Peru; Port of Spain, Trinidad; St. Thomas and St. Croix, Virgin Islands; Birmingham, England; Marseilles and Paris, France; Munich, Germany; Piraeus, Greece; Rome, Italy; Zurich, Switzerland; Port Harcourt, Nigeria; and Lahore, Pakistan; two branches in Bogota, Colombia; David, Panama; Asuncion, Paraguay; Brussels, Belgium; London, England; and Hong Kong; three branches

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in Valparaiso, Chile; and Seoul, Korea; four branches in Santiago, Chile; and five branches in Buenos Aires, Argentina.

Latin America	*133*
Argentina	25
Bahamas	3
Bolivia	2
Brazil	15
Chile	17
Colombia	8
Dominican Republic	5
Ecuador	4
El Salvador	1
Guatemala	2
Guyana	1
Honduras	2
Jamaica	1
Mexico	5
Nicaragua	2
Panama	19
Paraguay	4
Peru	5
Trinidad	4
Uruguay	2
Venezuela	4
Virgin Islands (British)	2
Continental Europe	*34*
Austria	1
Belgium	8
Germany	9
France	6
Greece	2
Italy	2
Netherlands	3
Switzerland	3
England	*24*
Ireland	*1*
Africa	*3*
Liberia	1
Nigeria	2
Near East	*6*
Dubai	1
Lebanon	3
Saudi Arabia	2
Far East	*63*
Hong Kong	10
India	8
Japan	12
Korea	3
Malaysia	5
Okinawa	2
Pakistan	4
Philippines	5
Singapore	8
Taiwan	2
Thailand	2
Vietnam	2
U.S. Overseas Areas and Trust Territories	*31*
Canal Zone	2
Guam	2
Puerto Rico	16
Truk Islands	1
Virgin Islands	10
Total	**295**

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Acceptance powers of member banks. During the year the Board approved the applications of four member banks, pursuant to the provisions of Section 13 of the Federal Reserve Act, for increased acceptance powers. Two banks were granted permission to accept drafts or bills of exchange drawn for the purpose of furnishing dollar exchange as required by the usages of trade in such countries, dependencies, or insular possessions of the United States as may have been designated by the Board of Governors. The other two banks were granted permission to accept commercial drafts or bills up to 100 per cent of paid-up and unimpaired capital stock and surplus.

Foreign banking and financing corporations. At the end of 1967 there were five corporations operating under agreements with the Board pursuant to Section 25 of the Federal Reserve Act relating to investment by member banks in the stock of corporations engaged principally in international or foreign banking. Three of these "agreement" corporations have head offices in New York, and one has its head office in Miami, Florida. The four corporations were examined during the year by examiners for the Board of Governors. The fifth "agreement" corporation is a national bank in the Virgin Islands and is owned by a State member bank in Philadelphia.

During 1967, under the provisions of Section 25(a) of the Federal Reserve Act, the Board issued final permits to five corporations to engage in international or foreign banking or other international or foreign financial operations. Four of these corporations commenced operations in 1967. At the end of the year there were 46 corporations in active operation under Section 25(a): 28 have home offices in New York City, three in Boston, four in Philadelphia, one in Pittsburgh, one in Winston-Salem, one in Atlanta, two in Chicago, two in Detroit, two in San Francisco, one in Los Angeles, and one in Seattle. The corporation in Seattle has five active branches in Hong Kong, and one of the corporations in Philadelphia operates a branch in London. Examiners for the Board of Governors examined 43 of these corporations during 1967.

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Bank Examination Schools and other training activities. In 1967 the Bank Examination School conducted four sessions of the School for Examiners, four sessions of the School for Assistant Examiners, and one session of the School for Trust Examiners. The Bank Examination School was established in 1952 by the three Federal bank supervisory agencies, and since 1962 has been conducted jointly by the Federal Reserve System and the Federal Deposit Insurance Corporation.

Since the establishment of this program, 3,385 persons have attended the various sessions. This number includes representatives of the Federal bank supervisory agencies; the State Banking Departments of California, Connecticut, Idaho, Indiana, Kentucky, Louisiana, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia, Washington, and Wyoming; the Treasury Department of the Commonwealth of Puerto Rico; and 16 foreign countries.

Another school, the Discount Collateral Evaluation Training School, was set up in 1967 for the purpose of training System personnel responsible for the discount function in the application of suitable standards for the evaluation of collateral presented by member banks for discount purposes. Two sessions of the school were held during the year with a total of 40 System personnel in attendance.

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LEGISLATION ENACTED

Real estate loans by national banks. An Act of Congress approved May 25, 1967 (Public Law 90-19), amended the provision of Section 24 of the Federal Reserve Act, exempting certain industrial loans from the restrictions or limitations upon real estate loans, by substituting the Secretary of Housing and Urban Development for the Housing and Home Finance Administrator.

Loans to executive officers. An Act of Congress approved July 3, 1967 (Public Law 90-44), amended Section 22(g) of the Federal Reserve Act so as to liberalize the restrictions on loans by member banks of the Federal Reserve System to their executive officers.

Antitrust exemptions for voluntary agreements or programs. An Act of Congress approved August 9, 1967 (Public Law 90-62), extended to June 30, 1969, the standby authority for providing procedures for obtaining exemptions from the antitrust laws to assist in safeguarding the balance of payments position of the United States. As stated in the report of January 1, 1968, which the Attorney General is required to make to the Congress, the exemptions provided by the standby legislation have not been put into effect.

Interest on deposits; reserves of member banks; open market operations. An Act of Congress approved September 21, 1967 (Public Law 90-87), amended Sections 19 and 14(b) of the Federal Reserve Act by extending for 1 year the temporary authority of the Board (1) to exercise more flexibility in regulating the maximum rates of interest payable by member banks on deposits, (2) to fix higher reserve requirements on time deposits of member banks, and (3) to permit open market operations by Federal Reserve Banks in direct obligations of, or those fully guaranteed by, any agency of the United States. The additional powers granted by this law expire September 21, 1968.

Acquisition of stock of small business investment companies. An Act of Congress approved October 11, 1967 (Public Law 90-

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104), increased the aggregate amount that a bank may invest in the stock of small business investment companies from 2 to 5 per cent of the bank's capital and surplus, but limited such investment in any one company to 50 per cent of any class of its equity securities having actual or potential voting rights.

Lottery ticket sales by State member banks. An Act of Congress approved December 15, 1967 (Public Law 90-203), added Section 9A to the Federal Reserve Act, effective April 1, 1968, to prohibit State member banks from fostering or participating in gambling activities, and particularly the sale of lottery tickets.

Salaries of members of Federal Reserve Board. An Act of Congress approved December 16, 1967 (Public Law 90-206), contained a provision which, in effect, amended Section 10 of the Federal Reserve Act by increasing the salaries of the members of the Board, other than the Chairman, from $28,500 to $29,500 per annum. The salary of the Chairman remains $30,000.

Tax status of bank holding company distributions. An Act of Congress approved December 27, 1967 (Public Law 90-225), added a new subsection (e) to Section 1102 of the Internal Revenue Code of 1954 relating to special rules for income tax treatment of distributions resulting from the 1966 amendments to the Bank Holding Company Act of 1956.

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LEGISLATIVE RECOMMENDATIONS

Lending authority of Federal Reserve Banks. Under present law, when a member bank borrows from its Reserve Bank on collateral other than U.S. Government obligations or paper (such as short-term promissory notes of the member bank's customers) that meets statutory "eligibility" requirements, it must pay interest at a rate not less than one-half of 1 per cent higher than the Reserve Bank's basic discount rate. For several years the Board of Governors has urged legislation that would permit a member bank, in appropriate circumstances, to borrow on any security satisfactory to its Reserve Bank without the necessity of paying a higher rate of interest simply because the security was "ineligible" for the basic rate.

The Board's recommendation is embodied in S. 966, 90th Congress, which passed the U.S. Senate on April 14, 1967. The need for enactment of such legislation has increased as member banks have reduced their holdings of U.S. Government securities and broadened the scope of their lending in order to meet the expanding credit demands of their customers. Many of these loans cannot qualify as security for Federal Reserve advances except at the "penalty" rate of interest, although their quality may be equal to that of presently "eligible" paper.

To enable the Federal Reserve System always to be in a position to carry out promptly and efficiently one of its principal responsibilities—the extension of credit assistance to enable the banking system to meet the legitimate needs of the economy—and to avoid penalizing those uses of credit that generate sound paper that is not "eligible" under existing law, the Board urges enactment of S. 966, which would enable member banks to borrow from a Federal Reserve Bank, at the basic discount rate, on their notes secured to the satisfaction of the Reserve Bank.

"Par clearance." Most banks pay the face amount of all checks presented to them for payment; this practice is frequently described as "par clearance." In a few areas of the country, how-

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ever, many small banks deduct a so-called "exchange charge" from the face amount of checks presented by mail and remit only the balance. In such circumstances the drawee bank shifts all or a portion of the expense incurred by it in connection with the collection process to the payee of the check or to an indorsee. In the Board's view there is no justification for the increased costs, delays, and inefficiencies that result when banks do not pay all checks at their face amount.

The trend of legislation in this area at the State level has been toward requiring banks to pay the face amount of checks drawn upon them. Florida, Minnesota, and South Dakota have recently enacted legislation along these lines. At the Federal level, several bills have been introduced into the 90th Congress to require "par clearance" by all insured banks. Despite the progress in this direction that has been made at the State level, the Board favors enactment of such a requirement as it is embodied in S. 1737. Such a bill would defer the effective date of the requirement for 1 year from the date of enactment to give nonpar banks a sufficient time to adjust their practices.

Reserve requirements. In its ANNUAL REPORTS for 1964, 1965, and 1966, the Board of Governors favored legislation that would (1) authorize it to fix required reserve percentages on a graduated basis according to the amount of a bank's deposits and (2) make such requirements applicable to all Federally insured banks (rather than to member banks only). Legislation proposed by the Board to accomplish these purposes is embodied in S. 1298, 90th Congress.

The reasons for the proposed changes in the structure of bank reserve requirements have become stronger with the passage of time. Thus, in the Board's judgment, the differences between reserve city and "country" banks, in both size and functions, have decreased substantially and the division of member banks into such categories has become arbitrary to the point where such division is a major obstacle to the development of a more equitable system of reserve requirements. Since deposits in nonmember

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banks are part of the country's money supply just as are those in member banks, their exemption from Federally imposed reserve requirements cannot be justified.

Although the Board was given increased flexibility in fixing reserve requirements by legislation enacted in 1966 and extended in 1967 to September 20, 1968, that legislation is temporary in nature, it retains the outmoded differentiation between reserve city and "country" banks, and it does not apply to nonmember banks. Enactment of S. 1298 would provide a rational and equitable basis for reserve requirements. All Federally insured banks of the same size, in terms of demand deposits, would carry equal reserves against such deposits. In connection with making reserve requirements applicable to nonmember insured banks, S. 1298 would grant such banks access to Federal Reserve discount facilities.

The Board urges enactment of S. 1298.

Margin requirements for securities transactions. For decades, the Board's Regulation T has limited the credit that brokers and dealers may extend on securities that are registered on exchanges, and its Regulation U has limited the credit that banks may extend for the purpose of purchasing or carrying securities so registered. Recently the Board promulgated Regulation G to bring lenders other than brokers, dealers, or banks within the scope of margin requirements in connection with transactions involving registered securities.

Insofar as securities traded over the counter are concerned, the law, generally speaking, forbids brokers and dealers to extend any credit whatever, while permitting banks and other lenders to extend credit unlimited by any governmentally imposed margin requirements. The Board considers that its inability to extend the coverage of margin requirements to credit extended by banks and other lenders for the purpose of purchasing and carrying over-the-counter securities represents a serious gap in the effectiveness of its regulations in preventing excessive use of credit in the securities market.

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Accordingly, the Board renews the recommendation submitted in previous ANNUAL REPORTS that the Congress enact legislation modifying Section 7 of the Securities Exchange Act of 1934 to eliminate the difference in status, for credit purposes, of securities that are registered on a national securities exchange and securities that are traded only over the counter. A proposal to bring over-the-counter securities within the coverage of margin regulations was made by the Securities and Exchange Commission's 1963 *Special Study of Securities Markets.* The continuing growth of the over-the-counter securities market has given this problem increased importance.

S. 1299 and H.R. 7696 would modify the law in the form favored by the Board, and the Board recommends enactment of such legislation.

Purchase of obligations of foreign governments by Federal Reserve Banks. Under present law, balances that the Reserve Banks acquire in foreign central banks in connection with the System's foreign currency operations may be invested in prescribed kinds of bills of exchange and acceptances. On occasion these investment media have not been conveniently available. S. 965, which was passed by the Senate on April 14, 1967, would facilitate economic use of such balances by permitting them to be invested in any obligations of foreign governments or monetary authorities that will mature within 12 months and that are payable in a convertible currency. For several years the Board has favored the authorization of such investments; accordingly, it recommends enactment of S. 965.

Loans to bank examiners. The Criminal Code prohibits loans to a bank examiner by any bank that the examiner is authorized to examine. For several years the Board has favored modification of this prohibition to permit, under appropriate safeguards, a Federally insured bank to make a home mortgage loan to a bank examiner in an amount not exceeding $30,000. This modification is embodied in H.R. 7451, which the Board recommends be enacted.

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LITIGATION

Investment Company Institute et al. v. Camp. The Investment Company Institute, representing open-end investment companies, investment advisers, and principal underwriters, filed suit in the U.S. District Court for the District of Columbia for a declaratory judgment and an injunction seeking to restrain the Comptroller of the Currency from purporting to authorize a national bank to invest funds collectively that had been tendered to the bank as managing agent solely for investment.

Pursuant to statutory authority to regulate the fiduciary activities of national banks (12 U.S.C. 92a), the Comptroller promulgated a revised fiduciary regulation (Regulation 9, 12 CFR 9) which purported to authorize, in addition to the types of collective investment funds already permitted, collective investment accounts for funds held by a national bank in the capacity of managing agent and to authorize the Comptroller to approve the collective investment of such funds in manners other than those expressly provided.

On May 10, 1965, the Comptroller approved a plan submitted by First National City Bank of New York for the establishment and operation of a collective investment fund called the Commingled Investment Account. After registering the Account with the Securities and Exchange Commission, pursuant to the Investment Company Act of 1940 (15 U.S.C. 80), and filing a registration statement pursuant to the Securities Act of 1933 (15 U.S.C. 77a), the bank sold participating interests to the public. The plan contemplated operation of the Account by a committee of five persons, initially appointed by the bank and thereafter to be elected annually by the participants in the Account. At least 40 per cent of the members of the committee were required to be persons not affiliated with the bank, but the majority of the members were expected to be officers in the bank's trust and investment division. The committee was authorized to enter into a management agreement with the bank, subject to approval by

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the Comptroller and by participants having a majority of the units of participation; pursuant to such an agreement, the bank served as investment adviser and custodian for the Account at a stated fee.

The Institute attacked the Comptroller's revised regulation as unauthorized under the provisions of 12 U.S.C. 92a and in violation of certain provisions of the Federal banking laws (12 U.S.C. 24, 78, 377, and 378). The Court concluded, with respect to certain procedural questions raised, that (1) the plaintiffs had a right to complain of the competition that was being condoned under the Comptroller's regulation, that is, that the plaintiffs had legal standing to challenge the Comptroller's Regulation 9; and (2) a justiciable controversy existed between the parties on the basis of the impact upon the plaintiffs of the authority claimed by the Comptroller in promulgating the regulation at which the suit was directed. On the substantive merits of the suit, the Court held that the commingling of managing agency accounts is not a "fiduciary" activity within the meaning of 12 U.S.C. 92a, that such commingling is not authorized under Federal laws or those of the State of New York, and that the Comptroller therefore did not have statutory authority to empower the bank to create, organize, and manage the Account. The Court further concluded that the Account was in fact an investment fund and that the banking laws make it illegal for a national bank to establish, operate, or be affiliated with such an investment fund (12 U.S.C. 24, 78, 377, 378).

An interpretation by the Board (Federal Reserve *Bulletin*, October 1965, p. 1410) to the effect that interlocking personnel relationships between the bank and the Account were not prohibited by Section 32 of the Banking Act of 1933 (12 U.S.C. 78) —based on a finding that the Account was in effect a department of the bank—was rejected by the Court on the ground that the Account and the bank were contractually affiliated and that one may not be considered a department of the other.

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Baker Watts & Co. et al.* v. *Saxon. In a suit instituted by a group of investment bankers, the court rejected an interpretation by the Comptroller of the Currency purporting to authorize national banks to underwrite and deal in governmental securities known as "revenue bonds." (See ANNUAL REPORT for 1966, page 314.) The court's decision is under review in the U.S. Court of Appeals for the District of Columbia, on an appeal by the Port of New York Authority.

Detroit Bank & Trust Co. et al.* v. *Saxon and Board of Governors of Federal Reserve System. A suit was instituted in November 1966 to prevent consummation of a proposed acquisition by Michigan National Bank, Detroit, Michigan, of voting stock of Michigan National Bank N.A., Detroit. (See ANNUAL REPORT for 1966, page 316.) On June 5, 1967, a stipulation for dismissal of the suit, joined in by all parties, was filed in the U.S. District Court for the District of Columbia. An order of dismissal was thereafter entered by the Court.

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RESERVE BANK OPERATIONS

Earnings and expenses. The accompanying table summarizes the earnings, expenses, and distribution of net earnings of the Federal Reserve Banks for 1967 and 1966.

EARNINGS, EXPENSES, AND DISTRIBUTION OF NET EARNINGS OF FEDERAL RESERVE BANKS, 1967 AND 1966

(In thousands of dollars)

Item	1967	1966
Current earnings	2,190,404	1,908,500
Current expenses	220,121	207,401
Current net earnings	1,970,283	1,701,099
Net addition to current net earnings	2,094	996
Net earnings before payments to U.S. Treasury	1,972,377	1,702,095
Dividends paid	35,028	33,696
Payments to U.S. Treasury (interest on F.R. notes)	1,907,498	1,649,455
Transferred to surplus	29,851	18,944

Current earnings of $2,190 million in 1967 were 15 per cent higher than in 1966, reflecting increases of $301 million on U.S. Government securities and $3 million on foreign currencies, and a decrease of $21 million on discounts and advances.

Current expenses were $13 million more than in 1966, or 6 per cent. Statutory dividends to member banks amounted to $35 million, an increase of $1 million from 1966. This rise in dividends reflected an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Federal Reserve Banks.

Payments to the Treasury as interest on Federal Reserve notes totaled $1,907 million for the year, compared with $1,649 million in 1966. This amount consists of all net earnings after dividends and the amount necessary to bring surplus to the level of paid-in capital.

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Expenses of the Federal Reserve Banks include costs of $847.71 for nine regional meetings incident to the Treasury Department savings bond program.

A detailed statement of earnings and expenses of each Federal Reserve Bank during 1967 is shown in Table 7 on pages 358 and 359 and a condensed historical statement in Table 8 on pages 360 and 361.

Holdings of loans and securities. The accompanying table shows holdings, earnings, and average interest rates on loans and securities of the Federal Reserve Banks during the past 3 years.

Average daily holdings of loans and securities during 1967 amounted to $46,417 million—an increase of $3,805 million over 1966. Holdings of U.S. Government securities increased $4,289 million, whereas there were decreases of $471 million in discounts and advances and $13 million in acceptances.

RESERVE BANK EARNINGS ON LOANS AND SECURITIES, 1965–67

Item and year	Total	Discounts and advances	Acceptances	U.S. Govt. securities
	In millions of dollars			
Average daily holdings: [1]				
1965	39,230	492	77	38,661
1966	42,612	649	117	41,846
1967	46,417	178	104	46,135
Earnings:				
1965	1,545.0	19.8	3.2	1,522.0
1966	1,885.8	29.2	5.8	1,850.8
1967	2,164.6	7.7	4.8	2,152.1
	In per cent			
Average rate of interest:				
1965	3.94	4.03	4.14	3.94
1966	4.43	4.50	4.96	4.42
1967	4.66	4.33	4.62	4.66

[1] Based on holdings at opening of business.

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The average rates of interest on holdings increased from 4.42 per cent to 4.66 per cent on U.S. Government obligations and decreased from 4.50 per cent to 4.33 per cent on discounts and advances and from 4.96 per cent to 4.62 per cent on acceptances.

Volume of operations. Table 10 on page 362 shows the volume of operations in the principal departments of the Federal Reserve Banks for 1964–67.

Discounts and advances sharply reversed the rising trend of recent years in both number and dollar amount, and the number of banks borrowing dropped to 1,104 from 1,658 in 1966.

Volume was again higher than in the previous year in most of the other operations, particularly in coin received and counted, in food stamps redeemed, and in transfers of funds.

Fiscal agency function: Premature disclosure of information. On August 17, 1967, the Federal Reserve Bank of New York informed the Treasury that reports in the securities market gave reason to believe that terms of the Treasury offering that day had been "leaked" before the official release time. Investigation by the Treasury revealed that a middle-grade employee of the Federal Reserve Bank of Philadelphia had prematurely disclosed the terms to an employee of a securities firm. The Reserve Bank employee was immediately relieved of all duties and died of a heart attack a few days later. Investigating agents found no evidence that he had received any remuneration. The findings were turned over to the Department of Justice for further review to determine whether there had been a violation of criminal law, and new procedures were developed by the Treasury and Federal Reserve to prevent the possibility of a recurrence.

Loan guarantees for defense production. Under the Defense Production Act of 1950, the Departments of the Army, Navy, and Air Force, the Defense Supply Agency of the Department of Defense, the Departments of Commerce, Interior, and Agriculture, the General Services Administration, the National Aeronautics and Space Administration, and the Atomic Energy Com-

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mission are authorized to guarantee loans for defense production made by commercial banks and other private financing institutions. The Federal Reserve Banks act as fiscal agents of the guaranteeing agencies under the Board's Regulation V.

During 1967 the guaranteeing agencies authorized the issuance of eight guarantee agreements covering loans totaling $106 million. Loan authorizations outstanding on December 31, 1967, totaled $52 million, of which $45 million represented outstanding loans and $8 million additional credit available to borrowers. Of total loans outstanding, 70 per cent on the average was guaranteed. During the year approximately $205 million was disbursed on guaranteed loans, most of which are revolving credits.

Authority for the V-loan program, unless extended, will terminate on June 30, 1968.

Table 15 (page 365) shows guarantee fees and maximum interest rates applicable to Regulation V loans.

Foreign and international accounts. Assets held for foreign account at the Federal Reserve Banks increased $2,371 million in 1967. At the end of the year they amounted to $21,211 million: $10,661 million of earmarked gold; $9,223 million of U.S. Government securities (including securities payable in foreign currencies); $135 million in dollar deposits; $156 million of bankers' acceptances purchased through Federal Reserve Banks; and $1,036 million of miscellaneous assets. The latter item includes mainly dollar bonds issued by foreign countries and international organizations. Assets held for international organizations, including IMF gold deposit, decreased $79 million to $9,438 million.

In 1967 new accounts were opened in the names of the Central Bank of Algeria, Central Bank of the West African States, Central Bank of Kenya, Foreign Exchange Bank of Korea, and Bank of Uganda.

New gold collateral loan arrangements—including a standby commitment—amounted to $50 million in 1967. All drawings

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during the year under the loan arrangements were repaid by the end of the year. Loans on gold are made to foreign monetary authorities to help them meet dollar requirements of a temporary nature.

The Federal Reserve Bank of New York continued to act as depositary and fiscal agent for international organizations. As fiscal agent of the United States, the Bank continued to operate the Exchange Stabilization Fund pursuant to authorization and instructions of the Secretary of the Treasury. Also on behalf of the Treasury Department, it administered foreign assets control regulations pertaining to assets in the United States of North Vietnam, Cuba, Communist China, and North Korea, and their nationals, and to transactions with those countries and their nationals.

Bank premises. During 1967, with the approval of the Board, properties adjacent to the Federal Reserve Bank of Cleveland and to the Buffalo and Omaha Branches were acquired for future expansion, and a site was obtained for a new building for the Memphis Branch.

Table 6 on page 357 shows the cost and book value of bank premises owned and occupied by the Federal Reserve Banks and of real estate acquired for banking-house purposes.

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PUBLIC INFORMATION, ORGANIZATION, AND PROCEDURE

During 1967 a number of changes were made in Rules of both the Board of Governors and the Federal Open Market Committee regarding public information, organization, and procedures. The revised Rules are summarized below.

Public information. An Act of Congress, approved June 5, 1967 (Public Law 90-23), amended section 552 of title 5, United States Code, to codify the provisions of Public Law 89-487, effective July 4, 1967, which had revised the Public Information Section of the former Administrative Procedure Act. Accordingly, the Board of Governors and Federal Open Market Committee adopted, effective July 4, 1967, revisions of their respective Rules relating to the availability of information to the public. Under the new Rules, unpublished records of the Board and of the Committee are made available upon request unless the particular records fall within stated exemptions contained in the law. For conforming purposes, the Board and Federal Open Market Committee also amended their Rules of Organization and Rules of Procedure. (These revisions in Rules were published in full in the Federal Reserve *Bulletin* for July 1967, pages 1153-62.)

Delegation of authority. Effective July 1, 1967, the Board of Governors adopted a new regulation, "Rules Regarding Delegation of Authority," pursuant to and in accordance with the provisions of section 11(k) of the Federal Reserve Act (12 U.S.C. 248(k)), which became effective November 5, 1966. The new Rules are designed to provide a more expeditious means for performance of certain of the Board's supervisory functions and to improve its over-all efficiency in fulfilling its statutory responsibilities. (This Regulation was published in full in the Federal Reserve *Bulletin* for June 1967, pages 965-67.

Formal hearings. Effective August 1, 1967, the Board revised its "Rules of Practice for Formal Hearings." This revision resulted principally from the Financial Institutions Supervisory Act of 1966, which among other things authorized the Board to act

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to prevent unsafe or unsound banking practices and violation of law, rules, or regulations by State-chartered banks of the Federal Reserve System, through the issuance of an order requiring such a bank to "cease and desist" from engaging in the unlawful activity. (The revised Rules were published in full in the Federal Reserve *Bulletin* for August 1967, pages 1342-54.)

Organization and procedure. Effective August 9, 1967, the Board of Governors revised its Rules of Organization pursuant to the requirement of section 552 of title 5 of the United States Code that each agency publish in the Federal Register a description of its central and field organization.

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BOARD OF GOVERNORS

Building annex. The Board has authorized construction of an annex to its present building on property acquired as part of the original site in 1934. For this purpose it has employed Harbeson Hough Livingston and Larson, the architectural firm that is successor to Paul P. Cret, architect of the original building.

Income and expenses. The accounts of the Board for the year 1967 were audited by the public accounting firm of Lybrand, Ross Bros. & Montgomery.

Accountants' Opinion

Board of Governors of the
Federal Reserve System:

We have examined the balance sheet of the Board of Governors of the Federal Reserve System as of December 31, 1967, and the related statement of assessments and expenses for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the balance sheet and related statement of assessments and expenses present fairly the financial position of the Board of Governors of the Federal Reserve System at December 31, 1967 and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Lybrand, Ross Bros. & Montgomery

Washington, D.C.
January 25, 1968

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ANNUAL REPORT OF BOARD OF GOVERNORS

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEET
DECEMBER 31, 1967

ASSETS

OPERATING FUND:		
Cash		$ 1,181,729
Miscellaneous receivables and travel advances		5,185
Stockroom and cafeteria inventories at first-in, first-out cost		28,962
Total operating fund		1,215,876
PROPERTY FUND:		
Land and improvements		792,852
Building and building construction		4,443,307
Furniture and equipment		1,048,879
Total property fund		6,285,038
		$ 7,500,914

LIABILITIES AND FUND BALANCES

OPERATING FUND:		
Current liabilities:		
Accounts payable and accrued expenses	$ 714,619	
Income taxes withheld	331,543	
Accrued payroll	325,582	
		$ 1,371,744
Fund balance:		
Balance, January 1, 1967	(220,731)	
Excess of assessments and extraordinary item over expenses for the year ended December 31, 1967	64,863	
		(155,868)
Total operating fund		1,215,876
PROPERTY FUND:		
Fund balance:		
Balance, January 1, 1967	6,471,292	
Additions	252,503	
Property adjustments and disposals	(438,757)	
Total property fund		6,285,038
		$ 7,500,914

The accompanying notes are an integral part of the financial statements.
[See page 346 for notes.]

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENT OF ASSESSMENTS AND EXPENSES FOR THE YEAR ENDED DECEMBER 31, 1967

ASSESSMENTS LEVIED ON FEDERAL RESERVE BANKS:		
For Board expenses and additions to property		$10,769,600
For expenditures made on behalf of the Federal Reserve Banks		17,334,358
Total assessments		28,103,958
EXPENSES:		
Expenditures for printing, issue and redemption of Federal Reserve Notes, paid on behalf of the Federal Reserve Banks		17,334,358
For the Board:		
Salaries	$6,852,515	
Retirement and insurance contributions	1,374,737	
Travel expenses	363,461	
Legal, consultant and audit fees	52,677	
Contractual services	442,808	
Printing and binding—net	454,608	
Equipment and other rentals	516,554	
Telephone and telegraph	174,434	
Postage and expressage	129,745	
Stationery, office and other supplies	88,209	
Heat, light and power	56,533	
Operation of cafeteria—net	69,038	
Repairs, maintenance and alterations	48,105	
Books and subscriptions	29,210	
System membership, Center for Latin American Monetary Studies	27,000	
Miscellaneous—net	47,600	
		10,727,234
For property additions		252,503
Total expenses		28,314,095
EXCESS OF EXPENSES OVER ASSESSMENTS BEFORE EXTRAORDINARY ITEM.		(210,137)
EXTRAORDINARY ITEM		275,000
EXCESS OF ASSESSMENTS AND EXTRAORDINARY ITEM OVER EXPENSES		$ 64,863

The accompanying notes are an integral part of the financial statements.

[See page 346 for notes.]

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ANNUAL REPORT OF BOARD OF GOVERNORS

Board of Governors of the Federal Reserve System

Notes to Financial Statements

Accounting methods

The Board has consistently followed the practice of not providing for depreciation on fixed assets. Acquisitions are charged to expense and proceeds from sales of fixed assets are recorded as income. The property accounts are increased or reduced at full cost, with corresponding increases or decreases in the property fund balance when property is acquired or sold.

Assessments and expenditures made on behalf of the Federal Reserve Banks for the printing, issuance and redemption of Federal Reserve notes are recorded on the cash basis and produces results which are not materially different from those which would have been produced on the accrual basis of accounting.

Extraordinary item

During 1967, $275,000 was received by the Board from a federal government department for the sale of computer equipment purchased in 1964 for $422,589.

Long-term leases

The Board leases outside office space at an annual rental of $269,225 under a lease expiring in 1972. This lease may be terminated with six months notice after 1969.

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In 1968 restraint of inflationary pressures was the principal economic problem facing monetary policy. Federal Reserve efforts to curb such pressures, to foster a sustainable rate of economic expansion, and to help attain reasonable equilibrium in the balance of payments were aided by enactment in June of a package of fiscal restraint, including a 10 per cent surtax on personal and corporate income and certain constraints on Federal spending. As fiscal restraint was added to the monetary-fiscal policy mix, the rate of expansion in economic activity began to moderate in the second half of the year. But the rate of economic expansion remained higher than had generally been expected, and higher than appeared desirable in view of the need to restrain price advances and reduce inflationary expectations. As a result, monetary policy, which had become somewhat easier in the summer, moved toward greater restraint in the autumn. And as the year drew to a close, the banking system was again under reserve pressure, and most interest rates had reached new highs.

During the first half of 1968, expansion in real gross national product accelerated to an annual rate in excess of 6 per cent from just under 4 per cent in the second half of 1967. This surge in economic activity was spurred in the early months of the year by expanded consumer expenditures, continued increases in Federal defense outlays, and growth in residential construction. During the spring, growth in such final demands slowed, but a fast pace of expansion in over-all economic activity was sustained by a marked increase in inventory investment, partly in preparation for a possible steel strike in the summer. With demands generally strong and unit labor costs rising, price increases continued to be large and widespread over the first half.

The strengthening of domestic demand for goods and services,

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together with rising prices of domestically produced goods, led to a sharp increase in imports in the first half of the year. Although exports also were rising more rapidly than they had during most of 1967, the surplus in U.S. international transactions in goods and services dropped markedly.

The surge in economic activity, the deterioration in the U.S. foreign trade position, and the continuing very large deficit in the Federal budget highlighted the need for measures of fiscal restraint. While such measures were being considered, monetary policy actions were taken to restrain credit expansion and to make credit more costly. Effective in mid-January, reserve requirements against demand deposits in excess of $5 million at all member banks were increased by ½ of a percentage point; this action had been announced in late December 1967. Monetary restraint was intensified in subsequent months by restrictive open market operations and two increases in the discount rate, and during the March–June period there was little growth in bank reserves.

In mid-March the Federal Reserve discount rate was raised from 4½ to 5 per cent to strengthen the international position of the dollar and to combat domestic inflationary pressures. Evidences of domestic overheating were widespread. At the same time there was a large-scale movement out of many national currencies into gold, based partly on fears of a change in U.S. gold policy. The Governors of central banks actively participating in the gold pool met in Washington on March 16 and 17 and reached agreement on a number of issues connected with the role of gold and with currency speculation. Pressures in the gold market subsequently abated.

The Federal Reserve discount rate was raised again, to 5½ per cent, in mid-April. This increase, together with more restrictive open market operations, led to a further rise in market interest rates. At the same time, Regulation Q ceiling rates on large-denomination time certificates of deposit were raised—from 5½ per cent to a scale ranging from 5½ to 6¼ per cent

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depending on maturity—so as to avert a sharp contraction in outstanding bank deposits and bank credit. With market interest rates near the new Regulation Q ceilings, time deposit growth slowed and bank credit expansion moderated in the second quarter. Outstanding large-denomination CD's declined somewhat during the quarter, and banks with foreign branches greatly increased their borrowings of Euro-dollars.

Meanwhile, net inflows of deposits to savings and loan associations and mutual savings banks continued at around the reduced pace that had come to prevail since the last quarter of 1967. These institutions became somewhat more cautious, however, in making commitments for mortgages because they did not know how large a volume of savings would be withdrawn at the midyear interest-crediting period.

Passage of fiscal restraint legislation led to market expectations of declining interest rates, predicated for the most part on anticipations of a slower economic growth and an easier monetary policy. Longer-term interest rates and Treasury bill rates declined during the first part of the summer. A large volume of reserves was provided during the summer through System open market operations, which were conducted with a view to accommodating tendencies for short-term interest rates to decline and for somewhat less firm money market conditions to develop in the wake of the fiscal restraint legislation. Federal Reserve discount rates were reduced from 5½ to 5¼ per cent in mid-August, primarily to move the rate into closer alignment with the reduced level of short-term rates.

The reduced level of market interest rates enabled banks to acquire more funds through an accelerated expansion of time and savings deposits, particularly large-denomination CD's. As a result, banks greatly expanded their investments in U.S. Government and State and local government securities, and the prime loan rate charged businesses was reduced in late September. Net inflows of funds to thrift institutions did not show a resurgence, but they were sustained at around their previous

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reduced rates; and with uncertainties removed, these institutions increased their mortgage commitment activity.

As the summer progressed, demands for goods and services in the economy turned out to be stronger than most observers had anticipated. Private credit demands were exceptionally large during the third quarter—reflecting in part a sharp rise in consumer spending on durable goods as well as increased outlays by State and local governments. Business credit demands were sustained by a renewed expansion in fixed investment and by inventory accumulation at a rate that was only somewhat lower than in the second quarter. However, fiscal restraint was beginning to take hold. The rate of increase in Federal spending dropped sharply in the third quarter and declined further in the fourth. And as the higher tax rates reduced the growth of disposable personal income, consumer spending showed only a minor further rise after the burst of buying of durable goods in the summer.

Nevertheless, there was no diminution of price pressures. And an inflationary psychology was becoming embedded in decision-making for key sectors of the economy. Most notably, businesses enlarged their plans to buy plant and equipment. In financial markets, long-term interest rates rose sharply in the last few months of the year to new highs, while stock prices also advanced markedly from around midsummer until the last few weeks of the year.

In an effort to resist inflationary pressures and psychology, monetary policy actions became more restraining. Reserves were provided less readily through open market operations in the autumn, a period when a continued tendency for bank credit to expand rapidly suggested that both credit demands and demands for goods and services were remaining relatively strong. In these circumstances member banks were forced to increase their borrowings from the Federal Reserve to obtain reserve funds, and the rates on Federal funds and 3-month Treasury bills rose from their lows of the late summer and early autumn.

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In mid-December the Federal Reserve discount rate was raised to 5½ per cent, and this action, in combination with firming through open market operations, led to further upward movements in interest rates.

As the year drew to a close, short-term market interest rates were above Regulation Q ceilings. Hence, banks were unable to roll over all of their maturing large-denomination CD's, and a sizable attrition of such outstanding deposits began to develop. The reduced supply and higher cost of funds to banks, including the high cost of Euro-dollar funds, led the banks to undertake adjustments that affected the terms and availability of credit to borrowers. In particular, banks raised the prime loan rate charged businesses by two stages in December to a level of 6¾ per cent; and they sharply reduced their acquisitions of U.S. Government and—late in the year—State and local government securities. Net inflows of funds to nonbank savings institutions increased at a slower rate toward the year-end—contributing, along with generally higher market interest rates, to a stiffening of borrowing costs and other terms in the mortgage market.

While monetary restraint was developing in the fourth quarter, the money stock rose at a somewhat faster rate than in the third. The difference in the rate of increase between the two quarters was influenced to a large extent by short-run net transfers of funds between private demand deposits and U.S. Government deposits. Over the second half as a whole, the money stock rose at an annual rate of just over 6 per cent, a somewhat slower rate of increase than in the first half of the year.

For the year as a whole the U.S. balance of payments showed an over-all surplus on either of the two usual methods of calculation, despite the virtual disappearance of the merchandise trade surplus. A massive net inflow of private capital took place through a number of channels. Foreigners supplied ample funds to the Euro-dollar deposit market, thus facilitating the borrowing there by U.S. banks. Foreign investors purchased an unprecedented volume of U.S. equity securities as well as of issues

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sold abroad by U.S. companies to comply with the requirements of the mandatory controls imposed at the beginning of the year. The Federal Reserve's foreign credit restraint program (discussed on pages 57–59), together with market conditions, produced a reversal of the previous year's net outflow of bank credit. And foreign monetary authorities made large purchases of U.S. Treasury nonmarketable securities.

The Federal Reserve, together with the U.S. Treasury, continued to participate actively during the year in the cooperative actions taken by monetary authorities of various countries to deal with speculation in the gold and foreign exchange markets.

The Federal Reserve's reciprocal currency arrangements with central banks of other countries were expanded further. The total swap network was enlarged from $7,080 million to $10,505 million. Substantial use was made of these swap facilities by central banks of other countries during the year. On December 31 outstanding swap drawings by the Bank of England and the Bank of France totaled about $1.6 billion. Federal Reserve commitments under outstanding swap drawings from continental European central banks, which had been about $1.8 billion at the end of 1967, were liquidated before the end of July; subsequently, the System drew again on its swap facilities with the Swiss and German central banks, and at the end of the year it had outstanding commitments of about $400 million. □

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Period or announcement date	*Action*	*Purpose*
January 1	Issued revised and substantially more restrictive guidelines for banks and other financial institutions for restraint of foreign credits as a part of the President's balance of payments program.	To strengthen the U.S. balance of payments by achieving a net inflow of at least $500 million during 1968.
January through late June	Directed that System open market operations be conducted with a view to maintaining firm conditions in the money market and, from time to time, attaining firmer conditions or facilitating adjustments to increases in Federal Reserve Bank discount rates, with provisions for modification of operations depending on the course of bank credit developments.	To foster financial conditions conducive to resistance of inflationary pressures and to attainment of reasonable equilibrium in the country's balance of payments.
March 11	Imposed a new margin requirement of 70 per cent on loans made by "other lenders" (i.e., other than banks, brokers, and dealers) for the purpose of purchasing or carrying registered equity securities. Imposed a new margin requirement of 50 per cent on such loans made by banks or "other lenders" against securities convertible into registered equity securities. Lowered the margin requirement on such loans by brokers and dealers to 50 per cent.	To broaden the coverage of, and in most respects to tighten, the Board's regulations governing the use of credit in stock market transactions.
March 13	Announced revisions in the guidelines for banks and nonbank financial institutions issued under the President's balance of payments program.	To implement an agreement reached between the Governments of Canada and the United States.

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DIGEST—Continued

Period or announcement date	*Action*	*Purpose*
March 14	Discount rates increased from 4½ to 5 per cent at 9 Reserve Banks, effective March 15. (By March 22, the 5 per cent rate was in effect at all Reserve Banks.)	To strengthen the international position of the dollar and to curb inflationary pressures in the domestic economy.
April 18	Discount rates increased from 5 to 5½ per cent at 3 Reserve Banks, effective April 19. (By April 26, the 5½ per cent rate was in effect at all Reserve Banks.)	To restrain intensifying inflationary pressures and to strengthen the position of the dollar at home and abroad.
	Maximum interest rates payable by member banks on single-maturity time deposits of $100,000 or more revised, effective April 19, 1968, from 5½ per cent on all maturities to: *Per cent* — *Maturity group* 5½ — 30-59 days 5¾ — 60-89 days 6 — 90-179 days 6¼ — 180 days and over	To avoid a sharp contraction in outstanding bank deposits and bank credit.
June 7	Increased the margin requirement on loans by banks, brokers and dealers, and other lenders for the purpose of purchasing or carrying registered equity securities from 70 to 80 per cent. Increased the margin requirement on such loans by these lenders against securities convertible into registered equity securities from 50 to 60 per cent.	To prevent excessive use of credit to finance transactions in securities.
Late June through early September	Directed that System open market operations be conducted with a view to accommodating tendencies for short-term interest rates to decline and for somewhat less firm money market conditions to develop in	To foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

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	connection with enactment of fiscal restraint legislation and to facilitating orderly adjustments to the reduction (in mid-August) in Federal Reserve Bank discount rates, with provisions for modification of operations depending on the course of bank credit developments.	
August 15	Discount rate reduced from 5½ to 5¼ per cent at one Reserve Bank, effective August 16. (By August 30, the 5¼ per cent rate was in effect at all Reserve Banks.)	To align the discount rate with the change in money market conditions that had occurred chiefly as a result of the enactment of the tax increase and the related expenditure constraints and the associated expectations of reduced Treasury demand for financing.
Early September to mid-December	Directed that System open market operations be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets, with provisions for modification of operations depending on the course of bank credit developments.	To foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.
After mid-December	Directed that System open market operations be conducted with a view to attaining firmer conditions in money and short-term credit markets while taking account of the effects of other possible monetary policy action, with provision for modification of operations depending on the course of bank credit developments.	To foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.
December 17	Discount rates increased from 5¼ to 5½ per cent at 9 Reserve Banks, effective December 18. (By December 20, the 5½ per cent rate was in effect at all Reserve Banks.)	To foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic expansion and attaining reasonable equilibrium in the country's balance of payments.
December 23	Announced revised guidelines for restraint of foreign credits by banks and other financial institutions.	To continue the President's program, announced on January 1, 1968, to strengthen the U.S. balance of payments.

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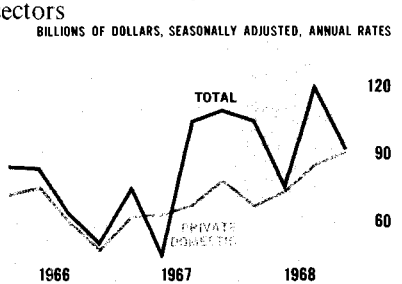
During 1968 the changing mix of fiscal and monetary policies—both as it developed and as it was expected to develop—gave rise to sharp variations in attitudes of credit market participants and to large swings in both the cost and the availability of lendable funds. Demands for credit remained generally strong, buoyed by a continued expansion of economic activity, which slowed only moderately after enactment of fiscal restraint measures at midyear. Demands for credit were larger, in fact, in the second half of the year than in the first—reflecting a third-quarter surge in consumer spending, increased activity in real estate markets, large offerings of State and local government securities, and sizable borrowing by the Federal Government to finance a larger-than-seasonal deficit.

Early in the year, with the Federal budget continuing to be expansive, with prospects for fiscal restraint in doubt, and with a progressive firming in monetary policy under way, market rates of interest rose. By spring, these higher rates had resulted in a moderation of inflows of funds to depositary institutions, particularly banks. Market rates began to decline, however, in response to the midyear shift in the fiscal-monetary policy mix. These declines made it possible for banks to more than recoup their earlier losses of CD funds and to increase sharply the share they advanced of total funds raised in credit markets.

As the second half of the year progressed, it became apparent that demand forces in the economy were stronger than most analysts had anticipated and that the restrictive impact of the fiscal legislation was going to be felt much more slowly than had been expected earlier. Monetary policy became more restrictive in the last few months of the year. Although the resulting constraint on reserve growth and the rise in market rates of interest began to slow deposit inflows to banks—and hence the increase in bank credit—it was not until the last few weeks of the year that the availability of funds to banks was sharply curtailed.

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1. Volume raised by nonfinancial sectors



2. Shares in funds supplied by selected institutions

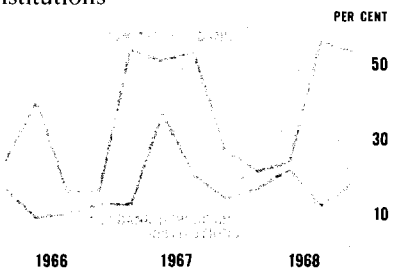


TABLE 1: BORROWING BY TYPE OF INSTRUMENT
In billions of dollars

Type of instrument	Calendar year 1967					Calendar year 1968				
	I	II	III	IV	Year	I	II	III	IV	Year
U.S. Govt. securities [1,2]	.5	−8.8	9.4	11.6	12.7	6.5	−2.7	8.4	4.7	16.9
State and local govt. issues [1]	4.1	3.8	3.1	3.6	14.6	3.7	3.8	4.6	4.3	16.5
Corporate securities [1]	5.4	6.1	6.6	6.1	24.1	5.0	5.5	5.0	5.4	21.0
Consumer instalment debt [3]	.6	.6	1.0	1.1	3.3	1.8	2.1	2.5	2.6	9.0
Mortgage debt [3]	3.9	5.1	6.6	7.1	22.7	6.8	6.5	6.4	7.3	27.1

[1] Quarterly and yearly totals, not seasonally adjusted.
[2] Total net issues, flow of funds data.
[3] Quarterly and yearly changes, seasonally adjusted.

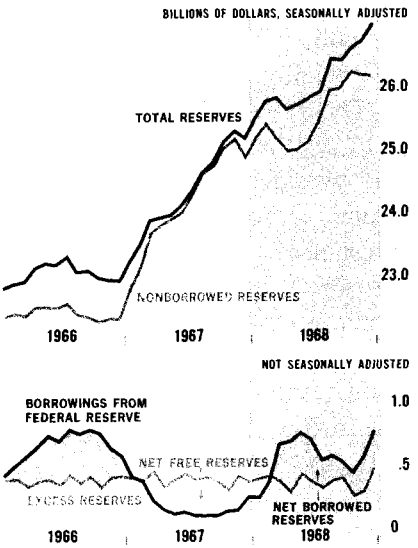
TABLE 2: BANK CREDIT
Seasonally adjusted changes, in billions of dollars

Component	Calendar year 1967 [1]					Calendar year 1968 [1]				
	I	II	III	IV	Year	I	II	III	IV	Year
Total loans and investments	11.0	4.7	12.9	7.4	36.0	6.0	5.3	17.0	9.7	38.0
Investments:										
U.S. Govt. securities	3.7	−1.4	5.5	−1.7	6.1	.2	.5	3.6	−2.3	2.0
Other securities	3.7	3.8	1.5	3.7	12.7	2.2	.3	3.1	3.5	9.1
Loans:										
Total	3.7	2.2	5.8	5.5	17.2	3.6	4.5	10.3	8.5	26.9
Business	2.3	1.9	1.5	2.0	7.7	1.5	1.8	2.3	2.8	8.4
Consumer	.2	.2	.7	.7	1.8	1.0	.8	1.5	1.6	4.9
Real estate	.7	.8	1.4	1.7	4.6	1.7	1.3	1.3	2.2	6.5
Securities	.4	−0.9	2.2	−0.4	1.3	−0.5	−0.5	3.8	−1.1	1.7

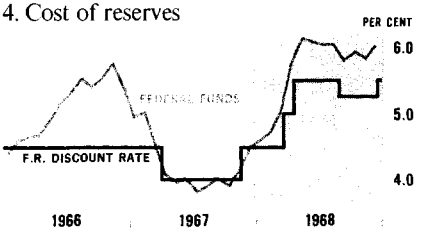
[1] Quarterly data are seasonally adjusted.
NOTE.—Figures for all commercial banks.

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3. Bank reserves and borrowings



4. Cost of reserves



5. Interest rates

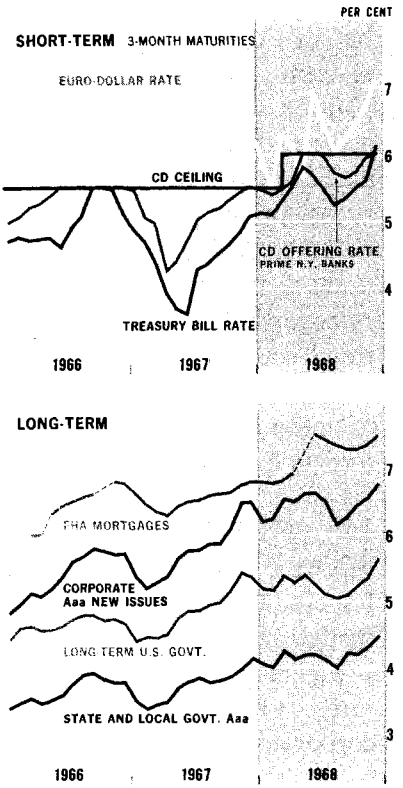


TABLE 3: DEPOSIT FLOWS

Annual rate of change, in per cent

Item	Calendar year 1967 [1]					Calendar year 1968 [1]				
	I	II	III	IV	Year	I	II	III	IV	Year
Total member bank deposits	15.4	8.7	13.7	7.2	11.7	7.0	1.2	13.1	12.4	8.6
Money stock	6.6	6.5	7.0	4.9	6.4	4.6	8.7	4.5	7.4	6.5
Time and savings deposits at banks	19.7	16.2	15.8	9.1	16.1	7.0	3.2	17.9	15.7	11.3
Savings accounts in nonbank thrift institutions	9.5	11.0	9.4	6.4	9.4	6.1	5.9	6.1	6.3	6.3

[1] Quarterly data are seasonally adjusted.

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FIRST HALF OF YEAR

Demands for credit were relatively large in the first half of 1968, but as Federal Reserve monetary policy moved further toward restraint, interest rates rose fairly steadily and bank credit expansion was curtailed by spring. The rise in interest rates was accentuated at times by doubts as to whether the Congress would enact restrictive fiscal legislation, by uncertainties concerning prospects for peace in Vietnam, and by developments in international gold and foreign exchange markets. As enactment of fiscal restraint began to seem more likely in late spring, interest rates tended to stabilize, and some even began to decline. This trend was also encouraged by developments with respect to the Vietnam conflict and by progress in resolving difficulties related to international liquidity and the difficulties in the gold and foreign exchange markets.

DEMANDS FOR CREDIT

With the rapid expansion in economic activity, private demands for credit were well sustained during the first half of 1968. A further increase in plant and equipment outlays early in the year —together with continued efforts to build liquidity and restructure outstanding debt—led to relatively heavy public offerings of corporate securities, although these offerings were somewhat below the exceptional 1967 pace. Business borrowing of a shorter-term nature, through bank loans and dealer-placed commercial paper, began to accelerate in the spring, probably in response to financing of increased tax payments as well as more rapid accumulation of inventories.

A sharp rise in disposable personal income in the early months of 1968—when there was a large upward adjustment in social security benefits and a substantial advance in the minimum wage —led to greatly expanded consumer expenditures. This increase in outlays was concentrated in durable goods and was financed in part by a sharp rise in consumer instalment debt. The expansion in mortgage debt outstanding continued at a pace approxi-

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mately as rapid as that reached in the latter half of 1967, when the impact of the late 1966 and early 1967 easing of monetary policy was reflected in a marked recovery in housing starts and construction outlays.

Borrowing in the capital markets by State and local governments also was large over the first half of the year—nearly equaling the record volume in the first half of 1967. Most of this borrowing was to cover continued heavy expenditures, although there was also a pronounced rise in issues of industrial revenue bonds—generated by fears that Federal tax exemption on these bonds would be removed.

Cash borrowing by the Federal Government continued to be sizable in the first quarter of 1968, when a further sharp rise in expenditures contributed to a sustained large budgetary deficit. Market doubts about the willingness of the Congress to enact fiscal restraint legislation that would reduce the huge deficit ($25 billion in the fiscal year 1968) contributed to upward pressures on interest rates. Federal demands in credit markets dropped sharply in the second quarter of 1968 when the Government drew down its cash balances contraseasonally as an alternative to borrowing to finance current outlays.

AVAILABILITY AND COST OF CREDIT

With increasing domestic and international pressures on the dollar and in the absence of fiscal action, the Federal Reserve had begun in late 1967 to implement a variety of measures designed to limit the availability and to increase the cost of credit. The discount rate was raised three times—from 4 per cent to 5½ per cent in steps of ½ percentage point—between November 1967 and April 1968. An increase of ½ percentage point in reserve requirements against demand deposits in excess of $5 million at member banks became effective around mid-January. Moreover, increasing pressure was placed upon member bank reserve positions through System open market operations.

As a result of these various policy actions, nonborrowed re-

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serves of member banks declined slightly over the second quarter of 1968, after having risen at an annual rate of 4.5 per cent in the first quarter. Although member bank borrowings at the Reserve Banks increased, total reserves showed virtually no change in the spring quarter, following a relatively rapid rise in the winter. On a monthly-average basis, member bank borrowings reached a peak of nearly $750 million in May, roughly three times the January average.

The progressive tightening in money market conditions early in the year was reflected in a rise in the Federal funds rate—the rate at which banks lend excess reserves on an overnight basis—to 6 per cent and above in late spring as the availability of reserves to banks was restrained relative to demand. Commercial paper rates also rose rapidly: two increases in prime lending rates at banks—in November 1967 and in April 1968—induced some borrowers to shift to open market paper for funds. By mid-May most short-term rates had surpassed the peak levels reached in 1966, and the market rate on 3-month Treasury bills reached a high of 5.92 per cent. In late May, however, prospects for fiscal restraint improved and most short-term market rates of interest declined, with market yields on Treasury bills dropping 40 to 60 basis points by midyear.

Long-term interest rates—while fluctuating widely in response to developments in the Vietnam conflict, the proposed fiscal package, and the gold crisis—also tended to move higher during the first half of the year. By mid-May most long-term rates had also surpassed their previous highs. However, these rates began to decline somewhat after enactment of the fiscal restraint program in late June.

Increased pressure on bank reserve positions, together with rising interest rates, led to reduced inflows of funds to the major types of financial institutions in the first half of 1968. As market yields became more attractive relative to those on time and sav-

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ings deposits of banks and nonbank savings institutions, flows of funds began to bypass these intermediaries; as a result these institutions accounted for a much smaller share of the total credit supplied than during most of 1967. In the first half of 1968 depositary institutions supplied about 40 per cent of net funds raised in credit markets; this was about half of their share in 1967, but still a somewhat larger share than in the second half of 1966.

Net inflows of time and savings deposits at commercial banks slowed considerably in late 1967 and early 1968 and had dropped further by the spring of 1968. The bulk of the reduction in time and savings deposit growth in the second quarter stemmed from attrition of large-denomination CD's as short-term market rates surpassed the Regulation Q ceiling rates on such deposits.

In the early part of the year banks had been able to maintain their outstanding CD's, on balance, at the peak levels prevailing in late 1967 by keeping offering rates on these instruments at or near the Regulation Q ceiling. By late March, however, short-term interest rates on other money market instruments had risen enough that even the maximum CD offering rate of 5½ per cent then in effect for all maturities was relatively unattractive to large, interest-sensitive investors. In the first 3 weeks of April outstanding CD's at large commercial banks declined by more than $1.0 billion.

The Federal Reserve revised Regulation Q ceilings on CD's in mid-April. The ceiling rate on 30- to 59-day maturities was left at 5½ per cent, but rates for other maturities were raised as follows: to 5¾ per cent on 60 to 89 days, to 6 per cent on 90 to 179 days, and to 6¼ per cent on 180 days or more. Nevertheless, outstanding CD's continued to decline through mid-June, although much less rapidly than earlier. In an effort to offset this run-off of CD funds, major banks borrowed heavily in the Euro-dollar market, and liabilities of head offices to foreign branches increased about $1.5 billion between April

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and June. By the latter part of June short-term market rates of interest had declined enough to enable banks to attract CD funds again.

While consumer-type time and savings deposit inflows at commercial banks also were sustained comparatively well in the early months of the year, there was a marked slowing in growth following a large outflow of passbook savings deposits after the interest-crediting period at the end of March. Net savings inflows at nonbank thrift institutions—after slowing in late 1967—moderated only slightly further through mid-1968.

The increase in interest rates during the first half of 1968 also made it much more expensive to hold demand deposits, and in spite of an increased need for transactions balances associated with the accelerated rate of economic activity, growth in the money stock—private demand deposits plus currency outside banks—over the first quarter slowed to an annual rate of about 4.5 per cent from the 6.0 per cent pace in the last half of 1967. Although interest rates rose further in the second quarter, growth in the money stock accelerated to an annual rate of about 8.5 per cent. However, much of this increase reflected net transfers out of U.S. Government deposits. Moreover, the sharply increased pace of financial activity during the second quarter probably also contributed to the increase in holdings of money.

In view of reduced deposit inflows and heavy demands for credit, banks backed away from security investments and began to draw down liquidity positions, which they had rebuilt in 1967. After having acquired large amounts of U.S. Government securities during most of 1967, major reporting banks liquidated holdings of Treasury bills almost continuously from late in that year to mid-1968, although they did add to holdings of coupon issues during Treasury financings. Banks also found it necessary to cut back on their acquisitions of other securities, principally State and local government issues.

Pressures on security markets from bank portfolio adjust-

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ments were strongest after about mid-March when tight monetary policy and sustained attrition of CD's coincided with an accelerated demand for business loans. Consumer loan demands at banks were relatively strong throughout the first half of 1968, reflecting the broad expansion in consumer expenditures. The net increase in real estate loans at banks continued near the relatively advanced pace of the second half of 1967.

Despite reduced net inflows of funds, savings and loan associations were able to extend mortgage credit in the first half of 1968 at a rate only slightly less than that in the second half of 1967. In 1967 these institutions had used a substantial portion of new savings flows to rebuild liquid assets and to repay borrowing from the Federal Home Loan Bank Board. As in 1967, mutual savings banks devoted a somewhat larger share of their funds to the acquisition of corporate securities in the first half of 1968 than they had in other recent years, apparently to take advantage of the relatively attractive yields available on these securities.

SECOND HALF OF YEAR

In the second half of 1968 financial markets were influenced by several factors: a sharp shift in market attitudes early in the summer, brought on by enactment of the fiscal restraint program; continued and unexpectedly strong credit demands; a reversal of market expectations later in the year, when inflationary psychology became predominant as business activity remained relatively strong; and variation in Federal Reserve policy from accommodation of market ease to increased monetary restraint.

The Revenue and Expenditure Control Act of 1968, enacted in late June, provided for a 10 per cent surtax on personal and corporate incomes and for certain restraints on Federal spend-

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ing. In the early summer participants in the securities markets generally anticipated that interest rates would decline as a result of the fiscal package, which was expected to moderate economic activity and to reduce reliance on monetary policy, as well as shift the Federal budget position from a large deficit to a modest surplus.

Reflecting these expectations, interest rates did decline as dealers in U.S. Government securities and other debt instruments bid aggressively for securities and increased sharply their inventories of Treasury bills and coupon issues. Positions of U.S. Government securities dealers alone nearly doubled from late June to early August—reaching a level of $6.1 billion during the first week in August. Moreover, commercial banks became large net buyers of both U.S. Government and State and local government securities at the attractive yields still available. Banks financed their purchases in large part through issuance of large-denomination CD's, which became competitive again as short-term market rates of interest declined.

The market yield on 3-month Treasury bills reached a low of 4.89 per cent in early August, about 100 basis points below the mid-May high. Over the same period long-term interest rates declined by 30 to 50 basis points from their earlier highs. In line with the declines in market rates resulting from the change in fiscal stance, Federal Reserve discount rates were reduced from 5½ to 5¼ per cent in mid-August.

By the fourth quarter of 1968, however, market attitudes had changed noticeably, and interest rates rose steadily during the quarter—reaching new highs in most cases. The continuing relatively strong business news and upward price pressures created doubts about the extent to which fiscal restraint was taking hold and led many to expect that monetary authorities would adopt a policy of greater restraint. As price pressures persisted, inflationary expectations became more widespread and were affecting business decisions. For example, plant and equipment surveys revealed that businesses had increased the volume of fixed

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investment outlays planned for the future. In financial markets prices of common stocks rose sharply, partly in response to a shift in investor interest from bonds to stocks. And Government securities dealers acted to reduce their holdings of both short- and long-term Treasury issues, thereby contributing to upward pressure on interest rates.

The initial decline and the subsequent sharp rise in interest rates during the second half of 1968, of course, were not wholly the product of changing expectations. The System increased the rate at which it supplied bank reserves through open market operations in the third quarter but in the autumn it sharply curtailed the supply of these reserves.

In the months immediately following passage of the fiscal restraint measures, required reserves of member banks rose sharply in response to increased deposit inflows. The Federal Reserve supplied these reserves through open market operations. During the third quarter nonborrowed reserves of member banks rose at an annual rate of about 13 per cent. Total reserves, however, rose by less, as banks reduced their borrowings at the Federal Reserve Banks.

This expansion in reserves was accompanied by only a slight reduction in the Federal funds rate, since demands for very short-term funds were large. These demands stemmed in part from the build-up in dealer inventories of U.S. Government securities that resulted both from anticipation of interest-rate declines and from dealer underwriting of the large Treasury bill and coupon financings in July and August, which raised $5.7 billion of new cash. Banks too bought large amounts of the new Treasury issues, and major money market banks financed their acquisitions not only through issuance of CD's but also through short-term funds raised in the Federal funds and Euro-dollar markets.

After the initial favorable impact of the fiscal restraint pack-

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age on market expectations waned, demands for very short-term credit and for bank reserves were reduced as dealers pared their inventories of securities and as banks became less willing buyers of U.S. Government issues. At the same time, however, the Federal Reserve made reserve funds less readily available to the banking system, thereby exerting additional upward pressure on the Federal funds rate and on Treasury bill rates.

Nonborrowed reserves of banks increased at an annual rate of only 3 per cent in the fourth quarter as a whole and actually declined during the last 2 months of the year. With open market operations providing fewer reserves, banks increased their borrowing at the Federal Reserve Banks. They were willing to pay higher interest rates for Euro-dollar funds abroad, although outstanding Euro-dollar borrowings showed little net change over the fourth quarter.

In furtherance of its policy of monetary restraint, the Federal Reserve raised the discount rate from 5¼ to 5½ per cent in mid-December. Later in the month the market rate on 3-month Treasury bills reached a peak of 6.29 per cent, an increase of about 130 basis points in a little more than 4 months. Yields on new high-grade corporate issues (with 5-year call protection) had risen to 6.92 per cent, and those on long-term U.S. Government securities to 5.90 per cent, representing increases of 80 and 100 basis points, respectively, from their August lows.

During the third quarter of 1968 both the amount of funds raised by all borrowers and the amount raised by the private sector rose sharply to levels well in excess of previous records. All sectors combined raised about one-third more funds than they had on the average during the first two quarters of the year. While cash borrowing by the Federal Government increased substantially, State and local governments, businesses, and consumers together accounted for more than half the rise. Private borrowing was relatively well maintained into the fourth quar-

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ter, but the net amount of Treasury cash borrowing declined. After having built up its balance in the third quarter through large new security issues, the Federal Government reduced its cash balance to help finance its relatively large fourth-quarter budgetary deficit.

Consumers increased their borrowing during the summer as they expanded their outlays further, particularly for durable goods. They financed their increased expenditures not only by borrowing more but also by reducing their saving rate sharply.

The volume of corporate borrowing in the bond market after midyear remained at about the first-half rate as plant and equipment expenditures—after declining in the second quarter—rose at a pace nearly as fast as in the first quarter. Short-term borrowing by businesses actually accelerated in the second half, particularly in the last few months of the year when inventory accumulation increased. Demand for mortgage credit also remained large, on balance, as the backlog of housing demand led to a sharp advance in construction activity toward the end of the year. And credit demands by State and local governments reached new highs, reflecting in part the rush to issue industrial revenue bonds before the year-end, when under the terms of legislation enacted at midyear the Federal tax exemption on such bonds of over $5 million would terminate.

BANK DEPOSITS AND CREDIT

Although short-term market rates of interest had begun to fall after mid-May, it was not until the end of June that they had declined enough relative to the maximum rate of interest that banks could pay on time and savings deposits to permit a significant net expansion of such deposits. In the third quarter banks added nearly $3.0 billion to their outstanding CD's, or about $1.0 billion more than they had lost earlier. Inflows of consumer-type time and savings deposits also began to show a rather steady increase from the somewhat reduced pace of the second quarter.

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With market rates of interest rising during the autumn, growth in total time and savings deposits at banks moderated, and toward the year-end expansion became quite limited. From the end of September through the first week of December banks were able to add $2 billion to their outstanding CD's—bringing the total increase since midyear to more than $5.0 billion. But by the latter part of December most short-term market rates were again above the Regulation Q ceilings applicable to large-denomination CD's. Outstanding CD's declined considerably more than seasonally during the last 3 weeks of the year.

Meanwhile, inflows of consumer-type time and savings deposits in the fourth quarter were well sustained, in part because some depositors were reluctant to withdraw funds before the year-end interest-crediting period. Stepped-up promotional campaigns and the expansion of the types of time deposit accounts offered by banks also helped to maintain these inflows.

Growth in private demand deposits at banks in the third quarter was reduced sharply from the second-quarter rate, but then spurted in the last 2 months of the year. The third-quarter growth in these deposits was restrained in part by net transfers of funds to U.S. Government deposits. In addition, an abatement in financial activity probably reduced needs for transactions balances. Toward the year-end, reductions in U.S. Government deposits to finance the budgetary deficit, resurgent stock market activity, and possibly expectations of rising interest rates contributed to the expansion in private cash balances. Over the second half as a whole the money stock rose at an annual rate of about 6 per cent, somewhat slower than in the first half.

With their total deposits—time and demand together—rising sharply after midyear, commercial banks were able to accommodate a much greater share of the growing demands for credit. They advanced about half of the total funds raised in markets during that period, compared with slightly more than 20 per cent in the first half.

Banks used a substantial portion of their deposit inflows to

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acquire securities, in part to rebuild their holdings of liquid assets—which had been depleted earlier in the year—and also to take advantage of the relatively high yields on intermediate- and long-term State and local government and Federal Government issues in a period when interest rates were expected to decline further. In July and August alone banks added $3.5 billion to their holdings of U.S. Government securities, mainly during the Treasury financings. Moreover, banks accelerated their net acquisitions of other securities markedly after midyear. Increases in holdings of securities accounted for about 40 per cent of total bank credit expansion during the third quarter.

In the fourth quarter, with deposit inflows slowing, banks were less active in the securities markets. They reduced their holdings of U.S. Government securities, on balance, in part to help finance continued large loan demands. And by December banks had sharply reduced the rate at which they took State and local government securities into portfolio.

Growth in bank loans accelerated sharply after midyear. But more than a third of the increase in the third quarter was in security loans, reflecting the build-up in dealer inventories. The reversal of market expectations in the autumn led to a reduction in dealer inventories and in outstanding security loans in the last few months of the year.

Business, consumer, and real estate loans at banks all rose more in the second half of the year than in the first half. Business borrowing increased as a result of both accelerated tax payments and a continued high level of economic activity—including the resumption of large expenditures on plant and equipment after midyear and a substantial pick-up in the rate of inventory accumulation in the fourth quarter. By industry category, the rise in business loans was much the largest in retail trade; nevertheless, public utilities, construction, and service industries also increased their borrowing substantially at banks. With sizable demands for loans and with available funds becoming more limited and more costly, banks raised the prime

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loan rate in three stages from 6¼ per cent (to which it has been reduced by most banks in September) to 7 per cent by shortly after the year-end.

FLOWS TO OTHER DEPOSITARY INSTITUTIONS

The sharp increase in flows of deposits to banks during the second half of 1968 was not matched at savings and loan associations and mutual savings banks. Because the savings that currently flow into these institutions are less interest-sensitive than those that flow into large-denomination CD's, which are an important element in banks' time deposits, the nonbank thrift institutions had not been so adversely affected as banks by the rise in market interest rates in the second quarter. Similarly, they were not so favorably affected by the decline in interest rates during the summer. Over the second half of 1968 as a whole, deposits at nonbank thrift institutions increased at an annual rate of a little more than 6 per cent, only a little faster than in the second quarter.

Savings and loan associations extended mortgage credit in the latter half of 1968 at a somewhat faster pace than they had earlier in the year. They also increased the rate at which they made new mortgage commitments, which had been held back in the spring in anticipation, prior to the tax increase, of a substantial withdrawal of deposits around the midyear interest-crediting period. Mutual savings banks also increased their mortgage lending in the second half; some of this lending was financed by cutbacks in acquisitions of corporate securities. □

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Demands, Resource Use, and Prices

1968 marked the eighth consecutive year of expansion in output, employment, and incomes from the cyclical low in early 1961. Real GNP increased by 5 per cent, double the rise of 1967. The 1968 rate had been exceeded in four of the seven preceding years, but this had occurred in periods when the margin of unutilized manpower resources had been larger. By late 1968 the unemployment rate had declined to 3.3 per cent, its lowest level in 15 years. Although the capacity utilization rate in manufacturing did not quite match the reduced level of 1967, prices throughout the year were under severe upward pressure. According to the GNP deflator, prices advanced almost 4 per cent, the largest increase in more than a decade.

Unit labor costs again rose considerably—by about 4 per cent. Even though the rise in output per man-hour was larger than in 1967, it did not equal the exceptionally rapid increases in average wage rates, which reflected—among other influences—strong demands for labor, a large statutory increase in minimum wages, and marked advances in consumer prices.

The surplus on U.S. net exports of goods and services in 1968 was less than half that of 1967. The sharp decline was attributable to the virtual disappearance of the surplus on merchandise trade, which amounted to only $100 million as compared with $3.5 billion in 1967. Imports continued the rise that had begun in the final quarter of 1967, and for the year as a whole they increased by 23 per cent. Exports too made gains during the year, but the gains were not nearly enough to offset the surge in imports.

In view of the continued rapid growth in economic activity and employment and the persistent rise in prices during the first half of the year, fiscal measures to dampen the inflationary expansion were enacted in late June to give support and aid to monetary and credit policies. As a result, during the second half the Federal Government's fiscal position moved from large deficit

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to balance, and the rate of growth in both current-dollar and real GNP moderated.

Nevertheless, there was an unexpectedly long lag between enactment of the fiscal restraint program and dampening of inflationary expansion. The underlying strength of demand was even stronger than had been anticipated. Futhermore, inflationary expectations became still more widespread and were an influential element in decisions with respect to capital spending programs, wage negotiations, and pricing policies. At the year-end businesses were expanding their expenditures for fixed capital and inventories at rapid rates and were planning to expand fixed investment outlays considerably further in 1969.

DEMANDS

An unusual feature of the pattern of demands during 1968 was that final sales and inventory investment alternated as major sources of short-run expansion in GNP. As Table 4 shows, final sales surged in the first and third quarters; in the second and fourth quarters these sales slowed, but the rate of inventory accumulation increased and tended to take up the slack. But over-all growth in GNP in both current and constant prices was significantly faster in the first half than in the second.

The rapid rise in activity in 1968 had its roots in events during the preceding year. Thus, in the second half of 1967, after virtually no growth in the first half, real GNP was increasing again, at an annual rate of 3.8 per cent, and price increases were widespread and substantial. Expansion accelerated in the first quarter of 1968 as consumer spending climbed at a record rate. For the most part this upsurge was in response to an exceptionally large gain in consumer income as increases in the statutory minimum wage and in social security benefits augmented a substantial rise in income from much higher employment and higher wage rates. Furthermore, the rate of personal saving—which had been very high in 1967, especially near the year-end—declined somewhat.

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TABLE 4: GROSS NATIONAL PRODUCT

Item	1967	1968	1968[1]			
			I	II	III	IV
	In billions of dollars					
Total	789.7	860.6	831.2	852.9	871.0	887.4
Inventory change	6.1	7.7	2.1	10.8	7.5	10.6
Final sales	*783.6*	*852.9*	*829.1*	*842.1*	*863.5*	*876.8*
Private[1]	693.0	752.9	732.0	742.0	762.3	775.0
Federal	90.6	100.0	97.1	100.0	101.2	101.7
	Change from preceding period: In billions of dollars					
Total	42.1	70.9	20.2	21.7	18.1	16.4
Inventory change	−8.6	1.6	−6.2	8.7	−3.3	3.1
Final sales	*50.8*	*69.3*	*26.4*	*13.0*	*21.4*	*13.3*
Private[2]	37.6	59.9	22.8	10.1	20.2	12.7
Federal	13.2	9.4	3.6	2.9	1.2	.5
	In per cent					
GNP in current dollars	5.6	9.0	10.0	10.4	8.5	7.5
GNP in 1958 dollars	2.4	5.0	6.4	6.2	5.1	3.4
GNP implicit deflator (1958 = 100)	3.1	3.8	3.7	4.0	3.6	3.9

[1] Quarterly figures are at seasonally adjusted annual rates.
[2] Adjusted to include State and local governments.
Note.—Basic data from Dept. of Commerce.

In the first quarter of 1968 demand for automobiles benefited from a spillover from the fourth quarter of 1967, when a prolonged strike at a major producer had greatly limited the availability of new cars. In addition, outlays for residential construction showed a sizable expansion, stemming from an earlier upward trend in housing starts, and business expenditures for fixed capital continued to grow. Finally, there was a further large rise in Federal purchases, particularly for defense. Even though inventory investment was much less than in the preceding quarter, real GNP and the industrial production index rose at annual rates of about 6.5 and 6.0 per cent, respectively. The labor market tightened further, and increases in wage rates averaged

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6 to 7 per cent annually; this was somewhat more than in 1967 and appreciably faster than growth in productivity. As a result, unit labor costs rose considerably further, and with demands brisk, strong upward pressures on prices continued.

In the second quarter consumer spending rose only half as much as it had in the first, and business outlays for fixed capital declined. While defense spending continued to rise strongly, the increase in total final sales was only about half that for the first quarter; indeed, after adjustment for price increases private final sales were unchanged. However, inventory accumulation expanded considerably, and the rise in real GNP almost matched the first-quarter growth. The index of industrial production also continued to climb, and the rise in the GNP price deflator accelerated.

The Revenue and Expenditure Control Act of 1968 imposed a 10 per cent surcharge on corporate income taxes and on most individual income taxes. For corporations the surcharge was made retroactive to January 1; and for individuals, to April 1. For persons or families with small taxable incomes, however, the surcharge was less than 10 per cent, and for those in the lowest brackets there was no surcharge. Withholdings on personal income were raised enough in July to cover most of the increase in current liabilities, but the increase in withholdings did not cover the increased liability for the April–June period. The Act also imposed limitations on expansion of Federal spending in the fiscal year 1969.

Partly in view of the sharp slowing of expansion in final sales in the second quarter, expectations were widespread that fiscal restraint would cause an almost immediate and substantial dampening of the expansion in real growth and that as a result the rapid advance in prices would taper off. As it turned out, the third-quarter rise in Federal purchases was the smallest in 3 years, despite a general pay raise in July for Federal civilian employees and members of the Armed Forces. Defense outlays changed little, as expenditures connected with the war in

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Vietnam began to level off. And with the tax surcharge going into effect on withholdings about July 15, the third-quarter rise in personal disposable income was less than half the average for the first half of the year.

But the widespread expectations that the rise in output would slow markedly failed to materialize in the short run, mainly because consumers increased their spending by reducing sharply their rate of current saving. Moreover, record sales of new automobiles—stimulated in part by forthcoming price advances on the 1969 models to be introduced in late September—were facilitated by a rapid expansion of instalment credit.

In addition to the unexpected surge in consumer spending, housing starts in the third quarter increased to the highest rate since early 1964. This rise reflected in part the release of mortgage funds that had been held back pending the successful outcome of efforts to raise permissible ceilings on mortgage interest rates in several States. But it also indicated the strength of the backlog of demand for new homes and the belief in many quarters that effective fiscal restraint would permit substantial easing in credit availability. Business spending for plant and equipment rebounded from its dip in the second quarter, but as indicated above, inventory accumulation was less than in the second quarter.

Thus, although the Federal deficit declined from an annual rate of more than $10 billion in the second quarter to $3 billion in the third (as measured in the national income accounts), expansion in real GNP was at an annual rate of 5 per cent, only moderately below that of the first half. While the quarterly GNP price deflator slowed from its rate of advance in the first half, the monthly consumer price index increased a little faster than it had earlier because of a sharp jump in mortgage interest rates, and inflationary expectations became widespread.

In the fourth quarter growth of real GNP slowed to an annual rate of 3.4 per cent, with total final sales much less expansive

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than in the third quarter. Consumer expenditures showed one of the smallest increases in recent years in dollar terms, and in real terms they were unchanged. Auto sales declined somewhat from the very high third-quarter rate, and sales of nondurable goods rose little. Federal spending for goods and services increased by only a small amount. Nevertheless, there were still many indications of exuberance: businesses, in particular, appeared to be preparing for a prolonged period of expansion and were raising sharply their current and prospective outlays for fixed capital. Housing starts edged up further, and expenditures for residential construction—which had changed relatively little in the first three quarters—rose considerably. Inventory accumulation increased, and industrial production advanced at an annual rate of 5 per cent. And prices, as measured by the GNP deflator, rose as fast as they had in the first half of the year.

CONSUMER EXPENDITURES AND INCOME

Strong surges in consumer spending in the first and third quarters alternated with much smaller increases in the second and fourth quarters—particularly the fourth. To some extent this pattern reflected variations in the growth of personal disposable income, but it also stemmed from large swings in the saving rate. For the four quarters, the personal saving rate was successively 7.1, 7.5, 6.3, and 6.8 per cent. The big decline in the third quarter made possible roughly $7 billion of additional consumer spending. The high rate of saving for the year as a whole—6.9 per cent—had been exceeded to a significant degree only once in the preceding 15 years—in 1967, when the annual average had been 7.4 per cent.

The recent high rates of saving may reflect to some extent the higher levels of real as well as money income in the past few years. Per capita disposable income measured in constant dollars increased 3.0 per cent in 1968 and was 29 per cent above its level in 1961—the year when the last recession reached its trough. High rates of saving in recent years have been accom-

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panied by a bulge in additions to consumer holdings of financial assets; this was particularly true in 1967 and 1968. However, after 2 years of diminished growth, consumer instalment and mortgage debt rose sharply in 1968 as automobile purchases (including imports) expanded to a record 9.6 million units and home purchases increased considerably.

In 1968 wage and salary income, transfer payments, and interest income all expanded strongly, whereas rents, proprietors' income, and dividends—continuing the pattern of changes in other recent years—showed less rapid increases. Wages and salaries accounted for 67.6 per cent of total personal income in 1968, compared with an average of 67.0 per cent in the period 1960 through 1966, a large shift for this component. Disposable personal income was 69.0 per cent of GNP in the first half of 1968, about the same as the 1960–66 average proportion, but then it declined to 68.0 per cent in the second half, when the surtax became effective.

High levels of real income, large reserves of assets, and relatively favorable consumer debt positions have been suggested as reasons for the limited impact of the increase in the surtax on consumer spending in the third quarter. An additional factor may have been the greater impact of the tax on high-income groups than on lower-middle-income and low-income groups. While it is usual for changes in income to be followed by gradual adjustments in expenditures, the big bulge in consumer spending in the third quarter in the face of a "halving" of the growth in disposable income was unusual.

More than two-fifths of the increase of 8.5 per cent in total consumer expenditures from the year 1967 to the year 1968 represented increases in prices, but the growth of almost 5 per cent in the physical volume of takings was substantial. Prices of services rose considerably more than did those of goods—reflecting in part the relatively larger wage component of services. Prices of nondurable goods went up more than prices of durable goods.

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RESIDENTIAL CONSTRUCTION

Private housing starts exceeded 1.5 million units in 1968, one-sixth more than in 1967 and the largest number since 1964. Starts of both single-family and multifamily units increased, but the latter rose more in both absolute and percentage terms and for the year accounted for 40 per cent of all starts, a new high. The increase of over one-fifth in expenditures for residential construction reflected higher costs per unit as well as, with some lag, the higher level of starts. The market for new homes and apartments remained strong throughout the year, despite higher costs and the highest mortgage interest rates since the 1920's. Vacancy rates continued to decline, reaching the lowest levels in more than 10 years.

In the first quarter of 1968 housing starts were at an annual rate of 1.5 million, but they declined somewhat in the second quarter—reflecting tight money conditions and the fact that a number of States still had relatively low usury ceilings, which tended to curtail the flow of mortgage funds. By the middle of the year ceilings had been lifted in some heavily populated States in the Northeast, and a surge in housing starts followed. In the third quarter, even though mortgage market conditions improved only moderately, starts recovered to a 1.5-million annual rate, and in the fourth quarter they rose to an even higher rate—1.6 million. In December the volume of outstanding mortgage commitments was still very large, but conditions in the mortgage market were tending to moderate the expansion in new commitment activity.

INVESTMENT IN FIXED CAPITAL

Business investment in fixed capital increased by about 8 per cent in 1968. This increase compares with only 3 per cent in 1967 but was far short of the average annual rise of one-sixth in the 1964–66 period. About half of the 1968 increase represented higher prices of structures and of producers' durable

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equipment. Indeed, increased costs apparently accounted for all of the current-dollar increase in outlays for structures.

The sharp fourth-quarter rise in spending for fixed capital reflected to some extent a make-up for the failure of businesses to realize plans in the first three quarters as indicated by successive shortfalls in actual from planned spending shown in Commerce–Securities and Exchange Commission surveys. Nonetheless, the strength of plant and equipment outlays in the fourth quarter may have also reflected an increase in expansion plans, in part in response to widespread inflationary expectations.

The intentions expressed by businesses in late 1968 to increase spending for plant and equipment were somewhat surprising in view of the substantial volume of unused capacity in manufacturing but not so surprising in view of the further rise of 6 per cent in 1968 in corporate profits after tax, including the surcharge. This rise, inflationary expectations, the rapid pace of technological changes, frequent shifts in styles and models, and the continuing strong pressures to reduce costs—all served to stimulate plans for new plant and equipment spending. Although industrial output rose more than 4 per cent in 1968 and has risen 15 per cent since 1965, additions to capacity have more than kept pace with the increase in output. The capacity utilization rate in manufacturing had fallen from more than 90 per cent in 1966 to 85 per cent in 1967, and it remained close to that level in 1968.

Following the pronounced inventory adjustment during the first half of 1967, which brought the annual rate of accumulation down from $20 billion in the fourth quarter of 1966 to $2 billion in the second quarter of 1967, inventory investment picked up after mid-1967. When consumer expenditures showed an unexpectedly strong spurt in early 1968, there was a sharp drop in the rate of accumulation. Subsequently, the rate moved up and

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for the remainder of the year averaged well above the 1967 rate. In view of the large increase in final sales, however, inventory accumulation in 1968 was relatively moderate—about $7.5 billion (GNP basis), compared with $6.1 billion in 1967 and the exceptionally high rate of nearly $15 billion in 1966.

In late 1967 and the first half of 1968 business inventory accumulation was augmented by substantial additions to steel stocks in anticipation of a possible strike on July 31. In the second quarter of 1968 there was also a large build-up in auto stocks. The reduction in steel output after the wage settlement proved to be less than expected as demands from both consumer-goods and producer-durable-goods industries became more vigorous. Even with auto sales at new record levels during most of the second half, there was a sizable further increase in auto stocks, and at the year-end such stocks were relatively high.

Stock/sales ratios for durable goods remained high in 1968. At manufacturers, inventories did not appear to be excessive in view of the level of unfilled orders. The stock/sales ratio at durable goods retailers, which in 1967 had not fully readjusted to levels existing before the Vietnam war, was rising again in late 1968. The ratio for nondurable goods, which had been reduced to record low levels in the third quarter of 1968, also moved up somewhat late in the year.

FEDERAL SECTOR, NATIONAL INCOME ACCOUNTS

The Federal deficit fell to an annual rate of about $9.5 billion in the first half of the calendar year 1968 from about $12.5 billion in the second half of 1967. Receipts rose briskly early in the year, in part because of rising profits and incomes but also because of the retroactive liabilities under the 10 per cent corporate surcharge. Moreover, an increase in the taxable wage ceiling effective January 1 led to higher contributions for social insurance. On the other hand social security benefits were increased in the first quarter, and Federal expenditures, particularly for defense, rose rapidly in the first half of the year.

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In the third quarter the deficit fell sharply as withholdings of individual income taxes were increased to reflect the 10 per cent surtax. Another factor tending to reduce the deficit was the cutback in Federal expenditures in the fiscal year 1969 from the rate of outlays proposed in the January 1968 budget as required by the Revenue and Expenditure Control Act of 1968. Since expenditures for the war in Vietnam were exempted from the cutback—as were some other relatively uncontrollable categories such as interest on the debt and social security benefits—the realized net decline from the aggregate expenditure figures as proposed in January is likely to be considerably smaller.

As a result of the tax surcharge and the constraints on Federal spending, the deficit of the Federal Government as estimated in the NIA fell from about $12.5 billion in the calendar year 1967 to an annual rate of $9.5 billion in the first half of 1968 and of less than $3 billion in the third quarter. And in the fourth quarter the NIA budget was in balance. For the calendar year as a whole, the deficit was a little over $5 billion.

LABOR MARKETS

Reflecting strong demands in most sectors of the economy, the labor market continued to tighten in 1968. Expansion in employment was most pronounced early in the year and again in the fourth quarter. Employment rose more rapidly than the labor force, and the unemployment rate dipped to 15-year lows—3.3 per cent at the year-end, and 3.6 per cent for the year as a whole. Nonfarm payroll employment rose by 2.1 million persons—slightly more than in 1967—with more than four-fifths of the expansion occurring in nonmanufacturing activities. Employment increases in trade, in services and finance, and in State and local government each exceeded 500,000 in 1968. Manufacturing employment increased by 300,000. Farm employment, including both farm operators and family and hired labor, declined further.

The civilian labor force increased by 1.4 million in 1968—

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about the expected "normal" rise as estimated from population growth in working-age brackets and trends in participation rates. The increase included 800,000 adult women, 500,000 adult men, and 100,000 teenagers.

In manufacturing, employment was essentially unchanged between June and October. During the latter part of this period, employment gains in several industry groups were offset by declines in steel—where inventories had been built up to record levels in anticipation of a late-summer strike, which did not materialize. With the inventory adjustment in steel well along in late 1968, manufacturing employment was again on an upswing, having spurted by more than 160,000 between October and December. Indications of renewed strength were widespread among both durable and nondurable goods industries, but they tended to be more definite in industries manufacturing producers' durable goods, in line with the step-up in business fixed investment programs.

The average work-week in manufacturing in 1968 was little changed from the preceding year, but it edged lower from September to December as employers in most industries reduced hours of work and increased the number of their employees.

Responding to a turnaround in building activity, employment in construction rose more than 50,000 in 1968, and the unemployment rate fell to 6.9 per cent, the lowest rate since the Korean war. A strong thrust in the final quarter raised construction employment to about the 1966 peak.

Developments in the manufacturing and construction industries were especially influential on the demand for men employees; the jobless rate for married men fell to an average of 1.6 per cent for the year, and at the year-end it was at a post-World-War-II low of 1.4 per cent. The rate for all adult men averaged 2.2 per cent for the year as a whole and was down to virtually a frictional rate of 1.8 per cent at the year-end. In 1968 the adult male labor force registered its second successive large increase, after a decade of much slower growth. These additional men

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contributed substantially to the fulfillment of increased manpower needs and helped to limit labor shortages during the year. Relatively large increases in the adult male civilian labor force will be common in coming years because of high post-World-War-II birth rates.

The bulk of the gain in nonfarm employment was concentrated in the service sector. Close to four-fifths of the total employment increase was accounted for by trade, finance, services, and State and local government. Since women account for a large part of employment in these activities, demands for their services continued firm, and their unemployment rate edged down to 3.8 per cent.

The Federal Government contributed little to the rise in employment in 1968, and after midyear Federal employment began to decline because of limitations on hiring and spending incorporated in the revenue and expenditures legislation. At the end of the year Federal employment was nearly 80,000 below its June peak.

In general, the pattern of demand in 1968 favored adult, full-time workers; teenage unemployment was virtually unchanged at nearly 13 per cent. As in other recent years, large numbers of unemployed teenagers were competing for a limited supply of part-time jobs during the school year, and during the summer the labor market was flooded with youngsters seeking full-time summer jobs or career opportunities. High levels of demand and a tight market for adults apparently are not sufficient to reduce unemployment of youngsters to acceptable levels, even though the number of teenagers in the labor force is no longer expanding at the rapid rates of the 1963–66 period. Jobless rates for Negro and other nonwhite youngsters—typically at very high levels—averaged 25 per cent in 1968. How to motivate, train, and provide job opportunities for young people, especially nonwhite youth, continues to be a key national problem.

Among nonwhite adults, however, high unemployment yielded in 1968 to the pressures of strong demand. Employment gains

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for this group exceeded the increase in the labor force, and their unemployment rates declined to the lowest levels since the Korean war. Nevertheless, unemployment rates for nonwhite men and women (3.9 and 6.3 per cent, respectively) were still nearly double the comparable rates for white adults.

WAGES AND COSTS

Average hourly earnings of workers in private nonfarm industries rose 7.3 per cent over the year ending in December 1968, significantly more than the 5.0 per cent increase in the previous 12-month period. The largest percentage increases were recorded in retail trade and in some service industries, where the increase in the minimum wage and the tight labor market had the greatest relative impact. For production workers in manufacturing, hourly earnings rose by 6.5 per cent.

A key factor making for large increases in wages was the accelerated rise in consumer prices, which generated demands for wage increases to offset increased living costs in addition to the usual demands that aim to provide a higher standard of living and additional fringe benefits. In 1968 more than 4.5 million workers covered by renegotiated major collective bargaining agreements received median first-year wage increases of 7.5 per cent, compared with a median first-year wage increase of 5.6 per cent in 1967 covering about the same number of workers.

The pattern of a substantially higher first-year increase had been a feature of the contract settlement with the major automobile companies in the final months of 1967. During 1968 this pattern spread to contracts negotiated in the glass, can, aluminum, aerospace, and steel industries in manufacturing and to the telephone, railroad, bituminous coal, and copper industries in nonmanufacturing activities. All of these contracts call for subsequent-year wage increases that are considerably smaller than the first-year boosts.

At the end of 1968 major collective bargaining agreements covering nearly 2.6 million workers contained provisions for

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cost-of-living adjustments; this number was only slightly more than a year earlier. The trends in recent years toward (1) establishing a maximum limit on the amount of the adjustment as well as a guaranteed minimum and (2) the substitution of annual for quarterly escalator adjustments were continued. In the automobile and farm equipment industries the provision for a maximum adjustment limited the size of the annual adjustment to amounts that were smaller than the increase in consumer prices in 1968.

Responding in part to the upswing in production, the increase in manufacturing productivity was stepped up in 1968, with output per man-hour rising nearly 2.5 per cent; although this increase was considerably larger than the 1.0 per cent rise in 1967, it was considerably below the average of 3.9 per cent for the years 1960 through 1965. Despite the productivity gain in 1968, unit labor costs rose 4.2 per cent—nearly as much as in 1967—because increases in hourly compensation accelerated to nearly 7 per cent; this was the largest rise in hourly compensation since 1951 and compared with about 5.5 per cent in 1967.

PRICES

Inflationary pressures, which had begun to accumulate in late 1965 with the intensification of the war in Vietnam, became even stronger in 1968. As was noted above, pressures of demands on labor resources were acute, the rise in wage rates accelerated sharply, and unit labor costs continued to show a pronounced upward thrust.

In such a setting, and with some industrial materials and foodstuffs in limited supply, wholesale prices of industrial commodities increased more than in any other year since 1957; prices of farm products and processed foods and feeds recovered much of their 1967 decline; and both the consumer price index and the broader GNP implicit price deflator showed the largest increases in 17 years.

In the course of 1968, as in each of the two preceding years,

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the pattern of wholesale prices of industrial commodities was influenced by fluctuations in the intensity of demand pressures as well as by special supply situations. Thus, the year began and ended with industrial prices rising at a fast rate, whereas for a brief period in the late spring and early summer these prices showed little change. The temporary ebb in the upward movement of industrial prices accompanied the abrupt slowing in the second quarter of the expansion in private final sales—which had been very strong in the first quarter—and widespread expectations that fiscal legislation would appreciably reduce the rate of expansion in total demands. Average price increases for a variety of industrial materials and products slowed during that period.

Also contributing to the virtual halt in the industrial price rise in the spring were the repercussions of the settlement in early April of the 8½ month strike in the copper industry. High and rising demands for copper products during that strike had been met by bidding up prices of copper scrap and foreign copper, which in turn were translated into sharp increases in prices of copper and brass mill products. Altogether, average prices of copper items increased nearly 30 per cent from early July 1967, just before the strike, to March 1968—and this price increase made a significant contribution to the sharp rise in average prices of all industrial commodities over that period. With restoration of domestic primary output following settlement of the strike, copper ingots advanced to 42 cents per pound from the pre-strike level of 38 cents. Nevertheless, average prices in the basic industry declined 18 per cent from March to July, with scrap, imported copper, and brass and copper products down sharply.

During the late summer consumer and business demands—for housing and autos in particular—held at much higher levels than had been anticipated; consumer prices except for foods continued to rise at a fast pace; and the rapid pace of wage increases showed no abatement. Under such conditions, whole-

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sale prices of industrial commodities resumed their upward course. Major factors in the sharp increase in the industrial average from July to December included: a 2.3 per cent increase in prices of steel mill products following the July 31 wage settlement—an increase half as large as the rise for the preceding 3 years combined; a sizable increase in prices of new autos; a renewed, fast rate of increase in prices of producers' equipment; and an extraordinarily large further rise in prices of lumber and plywood, supplies of which were limited relative to unexpectedly large demands.

Altogether, wholesale prices of industrial commodities increased at an annual rate of about 3.5 per cent in the first 4 months of 1968—continuing the sharp upswing of the last half of 1967. In the second half of 1968 they were rising at a rate close to 3 per cent. The rise for the year averaged 2.5 per cent; this compared with about 1.5 per cent in 1967 and 2 per cent in 1966.

The recovery in 1968 in average wholesale prices of foods and foodstuffs reflected a substantial rise in prices of livestock and products; supplies of these items leveled off following the large increase in 1967, while consumer demands expanded substantially further. For the year average prices of livestock and products were up 4 per cent and were almost back to the 15-year high reached in 1966. Prices of crops and products on the average were unchanged from 1967 and were less than 1.5 per cent below the post-World-War-II record of 1966.

Consumer prices rose at a rapid pace throughout 1968. In December the index was 4.7 per cent above a year earlier, and the average for the year was 4.2 per cent above 1967. The advance in 1968 was nearly half again as large as the increase in each of the two preceding years and was more than three times the average annual increase in the first 5 years of this long period of economic expansion.

Consumer price increases were widespread for both commodities and services. For commodities the rise at retail gen-

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erally exceeded by an appreciable margin the rise at wholesale, because upward labor and other cost pressures were generally stronger at the distributive level. Moreover, consumer demands —though varying from quarter to quarter—were generally strong; total personal consumption expenditures in 1968 were nearly $42 billion—or 8.5 per cent—higher than in 1967. In 1967 these expenditures had increased 5.7 per cent.

Retail prices of food, which had been about unchanged in 1967, showed a sizable increase in 1968. However, toward the end of the year they tended to stabilize as supplies of meats and of fruits and vegetables were expanding again. Among other commodities there were especially large increases in prices of apparel and furniture, and prices of new cars, appliances, and housefurnishings rose substantially. For the year, retail prices of nonfood commodities averaged 3.7 per cent higher than in 1967; this rise contrasts with increases of 2.5 per cent and 1.3 per cent in 1967 and 1966, respectively.

As usual, the rise in prices of services exceeded that for commodities. For the year service costs included in the consumer price index were 5.2 per cent above 1967—compared with increases of 4.4 per cent and 3.8 per cent in the two preceding years—and at the year-end they were running 6 per cent above late 1967. Much of the acceleration in the rise in 1968 stemmed from a spurt in mortgage interest charges and other costs of owning and maintaining a home and from a larger rise in rent. In December, rent was up nearly 3 per cent from a year earlier, as compared with a 2 per cent rise during the year 1967, and household services less rent were up nearly 8 per cent, more than double the rise during the preceding year. Costs of medical care services continued sharply upward—rising more than 7 per cent from December 1967 to December 1968—almost as much as during 1967. □

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U.S. Balance of Payments

During 1968 transactions in goods and services between the United States and the rest of the world showed the smallest net export balance this country has had in many years. Nevertheless, owing to massive inflows of private capital, the net reserve position of the United States—gold stock, position in the International Monetary Fund, and net asset-liability position against foreign official reserve holders—improved somewhat in the course of the year.

The shift in private capital flows toward the United States involved investors, lenders, and business creditors both here and abroad and reflected diverse influences. Among these influences were the greatly tightened controls on outflows from the United States of corporate investment funds and of U.S. bank credit to borrowers abroad; the unusually high interest rates in this country and the interest equalization tax (IET), both of which served to reinforce the effectiveness of the capital controls; a sharp growth in European investors' holdings of U.S. equity securities; and movements of liquid funds out of other currencies into the Euro-dollar market, facilitating a great increase in the use of Euro-dollar resources by U.S. banks.

In addition to the inflows of private capital, investments by foreign monetary authorities in over-1-year time deposits at U.S. banks and in certain types of U.S. Government securities helped to reduce the balance of payments deficit as measured on the liquidity basis. Indeed, the liquidity balance moved into surplus in the second half of the year, partly as a result of repatriations of funds late in the year by U.S. companies influenced by changing conditions in financial markets as well as by the direct investment control regulations.

TRANSACTIONS IN GOODS AND SERVICES

The surplus on goods and services fell sharply early in 1968 and remained low. For the year it amounted to about $2 billion, far

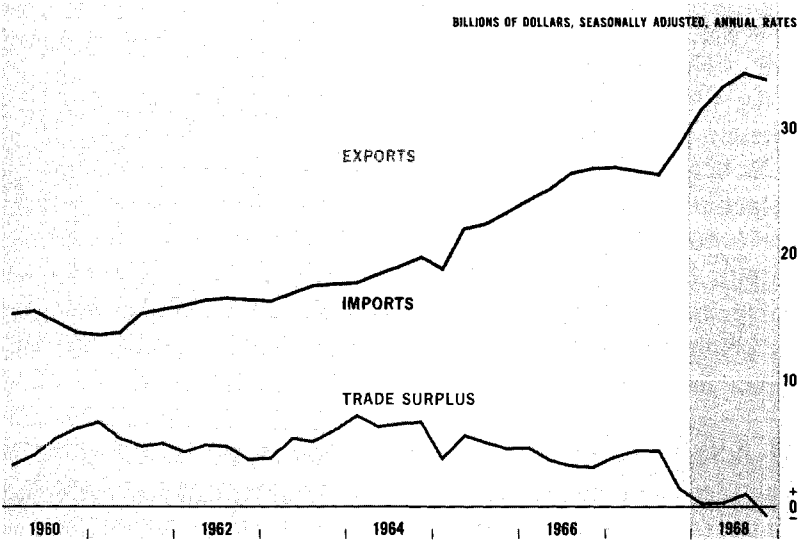
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below the balance of $4.8 billion achieved in 1967 or the average surplus of $7.0 billion in 1963–65.

Merchandise exports responded well to the general upswing in world demand, and their value in the second half of the year was 13 per cent greater than in the second half of 1967. Gains in exports to Western Europe, Canada, and Latin America were especially noteworthy. Increases were concentrated in nonagricultural products, particularly in machinery and equipment.

The shrinkage in the trade surplus was the result of an unprecedently large rise in merchandise imports. A new upswing in imports had started in the last few months of 1967—after a 13-month pause—and the rise continued through the first three quarters of 1968. For the year as a whole imports were 23 per cent greater in value than in 1967; and in the second half of the year, at an annual rate of $34.1 billion, they were 25 per cent larger than in the second half of 1967. The trade surplus, which in 1967 had amounted to $3.5 billion, nearly vanished in the first half of 1968 and remained virtually zero in the second

6. As IMPORTS grow much faster than EXPORTS, trade surplus shrinks



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half, when merchandise exports were at an annual rate of $34.2 billion.

The 25 per cent increase in value of imports from the second half of 1967 to the second half of 1968 accompanied a 10 per cent increase in the current value of GNP. While exceptionally rapid growth of automobile imports from Canada under the 1965 agreement accounted for several percentage points of the 25 per cent increase, there were also large advances in almost all other categories of imports. Under the conditions of recent years, with general prosperity in the United States and with U.S. consumer prices rising since late 1965 by more than 3 per cent a year, rapidly growing imports of finished manufactures have assumed increasing importance within the total. Partly for this reason, the trend of growth in total imports has accelerated. From 1963 to 1968 imports rose at an average rate of 14 per cent a year, compared with an average rate of 5 per cent over the preceding 10 years. The exceptionally rapid rise in imports after September 1967 reflected not only the accelerated trend but also the cyclical acceleration usually seen during a period of exceptionally rapid growth of national income in money terms.

Net receipts from current transactions other than merchandise trade increased a little in 1968. Income and fees received from direct foreign investments were substantially higher than in 1967, but much of this gain was offset by larger payments of interest to foreigners. Net tourist expenditures were reduced slightly from the 1967 peak related to the Canadian EXPO 67. Military expenditures abroad, which had risen rapidly in the two preceding years, increased more slowly and amounted to $4.6 billion in 1968.

REMITTANCES AND PENSIONS

Private unilateral transfers, at $0.75 billion, were a little smaller than in 1967, when contributions to Israel had been unusually large. Pensions and other miscellaneous transfers by the U.S. Government were about unchanged, at $0.4 billion.

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U.S. GOVERNMENT CREDITS AND ECONOMIC AID GRANTS

Economic aid grants by the U.S. Government declined a little further in 1968, to $1.7 billion. U.S. Government credits to foreign countries, net of repayments, were also slightly reduced, at $2.3 billion. Disbursements were somewhat higher, but so were repayments on outstanding credits despite the postponement of the instalment of the 1946 loan due from the United Kingdom at the end of the year. Repayments by foreign governments ahead of schedule amounted to about $250 million.

PRIVATE CAPITAL FLOWS

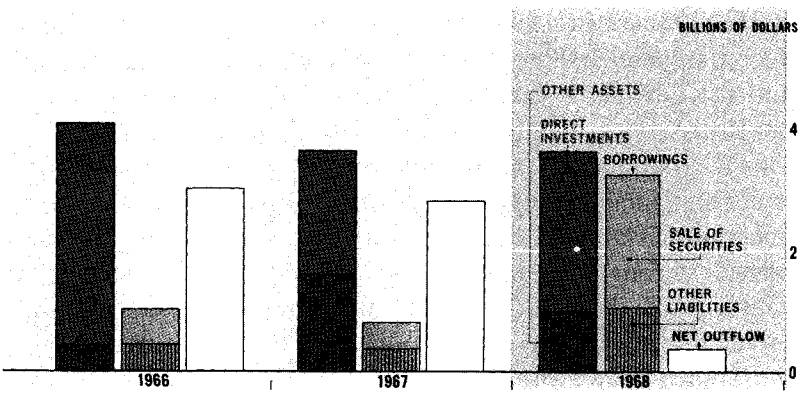
For the first time in many years, the net flow of private capital in 1968 was inward—to the United States from the rest of the world—instead of outward. Total inflows, including $3.4 billion of foreign liquid funds moving to the United States through commercial banks abroad, exceeded total outflows by nearly $5 billion. In 1967 there had been a net outflow approaching $2 billion. (These figures exclude all changes in the liquid and near-liquid claims of foreign monetary authorities on the United States and—in 1967—the U.K. liquidation of its special portfolio of U.S. securities, and they also exclude some relatively small changes in certain nonliquid liabilities of the U.S. Government to other foreign official and private creditors.)

Capital and credit transactions by **U.S. businesses other than banks,** apart from transactions in securities of unaffiliated companies, gave rise to a net capital outflow of only $0.3 billion in 1968, far below the $2.9 billion outflow of the preceding year. The announced goal for the year 1968 of the mandatory regulations imposed on direct investors was to reduce by $1 billion (as compared with 1967) the amount of direct investment outflow to countries other than Canada—defined, for this purpose, as including subsidiaries' undistributed foreign profits but as excluding use of funds borrowed abroad by U.S. companies. This goal was surpassed, primarily by increased borrowing abroad rather than by cutting back on investment outlays. Besides bor-

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rowings of the foreign operating subsidiaries themselves, new issues of convertible debentures and other bonds in Europe by affiliated financing subsidiaries incorporated in the United States were very large. These issues exceeded $2 billion, compared with $450 million in 1967. However, some of the proceeds of these issues were temporarily invested at short term abroad instead of being transferred to operating subsidiaries immediately; such funds remained available for financing of direct investment in the future without use of new funds from the United States.

7. U.S. CORPORATIONS reduce their net capital outflow through a massive increase in BORROWINGS ABROAD



In addition to bond financing, U.S. businesses increased other liabilities to foreigners by about $1 billion in 1968. Part of this increase reflected loans obtained from banks abroad for financing direct investment; and part represented receipt of advance payments on aircraft export contracts and other commercial credits, which are not related to the direct investment control program. Also—as required by the regulations, though not counting against the ceiling—there was a net return flow of liquid assets held abroad by U.S. businesses apart from the proceeds of past or current bond issues in Europe; this reversed the outflow of such funds that had occurred in 1967.

Under the Federal Reserve's foreign credit restraint program,

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discussed on pages 57–59, **U.S. banks' claims on foreigners** covered by the program were reduced by about $600 million in 1968. The net reflow for all U.S. bank-reported claims, including those handled by banks for their domestic customers, amounted to $250 million, in sharp contrast to a net outflow the year before of about $450 million.

The $2.6 billion shift in flows of corporations' investments and borrowings and the $0.7 billion shift in flows of U.S. bank-reported credits were both facilitated by the relatively easy credit conditions during 1968 in some European countries, especially Germany. A third important shift in flows was little affected by credit market conditions: **net foreign purchases of U.S. corporate stocks** attained in 1968 an extraordinary total of $2.0 billion, Such purchases had begun to increase about the middle of 1967, and the net inflow that year reached $0.8 billion (apart from net British sales, mainly from the United Kingdom's official portfolio). Continuation of an inflow of such massive proportions is not explainable merely as a reaction to political and economic uncertainties abroad, but reflects also a change in investor preferences through increased familiarity with the investment advantages of the U.S. equities market. There was also some increase in the inflow of foreign capital for direct investment in the United States—to more than $350 million in 1968 from $250 million in 1967.

Transactions in foreign securities resulted in a net capital outflow from the United States close to that of the preceding year—about $1.3 billion, net of redemptions. Sales of newly issued foreign bonds in the United States remained relatively high at $1.6 billion, though still concentrated in Canadian issues and those of the World Bank and other international institutions in consequence of the diversion of other issuers to the growing European market. The IET continued to play a role in preventing other foreign issues here and also served to hold down net U.S. purchases of outstanding foreign stocks and bonds to as little as $0.2 billion.

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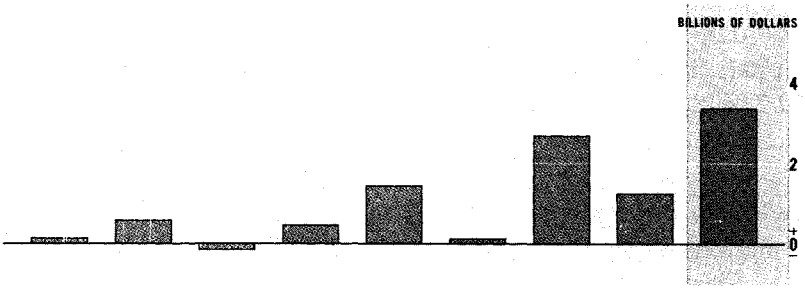
Bond issues of international and regional institutions sold in this country—included in the figure cited above—reached a record of nearly $0.5 billion. As a partial offset to this outflow of capital, however, the international institutions in 1968 added $0.2 billion to their **holdings of liquid and near-liquid assets** in the United States. Foreign private holders other than banks also increased their liquid assets in this country. The 1968 growth in these assets, $0.4 billion, was slightly larger than the annual average of such inflows since 1963.

A fourth major change in capital flows in 1968 was a new mushrooming of the **inflow of liquid funds to the United States through banks abroad.** The liabilities of U.S. banks to their foreign branches operating in the Euro-dollar market together with other U.S. liquid liabilities to banks abroad rose by $3.4 billion, compared with $1.3 billion in 1967 and $2.7 billion in 1966. The inflow thus generated may be viewed as a response to the efforts of U.S. banks to enlarge their lendable resources, but its very large size in 1968 was clearly a result of heavy speculative flows of foreigners' funds out of sterling and the French franc, which contributed to the ready availability of funds in the Euro-dollar market. Nearly $2 billion of the inflow occurred during May and June, at the time of the civil disturbances in France, when severe drains on French official reserves of gold and foreign exchange were occasioned not only by losses of exports but also by capital flight from the franc.

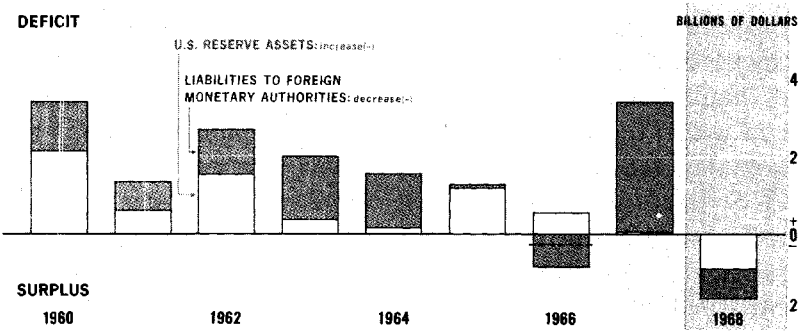
Later in the year the acute speculative crisis of November, this time centered on the German and French currencies, was not accompanied by any rise in U.S. liabilities to commercial banks abroad. Speculation on an upward revaluation of the German mark was a powerful magnet pulling funds into marks rather than dollars. In December, despite the beginning of a reflow out of marks, year-end influences—including repatriations of U.S. direct investors' funds—caused extremely tight conditions in the Euro-dollar market and produced a more-than-seasonal decline in U.S. banks' use of Euro-dollar resources.

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8. LIABILITIES TO FOREIGN COMMERCIAL BANKS increase by record amount in 1968 and ...



OFFICIAL RESERVE TRANSACTIONS reflect over-all surplus



OFFICIAL RESERVE TRANSACTIONS

With the massive shift in private capital flows from 1967 to 1968, which more than offset the deterioration in net exports of goods and services, the over-all balance of payments changed from very large deficit in 1967 to considerable surplus in 1968 as measured on the official settlements basis. In fact, the change from a deficit of $3.4 billion to a surplus of $1.6 billion was even greater than can be explained by the recorded and estimated data available at present. It is possible that additional capital inflows that have not been measured served to offset the unmeasured and unidentified outpayments that predominated all through the earlier years of the decade.

Despite the substantial balance of payments surplus to be covered by official settlements, the gold stock of the United

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States declined in 1968 by $1.2 billion. Sales of $1.4 billion were made in the first quarter, largely in support of the gold pool operations to keep the price of gold in private markets from rising much above the official price of $35 an ounce. Following the devaluation of sterling in November 1967, widespread speculation had developed on the possibility of a rise in the official price of gold against all currencies. To counter this, massive sales were made by the gold pool. Speculation on a rise in the private price of gold—if and when the gold pool operations were terminated—mounted to a peak of intensity in March.

On March 17 the Governors of the central banks of the active members of the gold pool issued a communiqué in Washington, announcing that they would no longer sell gold except to monetary authorities and expressing the opinion that it was no longer necessary, in view of the prospective creation of Special Drawing Rights (SDR's) in the International Monetary Fund, for central banks to buy gold from the market. During the rest of 1968 the price of gold fluctuated without rising above $43 an ounce on the London market. (Developments during 1968 related to SDR's and the March 17 communiqué are discussed on pages 328–32.)

The massive speculative purchases of gold in late 1967 and early 1968 created a floating supply of gold that played an important role in stabilizing gold prices subsequently. Another effect of the purchases, immediately felt, was to put a strain on the balances of payments and the reserve positions of the countries out of whose currencies speculators on gold were moving. During the period of speculation there was no significant net decline in private foreign liquid dollar claims on the United States. It appears therefore that on balance the rush to gold was financed by drains on the net reserves of other countries. Foreign purchases of gold from the United States, whether through the gold pool or through purchases by monetary authorities directly from the U.S. Treasury, had their counterpart in reducing the outstanding claims on the United States of foreign monetary

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authorities (rather than of private holders) or in increasing U.S. holdings of international reserve assets other than gold.

During the year 1968 as a whole U.S. holdings of convertible foreign currencies (mainly sterling and French francs) increased on balance by $1.2 billion, and the U.S. net position in the International Monetary Fund was enlarged by $0.9 billion. Total reserve assets, including gold, thus showed a net increase of $0.9 billion. The effect of the official settlements surplus of $1.6 billion, given these changes in reserve assets, was to reduce outstanding U.S. liabilities to foreign monetary authorities by $0.7 billion. Such liabilities fell very sharply during the first half of 1968, the period of the rush to gold and of the civil disturbances in France. During that half year U.S. liquid and near-liquid liabilities to foreign monetary authorities shrank by $2.4 billion. In the second half year, when U.S. reserve assets rose by $1.6 billion, U.S. liabilities to foreign reserve holders rose by $1.7 billion; particularly large increases in both accounts occurred in November in connection with the crisis in speculation on the German mark. □

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Foreign Credit Restraint Program

During 1968 the Board of Governors continued to administer that portion of the President's balance of payments program that applied to banks and other financial institutions, in accordance with guidelines issued on January 1, 1968, and described in the ANNUAL REPORT for 1967.

The President, by Executive Order 11387 dated January 1, 1968, made mandatory the program administered by the Department of Commerce for nonfinancial corporations and gave the Board of Governors the authority to impose regulations relating to the foreign transactions of banks and other financial institutions. However, in view of the degree of cooperation exhibited by financial institutions since the program was begun in early 1965, the Board elected to continue it as voluntary in nature.

On March 1, 1968, because of a difficult financial situation that developed for Canada early in the year, all transactions with that country were exempted from restriction under U.S. balance of payments programs. Changes in foreign claims by U.S. financial institutions on residents of Canada were excluded from the ceiling after February 29,1968. Bank claims on Canada increased by $46 million between that date and December 31, 1968. Claims of nonbank financial institutions on Canada of all maturities increased $405 million in 1968.

The objective of the 1968 program was to reduce covered assets outstanding by at least $500 million—$400 million by the banks and $100 million by the nonbank financial institutions. Actual reductions during the year totaled $852 million. As of December 31, 1968, banks had reduced their covered assets outstanding by $612 million (Table 5), and nonbank financial institutions had reduced such assets by $240 million (Table 6).

Financial institutions continued to follow the priorities set forth in the guidelines. Bank ceilings were reduced by a total of $226 million related to repayment of term loans to developed

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TABLE 5: FOREIGN CREDITS OF U.S. BANKS

Item	End of year			1968			
	1965	1966	1967	Mar. 31	June 30	Sept. 20	Dec. 31
Number of reporting banks...	161	148	151	153	153	154	161
	Millions of dollars						
Total foreign credits subject to ceiling.....	9,652	9,496	9,865	9,396	9,203	9,156	9,253
Ceiling to end of 1968.....	....	10,360	10,409	9,984	9,886	9,784	9,729
Net expansion of credit since December 1964.....	+156	−3	+370	−99	−292	−339	−242
Net leeway for further expansion of credit with ceiling for 1968.....	....	864	544	588	683	628	476

countries of continental Western Europe. There was a further reduction in the ceiling by $222 million representing 40 per cent of the amount of short-term credits to those countries outstanding on December 31, 1967. Short-term credits outstanding to those countries declined by $118 million during the year.

Long-term investments by nonbank financial institutions in developed countries other than Canada and Japan declined by $145 million in 1968.

On December 23, 1968, the President accepted a recommendation from the Cabinet Committee on the Balance of Payments that the balance of payments programs be continued in 1969 in substantially the same form as in 1968. On the same day the Board of Governors issued revised guidelines for banks and nonbank financial institutions.

The 1969 guidelines for banks maintain the ceiling at the 1968 level—that is, 103 per cent of the end-1964 base figure, or the 1967 ceiling plus one-third of the difference between that amount and 2 per cent of total assets as of December 31, 1966, whichever is greater. Banks were requested to continue to reduce their ceilings each month by the amount of repayment of long-term loans to developed countries of continental Western Europe outstanding on December 31, 1967. Banks also were asked to

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TABLE 6: FOREIGN ASSETS OF REPORTING NONBANK FINANCIAL INSTITUTIONS
Amounts shown in millions of dollars

Type of asset	Amount Dec. 31, 1968	Change from Dec. 31, 1967	
		Amount	Per cent
SUBJECT TO GUIDELINE			
Deposits and money market instruments, foreign countries except Canada	16	−35	−69.1
Short- and intermediate-term credits, foreign countries except Canada[1]	234	−60	−20.4
Long-term investments, "other" developed countries:[2]			
Investment in financial businesses[3]	112	8	7.6
Investment in nonfinancial businesses[3]	8	(4)	−1.8
Long-term bonds and credits	616	−42	−6.4
Stocks (except those acquired after Sept. 30, 1965, in U.S. markets, from U.S. investors)	456	−110	−19.5
TOTAL holdings subject to guideline	**1,443**	**−240**	**−14.2**
Adjusted base-date holdings[5]	1,597	(6)	(6)
Target ceiling[7]	1,517	(6)	(6)
NOT SUBJECT TO GUIDELINE			
Investments in Canada:			
Deposits and money market instruments	130	10	8.4
Short- and intermediate-term credits[1]	149	15	11.2
Investment in financial businesses[3]	586	18	3.1
Investment in nonfinancial businesses[3]	44	1	2.8
Long-term bonds and credits	7,906	404	5.4
Stocks	1,344	−43	−3.1
Bonds of international institutions, all maturities	984	81	8.9
Long-term investments in Japan and the developing countries:			
Investment in financial businesses[3]	25	13	101.9
Investment in nonfinancial businesses[3]	10	3	38.8
Long-term bonds and credits	768	78	11.3
Stocks	201	−22	−9.9
Stocks, "other" developed countries (if acquired after Sept. 30, 1965, in U.S. markets, from U.S. investors)	370	75	25.3
TOTAL holdings not subject to guideline	**12,517**	**632**	**5.3**

[1] Bonds and credits with final maturities of 10 years or less at date of acquisition.
[2] Developed countries other than Canada and Japan.
[3] Net investment in foreign branches, subsidiaries, or affiliates in which the U.S. institution has an ownership interest of 10 per cent or more.
[4] Less than $500,000.
[5] Dec. 31, 1967, holdings of assets subject to guideline, less carrying value of equities included therein but since sold, plus proceeds of such sales to foreigners.
[6] Not applicable.
[7] Adjusted base-date holdings multiplied by 95 per cent.

hold short-term credits to those countries to the level requested by the 1968 guidelines, that is, 60 per cent of the amount of such credits outstanding on December 31, 1967.

The revised guidelines for nonbank financial institutions were not changed substantively from the 1968 guidelines. □

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Operations in Foreign Currencies

The Federal Reserve System's foreign currency operations in 1968, as in earlier years, were designed to moderate and cushion destabilizing fluctuations in the flows of international payments and in monetary reserves, in cooperation with the central banks of other countries and with the U.S. Treasury. The Federal Reserve participated in actions to counteract speculation, including the provision of credit packages to supplement the official reserves of countries whose currencies were under speculative attack.

Potentially disruptive flows of funds were generated in Europe by speculation on changes in gold prices, until the gold pool was terminated in March; by speculation against the French franc after the civil disturbances in that country during May and June; and later in the year by speculation on the possibility that the German mark might be revalued upward. Despite improvement in British exports as a result of the November 1967 devaluation of sterling, confidence in the new sterling parity was not fully established in 1968. And the Canadian dollar was under heavy speculative attack for a short time early in the year, occasioned largely by fears that the U.S. balance of payments program announced on January 1 would adversely affect the Canadian balance of payments.

Despite the strains on the international monetary system, and despite a further deterioration in the U.S. balance on international transactions in goods and services, confidence in the dollar was not seriously affected. Large flows of private capital to the United States had the result of giving this country a balance of payments surplus as measured by official reserve transactions. The claims of foreign monetary authorities on the United States declined on balance; they were reduced by $2.4 billion in the first half of the year and increased by $1.6 billion in the second. (A discussion of the U.S. balance of payments appears on pages 47–56. An account of developments in 1968 related to gold and to SDR's will be found on pages 328–32.)

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At the beginning of 1968 the Federal Reserve had outstanding about $1.8 billion of foreign currency commitments arising from drawings it had initiated under reciprocal currency (swap) arrangements with the central banks of Switzerland, Italy, Germany, the Netherlands, and Belgium, and with the Bank for International Settlements. These swap drawings had been made during 1967 to provide cover for large amounts of dollars that accrued to continental European central banks' reserves as the result of speculative flows out of sterling and other balance of payments developments. By mid-July all of the Federal Reserve's outstanding swap drawings had been liquidated. The central banks concerned were adding to their reserve positions in the IMF (to finance drawings by Britain, France, Canada, and others), but they were experiencing substantial declines in their total claims on the United States, and in order to replenish working balances they reduced their holdings of dollars under the reciprocal currency arrangements. Liquidation of the swap drawings was also facilitated by sales of foreign-currency-denominated securities by the U.S. Treasury.

During the summer and autumn, and particularly in November, there were large speculative flows of funds into German marks and to a lesser extent into Swiss francs, chiefly out of French francs and sterling and also out of Euro-dollars. To cover the Swiss central bank's increased holdings of dollars in its reserves, the Federal Reserve drew on the reciprocal currency arrangement with that central bank. The System also made relatively small swap drawings of German marks in November, in connection with forward market operations. To offset speculative inflows, the German central bank had in various ways been encouraging outflows of short-term investment funds from Germany. For several days following the reopening of exchange markets after the Bonn meeting of finance ministers and central bankers of the Group of Ten, the German central bank made outright forward sales of marks in the market at a rate designed to make covered outflows of funds from Germany attractive; the

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Federal Reserve participated in this operation. At the end of 1968 the Federal Reserve's outstanding commitments on its swap drawings in Swiss francs and marks were somewhat over $400 million.

In April the Federal Reserve terminated its $500 million participation with the U.S. Treasury in giving technical commitments in forward lire, related to the dollar/lira swaps transacted by the Italian authorities with the Italian commercial banks. In October the Federal Reserve reciprocal currency arrangement with the Bank of Italy was increased from $750 million to $1 billion.

During 1968 several foreign central banks made use of Federal Reserve swap facilities. These included the Bank of Canada, the Bank of England, and the Bank of France, and also the central banks of the Netherlands, Belgium, and Denmark.

To help cope with the speculative attack on the Canadian dollar, early in March the United States granted Canada complete exemption from the restraints on U.S. capital outflows as outlined in the President's January 1 balance of payments program. To support the Canadian dollar, a $900 million international credit package was arranged, including a commitment by the U.S. Export-Import Bank. Earlier the Canadian authorities had made a drawing from the IMF and also a $250 million drawing under the reciprocal currency arrangement with the Federal Reserve; $500 million was still available under the latter facility. Following the meeting on March 16 and 17 of the Governors of central banks then active in the gold pool, increases were announced in several Federal Reserve swap arrangements, and these included a $250 million increase in the arrangement with Canada. All of these actions contributed to a turnabout in speculative flows of funds, and in June and July the Bank of Canada repaid its drawing from the Federal Reserve.

From time to time during 1968 the pound sterling was subject to severe selling pressure in the exchange markets. The rush to gold in the early months of the year involved sales of sterling

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assets by some speculators. The maturing of forward sales of dollars made by the Bank of England before the November 1967 devaluation of sterling, the shifting out of sterling of some parts of the official reserves of several sterling-area countries, and other withdrawals of funds from London—stimulated by disappointment at the slowness of improvement in the British trade position, and accentuated later in the year by nervousness generated by speculation on French franc devaluation and German mark revaluation—all put pressure on the United Kingdom's reserve position.

At the March 17 meeting in Washington, the central bank Governors announced that the total of credits immediately available to the United Kingdom (including the IMF standby) would be raised to $4 billion. As part of this package the Federal Reserve swap arrangement with the Bank of England—previously for $1.5 billion, much of which had already been drawn—was increased by $500 million. In September the BIS announced that a group of 12 central banks (acting where appropriate on behalf of their governments) would participate with it in a $2 billion medium-term credit facility to the Bank of England, to offset conversions of sterling balances by sterling-area countries. Such conversions, it was expected, would be limited as a result of agreements that had been reached between the British authorities and the sterling-area countries. To facilitate participation by the U.S. Treasury in this arrangement—by permitting, from time to time as might be necessary, warehousing by the Federal Reserve of sterling acquired by the Treasury—the Federal Open Market Committee authorized an increase of $650 million in the amount of foreign currencies the Federal Reserve might hold under commitments to deliver to the Treasury's Stabilization Fund.

Under the Federal Reserve reciprocal currency arrangement with the Bank of England, the latter drew substantial sums in the spring and summer. A considerable part of the United Kingdom's IMF drawing in June was used to reduce outstanding drawings under the Federal Reserve arrangement. At the end of

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the year, after large additional drawings during the November crisis, the Bank of England's commitments amounted to $1,150 million. In addition, Federal Reserve holdings of sterling included nearly $300 million under arrangements separate from the reciprocal currency arrangement. The Bank of England also had substantial commitments outstanding to the U.S. Treasury under special credit arrangements.

To help relieve pressures on the pound sterling stemming from strains in the Euro-dollar market, the Federal Reserve, through its arrangement with the BIS, supplied some dollars to the Euro-dollar market in June and again in December, for short periods. The BIS drew dollars from the Federal Reserve under the reciprocal currency arrangement and made the placements.

Faced with massive speculative outflows from the franc from May until near the end of November, the Bank of France made substantial use of its swap line with the Federal Reserve, in addition to selling gold, drawing on the IMF, and using other international credits—while taking actions to resist inflationary pressures and to improve the underlying French balance of payments position. The Federal Reserve reciprocal currency arrangement with the Bank of France was increased early in July from $100 million to $700 million. It was again increased, to $1 billion, at the time of the Bonn meeting in November. Of the $2 billion package of new international credits for France announced in November, the United States made available a total of $500 million—$300 million through the increase in the Federal Reserve swap line and $200 million in a facility extended to the Bank of France by the U.S. Treasury. Drawings by the Bank of France under the Federal Reserve arrangement reached a peak of over $600 million in November, but by the end of the year had been reduced to $430 million.

Drawings on their Federal Reserve swap lines by the central banks of the Netherlands and Denmark in June were liquidated within a few months, and drawings by the Belgian central bank

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in July and October were almost entirely liquidated by the end of the year.

At the end of 1968 the Federal Reserve's reciprocal currency arrangements with 14 central banks and the BIS totaled $10,505 million—having been increased at four times during the year, in March, July, October, and November.

A detailed review of Federal Reserve operations in foreign currencies during 1968 is given on pages 275–323. □

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Part 2
Records, Operations, and Organization

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Record of Policy Actions of the Board of Governors

JANUARY 18, 1968

AMENDMENT TO REGULATION Q, PAYMENT OF INTEREST ON DEPOSITS.

Effective January 18, 1968, Regulation Q was amended to alleviate a problem bearing on the exemption of time deposits of certain foreign official depositors from the maximum rate limitations contained in that regulation.

> Votes for this action: Messrs. Robertson, Mitchell, Maisel, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Messrs. Martin and Daane.

Under legislation enacted in 1962 and subsequently renewed, but due to expire on October 15, 1968, in the absence of further congressional action, the time deposits of foreign governments, of the monetary and financial authorities of foreign governments when acting as such, and of international financial institutions of which the United States is a member had been exempted from interest rate ceilings established under Regulation Q. It was not known whether this legislation would again be extended, but the efforts of commercial banks to attract or to renew official time deposits had been increasingly impeded by the banks' inability to guarantee payment of interest in excess of the regulatory ceilings beyond the October expiration date of the statute.

In order to alleviate this problem, the Board amended Regulation Q so as to exempt such foreign official time deposits with specified maturities up to 2 years from the interest rate ceilings of the regulation. The Board derived its authority for this action from legislation enacted in 1966 and renewed in 1967. That legislation placed the regulation of interest rates on a discretionary rather than a mandatory basis and authorized the Board

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to set different limits according to the nature or location of the depositor or according to such other reasonable bases deemed by the Board to be in the public interest. The legislation was itself scheduled to expire on September 21, 1968. But even if the legislation were not renewed, the present amendment to Regulation Q would allow banks to issue certificates of deposit until September 21, 1968, with maturities of up to 2 years to qualifying foreign official depositors at interest rates in excess of the Regulation Q ceilings.

(Note: The legislation was subsequently extended for a period of 1 year from September 21, 1968, and in light of that extension the exemption under this regulation was also continued. See the Board policy record entry for October 7, 1968, on page 92 of this ANNUAL REPORT.)

FEBRUARY 1, 1968

ADOPTION OF NEW REGULATION G, CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED EQUITY SECURITIES. AMENDMENTS TO REGULATION T, CREDIT BY BROKERS, DEALERS, AND MEMBERS OF NATIONAL SECURITIES EXCHANGES, AND REGULATION U, CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED STOCKS.

Effective March 11, 1968, the Board adopted a number of changes to broaden the coverage of, and in most respects to tighten, its regulations governing the use of credit in stock market transactions.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

The effect of adoption of the new regulation (designated Regulation G) was to extend to other lenders margin requirements corresponding to those that had long been applicable to brokers, dealers, and banks on credit extended for the purpose of purchasing or carrying registered equity securities. As a result of the adoption of Regulation G and of the continuation of applicable provisions of Regulations T and U (relating to loans by brokers and dealers and by banks, respectively), the margin

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required on virtually all registered stock transactions was 70 per cent, effective March 11, 1968.

Also under the provisions of Regulation G—and in this case with concurrent changes in Regulations T and U—the margin required on all loans for the purpose of purchasing or carrying securities convertible into registered stock was established at 50 per cent, effective March 11. This requirement, set independently of the margin requirement on stock transactions, was fixed initially at 50 per cent in recognition of the fact that convertible securities combine characteristics of both stocks and bonds.

The revised regulatory requirements were applicable to all new loans made on or after March 11, 1968, for the purpose of purchasing or carrying registered equity securities. The treatment of such loans made prior to that date varied, depending upon the category of lender. The adoption of margin requirements on loans made on convertible securities by brokers or dealers had no effect on loans made before March 11. For loans on convertible securities made by banks between October 20, 1967—the date the original proposals had been published for comment—and March 11, 1968, a fully margined status had to be achieved by April 10; bank loans made before October 20, 1967, were not affected unless there had been subsequent substitutions of collateral or conversion into stock. On all loans for purchasing or carrying registered equity securities made by Regulation G lenders between February 1 and March 11, 1968, a fully margined status had to be achieved by April 10. Loans by such lenders made prior to February 1 were not affected.

Also included in the Board's action was a requirement, applicable to all lenders, that loans on convertible securities having a margin status below the prescribed 50 per cent be subject to a 70 per cent "retention requirement": That is, 70 per cent of the proceeds from a sale of these securities would have to be retained to improve the status of the loan until it was margined at the full 50 per cent.

The regulations, as adopted by the Board, required that all

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lenders performing certain services "as agent" for foreign and other stock market lenders obtain a statement from their principals to the effect that the activities of the principals conformed to the applicable margin regulations. However, this provision never became effective. (See the entry for May 7 on page 83 of this ANNUAL REPORT.) Also, banks and Regulation G lenders were forbidden—as brokers and dealers long had been—to arrange for credit on lower margin than they could extend themselves.

Among the other provisions of the regulations was a requirement that banks and Regulation G lenders obtain from the borrower a signed statement providing for, among other things, an indication of the purpose of any stock-secured loan; determine in good faith that the statement was correct; and sign it as so accepted. (Since loans by brokers or dealers are generally for the purpose of purchasing or carrying securities, no statement of purpose would ordinarily be required in connection with such loans.)

FEBRUARY 1, 1968

AMENDMENT TO REGULATION T, CREDIT BY BROKERS, DEALERS, AND MEMBERS OF NATIONAL SECURITIES EXCHANGES.

Effective February 5, 1968, Regulation T was amended to extend by one day, to five full business days after the transaction, the period in which a broker or dealer must obtain the customer's margin deposit on a margin transaction.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

The purpose of this liberalizing change in Regulation T, which applied to all loans by brokers or dealers subject to margin requirements, was to reduce current pressures on the bookkeeping departments of brokerage firms by insuring that a weekend would always be included in the period of time within which the deposit must be obtained.

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FEBRUARY 5, 1968

AMENDMENT TO REGULATION O, LOANS TO EXECUTIVE OFFICERS OF MEMBER BANKS.

Effective March 15, 1968, Regulation O was amended chiefly to bring the regulation into conformity with recent legislation.

> Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, and Brimmer. Votes against this action: None. Absent and not voting: Mr. Sherrill.

Public Law 90-44, enacted on July 3, 1967, liberalized the rules governing loans by member banks to their own executive officers. Under the new provisions of Regulation O, amended to conform with this law and effective March 15, 1968, executive officers could borrow from their own banks up to $30,000 for a home mortgage, $10,000 for the education of children, and $5,000 for any unspecified purpose. Previously, an executive officer could not borrow more than $2,500 from his bank.

The amendment to Regulation O also redefined the term "executive officer," limiting its applicability to persons participating in the determination of major policies of a member bank. As a result, many bank officers with lesser responsibilities were granted a freer access to the credit facilities of their own institutions.

FEBRUARY 7, 1968

AMENDMENT TO REGULATION K, CORPORATIONS ENGAGED IN FOREIGN BANKING AND FINANCING UNDER THE FEDERAL RESERVE ACT.

Effective February 8, 1968, Regulation K was amended to require the Board's specific approval before corporations that were engaged in foreign banking and financing under the Federal Reserve Act could make any equity investment in a foreign business.

> Votes for this action: Messrs. Martin, Robertson, Mitchell, Maisel, and Brimmer. Votes against this action: None. Absent and not voting: Messrs. Daane and Sherrill.

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This amendment to Regulation K, intended to be of temporary duration, was adopted in furtherance of the purposes of the Government's balance of payments program announced by the President on January 1, 1968. The amendment revoked the "general consent" provision of Regulation K, which had permitted so-called "Edge Act" and "Agreement" corporations to make certain investments without application to the Board for its specific approval. As a result, all equity investments abroad by member banks or such corporations, as well as the holding by them of shares of a subsidiary that made any equity investment abroad, were subject to the specific approval of the Board.

The Board indicated that, in line with the objectives of the balance of payments program, equity investments in developed countries of continental Western Europe would not be approved unless circumstances clearly demonstrated that the transaction would not be detrimental to the U.S. balance of payments. Applications to make investments elsewhere would be considered on their merits, provided the investments could be made within the ceiling established for the applicant under the voluntary foreign credit restraint program and provided the priorities established in that program were being followed.

The Board stressed that all equity investments abroad by member banks and by Edge Act and Agreement corporations would continue to be regarded as extensions of credit to foreigners for purposes of the foreign credit restraint program.

FEBRUARY 8, 1968

AMENDMENTS TO REGULATION Y, BANK HOLDING COMPANIES.

Effective March 15, 1968, Regulation Y was revised primarily to make the regulation conform to the provisions of governing legislation.

> Votes for this action: Messrs. Martin, Robertson, Mitchell, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Messrs. Daane and Maisel.

The principal purpose of this action was to incorporate into

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Regulation Y certain technical changes and other revisions conforming to the new provisions that became effective under the Bank Holding Company Act amendments of 1966.

MARCH 8, 1968

AMENDMENTS TO REGULATION G, CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED EQUITY SECURITIES; REGULATION T, CREDIT BY BROKERS, DEALERS, AND MEMBERS OF NATIONAL SECURITIES EXCHANGES; AND REGULATION U, CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED STOCKS.

Effective March 11, 1968, the Board adopted technical amendments to Regulations G, T, and U designed to clarify certain provisions of the margin regulations announced on February 1, 1968.

Votes for this action: Messrs. Robertson, Mitchell, Maisel, and Brimmer. Votes against this action: None. Absent and not voting: Messrs. Martin, Daane, and Sherrill.

On February 1, 1968, the Board had adopted, effective March 11, 1968, a number of changes to broaden the coverage of, and in most respects to tighten, its regulations governing the use of credit in stock market transactions. Since that time a need for several technical improvements in the regulations had come to light, and the amendments now adopted were designed for that purpose.

The amendments clarified that the 50 per cent margin requirement applicable to convertible debt securities was not applicable to preferred stocks, the latter being subject to the same margin requirements as other registered equity securities. The amendments also sharpened the definition of the term "indirectly secured" as used in Regulations G and U. The amendments eliminated the requirement that banks obtain "purpose statements" in connection with certain routine transactions. And, finally, they clarified the method by which short sales of convertible bonds were to be carried out under Regulation T.

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MARCH 12, 1968

REVISION OF FOREIGN CREDIT RESTRAINT PROGRAM GUIDELINES.

The Board adopted revisions in the guidelines for restraint of foreign credits by banks and other financial institutions.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Mr. Maisel.

Since the announcement on January 1, 1968, of revised guidelines for the use of banks and other financial institutions in limiting foreign credits, an agreement had been reached between the Governments of Canada and the United States under which such institutions would be permitted to increase claims on residents of Canada without reference to the guideline ceilings. The current revisions were in conformity with that agreement.

MARCH 14, 1968

INCREASE IN RATES ON DISCOUNTS AND ADVANCES BY FEDERAL RESERVE BANKS.

Effective March 15, 1968, the Board approved actions taken by the boards of directors of the Federal Reserve Banks of Boston, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, and Dallas establishing a rate of 5 per cent (an increase from 4½ per cent) on discounts and advances to member banks under Sections 13 and 13a of the Federal Reserve Act.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

Pursuant to the policy established by this action, the Board subsequently approved the same rate for the remaining Federal Reserve Banks effective on the following dates:

San Francisco	March 15, 1968
Philadelphia	March 18, 1968
New York	March 22, 1968

Effective the same dates the Board approved for the respective Fed-

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eral Reserve Banks a rate of 5½ per cent (an increase from 5 per cent) on advances to member banks under Section 10(b) of the Federal Reserve Act. In addition, the Board approved increases at most of the Banks in rates on advances to individuals, partnerships, and corporations other than member banks under the last paragraph of Section 13 of the Act.

(In accordance with the provisions of the Federal Reserve Act, the Federal Reserve Banks are required to establish rates on discounts for and advances to member banks at least every 14 days and to submit such rates to the Board for review and determination. Prior to this date the most recent rate changes were made in November 1967, as described on pages 79 and 80 of the Board's ANNUAL REPORT for 1967.)

Note: The directors of five Federal Reserve Banks had voted initially to establish rates other than 5 per cent under Sections 13 and 13a of the Federal Reserve Act, subject to the approval of the Board of Governors. These rates were 4¾ per cent voted by the directors of the Federal Reserve Bank of Chicago, 5½ per cent by the directors of the Federal Reserve Banks of Philadelphia, St. Louis, and Dallas, and 6 per cent by the directors of the Federal Reserve Bank of New York. Upon being advised that the Board was prepared to approve a rate increase of ½ percentage point, the Federal Reserve Banks in question voted to establish a rate of 5 per cent. In taking action to establish a rate of 6 per cent, the directors of the Federal Reserve Bank of New York had also voted to establish an alternative rate of 5½ per cent, if the former rate was not acceptable to the Board of Governors. The Board did not approve either alternative, and consequently the Reserve Bank's existing rate of 4½ per cent continued in force until the directors voted to establish, with the Board's approval, a rate of 5 per cent.

The action to increase the discount rate was taken at a time of strong inflationary pressures in the domestic economy and of massive speculation in world gold markets based on expectations of an increase in the price of gold. Such speculation had resulted in substantial sales of gold from the official stocks of the United States and other countries actively participating in the London gold pool in order to maintain the market price of gold at a level close to the official price of $35 per ounce. Expectations of continuing inflation in the United States and speculative attitudes in world markets had been influenced by the recent rapid expansion in U.S. economic activity, strong upward pressures on

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U.S. prices and costs, and consequent deterioration in the U.S. balance of trade, and also by the uncertain prospects for enactment of proposed fiscal restraint legislation.

Growth in bank reserves, bank credit, and the money supply had slowed on the average since late November 1967, when the discount rate had been raised from 4 to 4½ per cent. In the intervening period the System had implemented a policy of increased monetary restraint by raising reserve requirements against most demand deposits and by pursuing more restrictive open market operations. (The policy record entries of the Board and the Federal Open Market Committee that describe the firming actions noted above and furnish details on attendant economic and financial circumstances may be found in the ANNUAL REPORT for 1967 and in this ANNUAL REPORT beginning on page 122.)

The rates of expansion in bank reserves and in bank credit were believed to be moderating further in March, but growth in the money stock was expected to accelerate somewhat from its minimal February pace. In an atmosphere of unsettled foreign exchange markets and strong inflationary pressures in the domestic economy, market interest rates had risen considerably during the first half of March. The 3-month Treasury bill rate had advanced from around 5 per cent early in the month to nearly 5½ per cent on the day this action was taken; most yields in capital markets had moved to new highs, exceeding their peaks of late 1967.

In this situation the increase of ½ percentage point in the discount rate was designed to supplement actions already undertaken through other policy instruments. The increase was in accord with a policy of curbing inflationary pressures in the domestic economy and fostering progress toward attainment of reasonable equilibrium in the country's balance of payments, thereby strengthening confidence in the international position of the dollar.

In its review of actions by some Reserve Banks initially calling

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for larger increases in the discount rate, the Board concluded that such increases were not warranted in the present situation and ran the risk of engendering unduly large market reactions. The Board recognized, however, that domestic or international developments might make a further increase in the discount rate desirable at a later date.

APRIL 18, 1968

1. INCREASE IN RATES ON DISCOUNTS AND ADVANCES BY FEDERAL RESERVE BANKS.

Effective April 19, 1968, the Board approved actions taken by the boards of directors of the Federal Reserve Banks of New York, Philadelphia, and Minneapolis establishing a rate of 5½ per cent (an increase from 5 per cent) on discounts and advances to member banks under Sections 13 and 13a of the Federal Reserve Act.

> Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, and Brimmer. Votes against this action: None. Absent and not voting: Messrs. Maisel and Sherrill.

Pursuant to the policy established by this action, the Board subsequently approved the same rate for the remaining Federal Reserve Banks effective on the following dates:

San Francisco	April 19, 1968
Atlanta	April 22, 1968
Boston	April 23, 1968
St. Louis	April 23, 1968
Cleveland	April 26, 1968
Richmond	April 26, 1968
Chicago	April 26, 1968
Kansas City	April 26, 1968
Dallas	April 26, 1968

Effective the same dates the Board approved for the respective Federal Reserve Banks a rate of 6 per cent (an increase from 5½ per cent) on advances to member banks under Section 10(b) of the Federal Reserve Act. In addition, the Board approved increases at most of the Banks in rates on advances to individuals, partnerships, and corporations other than member banks under the last paragraph of Section 13 of the Act.

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2. AMENDMENT TO REGULATION Q, PAYMENT OF INTEREST ON DEPOSITS.

Effective April 19, 1968, the Board approved an amendment of the Supplement to Regulation Q to increase the maximum rates of interest permitted to be paid by member banks on certain single-maturity time deposits, including certificates of deposit (CD's), of $100,000 or more. The following schedule of maximum rates was adopted:

Maturity (days)	Maximum rate (per cent)
30- 59	5½
60- 89	5¾
90-179	6
180 and over	6¼

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, and Brimmer. Votes against this action: None. Absent and not voting: Messrs. Maisel and Sherrill.

Since December 6, 1965, the maximum rate payable on such large-denomination time deposits, apart from those of certain foreign official depositors, had been 5½ per cent for all maturities. No changes were made in the maximum rates of interest payable on other classifications of time and savings deposits, and time deposits of qualifying foreign official institutions remained exempt from the limitations of this regulation (see Regulation Q entries for January 18 and October 7 on pages 69 and 92 of this ANNUAL REPORT).

These actions were taken to supplement policy measures of monetary restraint adopted earlier, including successive firming actions through open market operations and an increase in the discount rate to 5 per cent in mid-March. (Policy record entries describing these actions may be found in this ANNUAL REPORT, beginning on pages 122, 136, and 76, respectively.) The more restrictive stance of monetary policy had been reflected in firmer money market conditions and higher short-term interest rates, with the 3-month Treasury bill rate rising recently to a range around 5.35 per cent. Growth in total member bank reserves had slowed sharply since February, and bank credit, as measured by the bank credit proxy—daily-average member bank

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deposits—had expanded at an appreciably reduced pace in March and was expected to show no further growth in April. Banks had met increasing loan demands in recent weeks through sizable reductions in their holdings of U.S. Government securities. Growth in the money stock had accelerated in recent weeks, however, reflecting in part sizable declines in U.S. Government deposits.

Despite the increased monetary restraint, expansion in domestic economic activity was continuing at an excessive pace and was being accompanied by substantial upward pressures on prices and costs. Against this background an overt move toward increased monetary restraint was deemed desirable to reaffirm the System's determination to help resist inflationary pressures at a time when enactment of proposed fiscal restraint legislation remained uncertain.

Rising interest rates in short-term debt markets had significantly reduced the ability of banks to compete for time and savings deposits under existing Regulation Q ceilings, with the result that the outstanding volume of large-denomination CD's had contracted substantially in recent weeks and growth in consumer-type time and savings deposits at banks and in savings accounts at nonbank thrift institutions had remained at a reduced pace. The further increase of ½ percentage point in the discount rate was expected to exert additional upward pressure on short-term market interest rates and to make it even more difficult for banks to replace maturing CD's. In these circumstances the Board concluded that ceiling rates under Regulation Q should be raised on large-denomination CD's in order to give banks some leeway to compete for interest-sensitive funds. It was believed desirable to set the new graduated scale of ceiling rates at levels that would enable banks to resist further large reductions in such deposits, but not so high as to permit a significant expansion in the outstanding volume of CD's and thus in bank credit.

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APRIL 23, 1968

AMENDMENTS TO REGULATION D, RESERVES OF MEMBER BANKS.

Effective September 12, 1968, Regulation D was amended to effect several changes in the method of computation of reserve requirements by member banks.

> Votes for this action: Messrs. Martin, Robertson, Mitchell, Maisel, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Mr. Daane.

The amendments were designed to facilitate more efficient functioning of the reserve mechanism. They did not represent any change in Federal Reserve monetary policy, but were expected to reduce uncertainties, for both member banks and the Federal Reserve, as to the amount of reserves required to be maintained during the course of any reserve-computation period. Adoption of the amendments was therefore expected to moderate some of the pressures for reserve adjustments within the banking system that occasionally develop near the close of a reserve period and produce sharp fluctuations in the availability of day-to-day funds.

The major changes in the rules by which member banks would compute and comply with System reserve requirements, which were substantively the same as those published for comment on January 29, 1968, were as follows:

(1) establishment of a 1-week reserve period for the so-called "country banks" instead of the former 2-week period, thus putting such banks on the same basis as reserve city banks;

(2) use of average deposits 2 weeks earlier in calculating the weekly average required reserves for the present period;

(3) use of vault cash held 2 weeks earlier, together with average balances at the Federal Reserve Bank for the current week, in the computation of weekly average reserves held in satisfaction of the requirements; and

(4) provision that either excesses or deficiencies averag-

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ing up to 2 per cent of required reserves might be carried forward to the next reserve week.

MAY 7, 1968

AMENDMENTS TO REGULATION G, CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED EQUITY SECURITIES; REGULATION T, CREDIT BY BROKERS, DEALERS, AND MEMBERS OF NATIONAL SECURITIES EXCHANGES; AND REGULATION U, CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED STOCKS.

The Board amended Regulations G, T, and U to revoke certain provisions that would have applied to banks, brokers, and other lenders when they acted as agents for others who were in the business of lending against registered equity securities.

Votes for this action: Messrs. Martin, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Messrs. Robertson and Mitchell.

On February 1, 1968, the Board, in adopting Regulation G and amending Regulations T and U, included a requirement that all lenders performing certain services "as agent" for foreign and other stock market lenders obtain a signed statement from their principals to the effect that the activities of the principals conformed to the applicable margin regulations. This requirement was originally scheduled to take effect on March 11, 1968. However, on February 29 the Board deferred the effective date until April 10, 1968. The purpose of the delay was to mitigate the administrative burden connected with handling a substantial volume of ministerial agency transactions involved in effectuating the requirement.

Subsequently, on March 27, 1968, the Board amended the pertinent provisions of the regulations to provide that the requirement apply only where the bank, broker, or other lender knew or should know that the services it performed as agent were connected with a loan secured in such a way that the agent

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would have had to observe the requirement of the regulations if it had itself made the loan. This change was scheduled to go into effect on April 17, 1968.

On April 12, 1968, the Board deferred the effective date to May 17 and on May 7 it revoked these provisions, which were thus never actually in effect. The Board deleted the requirement because of the possibility that it might give rise to disproportionate operational problems, particularly with regard to transactions involving foreign principals. The Board noted, however, that a potential for evasion of the regulations through agency activities did exist and that it planned to keep this area under surveillance.

MAY 9, 1968

PROPOSED AMENDMENT TO REGULATION U, CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED STOCKS.

On May 9, 1968, the Board voted not to adopt a proposed amendment to Regulation U that would have exempted from margin requirements loans made by banks to dealers to finance their market-making activities in convertible bonds.

> Votes for this action: Messrs. Martin, Robertson, Maisel, and Sherrill. Votes against this action: None. Absent and not voting: Messrs. Mitchell, Daane, and Brimmer.

In conjunction with the changes announced February 1, 1968, in its regulations governing the use of credit in stock market transactions, the Board had published for comment a proposal to exempt from margin requirements loans made by banks to dealers to finance their market-making activities in convertible securities. It was originally proposed that this exemption, if adopted, would become effective not later than March 11, 1968. To aid it in reaching a decision, the Board requested that dealers who wished to be eligible for the exemption begin to file certain reports.

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The Board, after twice deferring action because of difficulties encountered in collecting and analyzing sufficient data, decided not to grant the exemption. Analysis of the reports filed by dealer firms engaged in market-making activities had not revealed a clear need for extending credit on a more favorable basis to such firms, and it appeared that the exemption would lead to severe administrative difficulties. It was therefore required that bank loans on convertible securities made between October 20, 1967, and March 11, 1968, to those dealer firms that had filed reports to establish eligibility for possible exemption be brought up to 50 per cent margin status by May 10. Such loans had been granted temporary exemption pending final Board action.

JUNE 7, 1968

AMENDMENTS TO REGULATION G, CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED EQUITY SECURITIES; REGULATION T, CREDIT BY BROKERS, DEALERS, AND MEMBERS OF NATIONAL SECURITIES EXCHANGES; AND REGULATION U, CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED STOCKS.

Effective June 8, 1968, the Supplements to Regulations G, T, and U were amended to increase margin requirements from 70 to 80 per cent on loans made on stocks and from 50 to 60 per cent on loans made on convertible bonds.

> Votes for this action: Messrs. Martin, Robertson, Daane, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Messrs. Mitchell and Maisel.

During the month of April margin credit of brokerage customers had increased by $200 million, bringing the total of margin credit outstanding at brokerage houses to $6.4 billion, and preliminary indications were that a further rise had occurred in May. The recent increases in stock market credit marked

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a resumption of the upward trend observed during 1967, when such credit rose 29 per cent at brokerage houses and 19 per cent at commercial banks.

In view of these developments, the Board acted to increase margin requirements under the authority granted in the Securities Exchange Act of 1934 to prevent excessive use of credit to finance transactions in securities. The margin requirement on loans for the purpose of purchasing or carrying registered stocks was increased from 70 to 80 per cent; that on loans for the purpose of purchasing or carrying securities convertible into registered stock was raised from 50 to 60 per cent. These higher requirements were applicable to all new extensions of credit on or after June 8, 1968, for these purposes by brokers, banks, and other lenders. No change was made in the 70 per cent retention requirement applicable to undermargined accounts.

AUGUST 5, 1968

AMENDMENTS TO REGULATION F, SECURITIES OF MEMBER STATE BANKS.

Effective August 5, 1968, Regulation F was amended to implement recent statutory amendments to the Securities Exchange Act of 1934.

> Votes for this action: Messrs. Robertson, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Messrs. Martin and Mitchell.

The amendments to Regulation F implemented provisions of Public Law 90-439, effective July 29, 1968, insofar as they applied to State member banks. Those provisions required disclosure of certain information with respect to: (1) acquisition of more than 10 per cent of a class of equity securities registered pursuant to the Securities Exchange Act; (2) making of so-called "tender offers" (or solicitations favoring or opposing such offers); and (3) replacement of a majority of the directors of an issuer in connection with an acquisition, or tender offer,

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subject to the Act. State member banks engaging in any of the above actions were required to file prescribed information with the Board and, in the case of a tender offer, to include such information in the advertisement thereof.

AUGUST 6, 1968

AMENDMENTS TO REGULATION G, CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS FOR THE PURPOSE OF PURCHASING OR CARRYING REGISTERED EQUITY SECURITIES.

Effective August 8, 1968, Regulation G was amended to relax some provisions thereof, particularly as they applied to credit unions.

> Votes for this action: Messrs. Robertson, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Messrs. Martin and Mitchell.

Regulation G applied only to lenders with $50,000 in new loans or $100,000 in loans outstanding against registered equity securities in a given quarter. Therefore it affected only a very small minority of the credit unions in the United States. However, several of the provisions of Regulation G were felt to be unduly restrictive on even this small number of credit unions.

The first of the two major amendments included in this action permitted a lender subject to the regulation to extend up to $5,000 in general credit along with credit for purchasing or carrying registered securities. As originally adopted, the regulation forbade a lender subject to its provisions to extend both types of credit to the same borrower at the same time.

The second major amendment permitted credit unions whose membership was limited to employees and former employees of a corporation to make loans for the purchase of stock in the corporation under an employee stock-purchase plan without regard to initial margin requirements. It was required that the loans be made under a plan that embodied safeguards to discourage repayment with proceeds from the sale of the purchased

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stock. Such loans were already exempt if made by the corporation itself under similar safeguards.

AUGUST 13, 1968

OPERATIONS SUBSIDIARIES AND LOAN PRODUCTION OFFICES.

The Board reinterpreted provisions of the Federal banking laws relating to operations subsidiaries and loan production offices.

Votes for this action: Messrs. Martin, Mitchell, Daane, Maisel, and Sherrill. Votes against this action: Messrs. Robertson and Brimmer.

These interpretations, which reversed positions taken in 1966 and 1967, were as follows:

1. As far as Federal banking law is concerned, a member bank of the Federal Reserve System may purchase for its own account shares of corporations to perform, at domestic locations where the bank is authorized to engage in business, functions that the bank is empowered to perform directly.

2. As far as Federal banking law is concerned, a member bank of the Federal Reserve System may establish and operate, at any location in the United States, "loan production offices" that perform only servicing activities. Such offices may be established and operated by a bank either directly or indirectly through wholly owned subsidiaries.

In adopting these interpretations, the Board reexamined its position concerning the so-called "stock purchase prohibition" of Section 5136 of the Revised Statutes (12 U.S. Code Section 24), which forbids the purchase by a member bank for its own account of any shares of stock of any corporation, except as permitted by provisions of Federal law or as comprised within the concept of "such incidental powers as shall be necessary to carry on the business of banking." The Board concluded that the incidental powers clause permits a bank to organize its operations in the manner that it believes will best fa-

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cilitate the performance thereof, and that a wholly-owned subsidiary corporation engaged in activities that the bank itself may perform is simply a convenient alternative organizational arrangement and is permissible unless use of such a subsidiary is inconsistent with other Federal law, either statutory or judicial.

In view of the relationship between the operation of certain subsidiaries and the branch banking laws, the Board also reexamined its rulings on what constitutes "money lent" for the purpose of Section 5155 of the Revised Statutes (12 U.S. Code Section 36), which provides that "The term 'branch' . . . shall be held to include any branch bank, branch office, branch agency, additional office, or any branch place of business . . . at which deposits are received, or checks paid, or money lent." The Board concluded that a test similar to that adopted with respect to the servicing exemption under the Bank Holding Company Act is appropriate for use in determining whether or not "money [is] lent" at a particular office, for the purpose of the Federal branch banking laws.

Accordingly, the Board listed activities that it considered did not, individually or collectively, constitute the lending of money within the meaning of Section 5155 and concluded that when loans are approved and funds disbursed solely at the main office or branch of the bank, an office at which only preliminary and servicing steps are taken is not a place where "money [is] lent" and therefore is not a branch.

In stating the reasons for their dissent Messrs. Robertson and Brimmer said that, while they believed it would be in the public interest to amend the governing statutes to give national banks and State member banks greater latitude to conduct some of their business through subsidiary corporations, they also believed the problem should have been resolved through legislation rather than by changing the Board's interpretation of the law. They also stated that to go even further and adopt the position that State member banks may (through these subsidi-

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aries) establish loan production offices anywhere in the United States was to take such a long step toward a fundamental change in our banking structure as to call for legislative consideration even if the legality of that position were unquestionable, which in their view was not the case.

AUGUST 15, 1968

DECREASE IN RATES ON DISCOUNTS AND ADVANCES BY FEDERAL RESERVE BANKS.

Effective August 16, 1968, the Board approved the action taken by the board of directors of the Federal Reserve Bank of Minneapolis establishing a rate of 5¼ per cent (a decrease from 5½ per cent) on discounts and advances to member banks under Sections 13 and 13a of the Federal Reserve Act.

> Votes for this action: Messrs. Martin, Robertson, Maisel, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Messrs. Mitchell and Daane.

Pursuant to the policy established by this action, the Board subsequently approved the same rate for the remaining Federal Reserve Banks effective on the following dates:

Richmond	August 19, 1968
Philadelphia	August 23, 1968
Cleveland	August 23, 1968
Chicago	August 23, 1968
Kansas City	August 23, 1968
Boston	August 27, 1968
Dallas	August 28, 1968
New York	August 30, 1968
Atlanta	August 30, 1968
St. Louis	August 30, 1968
San Francisco	August 30, 1968

Effective the same dates the Board approved for the respective Federal Reserve Banks a rate of 5¾ per cent (a decrease from 6 per cent) on advances to member banks under Section 10(b) of the Federal Reserve Act. In addition, the Board approved decreases at all of the Banks in

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rates on advances to individuals, partnerships, and corporations other than member banks under the last paragraph of Section 13 of the Act.

Market interest rates had fallen considerably on balance in connection with enactment of fiscal restraint measures in late June, as a result of widespread expectations that these measures would be followed by moderation in the pace of economic expansion and reduction of inflationary pressures, some easing of monetary policy, and smaller Treasury financing requirements. In short-term debt markets rates on 3-month Treasury bills had declined by more than ½ percentage point to about 4.90 per cent by early August but since that time had climbed back up to about 5.15 per cent. Member bank borrowings had been reduced over this interval, but day-to-day rates in the money market, including rates on Federal funds, had remained at high levels and appeared increasingly to be exerting some upward pressure on the short-term yield structure.

The decline that had taken place in short-term market interest rates to levels well below Regulation Q ceilings on large-denomination CD's had enabled banks since early summer to replace the CD's they had lost earlier in the year. Growth in private demand deposits and in the money supply had leveled off since early July, but U.S. Government deposits had risen fairly rapidly. Bank earning assets had grown sharply in recent weeks, as banks had invested heavily in the U.S. Government securities offered in recent Treasury cash financings and had increased their acquisitions of State and local government obligations and their loans on securities.

The action to decrease the discount rate by ¼ percentage point moved the rate into closer alignment with the reduced level of short-term market interest rates. The Board believed that such a reduction would tend to moderate the tendency for short-term rates to move up from their summer lows and thereby help to forestall developments that might otherwise call for an enlarged provision of reserves.

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OCTOBER 7, 1968

AMENDMENT TO REGULATION Q, PAYMENT OF INTEREST ON DEPOSITS.

Effective October 15, 1968, Regulation Q was amended with respect to the payment of interest by member banks on certain time deposits of qualifying foreign official depositors.

> Votes for this action: Messrs. Robertson, Mitchell, Daane, Maisel, and Brimmer. Votes against this action: None. Absent and not voting: Messrs. Martin and Sherrill.

Pursuant to the enactment of Public Law 90-505, which became effective September 21, 1968, this amendment to Regulation Q clarified the authority of member banks to pay interest without regard to Regulation Q ceilings on time deposits of foreign governments, of the monetary and financial authorities of foreign governments when acting as such, and of international financial institutions of which the United States is a member. In this respect the amendment, which applied to time deposits with maturities of not more than 2 years, was essentially a restatement and extension of an earlier amendment, effective January 18, 1968 (see page 69 of this ANNUAL REPORT), which had been issued in light of the possible expiration of the Board's authority to regulate interest rates on a discretionary basis, an authority extended by Public Law 90-505.

The current amendment also modified an earlier position of the Board with respect to the payment of interest on deposits in the form of negotiable certificates of deposit (CD's) transferred by a so-called "exempt" organization, as defined above. Formerly, a member bank had been prohibited from paying interest at a rate exceeding the generally applicable maximum rate permitted by Regulation Q at the date of issue if a CD issued to an exempt organization had been transferred to a nonexempt holder at any time before maturity. Under the amendment a member bank could pay the contract rate on a CD issued to an exempt organization throughout the time it

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was held by such an organization even though the holder at maturity was not an exempt organization, provided that (1) in the event of a transfer, the date of transfer, attested to in writing by the transferor, appeared on the CD, and (2) the maximum rate limitations of Regulation Q in effect at the date of issuance of the certificate applied during such time as the CD was held by any person other than an exempt organization.

The Board indicated that, in keeping with the intent of the authorizing legislation, the current amendment was designed to encourage, to a greater extent than before, foreign monetary authorities to deposit funds in U.S. commercial banks and thus be of assistance in solving the nation's balance of payments problem.

NOVEMBER 13, 1968

AMENDMENT TO REGULATION A, ADVANCES AND DISCOUNTS BY FEDERAL RESERVE BANKS.

Effective November 13, 1968, Regulation A was amended with regard to the kinds of assets eligible as collateral for advances, thus bringing the regulation into conformity with recent legislation.

Votes for this action: Messrs. Robertson, Mitchell, Daane, and Maisel. Votes against this action: None. Absent and not voting: Messrs. Martin, Brimmer, and Sherrill.

Public Law 90-505, which became effective September 21, 1968, and the conforming changes in Regulation A now adopted by the Board broadened the definition of obligations eligible as collateral for advances to member banks to include all "such obligations as are eligible for purchase under Section 14(b) of the (Federal Reserve) Act." Previously, the reference had been to "notes . . . eligible for . . . purchase," which the Board had construed as not including obligations generally regarded as securities.

Obligations thus made eligible as collateral for advances included "direct obligations of, and obligations fully guaranteed

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as to principal and interest by, the United States or any agency thereof, and municipal obligations, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues, with a maturity from the date of the advance not exceeding six months."

In adopting the amendment, the Board revoked all previous interpretations with respect to the eligibility of specific obligations included in the above categories.

DECEMBER 16, 1968

REVISION OF FOREIGN CREDIT RESTRAINT PROGRAM GUIDELINES.

The Board adopted slightly revised guidelines for restraint of foreign credits by banks and other financial institutions. It was understood that these guidelines would be issued if the administration determined that the over-all U.S. balance of payments program should be continued in 1969 in substantially the same form as in 1968.

> Votes for this action: Messrs. Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Mr. Martin.

Adoption of the revised guidelines continued an integral part of the President's program, announced on January 1, 1968, to strengthen the U.S. balance of payments. In considering the foreign credit restraint program applicable to banks and other financial institutions, the Board concluded that balance of payments prospects for 1969 did not permit any basic change in the program and that restraint of capital outflows, both public and private, would continue to be required. Thus, the guidelines for 1969—announced on December 23, 1968, following acceptance by the President of a recommendation from the Cabinet Committee on the Balance of Payments regarding the over-all balance of payments program—were substantially the same as those for 1968. However, in view of the importance of increasing U.S. exports, the Board indicated its intention

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to review the program early in 1969 to determine whether additional flexibility for financing U.S. exports might be provided in the guidelines.

DECEMBER 17, 1968

INCREASE IN RATES ON DISCOUNTS AND ADVANCES BY FEDERAL RESERVE BANKS.

Effective December 18, 1968, the Board approved actions taken by the boards of directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, and Dallas establishing a rate of 5½ per cent (an increase from 5¼ per cent) on discounts and advances to member banks under Sections 13 and 13a of the Federal Reserve Act.

> Votes for this action: Messrs. Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None. Absent and not voting: Mr. Martin.

Pursuant to the policy established by this action, the Board subsequently approved the same rate for the Federal Reserve Banks of St. Louis, Kansas City, and San Francisco, effective December 20, 1968.

Effective the same dates the Board approved for the respective Federal Reserve Banks a rate of 6 per cent (an increase from 5¾ per cent) on advances to member banks under Section 10(b) of the Federal Reserve Act. In addition, the Board approved increases at all of the Banks in rates on advances to individuals, partnerships, and corporations other than member banks under the last paragraph of Section 13 of the Act.

Note: The directors of the Federal Reserve Banks of Philadelphia and St. Louis had initially voted to establish, subject to the approval of the Board of Governors, a rate of 5¾ per cent on discounts and advances to member banks under Sections 13 and 13a of the Federal Reserve Act, with corresponding secondary rates. Upon being advised that the Board was not prepared to approve a rate increase of ½ percentage point, the Federal Reserve Banks in question voted to establish a rate of 5½ per cent.

The discount rate increase was approved partly in light of the advances in other market interest rates that had occurred over recent months but also in recognition of the continued excessive strength of the economic expansion, the accompanying resur-

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gence of inflationary expectations, and the adverse impact of rapidly rising domestic prices on the country's balance of payments. In this situation a policy of increased monetary restraint was deemed appropriate and the discount rate action was taken, in conjunction with firming actions through open market operations, in furtherance of such a policy. Details of the attendant economic circumstances and the views of the Federal Open Market Committee, which voted to foster firmer conditions in money and short-term credit markets at its meeting on December 17, 1968, may be found in the entry for that date in the Record of Policy Actions of the Federal Open Market Committee, beginning on page 219 of this ANNUAL REPORT.

Before approving the increase of ¼ percentage point in the discount rate, the Board reviewed the arguments for a ½ point increase which had been voted initially by the directors of the Federal Reserve Banks of Philadelphia and St. Louis. The Board decided that, together with the firmer stance in open market policy, a ¼ point advance in the discount rate would be a sufficient change under current economic circumstances. The Board also recognized that conditions in domestic financial markets and in foreign exchange markets were highly sensitive and might tend to become unsettled if a larger increase were announced at this time.

During the course of the meeting the Board also considered arguments for a ½ point increase in member bank reserve requirements, the action to have an effective date in mid-January 1969 rather than immediately for technical reasons. Board members present were evenly divided in their assessment of the desirability of such an increase. Those in favor (Messrs. Robertson, Mitchell, and Brimmer) believed that this additional action would help reduce the availability of bank reserves without adding as directly to upward pressures on market interest rates as would open market sales of securities designed to absorb the same amount of reserves, and also that the action, in con-

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junction with the other measures of restraint being adopted, would provide an unmistakable signal of the System's determination to resist inflationary pressures in the economy. Those opposed (Messrs. Daane, Maisel, and Sherrill) thought that considerations similar to those underlying the decision against a ½ point increase in the discount rate militated also against an increase in reserve requirements—namely, that the other actions agreed upon were adequate in the current economic situation and that such further action would risk undesirably large reactions in financial markets. In their judgment consideration of an increase in reserve requirements should await an assessment of the impact of the firming actions being undertaken through open market operations and the ¼ point advance in the discount rate.

The Board agreed that the effectiveness of the more restrictive policy undertaken through open market operations and the increase in the discount rate would be enhanced if the maximum interest rates payable on various categories of member bank time and savings deposits under the Board's Regulation Q were maintained at prevailing levels.

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Record of Policy Actions of the Federal Open Market Committee

The record of policy actions of the Federal Open Market Committee is presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of Section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each such action, and that it shall include in its ANNUAL REPORT to the Congress a full account of such actions.

In the pages that follow, there are entries with respect to the policy actions taken at the meetings of the Federal Open Market Committee held during the calendar year 1968, including the votes on the policy decisions made at those meetings as well as a résumé of the basis for the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings, rather than on data as they may have been revised later.

It will be noted from the record of policy actions that in some cases the decisions were by unanimous vote and that in other cases dissents were recorded. The fact that a decision in favor of a general policy was by a large majority, or even that it was by unanimous vote, does not necessarily mean that all members of the Committee were equally agreed as to the reasons for the particular decision or as to the precise operations in the open market that were called for to implement the general policy.

Under the Committee's rules relating to the availability of information to the public, the policy record for each meeting is

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released approximately 90 days following the date of the meeting and is subsequently published in the Federal Reserve *Bulletin* as well as in the Board's ANNUAL REPORT.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market activities the Federal Reserve Bank of New York operates under two separate directives from the Open Market Committee—a continuing authority directive and a current economic policy directive. In the foreign currency area it operates under an authorization for System foreign currency operations and a foreign currency directive. These four instruments are shown below in the form in which they were in effect at the beginning of 1968. No revisions were made in the continuing authority directive during the year; changes in the other instruments are shown in the records for the individual meetings.

CONTINUING AUTHORITY DIRECTIVE WITH RESPECT TO DOMESTIC OPEN MARKET OPERATIONS
(in effect January 1, 1968)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of

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business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed (1) $125 million or (2) 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York, whichever is the lower;

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

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate ¼ of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

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CURRENT ECONOMIC POLICY DIRECTIVE

(in effect January 1, 1968)

The information reviewed at this meeting indicates that industrial output and employment have rebounded following strike settlements in the automobile and other industries, and that prospects have heightened for more rapid expansion of over-all economic activity in the months ahead. Both industrial and consumer prices have continued to rise at a substantial rate. The imbalance in U.S. international transactions has worsened, partly because of weakening in the export surplus since midyear. Foreign purchases of gold have been large following the devaluation of the pound sterling. Bank credit expansion has lessened, with diminished bank buying of Government securities and continued moderate loan growth. Most interest rates have risen further in reaction to the British devaluation and Bank rate increase, the rise in Federal Reserve discount rates, and waning expectations of enactment of the President's fiscal program. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to moving slightly beyond the firmer conditions that have developed in money markets partly as a result of the increase in Federal Reserve discount rates; provided, however, that operations shall be modified as needed to moderate any apparently significant deviations of bank credit from current expectations or any unusual liquidity pressures.

AUTHORIZATION FOR SYSTEM FOREIGN CURRENCY OPERATIONS

(in effect January 1, 1968)

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

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

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

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

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

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

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

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

(1) Commitments to deliver foreign currencies to the Stabilization Fund, up to $350 million equivalent;

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

(3) Other forward commitments to deliver foreign currencies, up to $550 million equivalent.

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

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap"

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arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	225
Bank of Canada	750
National Bank of Denmark	100
Bank of England	1,500
Bank of France	100
German Federal Bank	750
Bank of Italy	750
Bank of Japan	750
Bank of Mexico	130
Netherlands Bank	225
Bank of Norway	100
Bank of Sweden	200
Swiss National Bank	400
Bank for International Settlements:	
System drawings in Swiss francs	400
System drawings in authorized European currencies other than Swiss francs	600

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

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

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

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

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

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

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

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

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

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

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

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

FOREIGN CURRENCY DIRECTIVE

(in effect January 1, 1968)

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

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

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

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

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

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

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

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

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

C. To aid in avoiding disorderly conditions in exchange markets. Spe-

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

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

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

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

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MEETING HELD ON JANUARY 9, 1968

1. Authority to effect transactions in System Account.

Economic activity was expanding vigorously as 1967 drew to a close, and prospects were for further rapid growth in early 1968. Prices were rising at a substantial rate; and with demands strong and costs increasing, inflationary pressures were expected to persist in the period ahead.

Industrial production was tentatively estimated to have increased sharply further in December to a level above the peak of a year earlier. Nonfarm employment also continued to expand rapidly; in December nearly 1 million more persons were employed than in August, before the strike in the automobile industry. The unemployment rate, which in November had declined to 3.9 per cent, fell in December to 3.7 per cent, the same as a year earlier. Housing starts rose further in November, but part of the increase may have reflected an acceleration of schedules by some builders, in reaction to increasing uncertainties about future mortgage market conditions.

Average prices of industrial commodities continued to rise in December, according to preliminary estimates. Since midyear, such prices had advanced at an annual rate of about 3 per cent. Moreover, wholesale prices of farm products, which had been declining earlier, turned up in December—raising the possibility that advances in retail prices of food might resume. The consumer price index increased considerably further in November despite a slight decline in food prices.

Real gross national product in 1967 as a whole was estimated to have been about 2.5 per cent greater than in 1966. Growth was at a considerably higher rate in the second half of the year, however, and further acceleration appeared likely in early 1968. Recent surveys indicating that consumers were cautious in their attitudes and buying intentions suggested that personal saving

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would continue in the first quarter at the unusually high rate prevailing throughout 1967. Nevertheless, in view of the prospect for a large rise in incomes, a substantial increase in consumer expenditures was anticipated. Business spending on plant and equipment was expected to expand sharply, and the rate of inventory accumulation—which now appeared to have advanced more in the fourth quarter than had been estimated earlier—was expected to continue rising. Some further increase in outlays for residential construction appeared probable, in light of the upward course of housing starts through November and advances in construction costs. On the other hand, defense outlays—growth in which had slackened in the second half of 1967—were expected to level off.

The U.S. balance of payments worsened sharply in the fourth quarter of 1967. On the "liquidity" basis of calculation the deficit increased markedly from the third quarter, and on the "official reserve transactions" basis the balance shifted to a large deficit from a surplus in the preceding quarter.[1] For the year as a whole, the deficit on the liquidity basis was estimated at about $3.7 billion, compared with $1.4 billion in 1966; and the official settlements balance was in deficit by an estimated $3.4 billion, compared with a small surplus in 1966. Although detailed information on fourth-quarter payments was not yet available, it appeared that much of the deterioration was attributable to a reduction in the surplus on merchandise trade; in the October–November period exports declined and imports rose from their third-quarter rates. Special transactions—including the liquida-

[1] The balance on the "liquidity" basis is measured by changes in U.S. reserves and in liquid U.S. liabilities to all foreigners. The balance on the "official reserve transactions" basis (sometimes referred to as the "official settlements" basis) is measured by changes in U.S. reserves and in liquid and certain nonliquid liabilities to foreign official agencies, mainly monetary authorities. The latter balance differs from the former by (1) treating changes in liquid U.S. liabilities to foreigners other than official agencies as ordinary capital flows, and (2) treating changes in certain nonliquid liabilities to foreign monetary authorities as financing items rather than ordinary capital flows.

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tion of official British holdings of U.S. securities—also contributed to the deficit on both bases in the fourth quarter. For 1967 as a whole, the liquidity deficit was substantially reduced by the net effect of special transactions.

On January 1, 1968, the President announced a new program which was, in his words, "designed to bring our balance of payments to—or close to—equilibrium in the year ahead." After stressing the need for a tax increase and other actions to "help stem the inflationary pressures which now threaten our economic prosperity and our trade surplus," the President outlined elements of a program through which an improvement of about $3 billion in the U.S. payments balance would be sought in 1968. The most important of these were a mandatory reduction in the flow of U.S. funds into direct investments abroad, particularly to continental Western Europe, and increased restrictions, under the Federal Reserve's foreign credit restraint program, on lending abroad by U.S. financial institutions. The program also included reduction of expenditures by American citizens for travel outside the Western Hemisphere, curtailment of Government expenditures overseas, and a variety of measures to increase U.S. exports and the trade surplus.

Gold holdings of the U.S. Treasury were reduced in December by the record monthly amount of about $900 million, mainly as a result of settlement of the U.S. share of sales made by the gold pool in London in November and December. Following the President's announcement of the new balance of payments program, foreign purchases of gold slackened abruptly. In foreign exchange markets the dollar strengthened against all continental European currencies, and the position of sterling improved somewhat.

System open market operations since the preceding meeting of the Committee had been directed at fostering slightly firmer conditions in the money market. An announcement by the Board of Governors on December 27 of an increase in reserve require-

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ments against demand deposits, effective in mid-January, reinforced the belief of market participants that the System was moving toward greater monetary restraint.[2] The Federal funds rate, which earlier had fluctuated around the 4½ per cent discount rate established on November 20, increased somewhat to a range around 4⅝ per cent. Average free reserves of member banks were estimated to have declined to about $80 million in the three statement weeks ending January 3, from slightly over $200 million in the first 2 weeks of December.

Most short-term interest rates rose somewhat further in the latter half of December as money market conditions firmed, but longer-term yields remained stable or edged down. Various factors contributed to an improvement in the atmosphere in capital markets in this period; these included a seasonal lull in new private security issues, the absence of Treasury financing activity, and an apparent shift in investor expectations toward the view that longer-term rates were not likely to rise much further.

Both short- and long-term market interest rates declined following the announcement on January 1 of the new balance of payments program—which many investors interpreted as reducing the likelihood of greater monetary restraint in the near term —and the downtrend was reinforced by press reports suggesting that prospects for peace negotiations in Vietnam had improved. As a result, yields on new corporate bonds and on Treasury notes, bonds, and longer-term bills were now considerably below their levels at the time of the Committee's preceding meeting, and yields on municipal bonds were slightly lower. Most short-term yields, however, were higher on balance; the market rate on 3-month Treasury bills, at 5.02 per cent on the day before this meeting, was 12 basis points above its level 4 weeks earlier.

Interest rates on new-home mortgages rose further in Novem-

[2] Reserve requirements against demand deposits in excess of $5 million at each member bank were increased from 16½ to 17 per cent for reserve city banks, effective with the reserve computation period beginning Jan. 11, 1968; and from 12 to 12½ per cent for other member banks, effective with the computation period beginning Jan. 18, 1968.

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ber and apparently remained under upward pressure in December. Net inflows of funds to nonbank depositary institutions continued to moderate in late 1967, although the available information did not suggest that depositary institutions in general were facing substantial drains around the year-end interest- and dividend-crediting period. With inflows slackening, and with high yields on marketable bonds offering an attractive alternative form of investment, lenders in the aggregate were expanding their new mortgage commitments at a slower pace than they had earlier.

Growth in time and savings deposits at commercial banks also had continued to moderate recently. Such deposits expanded at an annual rate of 8.5 per cent in December—compared with rates of about 12 per cent in November and about 16 per cent over the year 1967. The moderation of growth was a result of substantial run-offs of large-denomination CD's and further slowing of the rise in other time and savings deposits. Private demand deposits declined slightly on average in December, and the money supply increased relatively little. With Government deposits contracting, the "bank credit proxy"—total member bank deposits [3] —was about unchanged. Banks reduced their borrowings of Euro-dollars through foreign branches in December, with much of the decline apparently seasonal in nature.

Over the year 1967 the money supply and the bank credit

[3] In recent years the Committee had been making use of daily-average statistics on total member bank deposits as a "bank credit proxy"—that is, as the best available measure, although indirect, of developing movements in bank credit. Because they can be compiled on a daily basis with a very short lag, the deposit figures are more nearly current than available bank loan and investment data. Moreover, average deposit figures for a calendar month are much less subject to the influence of single-date fluctuations than are the available month-end data on total bank credit, which represent estimates of loans and investments at all commercial banks on one day—the last Wednesday—of each month. For statistics on daily-average member bank deposits, see the Federal Reserve BULLETIN for October 1966, p. 1478, and subsequent months. Some brief comments on the relation between the member bank deposit series and the bank credit statistics are given in the note on p. 1460 of the October 1966 BULLETIN.

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proxy increased by about 6.5 and 11.5 per cent, respectively. As measured by end-of-month data on loans and investments, bank credit was estimated to have increased by about 11 per cent in 1967.

Business loans at commercial banks, which had been rising at a relatively slow pace in recent months, expanded sharply in December. Part of the acceleration reflected special factors, but part appeared to be related to the increasing pace of economic activity and to the smaller volume of capital market financing. With growth in their deposits limited, banks accommodated the larger demand for loans by selling a substantial volume of Government securities. Banks also reduced the rate at which they acquired State and local government issues.

On the day of this meeting the Treasury was offering $2.5 billion of tax-anticipation bills, for payment on January 15. Banks were expected to be the initial purchasers of practically all of the offering, for which they were permitted to make full payment by crediting Treasury tax and loan accounts. Largely as a consequence of such purchases, bank credit expansion was expected to resume in January; the proxy series was projected to rise at an annual rate in the range of 6 to 10 per cent if prevailing money market conditions were maintained. It appeared likely that growth in business loans would be slower than in December but still fairly rapid, and there was some prospect that in meeting loan demands banks would continue to limit their takings of municipal securities. Growth in time and savings deposits was expected to continue moderating in light of the high yields available to investors on competing market instruments. Little or no increase was anticipated in private demand deposits and the money supply, but Government deposits were projected to rise substantially.

Concern was expressed in the Committee's discussion about the inflationary environment and outlook, on both domestic grounds and in light of the recent contraction in the surplus on

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U.S. merchandise trade. The new balance of payments program was expected to result in a substantial reduction in the over-all deficit in 1968. It was observed, however, that the various elements of the program directed at improving the balance on specific types of international flows did not obviate the fundamental need for slowing the rise in domestic prices.

It was noted in the discussion that since mid-November the System had employed all three of the major instruments of monetary policy—discount rates, open market operations, and reserve requirements—in shifting toward a posture of somewhat greater restraint, that the effects of these policy actions were still unfolding, and that growth in bank credit and the money supply had slowed appreciably in recent months. It also was noted that forthcoming Presidential messages and further congressional hearings on an income tax surcharge would soon be providing new information on planned Federal expenditures and the prospects for a tax increase. Accordingly, the Committee decided to make no further change in policy at present. Reinforcing this decision was the possibility that higher interest rates resulting from a further firming of monetary policy at this time might have undesired effects on flows of funds to financial intermediaries.

The Committee agreed that it would be appropriate to maintain the somewhat firmer conditions in the money market that had developed as a result of recent System open market operations and the announced action with respect to reserve requirements. Some members noted in this connection that a slightly lower average level of marginal reserves might be required after the effective dates of the increase in reserve requirements in order to maintain prevailing money market conditions in other respects. The Committee also agreed that operations should be modified as needed to moderate any apparently significant deviations of bank credit from current expectations. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

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The information reviewed at this meeting indicates that over-all economic activity has been expanding vigorously, with both industrial and consumer prices continuing to rise at a substantial rate, and that prospects are for further rapid growth and persisting inflationary pressures in the period ahead. The imbalance in U.S. international transactions worsened further in late 1967, but the new program announced by the President should result in a considerable reduction in the deficit this year. Following announcement of the program, foreign purchases of gold slackened abruptly and the dollar strengthened in foreign exchange markets. Long-term bond yields have declined in recent weeks but some short-term interest rates have risen further. Bank credit has changed little on balance recently as banks have disposed of Government securities to accommodate strengthened loan demands. Growth in the money supply has slackened and flows into time and savings accounts at bank and nonbank financial intermediaries have continued to moderate. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the somewhat firmer conditions that have developed in the money market in recent weeks, partly as a result of the increase in reserve requirements announced to become effective in mid-January; provided, however, that operations shall be modified as needed to moderate any apparently significant deviations of bank credit from current expectations.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, and Wayne. Votes against this action: None.

2. Ratification of amendment to authorization for System foreign currency operations.

At this meeting the Committee ratified the action taken by members on December 14, 1967, amending paragraph 2 of the authorization for System foreign currency operations to change (1) the size of the swap arrangement with the Bank for International Settlements providing for System drawings in Swiss

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francs, and (2) the size of the arrangement with the Swiss National Bank, each from $250 million to $400 million equivalent, effective immediately. As indicated in the policy record for the meeting held on December 12, 1967, these increases supplemented the enlargements of the System's swap network that had been approved on November 27 and November 30.

Votes for ratification of this action: Messrs. Hayes, Brimmer, Francis, Maisel, Mitchell, Scanlon, Sherrill, Swan, and Wayne. Votes against ratification of this action: None.

Absent at this point in meeting and not voting: Messrs. Martin, Robertson, and Daane.

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MEETING HELD ON FEBRUARY 6, 1968

Authority to effect transactions in System Account.

According to reports at this meeting, prospects were for continued rapid growth in over-all economic activity and for persistent inflationary pressures in the period ahead. Preliminary estimates of the Department of Commerce indicated that real GNP had increased at an annual rate of 4.4 per cent in the fourth quarter of 1967, the same as in the preceding quarter, and that average prices, as measured by the GNP "deflator," had advanced considerably. In his January budget message the President had again proposed a 10 per cent surcharge on corporate and personal income taxes, now to be effective on January 1 and April 1, 1968, respectively. The budget estimates indicated that even if the tax surcharge were enacted as proposed the Government would incur a sizable deficit in the calendar year 1968.

Average prices of industrial commodities continued to increase at a substantial rate in January, according to preliminary estimates. Prices of farm products, which had turned up sharply in December, rose somewhat further. The consumer price index again advanced considerably in December, partly because retail prices of food rose after having declined moderately for 3 months.

Growth in real GNP was expected to accelerate in the first quarter of 1968. Prospects favored substantial increases in consumer incomes and spending, a sharp rise in business outlays on plant and equipment, a small increase in residential construction outlays, and—contrary to earlier expectations—some further growth in defense expenditures. The rate of business inventory accumulation, which now appeared to have increased considerably in the fourth quarter of 1967, was expected to rise only moderately further in the first quarter of 1968.

The worsening of the U.S. payments balance in the fourth quarter, according to newly available information, was due in

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large part to a marked decline in the surplus on merchandise trade. With imports rising sharply and exports edging down, the trade surplus in the fourth quarter was at a rate only about one-third that in the two preceding quarters and the lowest since the fourth quarter of 1959.

The gold stock of the U.S. Treasury was reduced by $100 million in early February, mainly to cover the U.S. share of sales made by the London gold pool in January. Although the overall atmosphere in foreign exchange markets had tended to improve in recent weeks, the Canadian dollar had come under heavy pressure. On January 22 the Bank of Canada raised its discount rate for the third time in 5 months, bringing the rate to 7 per cent. Interest rates in the Euro-dollar market had declined further from the unusually high levels they had reached in late November and December, following the devaluation of sterling.

System open market operations since the preceding meeting of the Committee had been directed at maintaining the somewhat firmer conditions in the money market that had developed earlier, although operations were complicated by large changes in the excess reserves of country banks as reserves first flowed out of money centers and then back again. In adapting operations to these changes in reserve distribution, the net reserve position of member banks was permitted to fluctuate over an unusually wide range—from free reserves of $405 million in the statement week ending January 10 to net borrowed reserves of $70 million in the following week.

The Federal funds rate continued to fluctuate around 4⅝ per cent, and late in the period interest rates on loans by money center banks to Government securities dealers edged up to a range of 5 to 5¼ per cent. On the other hand, interest rates on short-term market securities—including Treasury bills, large-denomination CD's, bankers' acceptances, and commercial and finance company paper—declined on balance during the period, in part

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perhaps because pressures in credit markets proved to be less intense than many participants had expected. Offering rates on large-denomination CD's maturing in less than 6 months moved down from the 5½ per cent ceiling established under Regulation Q; around the turn of the year banks had been offering the ceiling rate on CD's of all maturities. Although the market rate on 3-month Treasury bills had been rising recently, its level on the day before this meeting—4.91 per cent—was about 10 basis points below that of 4 weeks earlier.

Conditions in markets for longer-term securities had been generally buoyant in recent weeks, despite deferral of congressional action on the President's proposed income tax surcharge and new tensions in the Far East. Yields on long-term Treasury and corporate bonds fluctuated irregularly below the peaks they had reached in late 1967, and yields on State and local government issues declined. On January 31 the Treasury announced that it would offer a new 7-year, 5¾ per cent note in exchange for Treasury notes and bonds maturing in February, August, and November 1968, with settlement on February 15. Initial market reactions to the offering were favorable. The Treasury also announced that $4 billion of a 15-month note would be offered for cash subscription later in the month.

In mortgage markets yields rose further in December—reattaining the highs they had reached in November 1966—and growth in mortgage commitments outstanding continued to moderate. Preliminary data suggested that net inflows of funds to nonbank depositary institutions slackened further in December and January, but that withdrawals of savings around the year-end interest- and dividend-crediting period were not as large as many in the industry had feared.

Commercial bank credit expanded at a relatively fast pace in January after slowing markedly in late 1967. Contributing to the expansion were rapid growth in business loans early in the month and bank acquisitions of tax-anticipation bills sold by the Treasury at midmonth. The bank credit proxy—daily-average mem-

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ber bank deposits—rose from December to January at an annual rate of about 9 per cent, near the upper end of the range that had been projected earlier. Private demand deposits and the money supply increased sharply before turning down after mid-January; on the average the money supply rose at an annual rate of 8 per cent, in contrast to the expectation of little or no change. However, Government deposits rose less than had been anticipated, and total time and savings deposits—instead of growing relatively slowly on the average—declined slightly. Despite the reductions in offering rates on large-denomination CD's of shorter maturity, the volume of CD's outstanding increased over the course of January by nearly as much as it had declined in December.

Business loans at banks were expected to grow moderately in February—at a rate that was below the rapid pace of December and early January but that, as a result of enlarged business needs for inventory financing, was above the slow rate of the preceding autumn. Mainly because of Treasury financing operations, however, it appeared likely that total bank credit would continue to expand at roughly the January pace; growth in the bank credit proxy was projected at an annual rate in the 7 to 10 per cent range if prevailing money market conditions were maintained. It was expected that the money supply would change little, and might possibly decline somewhat, but that growth in time and savings deposits would resume. A rather sharp expansion was anticipated in Government deposits as a result of the Treasury's forthcoming cash financing.

Considerable concern was expressed in the course of the Committee's discussion about recent and prospective inflationary pressures in the domestic economy and about the sharp decline in the nation's foreign trade surplus. Against this background, a number of members indicated that they had been disturbed by various financial developments in January—including the unexpectedly sharp growth in the money supply and the general decline in short-term interest rates other than day-to-day money market rates—which suggested that monetary conditions had become less restrictive. There also was widespread sentiment to the

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effect that the growth in bank credit projected for February on the assumption of unchanged money market conditions was larger than desirable in the current environment. At the same time, it was recognized that the forthcoming Treasury financing operations imposed an important constraint on monetary policy at present.

The Committee concluded that it would be desirable to maintain firm money market conditions at this time and to seek firmer conditions, to the extent permitted by Treasury financing, if bank credit appeared to be expanding as rapidly as projected. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that over-all economic activity has been expanding rapidly, with both industrial and consumer prices rising at a substantial rate, and that prospects are for continuing rapid growth and persisting inflationary pressures in the period ahead. The imbalance in U.S. international transactions worsened further in late 1967, primarily because of a sharp reduction in the surplus on merchandise trade. Although day-to-day money market rates have remained firm, rates on other short-term instruments have declined recently; meanwhile, long-term bond yields have fluctuated irregularly below the peaks reached late last year. Growth in bank credit resumed in January, reflecting both loan expansion around the year-end and Treasury financing. The money supply expanded sharply following earlier slackening, but flows into time and savings accounts at bank and nonbank financial intermediaries have continued to moderate. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market, and operations shall be modified to the extent permitted by Treasury financing if bank credit appears to be expanding as rapidly as is currently projected.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Francis, Maisel, Mitchell, Robertson, Scanlon, Sherrill, Swan, and Wayne. Votes against this action: None.

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MEETING HELD ON MARCH 5, 1968

1. Authority to effect transactions in System Account.

Reports at this meeting indicated that over-all economic activity was expanding rapidly and that prices were rising at a substantial rate. The outlook was for faster expansion in real GNP in the first two quarters of 1968 than in the latter half of 1967, and for persisting inflationary pressures.

Consumers were expected to provide the major stimulus to economic activity in the current half-year. It appeared likely that disposable incomes would advance rapidly—particularly if a tax increase were not enacted—as a result of continuing rises in employment and wage rates and of higher social security benefits. Thus, even if personal saving remained at the unusually high rate of 1967, marked increases in consumer spending were in prospect.

In addition, it was anticipated that business fixed investment would rise sharply in the first quarter and moderately in the second and that defense spending would increase at a faster rate than previously estimated. On the other hand, in light of conditions in mortgage markets little or no further increase was foreseen in residential construction outlays. Growth in the rate of business inventory accumulation, which had contributed importantly to the expansion in the latter half of 1967, was expected to slow in the first quarter and taper off in the second.

Retail sales rose substantially in the first 2 months of 1968, according to incomplete information. Industrial production, however, declined somewhat in January and was expected to change little in February. The unemployment rate moved down in January for the third successive month—to 3.5 per cent, from 3.7 per cent in December—although growth in nonfarm employment slowed from its earlier rapid pace, apparently in large part

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because of the effect of bad weather on employment in the construction industry.

Average wholesale prices of both industrial commodities and farm products rose considerably further in February, according to preliminary estimates. Consumer prices continued to advance at a substantial rate in January and were 3.4 per cent higher than a year earlier. The recent pattern of settlements in wage negotiations and the increase on February 1 in Federal minimum wage rates suggested that unit labor costs would remain under upward pressure.

Both exports and imports of the United States rose sharply in January, but the surplus on merchandise trade fell somewhat below the markedly reduced fourth-quarter 1967 rate. With respect to the capital account, outstanding U.S. bank credit to foreigners declined more than seasonally and direct investment outflows apparently were reduced by the mandatory restrictions under the President's new balance of payments program. On balance, the deficit in U.S. international payments on the liquidity basis of calculation remained sizable in January, and also in the first 3 weeks of February according to tentative figures. The deficit on the official reserve transactions basis was considerably smaller, primarily as a result of large Euro-dollar borrowings by U.S. banks through foreign branches.

Heavy speculative demands for gold reemerged in the London market at the end of February and in early March, when fears of a change in U.S. gold policy became widespread. In foreign exchange markets, the generally improved atmosphere that had developed in January persisted for most of February. Late in the month, however, sterling and the Canadian dollar again came under pressure.

The Treasury completed two major financing operations in February. In a financing conducted during the first half of the month, $3.8 billion of publicly held securities maturing in February, August, and November 1968 were exchanged for new 7-

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year, 5¾ per cent notes. Also, the Treasury sold about $4.1 billion of new 15-month, 5⅝ per cent notes to the public for cash payment on February 21; commercial banks, which were permitted to make payment in full for these notes through credits to Treasury tax-and-loan accounts, initially subscribed for the bulk of the issue. Government securities dealers made good progress in distributing the 7-year notes they had acquired, while bank selling of the new 15-month issue appeared to be relatively light and was readily absorbed by the market. In February the Treasury also announced that it was resuming the $100 million addition to each weekly offering of 3-month bills.

Growth in bank credit and the money supply had moderated on balance since November 1967, when the System had begun to shift monetary policy toward a posture of somewhat greater restraint. In the 3 months through February the bank credit proxy—daily-average member bank deposits—had expanded at an annual rate of 6 per cent, compared with a rate of nearly 11.5 per cent over the preceding 7 months; and the money supply had grown at an annual rate of 4 per cent, about half that of the earlier period. For February, however, the bank credit proxy was estimated to have increased at an annual rate of 10 per cent. Both loans and investments of banks declined in the first part of February, but bank credit expanded sharply later in the month as a result of bank acquisitions of the new 15-month notes offered by the Treasury. The February advance in bank credit was at the upper end of the range projected at the time of the Committee's previous meeting and slightly faster than the pace in January, when growth was also stimulated by a large Treasury cash financing. Private demand deposits and the money supply, which had not been expected to grow in February, increased somewhat but substantially less than in January.

Time and savings deposits of commercial banks, after declining slightly in January, expanded in February at a rate below that of the summer and early fall of 1967. Most of the rise was

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in consumer-type deposits; with business loan demands not particularly strong, banks were not aggressive in seeking to expand their outstanding large-denomination CD's. Some banks were now offering the 5½ per cent ceiling rate on certificates with maturities as short as 4 months—in contrast to a 6-month minimum 4 weeks earlier—but rates on shorter-maturity CD's remained below the ceiling.

With no major Treasury financings in prospect for March, growth in the bank credit proxy was projected to moderate in that month to an annual rate in the range of 5 to 7 per cent, assuming no change in prevailing money market conditions. It was thought likely that somewhat firmer money market conditions would have relatively little effect on bank credit expansion in March. Projections for April suggested some further moderation in bank credit growth if money market conditions were unchanged and a quite low growth rate if such conditions were somewhat firmer, unless demands for business loans strengthened considerably or the Treasury decided to undertake a major financing. Time and savings deposits were projected to expand in March at about the February pace, and private demand deposits and the money supply were expected to grow somewhat more rapidly than in the preceding month.

System open market operations had been directed at maintaining stable conditions in the money market during the first part of February. The Treasury's financing operations were under way in that period and staff estimates of bank credit growth for the month were near the lower end of the range that had been projected at the previous meeting. Subsequently, after estimates of bank credit growth had been revised upward, operations were modified to achieve somewhat firmer conditions in the money market. The net reserve position of member banks shifted to average net borrowed reserves of about $95 million in the last two statement weeks of February from average free reserves of $120 million in the first 2 weeks, and average member bank bor-

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rowings rose by about $110 million, to about $425 million. The Federal funds rate, which initially had fluctuated for the most part in a range of 4⅝ to 4¾ per cent, later was predominantly in a range of 4¾ to 4⅞ per cent and at times was as high as 5 per cent.

Market rates on Treasury bills had risen since the preceding meeting of the Committee, but the advance was moderated by sustained nonbank demand for bills and, late in the period, by sizable purchases by foreign central banks. The 3-month bill rate, at 4.99 per cent on the day before this meeting, was up 8 basis points over the interval. Rates on most other short-term market instruments also had edged higher.

In longer-term debt markets the generally buoyant conditions of January had been succeeded by a more cautious atmosphere. Conditions in these markets were affected by a variety of conflicting factors—including expectations of further tightening of monetary policy, the belief that prospects for fiscal restraint had been somewhat enhanced recently, and continuing uncertainties relating to developments in Vietnam. Yields on Treasury notes and bonds had changed little on balance in the last 4 weeks, but advances in yields on corporate and State and local government bonds, particularly the latter, had resumed. While the calendar of new publicly offered corporate bonds remained relatively light, continuing additions were being made to an already large volume of prospective offerings of municipal securities.

Conditions in markets for residential mortgages appeared to have changed little in January, after tightening for some time. Primary market yields on conventional new-home mortgages rose slightly, but secondary market yields on FHA-insured home mortgages remained unchanged at the record level reattained a month earlier. The deposit experience of savings and loan associations and of mutual savings banks was mixed in January, but in general it apparently was better than many observers had anticipated.

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The Committee decided that greater monetary restraint was desirable at this time in light of the current and prospective pace of economic expansion, persisting inflationary pressures, and the sharply reduced surplus on U.S. merchandise trade. Specifically, the members agreed that it would be appropriate to seek somewhat firmer conditions in the money market than had been attained in recent weeks, and to seek still firmer conditions if bank credit appeared to be expanding more rapidly than projected.

In the course of the discussion a number of members expressed the view that a discount rate increase should be considered by the System soon. At the same time, it was noted that action under the Board's Regulation Q to increase the ceiling rate on large-denomination CD's might be needed at some point to avoid an undesirably large reduction in the outstanding volume of such CD's.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that over-all economic activity has been expanding rapidly, with both industrial and consumer prices rising at a substantial rate, and that prospects are for continuing rapid growth and persisting inflationary pressures in the period ahead. The foreign trade surplus has been at a sharply reduced level in recent months and the imbalance in U.S. international payments remains serious. Interest rates on most types of market instruments have edged up recently, following earlier declines. While growth in bank credit has moderated on balance during the past 3 months, bank credit expansion has been substantial in February, mainly reflecting Treasury financings. Growth in the money supply slowed in February, while flows into bank time and savings accounts expanded moderately. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat firmer conditions in the money market; provided, however, that

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operations shall be further modified if bank credit appears to be expanding more rapidly than is currently projected.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Ellis, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, and Sherrill. Votes against this action: None.

Absent and not voting: Mr. Daane.

2. Amendment of authorization for System foreign currency operations.

The Committee amended paragraph 3 of the authorization for System foreign currency operations in two respects. The phrase "Unless otherwise expressly authorized by the Committee" was added at the beginning of the first sentence of the paragraph, before language specifying that all foreign currency transactions should be at prevailing market rates. Such a qualification had been included at the corresponding point in the Committee's original authorization regarding foreign currency transactions adopted in February 1962, and had been inadvertently omitted when the previous instruments governing foreign currency operations were reformulated in June 1966. The effect of restoring the qualification was to simplify procedures in the event the Committee concluded that because of special circumstances a particular transaction should be undertaken at a rate different from that prevailing in the market.

At the same time, the second sentence of the paragraph, which had read as follows, was deleted:

Insofar as is practicable, foreign currencies shall be purchased through spot transactions when rates for those currencies are at or below par and sold through spot transactions when such rates are at or above par, except when transactions at other rates (i) are specifically authorized by the Committee, (ii) are necessary to acquire currencies to meet System commitments, or (iii) are necessary to acquire currencies for the Stabilization Fund, provided that these currencies are resold forward to the Stabilization Fund at the same rate.

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Restrictions on spot sales of foreign currencies at prices below par and on spot purchases at prices above par had been included in the Committee's foreign currency instruments since their original adoption in February 1962. The Committee now concluded that such restrictions were unnecessary, in light of the limitations on the purposes for which foreign currency operations could be undertaken given in paragraph 2 of the Committee's foreign currency directive. The restrictions also were considered undesirable on the grounds that spot sales of foreign currencies at prices below par and spot purchases at prices above par might be useful, on occasion, in furthering the purposes specified in the directive.

As amended, paragraph 3 of the authorization for System foreign currency operations read as follows:

> Unless otherwise expressly authorized by the Committee, all transactions in foreign currencies undertaken under paragraph 1(A) above shall be at prevailing market rates and no attempt shall be made to establish rates that appear to be out of line with underlying market forces.

Except for the changes resulting from these amendments, the Committee renewed the authorization in its existing form.

> Votes for this action: Messrs. Martin, Hayes, Brimmer, Ellis, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, and Sherrill. Votes against this action: None.
>
> Absent and not voting: Mr. Daane.

3. Review of continuing authorizations.

This being the first meeting of the Federal Open Market Committee following the election of new members from the Federal Reserve Banks to serve for the year beginning March 1, 1968, and their assumption of duties, the Committee followed its customary practice of reviewing all of its continuing authorizations

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and directives. The action taken with respect to the authorization for System foreign currency operations has been described in the preceding portion of the record for this date.

The Committee reaffirmed its continuing authority directive for domestic open market operations and its foreign currency directive in the forms in which both were outstanding at the beginning of the year 1968.

Votes for these actions: Messrs. Martin, Hayes, Brimmer, Ellis, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, and Sherrill. Votes against these actions: None.

Absent and not voting: Mr. Daane.

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MEETING HELD ON MARCH 14, 1968

1. Authority to effect transactions in System Account.

In the period since the preceding meeting of the Committee speculative demands for gold in London and other foreign markets had swelled to massive proportions. On the day of this meeting, the British authorities had temporarily closed the London gold market and had declared a Bank Holiday for the following day; the Board of Governors had approved an increase in Federal Reserve Bank discount rates from 4½ to 5 per cent, effective March 15; and arrangements were made for central bank governors of countries that had been actively participating in the London gold pool to meet in Washington on Saturday and Sunday, March 16 and 17, to consider their future policy with respect to gold. The purpose of this meeting of the Committee, which was held by telephone, was to review recent developments and make such changes in the Committee's policy instruments as appeared to be needed in light of those developments.

The Committee agreed that its current policy directive should be modified to permit adaptation of open market operations to the changed circumstances brought about by recent events, including the discount rate action. After discussion, the following current economic policy directive was issued to the Federal Reserve Bank of New York:

In light of recent international financial developments, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm but orderly conditions in the money market, taking into account the effects of increases in Federal Reserve discount rates.

Votes for this action: Messrs. Martin, Brimmer, Daane, Ellis, Hickman, Maisel, Mitchell, Robertson, Sherrill, Clay, Coldwell, and Treiber. Votes against this action: None.

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Absent and not voting: Messrs. Hayes, Galusha, and Kimbrel. (Messrs. Treiber, Clay, and Coldwell, respectively, voted as their alternates.)

2. Amendment to authorization for System foreign currency operations.

At this meeting the Committee authorized the Special Manager to undertake negotiations looking toward increases, up to specified limits, in a number of the System's reciprocal currency arrangements, on the understanding that any such enlargements —and the corresponding amendments to paragraph 2 of the authorization for System foreign currency operations—would become effective upon a determination by Chairman Martin that they were in the national interest. Specifically, negotiations were authorized for increases up to varying maximum amounts, ranging from $100 million to $400 million equivalent, in the System's two swap arrangements with the Bank for International Settlements and in the arrangements with the central banks of Belgium, Canada, Italy, Japan, the Netherlands, Sweden, and Switzerland.

Votes for this action: Messrs. Martin, Brimmer, Daane, Ellis, Hickman, Sherrill, Clay, Coldwell, and Treiber. Votes against this action: Messrs. Maisel, Mitchell, and Robertson.

Absent and not voting: Messrs. Hayes, Galusha, and Kimbrel. (Messrs. Treiber, Clay, and Coldwell, respectively, voted as their alternates.)

This action was taken on the ground that enlargements of the swap arrangements should prove helpful in coping with flows of short-term funds in foreign exchange markets if such flows became heavy in the current highly uncertain environment. The Committee concurred in the view of the Special Manager that under existing conditions it would be desirable if negotiated enlargements were to become effective immediately upon a

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determination by the Chairman that they were in the national interest, thus obviating the need for further Committee action.

Messrs. Maisel, Mitchell, and Robertson dissented from this action because of reservations about the desirability, under current circumstances, of authorizing a substantial enlargement of the swap network before discussions were held with monetary authorities of other countries on means for coordinating international financial policies. They favored postponing consideration of increases in the swap arrangements until after the forthcoming week-end meeting of central bank governors.

Subsequent to this meeting, on March 16, available members of the Committee (Messrs. Martin, Brimmer, Daane, Maisel, Mitchell, Robertson, and Treiber, the last voting as alternate for Mr. Hayes) voted unanimously to authorize the Special Manager to undertake negotiations looking toward an increase of $250 million equivalent in the System's swap arrangement with the German Federal Bank, on the understanding that any such increase, and the corresponding amendment to the authorization for System foreign currency operations, would become effective upon a determination by Chairman Martin that it was in the national interest. Messrs. Maisel and Robertson indicated that they continued to hold the general reservations concerning swap line increases that they had expressed on March 14, but that they had voted favorably on this action because—inasmuch as the Committee had taken the action it did on that date—they thought it appropriate to include the swap line with the German Federal Bank in an enlargement of the swap network.

On March 17, available members of the Committee (Messrs. Martin, Brimmer, Daane, Ellis, Galusha, Maisel, Mitchell, Robertson, Sherrill, and Treiber, the last voting as alternate for Mr. Hayes) voted unanimously to authorize the Special Manager to undertake negotiations looking toward an increase of $500

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million equivalent in the System's swap arrangement with the Bank of England, subject to the same understanding as in the actions taken on March 14 and 16.

On March 17 Chairman Martin determined that increases in the System's swap arrangements with the foreign banks listed below, in the indicated amounts (millions of dollars equivalent), were in the national interest:

Bank of Canada	250
Bank of England	500
German Federal Bank	250
Bank of Japan	250
Netherlands Bank	175
Bank of Sweden	50
Swiss National Bank	200
Bank for International Settlements:	
System drawings in Swiss francs	200
System drawings in other authorized European currencies	400

Accordingly, effective March 17, 1968, paragraph 2 of the authorization for System foreign currency operations was amended to read as follows:

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	225
Bank of Canada	1,000
National Bank of Denmark	100
Bank of England	2,000
Bank of France	100
German Federal Bank	1,000
Bank of Italy	750
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	400
Bank of Norway	100
Bank of Sweden	250
Swiss National Bank	600
Bank for International Settlements:	
System drawings in Swiss francs	600
System drawings in authorized European currencies other than Swiss francs	1,000

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MEETING HELD ON APRIL 2, 1968

1. Authority to effect transactions in System Account.

The domestic economic situation continued to be characterized by substantial increases in over-all activity and prices. Real GNP was estimated to have grown rapidly in the first quarter and another large rise appeared in prospect for the second quarter. From the preceding autumn, average prices of industrial commodities had advanced through March at an annual rate of about 4.5 per cent, and average consumer prices had risen through February at a rate of nearly 4 per cent. The outlook was for persisting inflationary pressures in the period ahead.

Industrial production was little changed in February; but according to tentative estimates, it had increased moderately in March. Nonfarm employment rose sharply in February, but the labor force also expanded markedly and the unemployment rate increased to 3.7 per cent from 3.5 per cent in January. Weekly retail sales figures for early March suggested that the sharp resurgence of consumer expenditures, under way since the beginning of the year, was continuing.

Consumer spending was expected to increase considerably further in the second quarter, even if a tax increase were enacted, because of the prospective rapid gains in income. In addition, defense outlays were running substantially above the levels that had been anticipated earlier, as had been noted by the President in the March 31 address in which he announced the de-escalation of bombing in North Vietnam. The President also indicated that estimates of defense expenditures in the fiscal year 1969 had been revised upward.

Apart from the consumer and defense categories, changes in activity in broad economic sectors were expected to be relatively moderate in the second quarter. It appeared likely that residential construction activity, which had risen slightly in the first quarter,

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would change little further. Some increase in the rate of business inventory investment was anticipated, following an apparent slowing in accumulation in the first quarter. On the other hand, growth in fixed investment was expected to level off after a substantial rise in the early months of the year. For 1968 as a whole businesses planned to increase their spending on new plant and equipment by 6 per cent, according to a recent Commerce–SEC survey, compared with a rise in actual outlays of 2 per cent in 1967. The survey indicated that capital spending would increase moderately from the first to the second half of 1968.

Uncertainties continued in the markets for gold and foreign exchange, but the heavy speculative activity of early March abated following the agreement on gold policy reached at the midmonth meeting of gold pool members in Washington. Speculation slackened further after the March 19 announcement by the British Government of a broad program designed to restrict growth of consumer incomes and spending, and after agreement was reached regarding special drawing rights (SDR's) in the International Monetary Fund at the month-end meeting in Stockholm of major industrial countries comprising the "Group of Ten." On March 21 the Bank of England lowered its discount rate from 8 to 7½ per cent. Gold holdings of the U.S. Treasury were reduced in March by $1.4 billion, largely as a result of settlement of the U.S. share of sales by the gold pool before operations of the pool were discontinued at midmonth and of sales to foreign central banks.

Incomplete data on the U.S. balance of payments in the first quarter suggested that the deficit was large on both the liquidity and official settlements bases of calculation, although not so large on either basis as in the fourth quarter of 1967. There had been improvement in flows in some important elements of the capital account, but the surplus on merchandise trade apparently had remained near the low level to which it had fallen in the preceding quarter.

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System open market operations in early March—between the meetings of the Committee held on March 5 and March 14—had been directed at achieving somewhat firmer conditions in the money market. Subsequently, operations were directed at confirming the still more restrictive monetary policy signaled by the midmonth increase in the discount rate from 4½ to 5 per cent, while maintaining orderly market conditions. In the last two statement weeks of March net borrowed reserves averaged about $370 million, compared with averages of about $240 million in the first half of the month and of about $90 million in the last half of February. The Federal funds rate moved up to a range around 5 per cent before mid-March and then advanced to a range around 5¼ per cent.

Interest rates on most types of market securities fluctuated widely during March but rose on balance. These rate developments reflected events relating to gold, shifts in sentiment regarding prospects for Vietnam peace negotiations and for domestic fiscal action, and the firming of monetary policy. Yields on Treasury securities of all maturities rose sharply until midmonth, when uncertainties in international financial markets were most intense, and subsequently declined somewhat. The swing in the market rate on 3-month Treasury bills was particularly marked; from an early-March level of close to 5 per cent, the rate rose to a peak of 5.45 per cent on March 14 and then fell irregularly to 5.13 per cent on April 1, the day before this meeting. Most other short-term market interest rates were considerably higher on April 1 than they had been 4 weeks earlier, and there had been sizable net increases in yields on long-term corporate and municipal securities.

Growth in bank credit slowed considerably in March, a month in which the Treasury undertook no major financing operations. The bank credit proxy—daily-average member bank deposits—was estimated to have expanded at an annual rate of about 4 per cent, compared with 10 per cent in February. Outstanding busi-

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ness loans at banks increased somewhat, but security loans and holdings of Government securities declined substantially.

With short-term interest rates rising on balance, by mid-March banks were generally offering the ceiling rate of 5½ per cent on large-denomination CD's of all maturities; earlier, the offering rate for shorter-term certificates had been below the ceiling. Nevertheless, banks experienced a substantial decline in outstanding CD's during March. The pace of growth in consumer-type time and savings deposits increased somewhat, however, and total time and savings deposits rose slightly more in March than in the preceding month. Government deposits declined, and private demand deposits increased by a relatively small amount. The money supply grew at a faster rate than in February, with more than half of the expansion reflecting an increase in currency holdings of the public.

In the 4 months through March, time and savings deposits and the money supply had grown at annual rates of about 6.5 and 3.5 per cent, respectively, and the bank credit proxy at a rate of about 5.5 per cent—in each case less than half the rate of the preceding 7 months. Inflows of funds to savings and loan associations and mutual savings banks also had been substantially curtailed in recent months.

Bank credit was projected to change little in April and to expand moderately in May—on the assumptions that the Treasury would raise a substantial volume of new cash in connection with its May refunding but would not undertake a major financing earlier, and that money market conditions would remain unchanged. In an alternative projection, in which a slight firming of money market conditions was assumed, the annual rate of change in the bank credit proxy in April was estimated in a range of +1 to −3 per cent.

It was expected that at the currently higher levels of market interest rates banks would find it more difficult in April to attract consumer-type time and savings deposits and that the banks

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would experience a further run-off of CD's of greater than seasonal dimensions. As a result, total time and savings deposits were projected to expand at a relatively low rate in April. On the other hand, growth in the money supply was expected to be more rapid than in March, largely as a consequence of a sizable decline anticipated in Government deposits.

The Committee agreed that continued firming of monetary policy was desirable in light of present and prospective inflationary pressures, the highly unfavorable developments of recent months in U.S. foreign trade, the persisting uncertainties in international financial markets, and the still uncertain outlook for fiscal action. Some members expressed the view that circumstances might soon require consideration by the System of a further increase in the discount rate.

At the same time, various reasons were advanced for moving cautiously in firming further through open market operations at present. These included some improvement in prospects for restrictive fiscal action by Congress; it appeared likely that the Senate would take affirmative action shortly on a measure providing for an increase in taxes and a reduction in budgeted Federal expenditures. In addition, it was noted that a considerable degree of monetary restraint had already been achieved, the effects of which were still unfolding, and that there had been insufficient time as yet to determine the economic implications of various recent events, including the de-escalation of bombing in North Vietnam. It also was noted that a marked further firming of monetary policy at this time might have undesirably large adverse effects on flows of funds to financial intermediaries. In this connection, some members foresaw a possible need at a later point for the Board to raise ceiling rates on large-denomination CD's, although none indicated that he thought such action was desirable immediately.

At the conclusion of the discussion the Committee agreed that slightly firmer money market conditions should be sought,

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but that operations should be modified if unusual liquidity pressures developed or if the change in bank credit appeared to be deviating significantly in either direction from the projection. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that over-all economic activity has expanded at a very rapid pace in early 1968, with prices rising substantially, and that prospects are for a continuing rapid advance in activity and persisting inflationary pressures in the period ahead. Since late fall, growth rates of bank credit, the money supply, and time and savings accounts at financial institutions have moderated considerably. Speculative activity in gold and foreign exchange markets, which was intense in early March, abated after the midmonth agreement on gold policy by gold pool members and appears to have slackened further following the Stockholm agreement regarding Special Drawing Rights. The foreign trade surplus, however, has remained at a sharply reduced level in recent months and the imbalance in U.S. international payments continues to be a matter of serious concern. Most market interest rates have fluctuated widely, although rising on balance, in reaction to international financial developments, the firming of monetary policy, and uncertainties regarding military and fiscal prospects. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining slightly firmer conditions in the money market; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if unusual liquidity pressures should develop.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Ellis, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, and Sherrill. Votes against this action: None.

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2. Ratification of amendments to authorization for System foreign currency operations.

At this meeting the Committee ratified the actions taken by members on March 16 and 17, relating to the System's swap arrangements with the German Federal Bank and the Bank of England. As indicated in the policy record for March 14, 1968, the members authorized the Special Manager to undertake negotiations looking toward increases of $250 million equivalent and $500 million equivalent, respectively, in the two arrangements, on the understanding that any such increases and the corresponding amendments to paragraph 2 of the authorization for System foreign currency operations would become effective upon a determination by Chairman Martin that they were in the national interest. The Chairman made such a determination on March 17, 1968.

Votes for ratification of these actions: Messrs. Martin, Hayes, Brimmer, Daane, Ellis, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, and Sherrill. Votes against ratification of these actions: None.

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MEETING HELD ON APRIL 19, 1968

Authority to effect transactions in System Account.

On the day before this meeting, the Board of Governors of the Federal Reserve System had approved an increase in Federal Reserve Bank discount rates from 5 to 5½ per cent and had raised the maximum rates payable by member banks on new large-denomination CD's having maturities of 60 days or more.[1] Both actions were effective on the day of this meeting. Following the announcement of these actions, interest rates advanced in domestic financial markets—with the market rate on 3-month Treasury bills rising about 20 basis points to around 5.55 per cent—and in foreign exchange markets the dollar strengthened against most currencies. The purpose of today's meeting, which was held by telephone, was to consider the need for revision of the Committee's current economic policy directive in light of yesterday's actions.

The Committee agreed that open market operations in the interval until its next scheduled meeting should be directed at achieving firmer money market conditions in keeping with the higher discount rate, while facilitating orderly market adjustments to the increase in that rate. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

[1] By amendment to Regulation Q the following schedule of maximum rates payable by member banks on CD's of $100,000 or more was adopted:

Maturity (days)	Maximum rate (per cent)
30- 59	5½
60- 89	5¾
90-179	6
180 and over	6¼

The maximum rate payable previously had been 5½ per cent for all maturities.

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System open market operations until the next meeting of the Committee shall be conducted with a view to achieving firmer but maintaining orderly conditions in the money market, while facilitating market adjustments to the increase in Federal Reserve discount rates.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Ellis, Galusha, Hickman, Kimbrel, Maisel, Mitchell, and Robertson. Votes against this action: None.

Absent and not voting: Mr. Sherrill.

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MEETING HELD ON APRIL 30, 1968

1. Authority to effect transactions in System Account.

Over-all economic activity had expanded at a very rapid pace thus far in 1968 and prices had risen substantially. The outlook was for continued rapid expansion in activity and persisting inflationary pressures.

In the first quarter, according to preliminary Department of Commerce estimates, real GNP advanced at a 6 per cent annual rate and average prices—as measured by the GNP deflator—at a 4 per cent annual rate. Defense spending and business capital outlays expanded considerably, and outlays on residential construction increased moderately. Most of the advance in GNP, however, reflected a sharp rise in consumer expenditures; personal income increased at an unusually rapid rate in the quarter, and the percentage of income saved fell below the unusually high figure of the preceding quarter. Partly because of the large increase in consumer expenditures, the rate of business inventory accumulation declined markedly.

In March nonfarm employment rose substantially further, and the unemployment rate edged down to 3.6 per cent from 3.7 per cent in February. Industrial production increased moderately, and retail sales continued to advance rapidly. In early April, however, retail sales apparently were adversely affected by civil disorders in many cities.

The consumer price index rose considerably further in March to a level about 4 per cent above a year earlier. With the cost of living advancing at a rapid pace, settlements in recent wage negotiations had provided for increases in wages and fringe benefits of 6 per cent or more per year. The rise in average prices of industrial commodities moderated in both March and April, mainly because of large declines for a few major industrial materials. Average prices of farm products changed relatively little in the 2 months.

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It appeared likely that in the second quarter real GNP would advance as fast as or faster than in the first quarter and that average prices would continue upward at about the first-quarter pace. In prospect were further large rises in consumer income and spending and another substantial increase in defense outlays. It was expected that business capital spending and outlays on residential construction would level off, but that business inventory accumulation would rebound from its low first-quarter rate.

Since the establishment of the two-market system for gold on March 17, the price of gold in the private market had for the most part ranged between $37 and $40 per ounce. The volume of foreign official gold purchases from the U.S. Treasury had increased considerably in recent weeks.

The deficit in the U.S. balance of payments in the first quarter now appeared to have been smaller than estimated earlier and considerably smaller than in the fourth quarter of 1967. The surplus on merchandise trade was reduced further in the first quarter from the low level to which it had fallen in late 1967; in March, when exports declined largely because of a longshoremen's strike in New York, U.S. foreign trade was in deficit. The deterioration in the trade account, however, was more than offset by a marked improvement in capital transactions, reflecting in part a net reflow of U.S. bank credits during the quarter that was about as large as the foreign credit restraint program was intended to achieve over the full year. The outlook was for some recovery in the trade account but for substantial deterioration in the capital account—especially in view of the likelihood that the reflow of bank credit and certain other favorable first-quarter capital movements would not be sustained.

System open market operations had been directed toward achieving slightly firmer conditions in the money market following the meeting of the Committee on April 2. After the increase in Federal Reserve Bank discount rates from 5 to 5½ per cent effective April 19 and the meeting of the Committee on that day,

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operations had been directed at achieving still firmer money market conditions while facilitating orderly market adjustments to the higher discount rate. In the first part of April the effective rate on Federal funds moved up to a range of 5½ to 5⅞ per cent, and subsequently it rose to a range around 6 per cent. Net borrowed reserves of member banks averaged $335 million in the 4 weeks ending April 24, compared with an average of about $310 million in March; and average borrowings of member banks increased to about $690 million in the latest 4 weeks from about $650 million in the earlier period.

Interest rates on most types of short- and intermediate-term market securities rose substantially over the course of April, in part as a result of the increase in discount rates and the firming of money market conditions. The market rate on 3-month Treasury bills, at 5.48 per cent on the day before this meeting, was 14 basis points above its level on April 18 and 35 basis points higher than on April 1. Yield changes were more irregular in capital markets, where investor sentiment was influenced by fluctuating prospects for fiscal action and for Vietnam peace negotiations, but since mid-April long-term yields in general had also been rising. Several large additions to the April and May calendar of public offerings of corporate bonds and the continuation of a relatively large volume of new issues of municipal bonds contributed to upward pressures on yields of such securities.

The Treasury was expected, on the day following this meeting, to announce the terms on which it would refund securities maturing in mid-May, of which about $4 billion were held by the public. Estimates suggested that the Treasury would have to raise a substantial amount of new cash before the end of the fiscal year. It was thought likely that some of this would be raised in connection with the May refunding, although the amount was uncertain, and that further cash financing would be undertaken in June.

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Interest rates on new-home mortgages, which had changed little in February, edged up in March to postwar highs. Net inflows of funds to nonbank depositary institutions had improved somewhat in February and March, but in the 4 months through March they were at an annual rate about one-third less than in the preceding 7 months. Although withdrawals during the interest- and dividend-crediting period in late March and early April were smaller than many observers had anticipated, net inflows in the period shortly thereafter apparently were not as large as usual.

Commercial bank credit, as measured by the bank credit proxy —daily-average member bank deposits—was estimated to have declined at an annual rate of 3.5 per cent in April. Business loans outstanding, which had begun to expand more rapidly after mid-March, increased substantially in April. However, banks continued to liquidate their holdings of U.S. Government securities. They also reduced the pace at which they acquired other securities, notably municipal obligations. Following the April 19 increase in the discount rate, commercial banks raised their prime lending rate from 6 to 6½ per cent.

The money supply increased in April at a pace considerably above that of earlier months of the year. Private demand deposits rose sharply as U.S. Government deposits declined, and currency holdings of the public continued to expand at a higher-than-normal rate. Total time and savings deposits of banks were estimated to have increased relatively little in April; with short-term interest rates rising, inflows of consumer-type time and savings deposits slackened and the volume of large-denomination CD's outstanding contracted substantially. The CD run-off was concentrated in the first half of the month, before offering rates were increased under the higher ceilings that became effective on April 19. By the month-end offering rates were at the new maximum levels for shorter-term CD's but were somewhat below the ceilings for longer-term certificates.

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In the 5 months through April the bank credit proxy had grown at an annual rate of 3.7 per cent, about one-third of the rate for the preceding 7 months. In the same period commercial bank time and savings deposits had expanded at a rate of 5.5 per cent, less than two-fifths of the earlier pace; and the money supply had grown at a 5.6 per cent rate, about two-thirds of that prevailing earlier.

Changes in bank credit in May and June were expected to depend in part on the pattern of Treasury financing operations. On the assumptions that prevailing money market conditions would be maintained and that the Treasury would raise only a moderate amount of new cash in connection with the May refunding—meeting the bulk of its residual needs for the fiscal year 1968 in June—the annual rate of change in the bank credit proxy was projected in a range of -2 to $+2$ per cent in May and in a range of $+4$ to $+6$ per cent in June. On the same assumptions, U.S. Government deposits were projected to decline substantially further in May and private demand deposits and the money supply to increase rapidly, although not so rapidly as in April. It was expected that banks would expand their outstanding CD's somewhat, but that consumer-type time and savings deposits would continue to grow at a relatively slow pace.

The Committee agreed that the Treasury's forthcoming refunding operation precluded a change in monetary policy at this time. Although members expressed concern about persisting inflationary pressures and the recent worsening in the U.S. foreign trade balance, a number indicated that they would have favored no change in policy at present even if Treasury financing were not in prospect. Among the reasons they advanced were the considerable degree of restraint already achieved by recent monetary policy actions, the effects of which were still in train; and the view that prospects for restrictive fiscal action had improved. At the same time, the desirability was noted of avoiding any tendency toward relaxation in the degree of money market firmness.

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The Committee concluded that the firmer conditions now prevailing in the money market should be maintained, with the proviso that operations should be modified, insofar as permitted by the Treasury financing, if bank credit appeared to be deviating significantly from the projection. It was understood that allowance would be made in interpreting this proviso for any substantial difference between the amount of new cash the Treasury actually raised in connection with the May refunding and the amount assumed in the projection.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that over-all economic activity has expanded at a very rapid pace thus far in 1968, with prices rising substantially, and that prospects are for a continuing rapid advance in activity and persisting inflationary pressures in the period ahead. Since late fall, growth rates of bank credit, the money supply, and time and savings accounts at financial institutions have on balance moderated considerably. Market interest rates have risen in recent weeks, partly in reaction to the firming of monetary policy including the further increase in Federal Reserve discount rates. The U.S. foreign trade balance has worsened further, and the international payments position of the United States continues to be a matter of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the firmer conditions prevailing in the money market; provided, however, that operations shall be modified, to the extent permitted by Treasury financing, if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Ellis, Galusha, Kimbrel, Maisel, Robertson, and Sherrill. Vote against this action: Mr. Hickman.

Absent and not voting: Mr. Mitchell.

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In dissenting from this action, Mr. Hickman expressed the view that the recent upward adjustment of interest rates had been less than contemplated under the policy directive the Committee had issued at its April 19 meeting, and less than was desirable in view of the inflationary pressures in the economy. He agreed that the prospective Treasury financing precluded substantial firming of money market conditions before the Committee's next meeting. Nevertheless, he thought that firmer conditions should be sought, if and when feasible after the Treasury financing had been completed, on the understanding that the stance of monetary policy would be reexamined should fiscal action be taken.

2. Amendment to authorization for System foreign currency operations.

The Committee amended paragraph 1B(3) of the authorization for System foreign currency operations to increase, from $200 million to $250 million, the limit on authorized System Account holdings of sterling purchased on a covered or guaranteed basis. With this amendment, the first paragraph of the authorization read as follows:

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

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

Austrian schillings
Belgian francs
Canadian dollars
Danish kroner

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Pounds sterling
French francs
German marks
Italian lire
Japanese yen
Mexican pesos
Netherlands guilders
Norwegian kroner
Swedish kronor
Swiss francs

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

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

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

(3) Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $250 million equivalent.

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

(1) Commitments to deliver foreign currencies to the Stabilization Fund, up to $350 million equivalent;

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

(3) Other forward commitments to deliver foreign currencies, up to $550 million equivalent.

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

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Ellis, Galusha, Hickman, Kimbrel, Maisel, Robertson, and Sherrill. Votes against this action: None.

Absent and not voting: Mr. Mitchell.

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This action was taken on grounds that it would be helpful in connection with discussions of specific arrangements, including a drawing by Britain on its $1.4 billion standby facility with the International Monetary Fund, for repayment by the Bank of England of outstanding drawings under its swap line with the Federal Reserve. It was understood that initial use of the enlarged authority would be subject to the approval of Chairman Martin in light of developments in those discussions.

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MEETING HELD ON MAY 28, 1968

1. Authority to effect transactions in System Account.

Reports at this meeting indicated that over-all economic activity was continuing to advance rapidly and that inflationary pressures were persisting. It appeared likely that growth in real GNP in the second quarter would again be large. Beyond midyear, economic prospects depended in large part on the outcome of pending fiscal legislation, which provided for a 10 per cent surtax on individual and corporate incomes and for a $6 billion reduction from the Budget estimate in Federal expenditures for the fiscal year 1969. Such legislation, if enacted, was expected to contribute to a marked slowing of the pace of expansion in aggregate output and to a gradual lessening of inflationary pressures.

Estimates for the second quarter included a further sizable rise in consumer spending, although not so large as the extraordinary advance of the first quarter. Defense expenditures were expected to continue to increase at a substantial rate. A sharp rise in housing starts in April, although it reflected temporary influences in large part, now suggested a moderate increase in outlays for residential construction in the second quarter. It appeared that business outlays for fixed capital would change relatively little; but inventory accumulation, which had been at a very low rate in the first quarter, was expected to increase considerably.

In April nonfarm employment rose moderately further, and the unemployment rate again edged down, to 3.5 per cent from 3.6 per cent in March. The industrial production index was unchanged from a March level that had been revised upward. Retail sales were advancing in early May, following a decline in April that was attributable largely to widespread civil disorders.

Gold and foreign exchange markets had been unsettled in recent weeks; important contributing influences included shifts

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in prospects for fiscal action in the United States and political uncertainties in France. The price of gold in the private London market had risen sharply after mid-May from around $39.50 per ounce to a new high of $42.60 on May 21, but subsequently declined somewhat. The Treasury gold stock recently had been reduced further, as a number of small central banks had purchased gold from the United States. Sterling was under renewed pressure in foreign exchange markets, and quotations for the French franc were nominal in most markets as a result of the general strike and the closing of French banks.

With respect to the U.S. balance of payments, the deficit on the official settlements basis was reduced in April and May by an accelerated rise in liabilities of domestic banks to their branches abroad. Movements out of sterling and French francs had contributed significantly to the availability of funds in the Euro-dollar market. U.S. exports of goods expanded sharply in April from the substantially reduced March level while imports increased slightly. For March and April together, however, the merchandise trade surplus was quite small.

In early May the Treasury marketed two new 6 per cent notes having maturities of 15 months and of 7 years for payment on May 15. The shorter-term note was offered for cash and attracted subscriptions mainly from commercial banks, which were allowed to make payment by credit to Treasury tax and loan accounts. The 7-year note was offered in exchange for securities maturing in mid-May, of which $3.9 billion were held by the public. After allowing for attrition of $1.3 billion in the exchange offering, the Treasury raised about $2.1 billion of new cash in these financings.

Interest rates had risen substantially on balance in all maturity areas since the preceding meeting of the Committee. Yield increases were especially pronounced after the mid-May announcement that there would be a further delay in congressional consideration of the pending fiscal legislation. Other influences

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included the tightening of monetary policy associated with the mid-April increase in the discount rate and the continuing large volume of new offerings in the corporate and municipal bond markets. During the week immediately preceding this meeting, some short-term market rates, particularly on Treasury bills, had declined from their peaks as renewed optimism concerning prospects for enactment of fiscal legislation emerged. The market rate on 3-month Treasury bills, at 5.67 per cent on the day before this meeting, was down 25 basis points from its May 21 high but was still 19 basis points above its level of 4 weeks earlier.

During April interest rates on residential mortgages had risen substantially and yields on both conventional new-home mortgages and on FHA-insured mortgages trading in the secondary market were at postwar highs. Early in May, as permitted by new legislation, maximum contract interest rates on Federally underwritten home mortgages were increased to 6¾ per cent. Net inflows of funds to nonbank depositary institutions had weakened considerably further in April from the reduced inflow of the first quarter.

System open market operations since the preceding meeting of the Committee had been directed at maintaining firm conditions in the money market while countering persistent tendencies toward excessive tightness. In view of the advanced level of market rates, System repurchase agreements were made at an interest rate of 5¾ per cent, one-quarter of a percentage point above the discount rate. The effective rate on Federal funds moved up further to a range around 6⅛ to 6⅜ per cent, compared with a range around 6 per cent in the latter part of April. Bank rates on new loans to Government securities dealers also advanced sharply. Member bank borrowings averaged $720 million and net borrowed reserves $380 million in the 4 weeks ending May 22, compared with averages of $690 million and $340 million, respectively, in April.

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Commercial bank credit, as measured by the bank credit proxy—daily-average member bank deposits—was estimated to have increased only a little in May following a small decline in April. Business loans, after a sharp rise in early April, had changed relatively little through early May while banks had continued to reduce their holdings of U.S. Government securities. The further advance in market interest rates acted to limit growth in commercial bank time and savings deposits, and in May, as in April, such deposits increased very little. Rates on large-denomination CD's generally moved up to the new Regulation Q ceilings, but the volume of outstanding CD's was little changed over the month. Rates on Euro-dollar deposits rose sharply as U.S. banks built up their Euro-dollar liabilities. The money supply continued to grow rapidly in May; private demand deposits expanded substantially as U.S. Government deposits declined.

The bank credit proxy was now projected to decline in June at an annual rate in the range of 1 to 4 per cent if prevailing money market conditions were maintained. Business demand for bank loans was expected to be strong in June, partly to finance tax payments. The money supply and private demand deposits were projected to increase at about the rapid April–May rate, and U.S. Government deposits were projected to decline sharply, assuming no large cash financing. Total time and savings deposits were anticipated to show virtually no growth and possibly to decline, as relatively high market interest rates were expected to continue to curtail growth in consumer-type time and savings deposits and to result in a sizable decline in outstanding CD's for which scheduled maturities were large in June.

The Committee agreed that a restrictive monetary policy was appropriate in view of the strength of domestic demands and persisting inflationary pressures, as well as of the deterioration in the U.S. foreign trade balance that was contributing to continuation of an unsatisfactory over-all payments position. At the

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same time, however, there was general agreement that a number of considerations militated against any additional tightening at present. An important consideration was the possibility that in the near future Congress would enact the pending fiscal-restraint legislation. Furthermore, a considerable degree of monetary restraint had already been achieved; the banking system was being subjected to increasing liquidity pressures; over-all expansion of bank credit appeared to have halted in April and May; and market rates of interest had advanced sharply to levels that could give rise to a substantial amount of disintermediation.

The Committee concluded that open market operations should be directed at maintaining about the prevailing firm conditions in the money market, but that operations should be modified if bank credit appeared to be deviating significantly from current projections or if unusual pressures should develop in financial markets. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that the very rapid increase in over-all economic activity is being accompanied by persisting inflationary pressures. There has been little or no growth on average in bank credit and time and savings deposits over the past 2 months, although the money supply has expanded considerably as U.S. Government deposits have declined. In recent weeks both short- and long-term interest rates have risen sharply on balance from their earlier advanced levels, partly in reaction to shifting expectations with regard to the likelihood of fiscal restraint. There has been some revival of speculative activity in the private gold market and in foreign exchange markets. The U.S. foreign trade balance and over-all payments position continue to be a matter of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and attainment of reasonable equilibrium in the country's balance of payments, while taking account of the potential for severe pressures in financial markets if fiscal restraint is not forthcoming.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market; provided, however, that operations

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shall be modified if bank credit appears to be deviating significantly from current projections or if unusual pressures should develop in financial markets.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Ellis, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, and Sherrill. Votes against this action: None.

2. Authority to purchase and sell foreign currencies.

The Committee amended paragraph 1B(3) of the authorization for System foreign currency operations to increase, from $250 million to $300 million, the limit on authorized System Account holdings of sterling purchased on a covered or guaranteed basis.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Ellis, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, and Sherrill. Votes against this action: None.

At its previous meeting the Committee had increased the limit in question from $200 million to $250 million. That action had been taken on grounds that it would be helpful in connection with discussions of specific arrangements, including a drawing by Britain on its $1.4 billion standby facility with the International Monetary Fund, for repayment by the Bank of England of outstanding drawings under its swap line with the Federal Reserve; and it had been understood that initial use of the enlarged authority would be subject to the approval of Chairman Martin in light of developments in those discussions. Today's action was taken on similar grounds and subject to the same understanding.

The Committee also amended paragraph 4 of the foreign currency directive, by adding the words "and to facilitate opera-

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tions of the Stabilization Fund" to clause (iv). With this amendment, paragraph 4 of the directive read as follows:

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

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Ellis, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, and Sherrill. Votes against this action: None.

On November 14, 1967, at a time when an increase in System Account and Stabilization Fund holdings of sterling was under consideration, the Committee had amended paragraph 1C(1) of the authorization for System foreign currency operations to enable the System Account to "warehouse" part of the Stabilization Fund's holdings of sterling if the Fund's resources should prove inadequate to meet all demands upon them from time to time in the future. Since such "warehousing" operations—none of which had been undertaken to date—would involve forward transactions, the Committee concluded that it was desirable to make a conforming change in the list of purposes, given in paragraph 4 of the foreign currency directive, for which forward transactions were authorized.

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MEETING HELD ON JUNE 18, 1968

Authority to effect transactions in System Account.

Reports at this meeting indicated that the continued rapid advance in over-all economic activity was being accompanied by persisting inflationary pressures. It appeared likely that Congress would act favorably within a few days on legislation providing for a 10 per cent income tax surcharge and a $6 billion reduction in expenditures from Budget estimates for the coming fiscal year. Such legislation was expected to contribute to a considerable moderation of the rate of advance in aggregate demands.

Staff estimates suggested that both real GNP and average prices—as measured by the "GNP deflator"—were continuing to increase at rapid rates in the second quarter. According to the estimates, however, business inventory accumulation would be considerably larger than in the first quarter and growth in final sales would be smaller. In particular, consumer expenditures were expected to rise substantially but at a pace well below the extraordinary advance of the first quarter; and according to a recent Commerce-SEC survey of business spending plans, outlays on new plant and equipment would change little in the second quarter after increasing sharply in the first. It also appeared that outlays for residential construction would rise moderately further and that defense spending would advance at about the rapid first-quarter rate.

Staff estimates for the third quarter suggested that growth in real GNP would slow sharply if the pending fiscal legislation were enacted. The rate of increase in disposable income was expected to slacken considerably—as a result of both the income tax surcharge and slow growth in employment—and a further slowing of growth in consumer expenditures appeared likely, despite an anticipated decline in the rate of personal saving. Prospects for the third quarter also included a moderate decline in residential construction outlays, a leveling off of the advance in defense expenditures, and little further change in the rate of

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inventory accumulation after a large second-quarter rise. However, the Commerce-SEC survey suggested that outlays on plant and equipment would increase somewhat in the third quarter. The lower over-all rate of economic growth in prospect seemed unlikely to have an appreciable effect immediately on advances in wage and other costs, and average prices in the private economy were expected to rise almost as rapidly in the third quarter as in the first half of the year.

In May the unemployment rate remained at 3.5 per cent. Nonfarm employment was unchanged from April, as an increase in the number of workers on strike offset employment gains elsewhere. Average hourly earnings continued to rise rapidly. Industrial production was estimated to have increased to a new high, and according to the advance report, retail sales rose moderately from an April level that had been held down by civil disorders in many cities.

Preliminary estimates indicated that average wholesale prices of industrial goods declined somewhat in May, primarily because of further sharp reductions for copper and related products following settlement of the copper strike; average prices of other industrial commodities continued to rise. Prices of foods and foodstuffs increased considerably, and the total wholesale price index edged up further. In April the consumer price index continued upward at about the average rate of other recent months and was 4 per cent above a year ealier.

With respect to the U.S. balance of payments, preliminary data for May suggested that the deficit on the liquidity basis diminished sharply from its high April level, in part because of the favorable effects of various special official transactions. The merchandise trade surplus was expected to increase in coming months from its recent low level, but net outflows of U.S. capital also were expected to rise. Such outflows had been unusually small in the early months of the year, following the introduction of the new restaint program on January 1.

On the official settlements basis, a payments surplus was now

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indicated for May and possibly for the second quarter as a whole, primarily as a result of an exceptionally large rise in the liabilities of U.S. banks to their branches abroad. The recent massive inflow of foreign liquid funds apparently reflected both increased demands for funds by domestic banks and large additions to the supply of Euro-dollars as a result of movements out of sterling and French francs. It was thought likely that the inflow would subside soon.

In foreign exchange markets, the position of sterling had improved somewhat in recent weeks, but the French franc had remained under severe pressure. The price of gold in the private London market had continued to fluctuate in a range of about $41 to $42 per ounce.

System open market operations since the preceding meeting of the Committee had been directed at maintaining firm conditions in the money market. Early in the period reserves were absorbed temporarily, by means of matched sale-purchase agreements, in order to counter easing tendencies. Late in the period, however, when tendencies toward undue tightness emerged, reserves were supplied by purchases of Treasury bills from foreign accounts and through repurchase agreements with nonbank dealers at a 5¾ per cent interest rate. For the period as a whole, effective rates on Federal funds were usually in a range of 6 to 6¼ per cent but occasionally were below 6 per cent. Member bank borrowings averaged about $730 million in the 3 weeks ending June 12, little changed from the preceding 4 weeks, but average net borrowed reserves increased to about $445 million from $375 million in the earlier period.

Interest rates on most types of market securities had declined substantially on balance since the preceding meeting of the Committee, primarily because of growing expectations that fiscal restraint legislation would be enacted soon. Yield reductions were more marked on Treasury bonds than on corporate and municipal bonds, for which the calendar of new offerings continued heavy. The market rate on 3-month Treasury bills, at 5.58 per cent on the day before this meeting, was 9 basis points

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below its level 3 weeks earlier, and rates on longer-term bills were down by 20 to 30 basis points.

Preliminary data for May suggested an increase in net inflows of savings funds to mutual savings banks and savings and loan associations. But with demands for mortgage funds continuing strong, and with uncertainties increasing about prospects for savings flows at thrift institutions around the midyear interest-and-dividend-crediting period, conditions in mortgage markets remained fairly tight. Contract interest rates on conventional new-home mortgages, which had been at a postwar high in April, rose sharply further in May.

At commercial banks, demands for business loans strengthened after a mid-April to mid-May lull. There was some improvement in net flows of time and savings deposits in the latter part of May, but for the month as a whole such deposits grew at an annual rate of only about 3 per cent, roughly the same as in April and less than half the first-quarter pace. With U.S. Government deposits declining further, private demand deposits and the money supply expanded considerably; growth in the money supply was now estimated at an annual rate of 11 per cent in May, compared with 6.5 per cent in April. Bank credit, as measured by the bank credit proxy—daily-average member bank deposits—expanded at an annual rate of 1.5 per cent in May, after declining at a 4.5 per cent rate in April. Allowance for changes in the daily average of U.S. bank liabilities to foreign branches, which are among the nondeposit liabilities of banks omitted in calculating the credit proxy, would have served to reduce the decline in April by about 1 percentage point and to have increased the rise in May by about 3.5 percentage points.

New projections suggested that if prevailing money market conditions were maintained the bank credit proxy would rise at an annual rate of 3 to 6 per cent in June and somewhat more slowly in July; and that if money market conditions were less firm, growth in July would continue at about the rate projected for June. Allowance for a further increase in average liabilities

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to foreign branches, expected to occur in June, would have added about 3 percentage points to the limits of the range of growth projected for that month. The projections for July assumed that the Treasury would raise a substantial amount of new cash—about $4 billion—early in the month through a sale of tax-anticipation bills. Further declines in the average level of Government deposits were anticipated in both June and July, and were expected to contribute to continued vigorous expansion of the money supply.

The Committee's policy discussion at this meeting was conducted against the background of the widespread expectation that Congress probably would act affirmatively within a few days on the pending fiscal legislation. It was thought likely that such action would be followed by further declines in Treasury bill rates and other short-term market interest rates. The possibility was recognized, however, that short-term rates might subsequently come under renewed upward pressure, partly as a consequence of the sizable cash financing the Treasury was expected to undertake in early July.

The Committee agreed that open market operations should be directed at maintaining firm conditions in the money market in the period before Congress acted on the pending legislation, and at countering any tendencies toward disorder that might result if such action were negative or delayed. As to the appropriate course if fiscal legislation were enacted soon, there was some sentiment for seeking less firm money market conditions on the grounds that over-all economic restraint otherwise was likely to prove excessive. At the same time, however, concern was expressed in the course of the discussion about the risk that premature monetary easing would offset the effects of fiscal restraint.

The Committee concluded that if Congress acted affirmatively on the pending fiscal legislation open market operations should seek to accommodate any resulting declines in short-term interest rates and to cushion any upward pressures on such rates

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that might emerge subsequently. The proviso was added that this course should be followed only so long as bank credit growth in June, and also in July, did not appear to be developing at a rate above the range projected for June.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that the very rapid increase in over-all economic activity is being accompanied by persisting inflationary pressures. Enactment of fiscal restraint measures now under consideration in Congress, however, would be expected to contribute to a considerable moderation of the rate of advance in aggregate demands. Growth in bank credit and time and savings deposits has been relatively small on average in recent months, although the money supply has expanded considerably as U.S. Government deposits have declined. Both short- and long-term interest rates have receded from the advanced levels reached in May, mainly in reaction to enhanced expectations of fiscal restraint. The U.S. foreign trade balance and over-all payments position continue to be a matter of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and attainment of reasonable equilibrium in the country's balance of payments, while taking account of the potential impact of developments with respect to fiscal legislation.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining generally firm but orderly conditions in the money market; provided, however, that if the proposed fiscal legislation is enacted operations shall accommodate tendencies for short-term interest rates to decline in connection with such affirmative congressional action on the pending fiscal legislation so long as bank credit expansion does not exceed current projections.

Votes for this action: Messrs. Martin, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, Sherrill, Bopp, and Treiber. Votes against this action: None.

Absent and not voting: Messrs. Hayes and Ellis. (Messrs. Treiber and Bopp voted as their alternates.)

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MEETING HELD ON JULY 16, 1968

1. Authority to effect transactions in System Account.

Staff estimates for the second quarter continued to indicate sharp further advances in real GNP and in average prices as measured by the "GNP deflator." It now appeared, however, that growth in consumer expenditures had been smaller than expected earlier and that business fixed investment had declined somewhat. Much of the increase in real GNP was a consequence of a marked rise in the rate of inventory accumulation, reflecting in part a build-up of stocks of steel as a precaution against a possible strike when current wage contracts expired on July 31.

Industrial production was estimated to have increased somewhat further in June and retail sales, according to the advance estimate, were unchanged. Although the labor market remained generally firm, growth of nonfarm employment had slowed in recent months. The unemployment rate rose from 3.5 per cent in May to 3.8 per cent in June, when young workers entered the labor force in larger numbers than usual.

The consumer price index advanced again in May and was about 4 per cent above a year earlier. Average hourly earnings had continued to rise at a substantial rate in recent months, but increases in consumer prices had held down gains in real earnings and had contributed to demands for higher wages. At the wholesale level, average prices of industrial goods rose again in June after declining in May. Although increases had become less widespread recently, it appeared likely that industrial prices would remain under upward pressure in coming months.

In late June legislation was enacted that provided for a 10 per cent surcharge on income taxes, retroactive to April 1, 1968, for individuals and to January 1, 1968, for corporations. The legislation also provided for a $6 billion reduction from the January Budget estimate for Federal expenditures in the fiscal year 1969. However, the exemption from cuts of certain categories of expenditures together with upward revisions in estimates of defense

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spending suggested that the net reduction was likely to be less than $6 billion.

Staff projections suggested that the pace of advance in aggregate demands would moderate considerably in the third quarter, partly as a result of this legislation. It was expected that consumer expenditures would advance at only about the moderate pace of the second quarter—with a decline in the rate of personal saving roughly offsetting the combined effects on disposable income of the income tax surcharge and smaller employment gains; that the rise in Federal spending would slow; and that residential construction outlays would turn down. On the other hand, some increase in business fixed investment outlays appeared likely. A significant reduction was now anticipated in the rate of inventory accumulation; businesses were expected to shift from accumulation to decumulation of steel stocks after the strike deadline and to adjust stocks of consumer goods in line with the recently smaller gains in sales.

In foreign exchange markets, the French franc continued under heavy pressure in late June and early July. The Bank of France increased its discount rate from 3½ to 5 per cent effective July 3, and on July 10 announced that it had arranged for $1.3 billion in new international credit facilities. The exchange rate for sterling reached a new low in late June, but subsequently strengthened markedly as a result of two developments: (1) an announcement on July 8 that 12 central banks and the Bank for International Settlements had given firm assurances of their willingness to participate in new arrangements to offset fluctuations in the sterling balances of countries in the sterling area; and (2) the publication on July 11 of figures indicating that British imports had declined significantly in June for the first time since devaluation of the pound. The price of gold in the private London market recently had fallen from around $41 to around $39 per ounce on rumors of an arrangement designed to encourage sales of gold in the market by South Africa.

Tentative estimates suggested that the deficit in the U.S. bal-

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ance of payments on the liquidity basis had declined markedly in the second quarter. All of the improvement, however, appeared to reflect special official transactions; except for these transactions, the deficit would have been large. The merchandise trade account was in deficit in May for the second time in 3 months. On the official settlements basis the payments balance was estimated to have been in substantial surplus in the second quarter, as a result of a record increase in liabilities of U.S. banks to foreign branches.

On July 2 the Treasury auctioned $4 billion of tax-anticipation bills maturing in March and April 1969, for which commercial banks were permitted to make payment in full by credits to tax and loan accounts. The Treasury was expected to announce at the end of July the terms on which it would refund the $8.6 billion of securities maturing in mid-August, of which $3.6 billion were held by the public. Current estimates suggested that the Treasury also would have to raise a substantial amount of new cash in August.

Conditions in securities markets had eased somewhat in reaction to the enactment of fiscal-restraint legislation, and yields on Government securities of all maturities had declined moderately on balance in the period since the preceding meeting of the Committee. The market rate on 3-month Treasury bills initially fell sharply—from 5.60 per cent on June 18 to 5.20 per cent on June 21. The abruptness of this decline was related to heavy reinvestment demands by holders of maturing tax-anticipation bills and to substantial purchase of bills by the System on June 19 to offset the effects on bank reserves of large-scale international transactions. Subsequently the 3-month bill rate came under upward pressure partly as a result of the Treasury's offering of tax bills in early July, and on the day before this meeting it was 5.42 per cent, 18 basis points below its level 4 weeks earlier. Rates on other short-term instruments showed smaller net declines over the interval, and some—such as those on commercial paper—remained at their mid-June levels.

Yields on long-term corporate and municipal bonds, for which

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the volume of new issues continued sizable in June and July, were little changed over most of the period since the preceding meeting of the Committee. Conditions in private bond markets had become more buoyant in recent days, however, following the good reception accorded a large corporate issue. Expectations of a near-term relaxation in monetary conditions contributed to the improvement in bond markets, as did the announcements of new international support for sterling and the French franc.

System open market operations since the preceding meeting of the Committee had been directed at maintaining firm conditions in the money market, while accommodating tendencies for short-term interest rates to decline following congressional action on fiscal legislation. The interest rate on System repurchase agreements with nonbank dealers was reduced to 5⅝ per cent on July 5 from the level of 5¾ per cent that had been employed since late April. The effective rate on Federal funds, which was mainly in a 6¼ to 6½ per cent range early in the interval, subsequently fluctuated primarily in a 6 to 6⅛ per cent range. Member bank borrowings averaged $595 million and net borrowed reserves $260 million in the 4 weeks ending July 10, compared with averages of $720 million and $410 million, respectively, in the preceding 4 weeks.

Conditions in markets for residential mortgages continued to tighten through mid-June but appeared to have stabilized thereafter. Preliminary indications suggested that the savings flow experience of nonbank depositary institutions during the interest-and-dividend-crediting period around the end of June was better than many industry observers had expected.

Growth in time and saving deposits at commercial banks in June remained at the low annual rate of about 3 per cent that had prevailed in the two preceding months. However, the net reduction during the course of the month in the volume of large-denomination CD's outstanding was considerably less than normal for the season, and in late June and early July the outstanding volume was increasing. By the time of this meeting most

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banks issuing such CD's had reduced their offering rates for certificates of longer maturity to levels below the Regulation Q ceilings. Private demand deposits and the money supply continued to expand rapidly in June, although not so rapidly as in May, and U.S. Government deposits increased slightly after declining steadily since February. In the second quarter as a whole, during which Government deposits fell substantially on balance, the money supply grew at an annual rate of about 8.5 per cent, compared with about 4.5 per cent in the first quarter.

Commercial bank credit, as measured by the bank credit proxy —daily-average member bank deposits—increased at an annual rate of 6 per cent in June after rising relatively little in May and declining in April. For the 3 months together, the proxy series increased at an annual rate of 1 per cent, compared with a rate of about 7 per cent in the first quarter. Allowance for changes in the daily average of U.S. bank liabilities to foreign branches, which are among the nondeposit liabilities omitted in calculating the credit proxy, would have served to increase the growth rates by about 2.5 percentage points in the second quarter and 0.5 of a percentage point in the first.

It was expected that the pattern of bank credit growth in July and August would be strongly influenced by Treasury financing operations and by business borrowing to finance additional tax payments required under the terms of the new legislation. Staff projections suggested that if prevailing money market conditions were maintained the bank credit proxy would grow at annual rates in the ranges of 1 to 4 per cent in July, 10 to 12 per cent in August, and 6 to 8 per cent in the 2 months taken together. In an alternative projection, in which somewhat easier money market conditions were assumed, the annual rate of increase in the bank credit proxy in July and August together was estimated in a range of 7 to 9 per cent. These projections assumed that the Treasury would raise a total of about $7.5 billion of new cash in the 2 months, including the $4 billion already raised in July through the sale of tax-anticipation bills. Allowance for a further increase

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in average liabilities to foreign branches, expected to occur in July, would have added about 1 percentage point to the limits of the ranges of growth projected for July and August together.

It appeared likely that private demand deposits and the money supply would continue to expand at a substantial rate on average in July, but to slow sharply in the latter part of the month and to change little on average in August, a period in which Government deposits were expected to rise substantially on balance. The outlook also favored further rapid growth in large-denomination CD's outstanding, at least in July.

In the course of the Committee's discussion a number of members indicated that they were inclined to maintain prevailing money market conditions for the time being, while awaiting evidence of the probable effectiveness of the recently enacted fiscal restraint measures in containing inflationary pressures and improving the underlying position of the balance of payments. Other members, while not advocating a substantially easier monetary policy at present, thought that the prospective effects of the new fiscal legislation warranted seeking somewhat less firm money market conditions to the extent such a course was consistent with the forthcoming Treasury financing.

After considering these alternatives, the Committee agreed upon an intermediate course. Specifically, it was decided that open market operations should be directed at accommodating easing tendencies in money market conditions in the period ahead if such tendencies arose from market forces; and at cushioning upward pressures on interest rates if they should develop. It also was agreed that operations should be modified, to the extent permitted by the Treasury financing, if bank credit appeared to be deviating significantly from current projections.

The Committee also discussed the appropriate interest rate for System repurchase agreements (RP's) with nonbank dealers. The members noted that market participants had attached some degree of policy significance to recent changes in the RP rate and to the fact that the rate employed most lately was still ⅛ of a

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percentage point above the discount rate. While the views of members differed regarding the desirability of regular use of a flexible RP rate as an instrument for influencing money market conditions, the Committee thought that under existing circumstances it would be appropriate to employ a 5½ per cent rate beginning with the next occasion on which the Account Management made repurchase agreements.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that over-all economic activity continued to expand rapidly in the second quarter, with inventory accumulation accelerating while the rise in capital outlays and in consumer spending slowed. The new fiscal restraint measures are expected to contribute to a considerable moderation of the rate of advance in aggregate demands. Industrial prices have been increasing less rapidly than earlier but consumer prices have continued to rise substantially and wage pressures remain strong. Growth in bank credit and time and savings deposits has been moderate on average in recent months; growth in the money supply has been larger as U.S. Government deposits have been reduced. Conditions in money and capital markets have eased somewhat, mainly in response to the increase in fiscal restraint. Although there recently have been large inflows of foreign capital, the U.S. foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of forthcoming Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to accommodating the tendency toward somewhat less firm conditions in the money market that has developed since the preceding meeting of the Committee; provided, however, that operations shall be modified, to the extent permitted by Treasury financing, if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, Sherrill, and Bopp. Votes against this action: None.

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(Mr. Bopp voted as an alternate member in place of Mr. Ellis, whose membership on the Committee had terminated on June 30, 1968, the effective date of his resignation as President of the Federal Reserve Bank of Boston.)

2. Amendments to authorization for System foreign currency operations.

The Committee ratified an action taken by members on July 2, 1968, effective on that date, to increase the System's swap arrangement with the Bank of France from $100 million to $700 million equivalent, and to make the corresponding amendment to paragraph 2 of the authorization for System foreign currency operations. As a result of this action, paragraph 2 read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, relations with foreign banks and bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	225
Bank of Canada	1,000
National Bank of Denmark	100
Bank of England	2,000
Bank of France	700
German Federal Bank	1,000
Bank of Italy	750
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	400
Bank of Norway	100

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Sweden	250
Swiss National Bank	600
Bank for International Settlements:	
System drawings in Swiss francs	600
System drawings in authorized European currencies other than Swiss francs	1,000

Votes for ratification of this action: Messrs. Martin, Hayes, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, Sherrill, and Bopp. Votes against ratification of this action: None.

(Mr. Bopp voted as an alternate member in place of Mr. Ellis, whose membership on the Committee had terminated on June 30, 1968.)

Although the arrangement between the Bank of France and the Federal Reserve had been the first negotiated when the System's swap network was established in 1962, it had remained at $100 million since early 1963 while various other lines in the network had been enlarged from time to time. The increase in this arrangement served to bring the relative sizes of the arrangements in the System's swap network into better balance. It formed part of a package of credit facilities provided to the Bank of France at this time by a number of central banks to help deal with destabilizing exchange market pressures.

The Committee also amended the foreign currency authorization in another respect at this meeting. Under paragraph 1C(1) of the authorization, as it had been amended on November 14, 1967, the Federal Reserve Bank of New York was authorized to have outstanding forward commitments to deliver foreign currencies to the Stabilization Fund of up to $350 million equivalent. The limit had been increased to that level (from a previous figure

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of $200 million) in November to facilitate the "warehousing" by the System Account of Stabilization Fund holdings of sterling if the resources of the Stabilization Fund proved inadequate to meet all the demands upon them from time to time in the future.

At this meeting the Committee approved an increase in the limit in question up to an amount not exceeding $1,050 million equivalent, on the understandings that (1) the specific amount would be determined by Chairman Martin (or in his absence, Mr. Robertson, Vice Chairman of the Board of Governors) and (2) that the action would become effective upon a determination by Chairman Martin (or in his absence, Mr. Robertson) that it was in the national interest.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, Sherrill, and Bopp. Votes against this action: None.

(Mr. Bopp voted as an alternate member in place of Mr. Ellis, whose membership on the Committee had terminated on June 30, 1968.)

This action was taken against the background of discussions at meetings in Basle, Switzerland, on July 6–8, 1968, and prior discussions between representatives of the U.S. Treasury and the Federal Reserve. At the Basle meetings agreement in principle had been reached among representatives of the Bank for International Settlements, the Bank of England, and 12 other central banks including the Federal Reserve regarding new arrangements for offsetting fluctuations in sterling balances held by countries in the overseas sterling area (OSA). In general, the agreement provided for the extension of a medium-term facility of $2 billion equivalent to the Bank of England by the BIS, with backing provided by the participating central banks, acting where appropriate on behalf of their Governments. It was understood that the agreement was contingent on the satisfactory completion of negotia-

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tions by the British authorities with the OSA countries concerning the management by the latter of their sterling reserves.

In the System's preliminary discussions with the U.S. Treasury it had been agreed that the Treasury should participate as principal in the arrangement, with the dollars to be made available on a swap basis against sterling by the Stabilization Fund. It was also agreed that if the resources of the Stabilization Fund should prove insufficient from time to time to meet these and other commitments, the Federal Reserve would undertake to warehouse temporarily for the Stabilization Fund necessary portions of the sterling acquired by the latter.

It was reported at this meeting of the Committee that the U.S. share in the arrangement would be in the neighborhood of $600 million to $700 million. After approving System participation in the arrangement in the manner described, the Committee noted that the agreement was contingent on certain negotiations by the British authorities and that the specific size of the U.S. share had not yet been determined. Accordingly, it was decided that both the effective date of the amendment to paragraph 1C(1) of the authorization and the new figure for maximum forward commitments to the Stabilization Fund to be established by that amendment (within the limit set by today's action) should be subject to determination by Chairman Martin, or in his absence, Mr. Robertson.

Subsequently, agreement was reached on the new arrangement at a meeting in Basle on September 9, 1968, with the U.S. share established at $650 million, and the arrangement went into force on September 23, 1968. On September 24, Chairman Martin determined that an increase in the limit on forward commitments to deliver foreign currencies to the Stabilization Fund of $650 million equivalent, to $1 billion, was in the national interest. Accordingly, effective September 24, 1968, paragraph 1C(1) of the authorization for System foreign currency operations was amended to read as follows:

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

* * *

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

(1) Commitments to deliver foreign currencies to the Stabilization Fund, up to $1 billion equivalent;

* * *

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MEETING HELD ON AUGUST 13, 1968

Authority to effect transactions in System Account.

Reports at this meeting indicated that some elements of economic activity had expanded vigorously in early summer. Staff projections suggested, however, that expansion in over-all activity would slow considerably in the months ahead as a result of the new fiscal restraint measures and a marked reduction in inventory accumulation.

Retail sales rose sharply in July, according to the advance report. Industrial production increased moderately, and nonfarm employment continued upward at the reduced pace of recent months. The unemployment rate edged down to 3.7 per cent from 3.8 per cent in June, but remained above the low of 3.5 per cent recorded in the two preceding months.

Average prices of industrial commodities advanced only slightly further in July, but increases in steel prices were announced following the wage settlement in the steel industry at the end of the month. Because of a marked, although largely seasonal, increase in prices of farm products and foods, the wholesale price index rose considerably in July. In June the consumer price index rose more than it had in other recent months. About one-half of the advance reflected higher costs of consumer services, including mortgage interest charges.

The staff projections suggested that inventory accumulation, which had contributed significantly to the rapid growth of real GNP in the second quarter, would slow in the third and fourth quarters. A sharp curtailment of steel production had already begun, and it was expected that liquidation of the stocks of steel that had been built up as a precaution against a strike would continue throughout the rest of the year and perhaps into early 1969. Growth in final sales was projected to remain at about the reduced second-quarter rate, in the expectation that the rise in Federal spending would taper off and that the income tax surcharge would damp increases in consumer expenditures.

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In foreign exchange markets the French franc had remained under pressure in recent weeks. The position of sterling had improved earlier, following the announcement that 12 central banks had expressed willingness to participate in new arrangements to offset fluctuations in overseas sterling balances and a report indicating that the British foreign trade deficit had narrowed in June. The sterling exchange rate moved lower on the day of this meeting, however, after publication of figures indicating that the British trade deficit had widened again in July. The price of gold in the private London market recently had continued to fluctuate in a narrow range around $39 per ounce.

In the second quarter the U.S. foreign trade balance had deteriorated further. Nevertheless, the over-all payments balance on the liquidity basis, although still in deficit, had improved substantially, partly as a result of various special official transactions. Even apart from such transactions, however, the balance had improved markedly in May and June, when there were sizable net inflows of private capital; and it appeared that the improvement had been maintained in July. A substantial surplus was recorded in the payments balance on the official settlements basis in the second quarter, mainly because of a massive increase in liabilities of U.S. banks to their branches abroad. Such liabilities increased further in early July, but declined in subsequent weeks.

On July 31 the Treasury offered a new 6-year, 5⅝ per cent note priced to yield about 5.70 per cent, for payment on August 15. Commercial banks were permitted to pay for 50 per cent of their allotments by credits to Treasury tax and loan accounts. The issue was very well received, and the Treasury raised about $1.9 billion of new cash in addition to refunding $3.6 billion of publicly held securities maturing in mid-August. This was the largest sale to the public of an intermediate-term issue in more than 20 years.

Most interest rates had declined substantially on balance since the previous meeting of the Committee. The declines were largely

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attributable to market expectations that credit conditions would ease as a result of slower economic growth, smaller prospective Treasury financing needs, and relaxation of monetary restraint following the recent enactment of fiscal legislation. Expectations of a near-term shift in monetary policy, perhaps including a cut in the discount rate, appeared to have been encouraged by a reduction in the interest rate on System repurchase agreements from 5⅝ to 5½ per cent on the day after the Committee's preceding meeting.

Contributing to the rate declines were increases in bank purchases of Treasury and municipal securities and a large build-up of dealer inventories of Treasury securities, as well as prospects for a substantial reduction in the volume of new corporate bond issues. The fact that only an intermediate-term obligation was offered in the Treasury's August financing—in contrast to the customary practice of including a short-term "anchor" issue—added to downward pressures on rates in short-term markets, where the declines were most pronounced.

Most recently, however, continued firmness in day-to-day money market rates had raised doubts about prospects for an immediate substantial easing of monetary policy. Both short- and long-term interest rates had turned up and had erased part of their earlier declines. On the day before this meeting the market rate on 3-month Treasury bills was 5.05 per cent, 16 basis points above the low reached in the preceding week but still 37 basis points below its mid-July level.

Net inflows of funds to mutual savings banks and savings and loan associations slowed in July. There were signs, however, that conditions in primary and secondary mortgage markets were beginning to ease, after tightening gradually but steadily for more than a year.

With interest rates on competing market instruments declining on balance in July, the volume of large-denomination CD's outstanding at commercial banks increased by an unusually large amount. Banks recently had reduced their offering rates on all

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CD's except those with short maturities, and by the time of this meeting such rates were still at the Regulation Q ceilings only for CD's maturing within 2 months. Growth in consumer-type time and savings deposits continued in July at about the moderate pace of previous months. Government deposits declined on average, and growth in private demand deposits and the money supply accelerated—the latter to an annual rate of about 13 per cent, from 8.5 per cent in the second quarter and 4.5 per cent in the first.

Business loans outstanding at banks increased more than seasonally in July, although the rise was somewhat less than might have been expected in view of the additional corporate tax payments required under the new fiscal legislation. Bank investments expanded sharply, however, as did loans to finance securities holdings. Total bank credit, as measured by the bank credit proxy—daily-average member bank deposits—grew at an annual rate of 9 per cent, compared with rates of 1 per cent in the second quarter and 7 per cent in the first. Allowance for changes in the daily average of U.S. bank liabilities to foreign branches would have served to increase the growth rate by 2 percentage points in July and slightly more in the second quarter.

System open market operations in the early part of the interval following the preceding meeting of the Committee had been directed at accommodating the tendencies for short-term interest rates to decline. Later in the period, however, when it became apparent that bank credit was increasing at a rate significantly above that projected at the time of the previous meeting, operations were modified to the extent permitted by the Treasury financing. Member bank borrowings, which had averaged $555 million in the 2 weeks ending July 24, rose to an average of $670 million in the following 2 weeks; and average net borrowed reserves increased from $215 million to $320 million. Since the preceding meeting of the Committee, the effective rate on Federal funds had fluctuated mostly in a 6 to 6¼ per cent range and bank rates on loans to dealers in U.S. Government securities,

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whose financing needs were heavy, also had remained high.

New staff projections suggested that the bank credit proxy would increase from July to August at an annual rate of 16 to 18 per cent if the prevailing stance of monetary policy were maintained. About three-fourths of the estimated growth reflected an expected increase in average Government deposits from July to August as a result of Treasury cash borrowing. Much slower growth—at an annual rate of 5 to 7 per cent—was anticipated for September, when the Treasury was not expected to engage in new borrowing except in connection with its regular bill offerings. The money supply was projected to remain about unchanged in August and to grow moderately in September when a decline in Government deposits was anticipated. Expansion in time and savings deposits was expected to moderate somewhat in August and September.

The Committee agreed that the rate of economic growth was likely to slow during the second half of the year. Several members noted, however, that some moderation in the recent rapid pace of expansion would be desirable in light of prevailing inflationary pressures, and that the evidence available to date was not sufficient to indicate the amount of slowing in prospect. Considerable concern was expressed about the rapid rates of increase in bank credit experienced in July and projected for August, even though it was noted that the spurt was projected to be temporary. At the same time, it was thought generally that it would be undesirable for short-term interest rates, which had been advancing in recent days, to rise substantially further.

The Committee concluded that it would be appropriate at this time to maintain, on balance, about the prevailing conditions in money and short-term credit markets, with some easing in day-to-day money market rates to be permitted if Treasury bill and other short-term rates remained under marked upward pressure. It was also agreed, however, that operations should be modified if bank credit growth in August and September appeared to be significantly exceeding current projections.

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Several members expressed the view that in light of the marked net decline in short-term interest rates since the enactment of fiscal legislation, a near-term reduction in the discount rate would be appropriate to bring it into better alignment with current market rates. These members noted that a cut in the discount rate might have the effect of moderating further upward pressures on short-term rates without requiring reserve injections of the size that might otherwise be needed for that purpose.

At the conclusion of the discussion the following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that some elements of economic activity continued to expand vigorously in early summer. Expansion in over-all activity, however, is projected to slow considerably in coming months as a result of the new fiscal restraint measures and a marked reduction in inventory accumulation. Industrial prices have been increasing less rapidly in recent months, but consumer prices have continued to rise substantially. Wage pressures remain strong, and the recent wage settlement in the steel industry was followed by announcements of steel price increases. Both short- and long-term interest rates have declined considerably, in large part as a result of expectations of easier credit conditions. Bank time and savings deposits, particularly large-denomination CD's, have expanded sharply in early summer; growth in the money supply has continued large as U.S. Government deposits have been drawn down further on average; and growth in total bank credit has been unusually rapid. Although the U.S. balance of payments has recently shown a marked improvement, the foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining, on balance, about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be significantly exceeding current projections.

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Votes for this action: Messrs. Martin, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, Sherrill, Bopp, and Treiber. Votes against this action: None.

Absent and not voting: Mr. Hayes. (Mr. Treiber voted as his alternate. Also, Mr. Bopp voted as an alternate member in place of Mr. Ellis, whose membership on the Committee had terminated on June 30, 1968, the effective date of his resignation as President of the Federal Reserve Bank of Boston.)

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MEETING HELD ON AUGUST 19, 1968

Authority to effect transactions in System Account.

On Thursday, August 15, the Board of Governors of the Federal Reserve System approved a reduction from 5½ to 5¼ per cent in the discount rate of the Federal Reserve Bank of Minneapolis.[1] In its announcement the Board stated that the change was primarily technical, to align the discount rate with the change in money market conditions that had occurred chiefly as a result of the enactment of the Federal tax increase and its related expenditure cuts. The purpose of today's meeting, which was held by telephone, was to consider the need for a revision of the Committee's current economic policy directive in light of the discount rate action.

Reports at this meeting indicated that the reaction in financial markets to the Board's discount rate announcement had been quite mild. Prices of Treasury notes and bonds had edged up slightly on Friday, August 16. The market rate on 3-month Treasury bills—which had advanced from 5.05 per cent on August 12, the day before the Committee's previous meeting, to 5.17 per cent on August 15—declined the next day to 5.11 per cent. There had been no significant change in the effective rate on Federal funds, which had been fluctuating in a 6 to 6¼ per cent range in recent weeks. Staff projections still suggested that the bank credit proxy—daily-average member bank deposits—would increase at annual rates of 16 to 18 per cent in August and 5 to 7 per cent in September, even if there were some easing of day-to-day money market rates in the wake of discount rate reductions.

The Committee agreed that open market operations should be directed at facilitating orderly money market adjustments to re-

[1] The reduction was effective August 16. Discount rates of the other Federal Reserve Banks were subsequently reduced to 5¼ per cent, with effective dates as follows: Richmond, August 19; Chicago, Cleveland, Kansas City, and Philadelphia, August 23; Boston, August 27; Dallas, August 28; and Atlanta, New York, St. Louis, and San Francisco, August 30.

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ductions in Federal Reserve Bank discount rates. As at the preceding meeting, the desirability was noted of cushioning upward pressures on short-term interest rates if they should develop.

The Committee also agreed that operations should be modified if bank credit appeared to be deviating significantly from current projections, on the understanding that this proviso was to be implemented as a result of any downward deviations only if such deviations were of considerable magnitude.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

System open market operations until the next meeting of the Committee shall be conducted with a view to facilitating orderly adjustments in money market conditions to reductions in Federal Reserve Bank discount rates; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Hayes, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Robertson, Sherrill, and Bopp. Votes against this action: None.

Absent and not voting: Messrs. Martin, Mitchell, and Morris. (Mr. Bopp voted as alternate for Mr. Morris.)

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MEETING HELD ON SEPTEMBER 10, 1968

Authority to effect transactions in System Account.

Consumer expenditures had been expanding vigorously this summer, according to reports at this meeting. Staff projections suggested, however, that the rate of business inventory accumulation was declining markedly in the third quarter—largely because of a shift from accumulation to liquidation of steel stocks—and that growth in over-all activity was slowing as a consequence.

Steel production had been cut back sharply following the wage settlement in the steel industry at the end of July, and as a result the industrial production index was tentatively estimated to have declined in August. Although nonfarm payroll employment increased fairly sharply in August, manufacturing employment was unchanged for the second consecutive month. Total civilian employment declined in August, but the labor force declined somewhat more and the unemployment rate fell to 3.5 per cent from 3.7 per cent in July.

Growth in Federal outlays appeared to be slowing in the third quarter, but total final sales were now estimated to be rising at a rapid rate. Retail sales, which had increased sharply in July, remained at a high level in August according to available weekly figures. The sizable advance in consumer spending apparently was associated with a decline in the saving rate; the new income tax surcharge affected paychecks beginning in mid-July, and disposable income was estimated to be advancing less rapidly in the third quarter than earlier in the year. Housing starts also rose considerably in July, and it appeared that residential construction outlays would be somewhat higher in the third quarter than in the second. A new Commerce—SEC survey, taken in August, indicated that business outlays on plant and equipment would be somewhat lower in 1968 as a whole than estimated earlier, but that businesses planned to increase their outlays moderately from the second quarter to the third.

Staff projections for the fourth quarter suggested that the rate

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of inventory accumulation would be reduced somewhat further as liquidation of steel stocks continued and that the expansion in final sales would slow. It was expected that the increase in Federal expenditures would be quite small and that the rise in consumer spending would slacken as a result of continuing slow growth of disposable income. Little change was anticipated in residential construction expenditures, and the recent Commerce—SEC survey suggested that business outlays for plant and equipment would be maintained at about the third-quarter rate.

Average prices of industrial commodities, according to preliminary estimates, were unchanged in August after rising only slightly in July. It was expected, however, that the industrial average for September would be affected by advances already announced in prices of steel mill products. Prices of farm products and foods, which had increased considerably in July, declined in August, and the over-all wholesale price index moved down to its June level. The consumer price index rose substantially in July for the second month in a row; as in June, a large part of the advance reflected higher costs of consumer services, including mortgage interest charges.

In foreign exchange markets, rumors in late August that a revaluation of the German mark was imminent led to large-scale inflows of funds into Germany and to sharply increased pressures on the French franc and sterling. On September 4 the French Government unexpectedly removed the foreign exchange controls it had imposed on May 31. Following the announcement of this action and the simultaneous publication of preliminary estimates of the French budget for 1969, the position of the franc improved; but pressures subsequently resumed. The sterling exchange rate strengthened appreciably after the announcement on September 9 that final agreement had been reached by the Bank of England and 12 other central banks on new arrangements to offset fluctuations in overseas sterling balances. The price of gold in the private London market had risen by about $1 per ounce

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since mid-August and currently was fluctuating narrowly around $40.

U.S. exports increased slightly and imports fell sharply in July —resulting in a small surplus in the foreign trade balance after 2 months of deficit. Despite a foreign trade deficit in the May-July period as a whole, the payments balance on the liquidity basis, apart from special official transactions, had improved considerably. However, tentative estimates for August suggested that a large deficit had re-emerged. The balance on the official settlements basis apparently was in surplus in August, as liabilities of U.S. banks to their foreign branches rose to a new high after declining during the last 3 weeks of July.

In domestic financial markets, prior to the reductions in Federal Reserve Bank discount rates from 5½ to 5¼ per cent—the first of which was announced on August 15—interest rates on various types of market securities had been rising from the lows they had reached early in the month. Market reactions to the discount rate cuts were varied; some observers interpreted the action as a confirmation of earlier expectations of some relaxation in monetary restraint, while others—who had expected more vigorous action—thought it indicated that a marked easing of policy was not likely in the near future.

On balance, interest rates on new corporate bonds and on Treasury securities changed little during the latter half of August. However, yields on municipal bonds remained under upward pressure in the face of continuing heavy flotations of new issues by State and local governments. In early September yields on new corporate bonds and on Treasury securities also advanced, as corporate underwriters released unsold new offerings from syndicate and some Government securities dealers acted to lighten their heavy inventories. The market rate on 3-month Treasury bills was 5.24 per cent on the day before this meeting, 13 basis points above its level following the mid-August announcement of discount rate action. Rates on longer-term Treasury bills had

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risen only slightly during the interval and currently were close to or below the rate on 3-month bills.

Growth in commercial bank time and savings deposits, which had stepped up sharply in July, accelerated further in August. Expansion in large-denomination CD's outstanding was substantial but less than the very large rise of July, when interest rates on competing market instruments had been declining. The average level of U.S. Government deposits increased considerably in August as a result of Treasury cash financings, and expansion in private demand deposits and the money supply slowed appreciably—the money supply to an annual rate of about 5 per cent from nearly 15 per cent in July.

In August, as in July, banks were heavy buyers in the large offerings of securities undertaken by Federal, State, and local governments. Growth in bank loans to businesses was maintained at about the recent average pace, and loans to brokers and dealers to finance holdings of securities increased moderately further. Total bank credit, as measured by the bank credit proxy—daily-average member bank deposits—expanded at the unusually high annual rate of 21 per cent, after rising at a 9 per cent rate in July. Allowance for changes in the daily average of U.S. bank liabilities to foreign branches would have served to increase the growth rate by about ½ of a percentage point in August and 1½ percentage points in July.

System open market operations in the period since the Committee's August 19 meeting had been directed mainly at facilitating orderly adjustments in money market conditions to the reduction in Federal Reserve Bank discount rates. As the period progressed less emphasis was placed on the supplementary objective of moderating upward pressures on Treasury bill rates, in light of accumulating evidence that bank credit was growing at a higher rate than that projected at the time of the Committee's previous meeting. The effective rate on Federal funds, which had been mostly in a 6 to 6¼ per cent range prior to the discount rate cuts, subsequently fluctuated in a 5¾ to 6 per cent range

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and was at the upper end of that range at the close of the period. Net borrowed reserves and member bank borrowings averaged about $185 million and $480 million, respectively, in the 3 weeks ending September 4, down from averages of about $290 million and $640 million in the previous 3 weeks.

Growth in bank credit was expected to moderate from the high August rate in September and October. The Treasury was not expected to engage in an another major cash financing until the latter part of October; and prospects favored some reduction from the current high level of outstanding loans to finance holdings of securities and also a slower growth in business loans, particularly after the mid-September tax date. New staff projections suggested that the bank credit proxy would expand at an annual rate of 7 to 10 per cent in September if prevailing conditions in money and short-term credit markets were maintained. Growth in about the same range was foreseen for October, on the assumption that the Treasury would raise about $3 billion of new cash in the latter part of the month. The projections suggested that expansion in time and savings deposits would moderate in September, and that on the average Government deposits would change little over September and October and the money supply would rise only slightly.

The Committee decided that no change in monetary policy was warranted at this time. On the one hand, a relaxation of monetary restraint was not deemed appropriate in light of the current strength of final demands and the persistence of inflationary pressures; on the other hand, greater restraint was not considered desirable in view of the outlook for slowing in overall economic activity, although it was noted that firm evidence was lacking thus far on the amount of slowing in prospect. However, a number of members—while not advocating a firming of policy—expressed concern about the rapid rates of bank credit expansion in recent months, and some thought that expansion in September and October at a rate near the upper end of the pro-

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jected range would be higher than desirable in the current economic environment.

At the same time, it was noted that Treasury bill rates might well come under temporary upward pressure as a result of credit demands associated with the September tax date and the larger-scale sales of bills by the System that were expected to be required in the next week or so to absorb reserves supplied by market factors. A number of members expressed the view that such pressures should be moderated if they proved to be unduly marked or prolonged, in light of the risk that persistent large increases in bill rates might precipitate a change in market expectations that would result in a new general uptrend in market interest rates.

The Committee concluded that it would be desirable at present for open market operations to be directed at maintaining about the prevailing conditions in the money and short-term credit markets, on the understanding that increases in Treasury bill rates in the near term, if moderate, would not be considered inconsistent with this objective. The proviso was added that operations should be modified if bank credit appeared to be deviating significantly from current projections.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that, although consumer demands have been strong this summer, reduced rates of inventory accumulation and tapering growth of Government expenditures are being reflected in a slowing of expansion in over-all activity. Industrial prices have been increasing less rapidly in recent months, but consumer prices have continued to rise substantially and wage pressures remain strong. Most market interest rates have changed little on balance following reductions in Federal Reserve Bank discount rates. Growth in bank credit and time and savings deposits has been rapid this summer; growth in the money supply slowed in August as U.S. Government deposits were built up following an extended decline. The earlier improvement in the U.S. balance of payments was not maintained in August, according to preliminary indications, and

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the foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Morris, Robertson, and Sherrill. Votes against this action: None.

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MEETING HELD ON OCTOBER 8, 1968

1. Authority to effect transactions in System Account.

Staff estimates of GNP in the third quarter had been revised upward since the preceding meeting of the Committee, mainly because consumer expenditures had proved stronger than expected. The estimates still suggested that expansion in real GNP had moderated from its very rapid pace in the first half of the year, but they indicated that economic growth had slowed by less than earlier projections had implied. Projections for the fourth quarter, which also had been raised, suggested that expansion would continue at about the rate now estimated for the third quarter.

According to retail sales figures for August and the first 3 weeks of September, consumer spending on both durable and nondurable goods was being maintained at the high level to which it had risen in July. Since growth of disposable income in the third quarter had been curtailed by the tax surcharge, it appeared that the rate of personal saving had declined sharply.

Little further change in the saving rate seemed likely in the fourth quarter, and with disposable income expected to continue rising slowly, growth in consumer spending was projected to slacken. The staff projections also suggested that other categories of final demand—including Federal outlays, residential construction expenditures, and business spending on plant and equipment—would provide relatively little stimulus to economic expansion in the fourth quarter. On the other hand, the rate of inventory accumulation, which had declined in the third quarter, was now expected to rise in the fourth quarter.

In September output of steel was curtailed further as users of the metal continued to reduce inventories that had been accumulated prior to the wage settlement in the steel industry. As a consequence, the industrial production index was estimated to have declined again. Employment in manufacturing—even apart from the steel industry—had not increased since June, but labor

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markets remained generally firm and in recent months average hourly earnings had continued to increase at a rapid pace.

Average prices of industrial commodities rose appreciably in September after having changed little for several months. The rise, which was the largest for any month since late winter, reflected not only the advance in steel prices following the wage settlement but also increases for a broad list of other commodities. With average prices of farm products and foods turning up, the over-all wholesale price index rose in September by about as much as it had declined in August. The consumer price index increased considerably less in August than it had in June and July, partly because of a slowing of the advance in mortgage interest charges.

In foreign exchange markets, pressures on the French franc abated for a time in late September but then increased again. However, speculation on an imminent revaluation of the German mark had subsided in recent weeks, and market conditions in general had improved considerably. The exchange rate for sterling, which had strengthened after the September 9 announcement that final agreement had been reached on the new sterling balances arrangement, advanced further following the publication on September 17 of figures indicating that the British foreign trade deficit had narrowed sharply in August. On September 19 the Bank of England reduced its discount rate to 7 per cent from the 7½ per cent rate that had been in effect since March 21.

In August a large rise in U.S. merchandise exports was exceeded by an even larger rise in imports, and the U.S. trade surplus declined from the low level of July. Part of the increase in both exports and imports was attributable to expectations of a possible strike of longshoremen on October 1. With respect to the over-all payments balance, tentative estimates for the third quarter indicated that the deficit on the liquidity basis was smaller than in the second quarter. All of the improvement, however, apparently had occurred in July; preliminary data suggested that sizable deficits had been incurred in August and September. It

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appeared that there was a moderate surplus in the third quarter on the official settlements basis, mainly as a result of a further increase in liabilities of U.S. banks to their branches abroad. Such liabilities rose sharply from mid-August to mid-September, but declined subsequently.

The Treasury was expected shortly to announce a cash offering of tax-anticipation bills, perhaps in the amount of $3 billion or $3.5 billion, for which commercial banks would be permitted to make payment by credits to tax and loan accounts. Also, an announcement was expected on October 23 of the terms on which the Treasury would refund notes and bonds maturing in mid-November, of which about $4 billion were held by the public. The possibility was noted that a pre-refunding of bonds maturing in mid-December, of which $1.6 billion were publicly held, might be undertaken along with the refunding of November maturities.

System open market operations since the preceding meeting of the Committee had been directed at maintaining about the prevailing conditions in the money and short-term credit markets. Although the System undertook an unusually large volume of operations for this purpose—absorbing reserves on a massive scale in the first part of the period and supplying substantial amounts of reserves later—money market conditions initially eased somewhat and subsequently firmed again. Thus, the effective rate in Federal funds transactions, which had averaged about 5⅞ per cent in the period before the previous meeting, fluctuated below that level for a time and then moved up to the 6 per cent area. Rates posted by major banks on loans to Government securities dealers followed a similar pattern.

A number of factors combined to complicate operations and to require a large volume of transactions by the System in this period. In addition to normal seasonal fluctuations, these factors included large international transactions affecting reserves; a sharp, although temporary, decline in Treasury balances at Reserve Banks before the September 18 payment date for corporate

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taxes; and the adoption of new methods for calculating required reserves of member banks under the revision of Regulation D that became effective on September 12.[1]

With respect to the last of these factors, the introduction of a 2-week lag in the deposit balances used for calculating required reserves, at a time when deposits were rising seasonally, had the effect of temporarily reducing required reserves and increasing excess reserves considerably relative to the levels that would have obtained under the prior procedures, thus necessitating offsetting open market operations. In addition, operations were complicated by uncertainties as to how member banks would react—particularly during a transition period—to this and the other changes in procedures, including the new carryover provisions for reserve excesses and deficiencies. The effects of the carryover provisions on reserve-management practices of banks were expected to have the incidental consequence of weakening the short-run relationship between marginal reserves—that is, free or net borrowed reserves—and the other measures used to assess money market conditions. As it turned out, net borrowed reserves increased on the average in the 3 weeks beginning September 12; average borrowings by member banks declined to about $475 million from $520 million in the preceding 4 weeks, but excess reserves declined more.

Yields on both short- and long-term Treasury securities, like day-to-day money market rates, moved down after mid-September and then rose again—changing little on balance during the

[1] Under Regulation D, as amended effective Sept. 12, 1968, all member banks are required to meet their daily-average reserve requirements on a weekly basis; previously, a biweekly settlement period had been employed for country banks. In addition, required reserves are calculated on the basis of average deposits 2 weeks earlier rather than on the basis of average deposits in the current settlement period. Similarly, the vault cash component of the total reserves maintained by banks is recorded with a 2-week lag. Also, member banks are permitted to carry forward into the next reserve week excesses, as well as deficiencies, in reserve requirements averaging up to 2 per cent of required reserves, except that any portion of such excesses or deficiencies not offset in the next week may not be carried forward into later weeks.

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period since the preceding meeting of the Committee. The market rate on 3-month Treasury bills, for example, fell from a high of 5.30 per cent reached before mid-September to 5.09 per cent late in the month and then advanced; on the day before this meeting it was 5.26 per cent, 2 basis points above its level 4 weeks earlier.

The initial downward pressures on Treasury security yields were reinforced by expectations of a reduction in the 6½ per cent prime lending rate of banks that had prevailed since mid-April. The prime rate was reduced in late September, to 6¼ per cent by most banks and to 6 per cent by a few. Among the factors contributing to the subsequent upward pressures on Treasury security yields were the failure of the 6 per cent prime rate to become general, indications that economic conditions were stronger than had been expected, and increasing attention among market participants to forthcoming Treasury financing operations.

In private capital markets yields on new corporate bonds had been relatively stable in recent weeks, but yields on State and local government issues had declined considerably, mainly because of continued heavy acquisitions by commercial banks. At the close of the period, however, both corporate and municipal yields were rising again.

Conditions in markets for residential mortgages appeared to have eased slightly further in September. Net inflows of deposits to nonbank financial intermediaries increased only moderately in August, the latest month for which data were available. However, liquidity ratios at Federal savings and loan associations declined markedly in both July and August after the Federal Home Loan Bank Board reduced minimum liquidity requirements, and this development helped to sustain mortgage lending activity by such associations.

Time and savings deposits at commercial banks, which had grown rapidly in July and August, expanded substantially again in September. Inflows of consumer-type deposits increased fur-

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ther, and the outstanding volume of large-denomination CD's declined less than seasonally despite moderate reductions in offering rates on all CD's except those of short maturity. Private demand deposits and the money supply declined; on balance the money supply had not increased since the first week of July, after rising substantially in preceding months.

Growth of business loans at banks slowed in September. Although banks' holdings of municipal securities expanded considerably further, their holdings of Treasury securities were about unchanged—in contrast to the two preceding months when banks had been heavy buyers of securities offered in Treasury financings. Total bank credit, as measured by the bank credit proxy—daily-average member bank deposits—rose at an annual rate of about 9 per cent in September, compared with a rate of more than 21 per cent in August. Allowance for changes in the daily average of U.S. bank liabilities to foreign branches would have served to increase the growth rate by about 1.5 percentage points in September and 0.5 of a percentage point in August.

Bank credit growth was expected to accelerate somewhat in October as a result of the anticipated cash financing by the Treasury. The latest staff projections suggested that the bank credit proxy would expand at an annual rate of 10 to 13 per cent if the conditions in money and short-term credit markets that had prevailed on the average since the Committee's preceding meeting were maintained. This projection assumed that the Treasury would offer $3.5 billion of tax-anticipation bills for payment in the latter part of the month and that commercial banks initially would acquire the bulk of the offering. Slower growth of bank credit was projected for November, when the Treasury was not expected to raise new cash. The October projection allowed for some moderation in the rate of expansion in time and savings deposits and for little growth in private demand deposits. A small increase in the money supply, reflecting mainly an expansion in currency, was anticipated.

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The Committee was divided in its views on the appropriate course for monetary policy under current circumstances, with a majority favoring no change and a minority advocating at least a slight increase in monetary restraint. The majority was opposed to greater restraint at present primarily because it continued to expect the rate of expansion of consumer spending and of economic activity in general to slow down as the effects of the recent fiscal restraint measures were increasingly felt. The fact that the Treasury would be undertaking a major refunding operation before the Committee's next meeting also was cited as a consideration militating against a change in policy at this time.

The Committee concluded that open market operations should be directed at maintaining the conditions in money and short-term credit markets that had prevailed on the average in the period since the preceding meeting, on the understanding that operations would not be undertaken to offset any moderate upward pressures on Treasury bill rates that might develop. The proviso was added that operations should be modified, insofar as the forthcoming Treasury refunding permitted, if the rate of bank credit expansion appeared to be significantly in excess of current projections.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that over-all economic expansion has moderated, although less than projected, from its very rapid pace earlier in the year, but upward pressures on prices and costs are persisting. Most market interest rates have changed little on balance in recent weeks. Bank credit and time and savings deposits expanded rapidly this summer, but the money supply has shown no net growth since July after rising substantially for several months. The earlier improvement in the U.S. balance of payments was not maintained in August and September, according to preliminary indications, and the foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, con-

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tinued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the forthcoming Treasury refunding operation, if bank credit expansion appears to be significantly exceeding current projections.

Votes for this action: Messrs. Martin, Brimmer, Daane, Galusha, Maisel, Mitchell, Morris, Robertson, and Sherrill. Votes against this action: Messrs. Hayes, Hickman, and Kimbrel.

Messrs. Hayes, Hickman, and Kimbrel dissented from this action because they thought that the rates of bank credit growth recorded in recent months and the rate projected for October were excessive, particularly in light of the persisting inflationary pressures and the unexpected strength in the economy. Accordingly, they favored seeking money market conditions somewhat firmer than those advocated by the majority, to the extent the Treasury refunding operation permitted.

2. Amendment to authorization for System foreign currency operations.

At its meeting on March 14, 1968, the Committee had authorized the Special Manager to undertake negotiations looking toward increases, up to specified limits, in a number of the System's reciprocal currency arrangements, on the understanding that any such enlargements—and the corresponding amendments to paragraph 2 of the authorization for System foreign currency operations—would become effective upon a determination by Chairman Martin that they were in the national interest. As indicated in the policy record for March 14, the Chairman had made the indicated determination for certain of these arrangements on March 17.

Among the arrangements covered by the Committee's action

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of March 14 was that with the Bank of Italy, for which negotiations looking toward an increase of up to $250 million equivalent had been authorized. Recently these negotiations had been successfully completed, and on the day of this meeting Chairman Martin determined that an increase in the swap arrangement with the Bank of Italy from $750 million to $1 billion equivalent was in the national interest. Accordingly, the corresponding amendment to paragraph 2 of the authorization for System foreign currency operations became effective on October 8, 1968.

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MEETING HELD ON OCTOBER 29, 1968

Authority to effect transactions in System Account.

The expansion in real GNP moderated somewhat in the third quarter, according to preliminary Commerce Department estimates. The amount of slowing—to an annual rate of about 5 per cent, from more than 6 per cent in the first half of the year—was less than had been implied by recent staff projections. New projections presented at this meeting suggested that the expansion would moderate somewhat further in the fourth quarter and would continue to slow in the first half of 1969.

The strong performance of the economy in the third quarter was attributable largely to a substantial increase in consumer spending. Growth in disposable income was sharply curtailed by the tax surcharge, so the rise in consumer spending was associated with a large decline in the rate of personal saving; indeed, the decline in the saving rate was one of the largest in nearly a decade. In addition, business outlays on plant and equipment increased substantially after moving down in the second quarter, and Federal outlays expanded further, although at a considerably slower rate than earlier in the year.

Retail sales in October were remaining close to the advanced level of the summer months, according to available weekly figures. Output of steel, which had been cut back sharply following the late-July wage settlement in that industry, turned up in early October, and the industrial production index for October was tentatively estimated to have risen slightly after declining for 2 months. In September nonfarm employment expanded only moderately, and the unemployment rate edged up to 3.6 per cent from 3.5 per cent in August. Labor markets remained firm, however, and wage rates continued under strong upward pressure.

Average prices of industrial commodities, which had increased appreciably in September following several months of little

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change, rose substantially further in October. In both months the advance encompassed a broad range of commodities. The over-all wholesale price index was unchanged in October, however, as prices of farm products and foods fell by about as much as they had risen in the preceding month. The consumer price index increased moderately in September.

Conditions in foreign exchange markets had improved in the latter part of September when speculation on an imminent revaluation of the German mark abated, and the markets remained quiet in October. The exchange rate for sterling had been firm in recent weeks. Although the exchange rate for the French franc remained at or close to its lower support limit, selling pressures against the franc appeared to have moderated considerably.

The surplus on U.S. merchandise trade in the third quarter was somewhat above the very low levels of the first two quarters of the year, with part of the improvement reflecting an acceleration of exports in anticipation of a possible strike of longshoremen on October 1. New estimates of over-all payments flows suggested that the balance on the liquidity basis was less unfavorable in September than had been thought earlier and that the deficit was smaller in the third quarter as a whole than previous estimates had indicated. However, fragmentary data for early October suggested renewed deterioration. The latest estimates of the balance on the official settlements basis still indicated a moderate surplus in the third quarter, mainly as a result of a further rise in borrowings of U.S. banks through their foreign branches.

On October 17 the Treasury auctioned $3 billion of tax-anticipation bills due in June 1969. Bidding in the auction was aggressive, in part because the offering coincided with widespread reports that a halt in the bombing of North Vietnam was imminent. On October 23 the Treasury announced that in exchange for securities maturing in mid-November and mid-December, of which about $5.6 billion were held by the public, it

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would offer 2 notes—a new 18-month, 5⅝ per cent note priced to yield 5.73 per cent, and a reopened 6-year, 5¾ per cent note priced at par. It was expected that the Treasury would auction additional tax-anticipation bills for payment in late November or early December mainly to compensate for cash redemptions in connection with the current refunding.

Interest rates on most types of market securities had risen on balance in recent weeks, although yields had fluctuated in response to shifting prospects for the de-escalation of hostilities in Vietnam. Both short- and long-term markets were influenced by continuing reports indicating that economic expansion was vigorous despite the recent fiscal legislation, and by the associated expectations that a firmer monetary policy might be required to resist inflationary pressures. In short-term markets yields increased on finance company and commercial paper, bankers' acceptances, and Treasury bills; the market rate on 3-month Treasury bills, at 5.46 per cent on the day before this meeting, was 20 basis points above its level of 3 weeks earlier. Contributing to the upward pressures on long-term rates were the large volume of new corporate security offerings and the record amount of State and local government issues in October, as well as the Treasury refunding.

In markets for home mortgages, the gradual easing of conditions that had been under way since mid-June continued in September, although the increase in net deposit inflows to nonbank financial intermediaries was again moderate. After the first week of October, however, there were indications that conditions in the secondary market for mortgages were beginning to tighten again.

Time and savings deposits at commercial banks continued to expand rapidly in October, according to preliminary estimates. It appeared that inflows of consumer-type time and savings deposits had accelerated further. In addition, banks increased their offering rates on large-denomination CD's slightly—by about the

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amount they had reduced them in September—and the volume of CD's outstanding rose considerably. Private demand deposits and the money supply were estimated to have increased fairly rapidly from September to October—the money supply at an annual rate of about 7 per cent—after changing little on balance since the first week of July.

Business loan demands at commercial banks were relatively strong in October, and banks continued to add to their holdings of municipal securities at a substantial pace. Total bank credit, as measured by the bank credit proxy—daily-average member bank deposits—was estimated to have increased at an annual rate of about 12 per cent in October, compared with 9 per cent in September. Allowance for changes in the daily average of U.S. bank liabilities to their foreign branches would have reduced the October growth rate by about one-half of a percentage point and increased the rate for September by about 1.5 percentage points.

System open market operations in the period since the preceding meeting of the Committee had initially been directed at maintaining about the prevailing conditions in the money and short-term credit markets. Later, however, some slight firming of conditions had been permitted, within the limitations imposed by the current Treasury refunding, because estimates from time to time indicated that bank credit was expanding at a rate at or above the upper end of the projected range (after some downward revision of the projection to allow for a smaller Treasury offering of tax-anticipation bills than had been assumed). The System had carried out relatively large operations, alternately absorbing and supplying reserves, to cope with sizable fluctuations in market factors affecting reserves and with pressures generated by continuing member bank adjustments to the new reserve computation procedures that had become effective on September 12. In recent weeks the effective rate on Federal funds had fluctuated mostly in a range of 5¾ to 6⅛ per cent. Member

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bank borrowings averaged about $425 million in the 2 weeks ending October 23, down slightly from the average of $455 million in the preceding 4 weeks. Excess reserves declined more on the average, however, and net borrowed reserves increased.

New staff projections suggested that, if prevailing conditions in money and short-term credit markets were maintained, the bank credit proxy would expand at an annual rate of 9 to 12 per cent in November and more slowly in December. The projections, which assumed that the Treasury would offer $2.5 billion of tax-anticipation bills for payment in the last week of November, were subject to revision if the size or timing of the offering were different. It was expected that business loan demand would remain fairly strong in November and that banks would continue to acquire municipal securities at a rapid pace. Prospects favored slower growth in the volume of large-denomination CD's outstanding and in total time and savings deposits at commercial banks, but it appeared likely that the money supply would increase at a rate equal to or slightly above that estimated for October.

The Committee agreed that the current Treasury refunding precluded a change in monetary policy at this time. Some members indicated that in the absence of the Treasury financing they would have favored seeking somewhat firmer money market conditions, on the grounds that recent and prospective rates of bank credit growth were excessive in light of prevailing inflationary pressures. Some other members expressed the view that an increase in monetary restraint was not warranted at present even apart from the financing. While recognizing the uncertainties in the outlook, they believed the most likely prospect at the moment was that the economic advance would slow sufficiently under the current stance of stabilization policies.

The Committee concluded that open market operations should be directed at maintaining about the prevailing conditions in money and short-term credit markets, with the proviso that op-

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erations should be modified, insofar as the Treasury financing permitted, if bank credit growth appeared to be in excess of current projections. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that over-all economic expansion has moderated somewhat from its very rapid pace earlier in the year, although less than projected, and that upward pressures on prices and costs are persisting. Market interest rates have risen in recent weeks. Bank credit and time and savings deposits have continued to expand rapidly, but savings inflows to thrift institutions have remained moderate. The money supply, after growing little on balance during the summer, has increased in recent weeks. The U.S. foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the Treasury financing, if bank credit expansion appears to be exceeding current projections.

Votes for this action: Messrs. Martin, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Morris, Robertson, and Sherrill. Vote against this action: Mr. Hayes.

In dissenting from this action, Mr. Hayes said he agreed that the current Treasury refunding precluded any substantial change in monetary policy. He thought, however, that the implications of the prevailing inflationary pressures for the domestic economy and the balance of payments were sufficiently serious to warrant seeking whatever degree of firming in money market conditions would be consistent with the Treasury financing—however slight that might be—in an effort to slow bank credit growth from a rate he considered excessive.

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MEETING HELD ON NOVEMBER 26, 1968

1. Authority to effect transactions in System Account.

The information reviewed at this meeting suggested that the expansion in over-all economic activity, while still strong, was moderating somewhat further in the fourth quarter from its very rapid pace earlier in the year. In particular, retail sales in October were no higher than they had been in August—suggesting that the surge in consumer spending was subsiding—and the rise in Federal expenditures was estimated to be slackening further. Staff projections implied that the rate of economic expansion would continue to moderate in the first half of 1969.

Recent data of various kinds indicated that the expansion was still strong. Industrial production, which was now reported to have turned up in September, advanced again in October, and new orders for durable goods increased sharply. Nonfarm payroll employment rose more in October than in other recent months, and the unemployment rate continued at the September level of 3.6 per cent. According to a private survey taken in October, businesses planned to increase their outlays on new plant and equipment in 1969 by about 8 per cent, or more than the rise currently estimated for 1968.

Average prices of industrial commodities increased slightly in November after advancing at a substantial rate in the two preceding months. In contrast, the consumer price index—which had increased only moderately in September—rose sharply in October. With labor markets remaining firm, sizable further advances in average hourly earnings were widespread among industries.

Foreign exchange markets were in turmoil during most of November. Speculative buying of German marks revived on a large scale in early November in response to renewed rumors of an imminent revaluation. Selling pressure on the French franc

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intensified, and sterling was also subject to pressure, particularly after the publication of figures indicating that the British foreign trade deficit had increased somewhat in October.

On November 19 the German Government announced that the mark would not be revalued, but that in order to reduce the German trade surplus the value-added tax rebate would be decreased by 4 percentage points for merchandise exports and the border tax would be reduced by 4 percentage points for most imports. The Finance Ministers and central bank Governors of the Group of Ten met at Bonn November 20 through 22. New credit facilities totaling $2 billion were made available to France, and the German authorities increased to 100 per cent the reserve requirements on additions to German commercial bank liabilities to foreigners.

On November 23, contrary to the expectations of many observers, the French Government announced that the franc would not be devalued, and on the following day President de Gaulle outlined the policy measures that would be adopted. In addition to the reimposition of exchange controls, these measures included a sizable reduction in French budget expenditures, a more restrictive policy toward wage and price increases, and changes in the tax system to favor exports and deter imports. Earlier, on November 13, the Bank of France had increased its discount rate from 5 to 6 per cent and had announced measures to limit the expansion of bank credit.

The British Government on November 22 announced new actions to restrain domestic demand and to improve the balance of payments. These included a 10 per cent surcharge on existing purchase and excise taxes; requirement of 6-month non-interest-bearing deposits equal to 50 per cent of the value of imports of most manufactured goods; and tighter ceilings on bank loans to the private sector.

Official estimates of the U.S. balance of payments indicated that there had been a small surplus in the third quarter on the

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liquidity basis of calculation, following a moderate deficit in the second quarter. Special official transactions operating to reduce the deficit remained large, but were not so large as in the second quarter. The trade surplus, although still quite small, was larger than in the first two quarters of the year; this resulted partly from acceleration of shipments in September in anticipation of a possible strike of longshoremen on October 1. Available data for October and the first 2 weeks of November suggested that a sizable deficit on the liquidity basis had again emerged.

Official data confirmed the earlier expectation that a moderate payments surplus had been recorded in the third quarter on the official settlements basis, largely because of a further increase in borrowings of U.S. banks through their branches abroad. The outstanding volume of such borrowings changed little after mid-September, however, and in October the balance on the official settlements basis probably was in deficit.

In its November refunding the Treasury offered 2 notes in exchange for securities maturing in mid-November and mid-December. Of the $5.6 billion of these issues held by the public, $2.5 billion were exchanged for a new 18-month, 5⅝ per cent note (priced to yield 5.73 per cent), and $1.3 billion were exchanged for a reopened 6-year, 5¾ per cent note (priced at par). On November 19 the Treasury announced that it would auction $2 billion of tax-anticipation bills due in June, for payment on December 2, mainly to raise cash to redeem the $1.8 billion of maturing securities not exchanged in the November refunding. This offering was expected to be the Treasury's last financing in the calendar year, and its size was near the lower end of the range that had been anticipated by market participants.

With the Treasury refunding under way, recent System open market operations had been directed at maintaining generally steady conditions in money and short-term credit markets. Operations were complicated, however, by shifts in the distribution of reserves—first away from banks in the money centers and

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then back again—and by the effects on total reserves of a sharp decline in Treasury balances at the Federal Reserve Banks and of large-scale international transactions. The effective rate on Federal funds was 6 per cent or higher on most days in the first half of November, but it subsequently fluctuated around 5¾ per cent. Member bank borrowings averaged about $520 million in the 4 weeks ending November 20, above the average of about $450 million in the preceding 4 weeks. Excess reserves also increased on the average but less than borrowings, and net borrowed reserves were slightly larger.

Yields on Treasury, corporate, and State and local government bonds had risen further in recent weeks, partly because of continuing heavy demands on the capital markets. The volume of corporate and municipal bond offerings in November, while less than in October, was relatively large. The upward rate pressures also reflected cautious attitudes on the part of investors, against the background of indications of strength in the economy, widespread expectations of inflation, and growing anticipations of a firmer monetary policy. On the other hand, there was relatively little reaction in capital markets to either the late-October announcement of a halt in the bombing of North Vietnam or the recent turbulence in foreign exchange markets.

Interest rates on various types of short-term instruments also had risen recently, in response to some of the same factors affecting longer-term rates as well as to seasonal pressures. However, there was little net change in yields on shorter-term Treasury bills, the market supplies of which had become limited at a time of strong domestic and foreign demands. The market rate on 3-month Treasury bills, at 5.42 per cent on the day before this meeting, was 4 basis points below its level of 4 weeks earlier.

Net inflows of deposits to nonbank financial intermediaries again increased only moderately in October. Yields on home mortgages in the secondary market, which had been declining for several months, edged up in October and apparently also in the first half of November.

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Rates paid by banks on large-denomination CD's also had advanced further in recent weeks. Most banks were now paying the Regulation Q ceiling rate of 6 per cent on certificates with maturities of 90 to 179 days, and some reportedly were paying the 6¼ per cent ceiling rate on longer-term certificates. According to tentative estimates, growth from October to November in the volume of outstanding CD's, and of other time and savings deposits as well, was slower than it had been in other recent months. On the other hand, the expansion in private demand deposits and the money supply accelerated—the latter to an estimated annual rate of more than 10 per cent, the highest since July. Bank credit, as measured by the proxy series—daily-average member bank deposits—was tentatively estimated to have increased from October to November at an annual rate of 10.5 per cent, compared with 12.5 per cent from September to October. In mid-November prime lending rates were raised to the generally prevailing level of 6¼ per cent by the few large banks that had reduced such rates from 6½ to 6 per cent in late September.

Staff projections suggested that the bank credit proxy would increase from November to December at an annual rate of 5 to 8 per cent if prevailing conditions were maintained in money and short-term credit markets. The projections assumed that the volume of large-denomination CD's outstanding would decline seasonally and that growth in other time and savings deposits would slow somewhat further. An anticipated reduction in the average level of U.S. Government deposits was expected to contribute to expansion in private demand deposits and the money supply at a rapid rate, although not so rapid as in November.

Committee members differed in their views on the appropriate course for monetary policy under current circumstances, with a minority favoring operations directed at attaining somewhat firmer money market conditions. The majority thought that, although it would be advisable to resist any easing of money market conditions that might be produced by market forces, a

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shift to a firmer policy stance was not warranted at this time.

Members of the majority shared the concern expressed about the persistence of inflationary pressures, and some indicated that they had found the question of appropriate policy to be close. On balance, however, they believed that domestic economic considerations did not suggest a clear and unequivocal need for a firmer policy at present. In their judgment, despite the unexpected strength of the economy since enactment of fiscal restraint legislation at midyear, evidences of slowing in the rate of expansion were likely to become more pronounced in coming months. Other considerations cited as militating against a policy change at present were the recent turbulence and the continuing uncertainties in foreign exchange markets, and the fact that in financial markets the peak seasonal pressures of the year were to be expected in the period just ahead. Several members expressed the view that a slight firming of policy at this time would not be effectual in combatting the prevailing inflationary psychology, and that a more marked firming would be undesirable on the other grounds cited.

The Committee concluded that open market operations should be directed at maintaining about the prevailing conditions in money and short-term credit markets, with the proviso that operations should be modified if bank credit expansion appeared to be exceeding current projections. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that the expansion in over-all economic activity, while still strong, is moderating somewhat further from its very rapid pace earlier in the year. Upward pressures on prices and costs are persisting. Most market interest rates have risen further in recent weeks. Bank credit has continued to expand rapidly. Growth in the money supply has accelerated from the low average rate of recent months, while expansion in commercial bank time and savings deposits has slowed.

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Savings inflows to thrift institutions increased somewhat further in October but remained moderate. Following discussions among leading industrial countries, France, Germany, and Britain have acted to combat the recent speculation in their currencies by taking steps designed to reduce imbalances in their external payments. The U.S. foreign trade balance and over-all balance of payments improved in the third quarter but partial data for recent weeks suggest that the improvement is not being sustained, and the underlying U.S. payments position remains a serious problem. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit expansion appears to be exceeding current projections.

Votes for this action: Messrs. Martin, Brimmer, Daane, Galusha, Maisel, Mitchell, Robertson, and Sherrill. Votes against this action: Messrs. Hayes, Hickman, Kimbrel, and Morris.

In dissenting from this action, Messrs. Hayes, Hickman, Kimbrel, and Morris indicated that they favored seeking somewhat firmer money market conditions in an effort to slow the rate of bank credit growth, which in their view had been excessive for several months. They thought such action was required in light of prevailing inflationary pressures and expectations. In their judgment, the latest information on the domestic economy lent support to the view that the rate of expansion, while perhaps moderating somewhat in coming months, was likely to remain excessive under the current stance of fiscal and monetary policies. The view also was expressed that a firmer monetary policy was desirable to help maintain the strength of the dollar in foreign exchange markets.

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2. Ratification of amendment to authorization for System foreign currency operations.

The Committee ratified an action taken by members on November 22, 1968, effective on that date, to increase the System's swap arrangement with the Bank of France from $700 million to $1 billion, equivalent, and to make the corresponding amendment to paragraph 2 of the authorization for System foreign currency operations. As a result of this action, paragraph 2 read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, relations with foreign banks and bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	225
Bank of Canada	1,000
National Bank of Denmark	100
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000
Bank of Italy	1,000
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	400
Bank of Norway	100
Bank of Sweden	250
Swiss National Bank	600

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank for International Settlements:	
System drawings in Swiss francs	600
System drawings in authorized European currencies other than Swiss francs	1,000

Votes for ratification of this action: Messrs. Martin, Hayes, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Morris, Robertson, and Sherrill. Votes against ratification of this action: None.

This increase in the Federal Reserve swap line with the Bank of France represented part of the U.S. share of the $2 billion in new credit facilities to France that had been announced in Bonn on November 22, following the meeting of the Finance Ministers and central bank Governors. In addition, the U.S. Treasury made a $200 million credit facility available to France, so total U.S. participation in the new facilities was $500 million.

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MEETING HELD ON DECEMBER 17, 1968

Authority to effect transactions in System Account.

The current rate of expansion in over-all economic activity was significantly higher than had been projected earlier, according to a broad variety of economic information that had become available since the preceding meeting of the Committee. New staff projections suggested that GNP in current-dollar terms would increase about as rapidly in the fourth quarter as it had in the third. Average prices, as measured by the "GNP deflator," were estimated to be rising at a faster pace again in the fourth quarter, and growth in real GNP was expected to moderate somewhat further from the very high rates recorded in the first two quarters of the year. Expectations of continued inflationary pressures appeared to be widespread.

The staff projections of GNP in both the fourth and first quarters had been revised upward from those of 3 weeks earlier largely because of the indication, from the Commerce–SEC survey of business plans taken in November, that outlays on new plant and equipment were rising sharply. Other evidences of strength in the current business situation were reflected in November data on production, employment, and retail sales. A sizable further advance in industrial production in November brought the index above the previous high recorded in July, when output of steel had been substantially larger. Nonfarm payroll employment again rose sharply, and the unemployment rate declined to 3.3 per cent—its lowest level in 15 years—from 3.6 per cent in October. Average hourly earnings continued to advance at the rapid pace of recent months. Retail sales, according to the advance estimate, rose in November after edging down in September and October. It appeared, however, that consumer expenditures would expand considerably less in the fourth quarter as a whole than they had in the third quarter.

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The staff projections still implied that the rate of increase in real GNP would moderate considerably in the first half of 1969, partly because of a marked swing from deficit to surplus that was already under way in the Federal fiscal position. In addition, it was expected that expansion in consumer expenditures would slow further as a result of slackened growth in disposable income and that the increase in residential construction outlays would be limited by tight conditions in mortgage markets. Against the background of prospects in these sectors, the resurgence of business capital outlays and the report that inventories had risen markedly in October suggested that imbalances could be developing in the economy as a result of inflationary expectations.

In foreign exchange markets, earlier speculative movements of funds were partly reversed following the actions taken in late November by Germany, France, and Britain to reduce imbalances in their external payments. The pound was again subject to selling pressure in early December, however, and the market for sterling remained uneasy even after publication of figures indicating that Britain's foreign trade balance had improved sharply in November.

Available information on the U.S. balance of payments in October and November suggested that sizable deficits had again emerged on both the liquidity and official settlements bases of calculation, following the surpluses—small in the case of the liquidity balance—that had been recorded in the third quarter. Since mid-September there had been relatively little net change in borrowings by U.S. banks through their foreign branches; in the spring and summer, increases in such borrowings had resulted in the payments surpluses recorded then on the official settlements basis. U.S. merchandise exports declined sharply in October after rising considerably in September in anticipation of a longshoremen's strike on October 1. Imports also declined in October, but more moderately than exports; for September and October together there was a small surplus in U.S. foreign

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trade. With the current Taft-Hartley Act injunction against the strike scheduled to expire on December 20, continued marked fluctuations in monthly foreign trade figures appeared likely.

In late November the Treasury auctioned $2 billion of tax-anticipation bills due in June 1969, for payment on December 2. Banks, which were allowed to pay for the bills through credits to Treasury tax and loan accounts, successfully bid for the bulk of the issue. Despite this cash financing, however, Treasury cash balances at banks were drawn down to very low levels prior to the quarterly corporate tax date in mid-December, and the Treasury temporarily replenished its balances in the period December 10–17 by selling special certificates of indebtedness to the Federal Reserve. The volume of such certificates outstanding was $92 million on December 10, none on December 11, $45 million on December 12, $430 million from December 13 through 15, $447 million on December 16, and $596 million on December 17. (Certificates outstanding on December 17 were redeemed the following day.)

Interest rates on market securities of all maturities had risen sharply further in recent weeks as the steady stream of statistics reflecting strength in the economy heightened concern about inflationary pressures and enhanced expectations of a firmer monetary policy. Increases in yields were particularly rapid in early December after commercial banks increased their prime lending rates from 6¼ per cent to the 6½ per cent level that had prevailed before the reductions of late September. Yields on most long-term securities rose to levels above the peaks that had been reached in the spring, and unsettled conditions in the capital markets led to the postponement or cancellation of a number of scheduled corporate and municipal bond offerings. Conditions in the secondary market for home mortgages continued to tighten in early December.

In markets for short-term securities, yield advances were particularly pronounced for Treasury bills; on the day before this

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meeting the market rate on 3-month bills was 5.94 per cent, 52 basis points above its level of 3 weeks earlier. Upward pressures on bill yields were augmented by seasonal forces, sales of bills by foreign monetary authorities, and sales by domestic commercial banks of tax-anticipation bills they had acquired in the Treasury's recent auction.

Rates paid by commercial banks on large-denomination CD's of longer maturity had increased further in recent weeks, and most large banks were now paying the Regulation Q ceiling rates for all maturities. The volume of CD's outstanding rose substantially in November, particularly after midmonth. Largely as a consequence, the expansion in total time and savings deposits from October to November was more rapid than earlier tentative estimates had indicated, although somewhat less rapid than in other recent months.

Estimates of November growth rates also had been revised upward somewhat for bank credit, as measured by the proxy series—daily-average member bank deposits—and for the money supply; both were now estimated to have increased from October to November at an 11.5 per cent annual rate. Since midyear, bank credit and the money supply had expanded at annual rates of about 13 and 6 per cent, respectively, compared with rates of about 4 and 6.5 per cent in the first half of the year. In November banks increased the volume of business loans outstanding considerably further and continued to acquire municipal securities at a rapid pace, while reducing their holdings of U.S. Government securities. To a large extent, the accelerated growth in the money supply in November reflected a rise in private demand deposits in the last half of the month, when U.S. Government deposits declined markedly.

System open market operations in the first part of the period since the Committee's preceding meeting were directed at maintaining about the prevailing conditions in money and short-term credit markets, and reserves were supplied partly in an effort to

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cushion the sharp reaction of short-term market interest rates to the rise in the prime rate. Operations subsequently were shifted in the direction of reserve absorption when market factors began to supply a large volume of reserves and when estimates indicated that bank credit was expanding at a rate in excess of the range projected at the time of the previous meeting. These operations were tempered, however, in view of the continuing increases in short-term rates. During the period as a whole, the effective rate on Federal funds fluctuated mostly in a range of 5¾ to 6 per cent. Member bank borrowings averaged $515 million in the 3 weeks ending December 11, little changed from the previous 4 weeks. With excess reserves lower on the average, net borrowed reserves rose in the period.

New staff projections suggested that if prevailing conditions in money and short-term credit markets were maintained, on balance, the bank credit proxy would expand at an annual rate of 8 to 11 per cent from November to December and at a rate of 4 to 7 per cent from December to January. Given the current relationships between short-term interest rates and Regulation Q ceiling rates, it was expected that banks would experience a larger-than-seasonal run-off of CD's in December and a contraseasonal run-off in January, and that inflows of consumer-type time and savings deposits would begin to moderate. Growth in the money supply was expected to slow considerably in December—and perhaps to taper off further in January, particularly if demands for business loans were reduced.

An alternative projection suggested that a firming of money market conditions would have relatively little effect on bank credit growth in December but would result in a slower rate of growth in January—an annual rate of perhaps 2 to 5 per cent —mainly as a result of a larger run-off of CD's. For purposes of the projections it was assumed that the Treasury would not engage in any new cash borrowing through the end of January.

Prior to this meeting the boards of directors of nine Federal

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Reserve Banks had acted, subject to the approval of the Board of Governors, to increase discount rates from the present level of 5¼ per cent. It was reported to the Committee that the Board of Governors planned shortly after this meeting to take action with respect to discount rates and also to consider the desirability of a moderate increase in member bank reserve requirements.

The Committee was unanimously of the view that greater monetary restraint was required at this time in light of the unexpected strength of current economic activity, the persistence of inflationary pressures and expectations, and the recent rapid rate of growth in bank credit. The members agreed that one element of the shift to greater monetary restraint should be a firmer open market policy. There also was general sentiment at the meeting that discount rates should be increased, although there were some differences of view with respect to the amount; and divergent opinions were expressed about the desirability of action now to raise reserve requirements.

A number of members expressed the view that the combination of a firmer open market policy and an increase of one-quarter of a percentage point in discount rates would be appropriate to the current economic situation. Some of these members added that, while additional measures could be taken later if deemed necessary, various considerations—including the continuing uncertainties with respect to foreign exchange markets, as well as the sensitive state of conditions in domestic financial markets with the attendant risks of unduly large market reactions—militated against also increasing reserve requirements at this time or raising discount rates by as much as one-half point. The basic argument advanced by those who favored a broader combination of policy actions now was that more limited actions were likely to be inadequate to dampen the prevailing inflationary psychology, particularly since it appeared that an increase of at least one-quarter point in the discount rate was already widely anticipated in financial markets.

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At the conclusion of the discussion the Committee agreed that open market operations should be directed at attaining firmer conditions in money and short-term credit markets, while taking account of the effects of any other monetary policy actions that might be taken. The proviso was added that operations should be modified if bank credit expansion appeared to be deviating significantly from current projections. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that over-all economic activity is expanding rapidly and that upward pressures on prices and costs are persisting. Market interest rates have risen considerably further in recent weeks. Bank credit growth has been sustained by continuing strong expansion of time and savings deposits, while growth in the money supply has accelerated and U.S. Government deposits have declined. The U.S. foreign trade surplus remains very small and the over-all balance of payments apparently worsened in October and November. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining firmer conditions in money and short-term credit markets, taking account of the effects of other possible monetary policy action; provided, however, that operations shall be modified if bank credit expansion appears to be deviating significantly from current projections.

Votes for this action: Messrs. Hayes, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Morris, Robertson, and Sherrill. Votes against this action: None.

Absent and not voting: Mr. Martin.

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Operations of the System Open Market Account

The following two reports describe the actions taken during 1968 to carry out the policy directives of the Federal Open Market Committee.

The report on operations in domestic securities was prepared by Alan R. Holmes, Manager of the System Open Market Account, who supervises these operations. It is written from the vantage point of the Trading Desk at the Federal Reserve Bank of New York, where operations in these securities are effected to carry out the policy directives of the Federal Open Market Committee. The report outlines the factors that the Manager takes into account in the day-to-day provision of bank reserves.

The report on foreign currency operations was prepared by Charles A. Coombs, Special Manager of the System Open Market Account, who supervises the Federal Reserve's operations in such currencies. The Federal Reserve has been buying and selling foreign currencies since early 1962 as part of the efforts to defend the dollar and strengthen the world payments system. All of these operations for the System Account are carried out, under the authorization of the Federal Open Market Committee, by the Federal Reserve Bank of New York, which also handles foreign currency transactions for the U.S. Treasury.

The report on operations in foreign currencies begins on page 275.

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REVIEW OF OPEN MARKET OPERATIONS IN DOMESTIC SECURITIES

Open market operations during 1968 were conducted against a backdrop of manifold uncertainties. One of the most vexing was concerned with fiscal restraint—first, as to the likelihood of enactment of fiscal restraint measures, and later, as to the timing and extent of the impact of such measures on the economy. Such uncertainties, together with recurring international financial crises, not only complicated policy decisions but also gave rise to widespread expectational shifts that in turn exerted a strong influence on economic and financial developments.

Monetary policy, as it was carried out through open market operations, passed through four phases during the year. During the first 4 months it became increasingly restrictive as a Federal budget deficit continued to stimulate an already booming economy and as the dollar was under attack from abroad. Then in May and June open market operations maintained strong pressure on the banking system. This policy over the first half of this year served to slow the rate of growth in bank credit after February and contributed to a rise in interest rates to the highest levels reached in many years up to that time. With the passage of revenue and expenditure control legislation in late June, open market operations shifted to accommodating the tendency for short-term interest rates to decline as the prevailing expectation was that the pace of economic advance would slow. Beginning in late summer, however, it appeared that inflationary pressures were not subsiding as had been projected, and with bank credit growing rapidly, the System began to move back toward restraint in its open market operations—thus marking the fourth phase of monetary policy. In December it undertook to increase such restraint significantly in order to deal with the excessive demands and inflationary psychology that still marked the economy. Interest rates, which had already regained their May peaks, rose to new highs during the month.

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Open market operations undertook to promote policy objectives by varying the degree of pressure on the banking system. The extent of this pressure was reflected in the rise of daily-average borrowing by member banks at their Reserve Banks from around $250 million in January to about $700 million in May–June, followed by an easing to about $550 million in July–September and then by a gradual rise to $750 million in December. The Federal funds rate traced a similar path, rising from around 4⅝ per cent in January to 6 to 6½ per cent in May–June; it then fell back to 5¾ to 6 per cent in late summer before rising above 6½ per cent in late December. Bank credit growth as measured by daily-average member bank deposits subject to reserve requirements—the bank credit proxy—slowed to a 4 per cent annual rate in the first half of the year but bounced back to a 13 per cent rate in the second half.

Open market operations involved outright purchases, sales, and redemptions of $19 billion of Treasury securities in 1968, not including the purchase and redemption of $775 million of special securities issued directly by the Treasury for brief periods. This represented a gain in dollar volume of 9 per cent over the 1967 total. But a much larger rise took place in the temporary provision and absorption of bank reserves through repurchase agreements and matched sale–purchase transactions. Almost $67.5 billion of such short-dated contracts were written and matured in 1968—a 77 per cent increase from the preceding year. This rise reflected the very extensive use of matched sale–purchase transactions to absorb reserves temporarily in large volume with a minimum impact on the Treasury bill market. The restrictive tenor of monetary policy during 1968 contributed to the more frequent use of this technique, especially in the last 4 months of the year when a move toward policy restraint was carried out alongside the introduction of new reserve-computation procedures, which altered established patterns of bank behavior and often tended to produce a temporary easing of money market conditions.

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On balance, the System's holdings of Government securities rose by $3.8 billion in 1968, considerably less than the $4.8 billion increase of 1967. At the end of the year such holdings totaled $52.9 billion.

JANUARY 1–APRIL 30:
IN THE ABSENCE OF FISCAL RESTRAINT, MONETARY POLICY BECOMES INCREASINGLY RESTRICTIVE TO RESIST INFLATION

The economic and financial environment. As 1968 opened, overall economic activity was expanding at a rapid rate, and inflationary pressures were strong and were expected to persist. The President reiterated his call for a 10 per cent income tax surcharge both on January 1—in a message devoted largely to outlining restraints on the flow of U.S. capital abroad—and in the budget message. The proposal for an income tax surcharge ran into considerable opposition in the Congress, and its outcome remained in doubt throughout the period under review. The U.S. balance of payments continued in serious disequilibrium, with the trade balance becoming especially weak, and extraordinary speculation in the gold and foreign exchange markets precipitated an international financial crisis in March. Concerted actions by international monetary authorities—discontinuing operations of the London gold pool and establishing a two-tier gold market—again repelled the threat to the international monetary system. But the episode underscored the need for halting inflation in the United States.

Against this background the Federal Reserve System moved forcefully to resist inflationary pressures and to foster improvement in the Nation's balance of payments position. An increase in reserve requirements announced on December 27, 1967, made very clear to member banks the more restrictive thrust of monetary policy. Open market operations persistently increased the pressure on bank reserve positions over the first 4 months of 1968. Total member bank borrowings from the Federal Reserve rose from a daily average of $237 million in January to $683

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million in April, while net reserve availability fell from net free reserves of $144 million to net borrowed reserves of $413 million. On March 15 and again on April 19 Federal Reserve discount rates were increased by ½ of a percentage point—bringing them to 5½ per cent, the highest level since 1929. Also on April 19, the Board of Governors raised ceiling rates under Regulation Q on large-denomination certificates of deposit to 5¾ per cent on those maturing in 60 to 89 days, 6 per cent on those maturing in 90 to 179 days, and 6¼ per cent on longer maturities. The ceiling on certificates maturing in 30 to 59 days remained at 5½ per cent, the rate previously applicable to all maturities. Open market operations both facilitated market adjustments to the higher rate levels and pressed for even firmer money market conditions.

The restraint exerted by monetary policy—interacting with the economy's credit demands—was accompanied by a steep rise in money market rates of interest and a pronounced slowing in the pace of bank credit expansion. The Federal funds rate rose from a range of 4½ to 4¾ per cent in January to 6 per cent, and briefly to 6¼ per cent, by the end of April (Chart 1). Rates posted by the major New York City banks on loans to Government securities dealers ("call loans" in charts) rose from around 4¾ percent in January to 6½ per cent in late April. Given the upward pull of financing costs, the rate on 3-month Treasury bills rose from about 5 per cent to 5½ per cent over this period in spite of the seasonal redemption by the Treasury of $5.5 billion of tax-anticipation bills maturing in March and April. Bank credit growth—as measured by the bank credit proxy—was at a seasonally adjusted annual rate of 4 per cent over the January–April period, compared with an increase of 11.7 per cent during all of 1967.

The slowdown of growth in bank credit over the interval reflected both a more-than-seasonal reduction in average Government deposits in March and April and a marked slowing in time deposit growth. Time deposits rose at an annual rate of only 6

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per cent in the first 4 months of 1968, compared with 16 per cent over the year 1967. Higher short-term market interest rates at first reduced the growth in negotiable CD's and by March and April led to a contraction in the volume outstanding; other time and savings deposits also rose at a somewhat slower pace than in 1967. (Savings at other thrift institutions also grew at a more moderate pace.) The money supply—demand deposits adjusted and currency outside banks—increased at an annual rate of 5 per cent, seasonally adjusted, during the first 4 months of 1968, compared with 6.4 per cent for the year 1967.

On the whole, bank loans grew at about the same rate during the first 4 months of 1968 as in 1967. Business loan demand was slightly below the 1967 pace, but consumer loans increased sharply. On the other hand, bank investments, in both Government and other securities, increased at a much slower rate than the rapid pace of 1967.

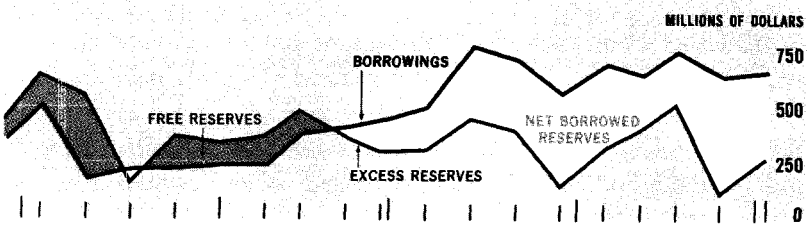
Short-term interest rates rose irregularly over the first 4 months and in fact worked temporarily lower in January. Banks, finding loan demand relatively moderate early in the year, were not aggressive in bidding for funds. However, they were able to extend the maturities on many CD's and to replace borrowings of Euro-dollars at declining rates. As money market rates rose under Federal Reserve pressure in February and March, rates on Treasury bills and CD's began to edge higher. During the mid-March gold crisis most Treasury bill rates advanced by 20 to 50 basis points while the rate on 3-month Euro-dollars rose by more than 1 percentage point to 7⅛ per cent for a few days. The acute tensions in short-term debt markets were relieved by various measures taken to alleviate the gold crisis. In late March the President's announcement of a partial halt of the bombing of North Vietnam also relieved market pressures.

Nevertheless, the strong pressure exerted by increases in day-to-day money market rates and by expectations of a further tightening of monetary policy in the absence of fiscal restraint led to a renewed rise in short-term rates. The banks experienced

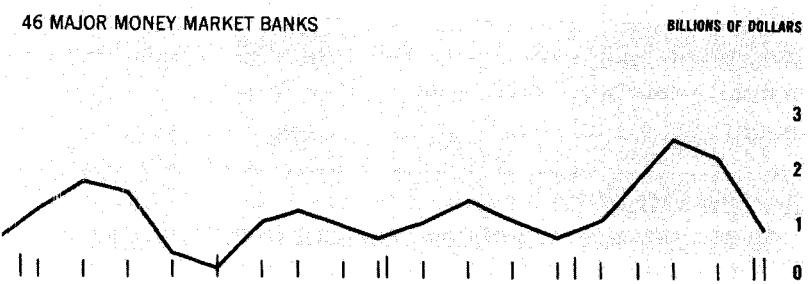
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I. DECEMBER 27, 1967 - MAY 1, 1968

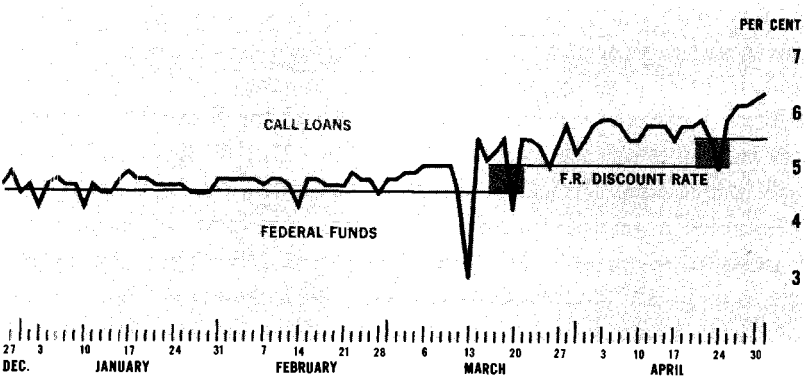
Reserves and borrowings



Basic reserve deficit



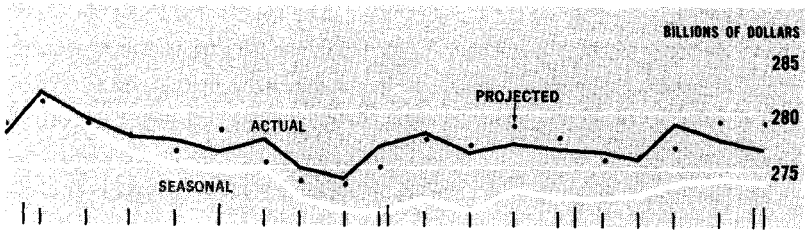
Money market rates



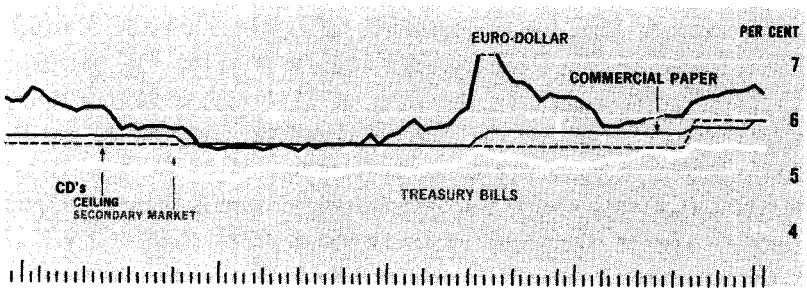
Money market rates: Federal funds, daily effective rate; call loans, daily range on new loans to U.S. Govt. securities dealers posted by New York City banks. *Bank credit proxy:* projection was made 4 weeks earlier. *Short-term rates:* bid rate on 3-month Euro-dollars; secondary market rate and Regulation Q ceiling on 3-month CD's; daily bid rate on 3-

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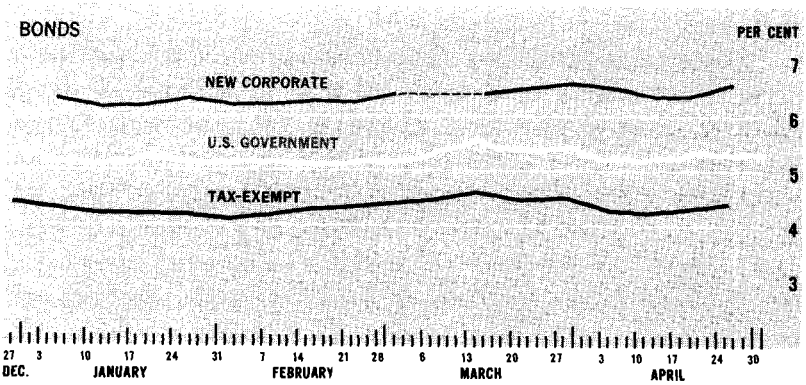
Bank credit proxy



Other short-term rates



Long-term rates



month Treasury bills; and offering rate on 4- to 6-month commercial paper. *Long-term rates:* corporate bonds, weighted averages of new publicly offered bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis; U.S. Govt. bonds, average yield on all bonds due or callable in 10 years or more; tax-exempt bonds, State and local govt. bonds (20 issues, mixed quality), Bond Buyer.

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a run-off of $1 billion in CD's over the 3 weeks ended April 17, nearly double the decline in the comparable 3 weeks around the mid-March tax date. The further increase in the Federal Reserve discount rate to 5½ per cent on April 19 confirmed the expectations regarding the intentions of the monetary authorities. After this action commercial banks raised the prime loan rate from 6 to 6½ per cent.

In the capital markets, yields fluctuated widely over the 4-month period in response to the changing supplies of new issues and shifting sentiment concerning the prospects for fiscal and/or monetary restraint, for an end of hostilities in Vietnam, and for the restoration of international monetary stability. On balance, yields changed little over the interval. Average yields on long-term Treasury bonds were 5.33 per cent at the end of April, compared with 5.36 per cent at the close of 1967. The Bond Buyer's index of yields on 20 municipal bonds was 4.44 per cent on May 2, the same as on December 28, 1967. New Aa-rated utility bonds with 5-year call protection were offered at yields of around 6.75 per cent in early May, about the same level as had prevailed in December 1967.

Treasury and Federal agency financing operations were large during the 4 months. In January the Federal National Mortgage Association (FNMA) took advantage of a buoyant market atmosphere to sell $1.25 billion of two issues of participation certificates (including $450 million to Government trust accounts); the 20-year maturity was offered at a yield of 6.084 per cent. Later, the Treasury conducted a successful two-phased offering—the first of its kind—to refund maturing securities and to raise new cash. In the first week of February a new 7-year, 5¾ per cent note was offered to holders of issues maturing in February, August, and November; of the $12.1 billion in public hands, $3.9 billion was turned in on February 15. Then on February 13 the Treasury sold for cash $4.3 billion of 15-month, 5⅝ per cent notes for payment on February 21.

The gold crisis in March triggered both a 40-basis-point rise

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in the average yield on long-term Government bonds and a similar sharp deterioration in the markets for corporate and municipal bonds. In the wake of the crisis FNMA's sale of $1 billion of three issues of participation certificates on March 26 (including $270 million placed with Government trust accounts) required a 6.45 per cent yield on the 20-year maturity, the highest on a Government obligation since the Civil War. The President's peace initiative and his renewed call on March 31 for a tax increase led to a spirited rally in the capital markets, but the price gains faded in April when the Congress adjourned for the Easter recess without clarifying the outlook for fiscal restraint legislation—suggesting to many the inescapability of further monetary restraint.

SYSTEM OPERATIONS IN GOVERNMENT SECURITIES DURING 1968
In millions of dollars

Type of operation	Jan. 1–Apr. 30	May 1–June 20	June 21–Sept. 25	Sept. 26–Dec. 31	Total
Outright purchases:					
Treasury bills:					
From market	1,595	1,356	1,380	1,543	5,874
From foreign accounts	1,196	675	671	1,888	4,430
Coupon issues	574	70	285	247	1,176
Special certificates of indebtedness	.....	.....	87	688	775
Outright sales:					
Treasury bills:					
To market	1,091	286	1,194	891	3,462
To foreign accounts	421	98	246	1,819	2,584
Coupon issues	.....	.....	.....	.....	.....
Matched sale—purchase transactions:					
With dealers:					
Sales	2,400	400	4,715	8,885	16,400
Purchases	2,400	400	4,715	8,885	16,400
With foreign accounts:					
Sales	.....	.....	.....	415	415
Purchases	.....	.....	.....	415	415
Redemptions:					
Treasury bills	592	171	278	436	1,477
Special certificates of indebtedness	.....	.....	87	688	775
Repurchase agreements:					
Government securities:					
Purchases	4,592	3,821	3,869	3,580	15,862
Sales	4,459	3,958	3,997	3,580	15,994
Federal agency obligations:					
Purchases	292	260	219	204	975
Sales	318	223	268	204	1,013
Net change	+1,368	+1,446	+441	+532	+3,787

NOTE—All figures are as of date of delivery.

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Open market operations. System open market operations unfolded against the backdrop of the foregoing economic and financial developments. (For a statistical summary of System operations in Government securities, see the accompanying table.) In January the money market had to cope with the huge flows of funds that are characteristic of the beginning of the year. Total member bank deposits (not seasonally adjusted) declined by $5 billion over the month, while large amounts of reserves shifted away from the money centers and then back again. The basic reserve deficit of the 46 major money center banks declined from an average of $1.7 billion in the week ending January 10 to $148 million in the week ending January 31 (middle left panel of Chart 1).[1] Country bank excess reserves also fluctuated widely, averaging as high as $520 million in the week ending January 10 and as low as $114 million in the following week.

The System alternately absorbed and supplied reserves—allowing net reserve availability to fluctuate widely in accordance with expected week-to-week changes in the demand for excess reserves. Initially, it supplied reserves in volume to avoid pressures arising from the expected early-January accumulation of excess reserves by country banks. When float rose beyond expectations and the weekly sample of country bank reserve positions pointed to higher-than-expected reserve availability, the System first sold bills outright and then on Wednesday, January 10, sold $460 million of bills under 1-day matched sale–purchase transactions to counter the influx of Federal funds at declining rates.

The matched sale–purchase technique, introduced in July 1966, enables the System to effect much greater short-term reserve absorption than would be feasible through outright sales since dealers do not need to assume the market risks involved in outright purchases from the System. During 1968 the Account

[1] The basic reserve position of this group of banks is defined as the group's excess reserves less its net purchases of Federal funds and its borrowings from the Reserve Banks.

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Manager made much more frequent use of this technique than earlier as he sought to maintain the desired pressure on bank reserve positions. Several matched sale–purchase operations during 1968 absorbed well over $1 billion of reserves for short periods.

Over the remainder of January, System operations were influenced by the reserve-management patterns of both the country and reserve city banks. In the weeks ending January 17 and 31, money market conditions tended to ease early in the week as the reserve city banks anticipated that substantial amounts of the excess reserves that country banks carried over into the final week of their biweekly reserve-settlement periods would flood the Federal funds market later in the week. In an attempt to keep money market conditions firm, the System absorbed reserves early in those weeks. However, the money market banks were content to accumulate sizable reserve deficiencies, which they still hoped to cover at lower rates at the end of the week. As a consequence, demands for funds far exceeded supplies on the Wednesday settlement dates, when these banks scrambled to cover their deficiencies. Rates for Federal funds rose from around 4¾ to as high as 5⅛ per cent on January 17 and on January 31 were as high as 5¼ per cent. On both settlement days the System made overnight repurchase agreements to moderate the tautness in the market, but even so, member bank borrowing from the Reserve Banks surged to more than $1 billion on January 17 and to $800 million on January 31.

The Treasury's February financing operations conditioned open market operations during the month, but they did not forestall an appreciable increase in monetary pressures on the banks after midmonth. During early February the System supplied reserves just a little after the needs became apparent, in order to keep the money market steadily firm; under these conditions Federal funds generally traded at rates ranging from 4⅝ to 4¾ per cent. Since indicated reserve needs were relatively short-lived, the System provided reserves entirely through repurchase agree-

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ments, including some against "rights" to the Treasury refunding—that is, issues eligible to be exchanged for the new 7-year notes.

Such agreements—written to mature on February 15, the exchange date—served a dual purpose: (1) to meet a part of the banking system's reserve needs, and (2) to facilitate the Treasury refunding by assisting dealers who purchased rights issues. However, when net reserve availability considerably exceeded expectations over the period February 9 to February 12—the holiday weekend when Lincoln's Birthday fell on a Monday—the System quickly switched to selling Treasury bills—at first outright, and then under 1-day matched sale–purchase transactions.

By about mid-February it became clear that bank credit growth was outrunning expectations (Chart 1, top right panel) and that a move toward greater restraint—to the extent permitted by Treasury financing—was called for under the proviso clause of the directive of the Federal Open Market Committee adopted at the February 6 meeting. Inasmuch as the distribution of the new 7-year notes was proceeding smoothly and the sale of $4.3 billion of 15-month notes on February 13 had been successful, the Account Manager began to allow the seasonal action of float and other factors affecting reserves to exert increasing pressure on the banks without taking fully offsetting action. Member bank borrowing from the Reserve Banks rose to an average of $424 million in the last 2 weeks of February from $313 million in the prior 2 weeks, and net borrowed reserves emerged for the first time in a year (except for 1 week in January). In late February the System tempered the tautness in the money market by making outright purchases of Treasury securities, including coupon issues.

Over the next 2 months the System carried out one of the swiftest increases in monetary restraint in history. An inflationary rate of expansion in the domestic economy and the threat that persistently rising domestic prices posed to international confidence in the dollar, and hence to the international monetary

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system, provided the backdrop for this action. In the first 2 weeks of March the Account Manager, acting under the Committee's March 5 directive, allowed conditions in the money market to tighten by not offsetting the reserve drains generated by gold losses and other reserve factors. The Federal funds rate reached 5 per cent on several days. Member bank borrowing from the Reserve Banks rose to an average of $640 million for the 2-week period, and net borrowed reserves to an average of $253 million.

Reflecting in part the uncertainties of the international monetary situation and expectations of a possible increase in the discount rate, banks managed their reserve positions cautiously, bidding strongly for Federal funds and borrowing heavily from the Reserve Banks—in excess of $1.2 billion over the March 8–10 weekend. As a result, a redundancy of reserves appeared in the money market on Tuesday, March 12. However, in view of the deterioration that developed in the securities markets as foreign demand for gold mounted, the System purchased Treasury bills offered for sale by foreign official accounts, instead of selling the bills for those accounts in an unreceptive market. When the money market displayed signs of marked easing on Wednesday, March 13, the end of settlement periods for both reserve city and country banks, the System roughly offset the immediate reserve effect of its purchases from foreign accounts by negotiating overnight matched sale–purchase transactions.

The securities markets opened on Thursday, March 14, amid reports that turnover on the London gold market had exceeded the previous daily peak recorded in the aftermath of the devaluation of sterling in November 1967. Sentiment in the securities markets deteriorated rapidly amid rising expectations of an increase of a full percentage point in the discount rate. To facilitate an orderly adjustment as market rates moved higher, the System conducted a go-around of the market at an unusually early hour and purchased $313 million of Treasury bills. It also purchased Treasury securities, including coupon issues, from foreign accounts. (The Treasury helped to offset the reserve impact of

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these operations by advancing a scheduled transfer of gold from the monetary stock to the Stabilization Fund by 3 days.) An increase of ½ of a percentage point in the discount rate to 5 per cent was announced on the afternoon of March 14, and prices of securities rebounded the next day. The announcement on March 17 of the termination of gold pool operations served to calm the debt markets further, and the System conducted no additional operations in the week ending March 20.

Following the increase in the discount rate, the Federal funds rate adjusted upward to the area of 5¼ to 5¾ per cent in late March and early April, and New York City banks raised their rates on new loans to Government securities dealers to a range of 5½ to 6¼ per cent. On Wednesday, March 27, an unusual kind of strain developed in the market—one that could mislead banks and others as to the degree of pressure the monetary authorities intended to bring to bear on the monetary system. In view of the large reserve deficiencies accumulated by large banks outside New York City, the Account Manager had expected tightness to occur in the market that day. However, the Federal funds rate did not begin to rise sharply until about 1:00 p.m., by which time neither repurchase agreements nor cash trades with dealers were feasible. When the rate for Federal funds rose to a new record high (since surpassed) of 6⅜ per cent later that afternoon, the System moved to show its concern over the aberrant tightness (and to meet a part of the following week's reserve needs) by buying Treasury bills for delivery the next day.

As April unfolded, the slightly greater restraint being exerted by open market operations—in accordance with the Committee's April 2 directive—contributed to, and was reinforced by, a marked increase in pressure on the major money market banks. These banks were confronted by the prospect of heavy demands for credit on the April 15 corporate tax date at a time when interest-rate relationships suggested the likelihood of considerable attrition in banks' outstanding CD's. The major New York City banks, which experienced a $700 million deepening in their basic

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reserve deficit in the week ending April 10, raised their rates on new loans to Government securities dealers to around 6¼ per cent. The Federal funds rate rose and fluctuated around 5¾ per cent as the 46 major money market banks bid heavily for funds to cover a basic deficit, which had deepened by almost $1.8 billion to $2.5 billion.

At the onset of these reserve pressures on April 4, the System stepped in to supply reserves—in part through outright purchases of Treasury bills and in part through repurchase agreements against Treasury securities and bankers' acceptances. The repurchase contracts were written at 5⅛ per cent—⅛ of a percentage point above the prevailing discount rate. The use of such a differential, it was explained to the dealers, was a new and flexible operating technique designed to make it possible to write such contracts at rates closer to prevailing market rates for short-term securities. In the past the Account Manager had on occasion made repurchase agreements at rates below the discount rate when relatively low market interest rates had made it necessary to depart from the usual practice of setting the rate on System repurchase agreements at the discount rate. However, it had not been the System's practice to set the rate on its repurchase agreements above the discount rate when market interest rates were well above the discount rate, and as a consequence the Account Manager had sometimes felt constrained from providing reserves through repurchase agreements at such times.

On Friday, April 5, the Manager negotiated additional contracts at the 5⅛ per cent rate. However, a number of market participants interpreted the premium repurchase rate as suggesting that further monetary restraint lay ahead, and this contributed to the upward pressure on Treasury bill rates.

The System reversed direction after the weekend and sold some Treasury bills to mop up a glut of reserves, which stemmed in part from a bulge in float that resulted from an unexpected bank holiday in New York State on April 9 in honor of Dr. Martin Luther King, Jr. During the following statement week, the System

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again injected reserves through outright purchases and repurchase agreements at 5⅛ per cent in order to accommodate the churning of funds over the April 15 tax-payment date and to moderate strong upward pressures on Treasury bill rates. These latter pressures threatened the viability of the existing 5½ per cent ceiling on interest payments on negotiable CD's under Regulation Q.

On Thursday, April 18, the Board of Governors announced the increase in Federal Reserve discount rates to 5½ per cent and an upward revision in Regulation Q ceilings on large-denomination CD's.[2] Earlier that day the System had bought some Treasury bills and short-term coupon issues to meet a part of the sizable reserve need foreseen for the week. Markets adjusted readily to the new rate levels, and the System stayed on the sidelines the next day.

Reserves bulged unexpectedly after the weekend, however, and the System sold Treasury bills outright and under matched sale–purchase transactions. Federal funds traded predominantly in a 5½ to 5⅞ per cent range during most of the week but dropped as low as 4 per cent on April 24, the reserve-settlement day. However, after the execution of matched sale–purchase transactions that day, the rate rose to 6¼ per cent. On Thursday, April 25, trading in Federal funds opened at 5⅞ per cent and in order to nudge the rate higher, the System sold Treasury bills under 1-day matched sale–purchase transactions. (It also purchased bills directly from foreign accounts to meet part of the week's reserve needs.) During that day some Federal funds were traded at rates as high as 6¼ per cent. Moreover, trading opened at that rate on the next 2 days, but most transactions were at 6⅛ per cent. Then on April 30, with the Federal funds rate tending even higher, the System injected reserves through repurchase agreements executed at a new high rate of 5¾ per cent, ¼ of a percentage point above the discount rate.

[2] See p. 80 for revised rates.

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MAY 1–JUNE 20:
CONTINUED MONETARY RESTRAINT PENDING ENACTMENT OF FISCAL RESTRAINT

The economic and financial environment. After several months of intensifying monetary restraint, System policy shifted to maintaining the degree of pressure on the banks already achieved, in part because prospects for enactment of fiscal restraint legislation appeared to have improved. As events unfolded, most of the System's open market operations during the 7 weeks prior to passage of the bill by the House of Representatives on June 20 were aimed at tempering a tendency toward undue tautness in the money market. For the 2 months May and June, member bank borrowings from the Federal Reserve averaged $719 million, compared with $683 million in April. For the same period net borrowed reserves averaged $334 million, compared with $413 million in April.

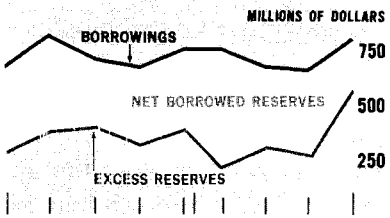
Rates on Federal funds fluctuated during May and June around or slightly above the high level attained at the very end of April. Most trading was in a 6 to 6½ per cent range, although rates occasionally dropped toward the end of statement weeks (Chart 2). At the beginning of May the major New York City banks posted rates on new loans to Government securities dealers as high as 7⅛ per cent, and the higher financing costs to the dealers contributed to the upward push of Treasury bill rates early in the period. These loan rates were gradually reduced, however, and they closed the interval at around 6½ per cent, about the same as at the end of April.

In early May the major New York City banks raised their offering rates on all maturities of negotiable CD's to the Regulation Q ceilings that had been put into effect on April 19. With secondary market rates at or above these levels throughout the period, however, the weekly reporting banks sustained net losses of nearly $700 million of CD's over the 7-week interval May 2–June 19. Large banks with access to the Euro-dollar market bid strongly for such funds, and they succeeded in attracting Euro-

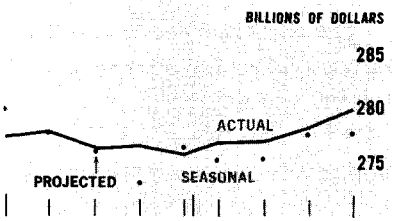
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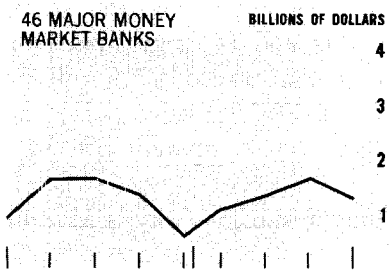
Reserves and borrowings



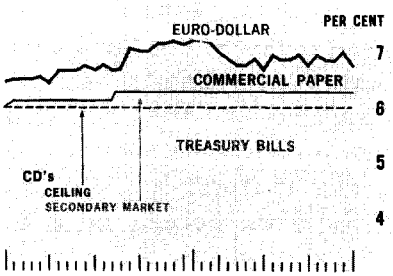
Bank credit proxy



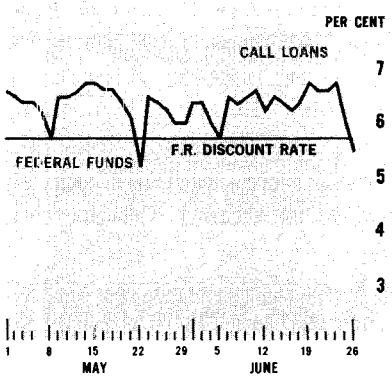
Basic reserve deficit



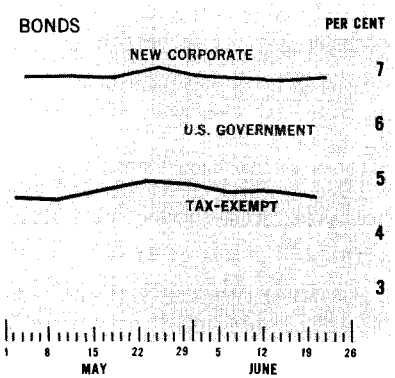
Other short-term rates



Money market rates



Long-term rates



For notes see pp. 232-33.

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dollars in an amount that was more than twice as large as their loss of CD's. In the process the rate on 3-month Euro-dollar deposits was driven as high as 7⅛ per cent by the end of May; this compared with 6½ per cent early in the month and was equal to the crisis level of March.

Reflecting the substantial reduction in CD's outstanding, as well as a slowdown in the growth of other time deposits, the increase in total commercial bank time deposits slowed to an annual rate of 3.5 per cent in May and June, compared with 6 per cent over the previous 4 months and 16 per cent for the year 1967. The money supply, on the other hand, grew at an annual rate of 10 per cent during May and June, double the rate of the prior 4 months. In part, the more rapid growth of money reflected a sharp decline in U.S. Government demand deposits, which are not counted as part of the money supply. In part, it may also have reflected the expanded volume of trading in corporate stocks. The bank credit proxy grew at the same average rate (4 per cent) during May and June as in the first 4 months of the year. Bank loans generally grew somewhat more slowly than they had in the earlier period, with the exception of loans to nonbank financial institutions. Meanwhile, banks continued to reduce their rate of net new investment in securities.

The atmosphere in the securities markets altered dramatically as the outlook for fiscal restraint changed during May and June. Prices generally declined until May 23, then began to move up.

After fluctuating irregularly during the first half of May, prices of debt issues plummeted in reaction to a delay in the vote on the tax measure announced by House leaders on May 15. Prices continued to drop sharply over the following week as dealers attempted to lighten inventories swollen by their underwriting of the Treasury's successful May financing (see below). Sizable purchases of Treasury coupon issues executed for Treasury accounts helped to relieve dealers' inventories without impeding substantial downward price adjustments. From April 30 to May 22, yields on intermediate- and long-term Treasury securities

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rose by about 30 and 20 basis points, respectively. Corporate bond yields rose some 25 basis points as dealers attempted to reduce their inventories in anticipation of the heavy June calendar. The municipal bond market was particularly depressed in late May, with yields up 30 to 40 basis points from their end-of-April levels (bottom right panel of Chart 2).

In early May the Treasury conducted a financing that was quite successful in view of the uncertain atmosphere prevailing in the market. In an operation that involved both an exchange issue and a cash offering, it raised $2.1 billion of new money and refunded notes and bonds maturing May 15. Private holders of $3.9 billion of maturing issues exchanged $2.7 billion of their holdings into new 7-year, 6 per cent notes, while $10.3 billion of subscriptions were tendered for $3.4 billion of new 15-month, 6 per cent notes offered for cash. (Large subscriptions to the shorter-term notes were allotted at a rate of 28 per cent.) In the initial favorable reaction to the offering, the new 7-year notes were bid as high as 100$^{3}/_{32}$, but by May 22, when the market was generally unsettled by the uncertain outlook for fiscal action, the bid price was 99$^{3}/_{32}$, equivalent to a yield of 6.13 per cent.

Prices of securities rebounded beginning on May 23 in a dramatic reversal of market sentiment. Sparked by the statement of the chairman of the House Ways and Means Committee that he foresaw congressional passage of the proposed tax bill, the rally gained renewed vigor following the President's statement on May 30 that he would accept the $6 billion reduction in expenditures demanded by congressional leaders. With the removal of the last potential obstacle to fiscal restraint, dealers sought aggressively to rebuild their inventories. While prices sustained relatively mild and brief setbacks in reaction to two further postponements of the vote on the tax and spending bill by the full House, they did rise from May 23 to June 20—when the House finally approved the bill; yields on intermediate-term Treasury securities showed declines of about 60 basis points, and those on long-term Treasury bonds about 40 basis points on the average.

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The price improvement was more restrained in the corporate and tax-exempt bond sectors, although prices rose sharply during the few days just before the House vote. Offerings of new corporate issues were heavy, and they encountered mixed receptions. In fact, some issues ran into investor resistance even at the record yields available. As the final vote on the fiscal restraint bill approached, however, investor interest in new issues picked up. The Blue List of dealers' advertised inventories of tax-exempt issues, for example, declined from its mid-May high of $649 million to $427 million as of June 20. On balance, yields on corporate and tax-exempt bonds were virtually unchanged over the May 1–June 20 period.

Treasury bill rates rose generally by 25 to 50 basis points over the first 3 weeks of May; the steepest increases occurred in the wake of the May 14 decision of congressional leaders to postpone House action on the tax bill. Market rates on 3- and 6-month bills reached record levels (since surpassed) of 5.92 and 6.08 per cent, respectively, just before Chairman Mills predicted on May 23 that the tax bill would eventually pass. Rates dropped sharply in response to that statement but moved somewhat higher in early June in reaction both to a subsequent delay in the House vote and to seasonal pressures. Rates again declined sharply on the eve of the House vote—reflecting renewed optimism over the outlook for fiscal restraint, very large purchases of bills by the System, and expectations of heavy seasonal demand for bills. By June 20, the market rate for 3-month bills was 5.40 per cent —down 11 basis points from the end of April and 52 basis points below the interim high.

Open market operations. The System's operations in the open market during the May 1–June 20 interval sought to maintain the firm conditions in the money market achieved by late April. A recurring problem was the need to head off or moderate undue tautness in the money market. During the interval—a period of seasonal reserve needs—the System injected a net of $1.4 billion of reserves. The Trading Desk arranged $4.1 billion of repur-

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chase agreements against Treasury and Federal agency securities, while maturities and withdrawals of such agreements totaled $4.2 billion. But on an outright basis the System purchased $2.0 billion of Treasury bills—$922 million on June 19 alone. Reserve absorptions were quite limited during the period; the total reflected outright sales of $384 million of Treasury bills, sales of $400 million of bills under 1-day matched sale–purchase transactions, and redemptions of $171 million of maturing bills.

During the first half of May—while the Treasury's May financing was proceeding smoothly—the System sought to maintain in the money market the firmer conditions that had been achieved earlier. Its operations were directed largely toward attempting to overcome the excessive tautness that developed in the money market as major banks sought to cover sizable reserve deficits by bidding aggressively for Federal funds. In part these conditions reflected a growing desire by these banks to conserve their use of the Federal Reserve discount window until the June corporate tax-payment date when the pressures of loan demands and run-offs of CD's might pose a major problem.

In resisting the resultant strong upward pressure on the Federal funds rate, the System repeatedly injected reserves through repurchase agreements with nonbank dealers in Government securities, and on several days when its first round failed to produce the intended relief to the market, it made a second round of such agreements. During the May 1–15 interval the Account Manager arranged a total of $2.3 billion of repurchase agreements against Treasury and Federal agency securities; these were supplemented by $84 million of such agreements against bankers' acceptances. All of these agreements were written at 5¾ per cent, ¼ of a percentage point above the Federal Reserve discount rate. In spite of these persistent reserve injections, Federal funds traded predominantly in a 6⅛ to 6⅜ per cent range in the first half of May, and a new record "effective" rate of 6½ per cent was set on May 14.

Around the middle of May, System operations were condi-

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tioned somewhat by developments in the securities markets, but there was no significant departure from money market objectives. At the opening on Thursday, May 16, the markets were very unsettled as a result of news of the postponement of congressional action on the tax bill until early June, and Federal funds were quoted at 6¼ per cent bid and 6½ per cent asked. In order to facilitate orderly adjustments in the market to the changed outlook for fiscal restraint and to provide for a part of the estimated sizable reserve needs for the week, the System conducted an early go-around of the market and purchased outright $301 million of Treasury bills; it also bought $33 million directly from foreign accounts. (Earlier still, the Trading Desk had purchased on behalf of a Treasury trust account a substantial amount of the new 7-year notes for which settlement had been made just the day before.) Later in the day the System injected an additional $301 million of reserves through 4-day repurchase agreements written against Treasury and Federal agency securities and bankers' acceptances; the rate on these agreements was 5¾ per cent.

As it turned out, the System's actions on May 16 more than filled the reserve needs for the week, and toward the end of the statement period conditions in the Federal funds market eased. No attempt was made to counter this temporary ease because of the unsettled state of the securities markets and because of the reserve needs projected for the next several weeks. Indeed, in view of these circumstances, the System purchased $265 million of Treasury bills and $70 million of Treasury coupon securities on Wednesday, May 22, for delivery the following day, which was the beginning of the next settlement period.

On several other occasions during May and June conditions in the money market eased near the end of a statement week. In view of the very tight conditions generally prevailing—and, at times, the unsettled state of the securities markets—the System usually made no effort to counter such temporary ease. But there was an exception in the week ending May 29, when easing

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tendencies manifested themselves relatively early in the statement period—on Monday, May 27—as the distribution of reserves shifted in favor of the major money centers. On that day the System sold $212 million of Treasury bills outright, and the next day it sold $400 million of bills under 1-day matched sale–purchase transactions. The only other outright sales during May and June took place on Tuesday, May 7, when the System sold $172 million of Treasury bills to combat easing tendencies that emerged temporarily.

The System was ready to absorb reserves again early in June but was inhibited by an unusually marked divergence between the reserve statistics and the tone of the money market. Firm money market conditions at the beginning of the statement week ending June 5 led to heavy member bank borrowing from the Reserve Banks—more than $1 billion—over the weekend. These borrowed reserves combined with a sharp decline in excess reserves at country banks in the final week of those banks' biweekly reserve-settlement period to produce a high level of net borrowed reserves as well as an easing of money market pressures after the weekend. The Account Manager stood ready to inject reserves if the money market should tighten—as the reserve figures indicated was likely. But the expected firming did not occur during the week, and the System took no action in the market. Net borrowed reserves for the week averaged $551 million (top left panel, Chart 2).

At the end of the period under review the System injected a huge volume of reserves to moderate unusually heavy pressures on the money market stemming from international transactions. On June 18 and 19 the System provided a total of $1.3 billion of reserves, largely to offset the reserve effect of an $800 million net repayment to the System on June 19 of a British swap drawing. On the day before the repayment the money market had been relatively comfortable—with Federal funds trading at 6⅛ per cent—and the System had confined its operations to the purchase of $134 million of Treasury bills available from

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foreign accounts for delivery on Wednesday, June 19. On the latter day, however, the money market became exceptionally tight, as the swap repayment absorbed reserves and as banks in the money centers scrambled to cover deficits in their reserve positions that had been accumulated earlier in the statement period. In these circumstances the System purchased $622 million of Treasury bills for immediate delivery and arranged $252 million of repurchase agreements at 5¾ per cent. In addition, as a start in meeting part of the sizable reserve needs projected for the next several weeks, the System purchased $300 million of Treasury bills in the market for delivery on Thursday, June 20. In spite of this record injection of reserves, Federal funds were bid as high as 6¾ per cent on June 19—although trading was predominantly at 6½ per cent—and total borrowings by member banks from the Federal Reserve Banks surged to $1.9 billion.

JUNE 21–SEPTEMBER 25:
MONETARY POLICY ACCOMMODATES TENDENCIES FOR SHORT-TERM RATES TO DECLINE FOLLOWING PASSAGE OF REVENUE AND EXPENDITURE CONTROL ACT

The economic and financial environment. With passage of the revenue and expenditure control bill by the House of Representatives on June 20 and by the Senate the next day, the thrust of national fiscal policy changed significantly. This in turn set the stage for a shift in monetary policy from the maintenance of firm conditions in the money market to the accommodation of tendencies for short-term interest rates to decline. In implementing that policy, somewhat less firm conditions were permitted to develop in the money market. Rates on both long- and short-term securities declined substantially over the next several weeks, and many market rates reached their lows for the year in early August. On August 15 the Board of Governors announced a reduction in one Reserve Bank's discount rate from 5½ to 5¼ per cent in a technical realignment with the changed market con-

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ditions; similar reductions at the other Banks followed within a 2-week period.

In accordance with the Committee's policy directives, open market operations accommodated the tendency toward lower short-term interest rates and somewhat less firm money market conditions by supplying reserves somewhat more generously than in the previous period. Meanwhile, time and savings deposits at banks were growing rapidly, and bank credit showed a sharp expansion in a period when Treasury financing operations were very large. As the period progressed, however, open market operations were directed at maintaining prevailing conditions in money and short-term credit markets and, at times, at resisting in a marginal way the tendency for growth in bank credit to outstrip expectations. In the generally less tight money market environment, average member bank borrowings from the Reserve Banks declined to $535 million in the third quarter from $707 million in the second, and net borrowed reserves dropped to $183 million on the average from $360 million.

The declines in interest rates reflected widely held expectations that the new fiscal restraint measures would produce quickly a slowdown in the rate of economic expansion and that monetary policy would need to be relaxed progressively. For a time there was even some talk of economic "overkill" if monetary restraint were not decisively lessened. But as the period progressed, the strength of various economic indicators kept pushing the expected slowdown further into the future. The most surprising element was a surge in personal consumption expenditures, which reflected in part a sharp cut in the rate of personal saving. Business fixed investment also showed renewed growth in the third quarter, and inventory accumulation slowed less than expected. Price inflation continued, and the nation's underlying balance of payments situation remained a matter of serious concern.

Anticipation of a relaxation of monetary restraint, reinforced by some evidence of such relaxation, contributed to a decline

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in money market rates and an acceleration in bank credit expansion. Federal funds traded generally around the 6⅛ per cent level through mid-August and in a 5¾ to 6 per cent range after the reduction in the discount rate (bottom left panel of Chart 3). Rates on loans to Government securities dealers posted by the major New York City banks were reduced somewhat in July, but such rates crept upward in the first half of August as dealers added to inventories in expectation of a further rise in prices. Although the cut in the discount rate led to some decline in dealer loan rates, these rates drifted upward again in late September. Bank credit, as approximated by the bank credit proxy, grew at a seasonally adjusted annual rate of 13 per cent from June to September, more than three times the rate in the first half of the year.

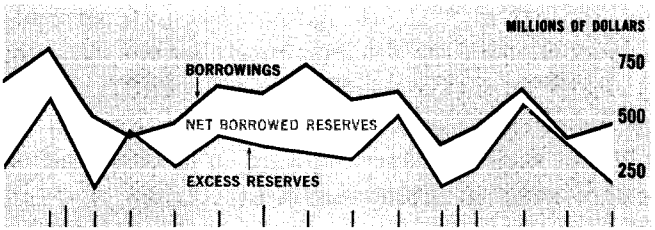
Most of the growth of the bank credit proxy in the third quarter was accounted for by time deposits. Such deposits expanded at an annual rate of 19 per cent as declining market interest rates made the rates offered by banks on time deposits more competitive. The secondary market rate on 3-month CD's fell from more than 6 per cent in June and July to a range of 5.60 to 5.70 per cent by late September—well below the maximum rate payable on new deposits. In the easier money market environment weekly reporting banks succeeded in adding some $3 billion to their outstanding CD's between June 19 and August 28 before experiencing a seasonal dip in September (figures not seasonally adjusted). In contrast to the rapid growth in time deposits, private demand deposits displayed little growth after early July. U.S. Government deposits, on the other hand, increased sharply—in large part as a result of Treasury financings and FNMA sales of participation certificates, which raised $7.0 billion of new money during the period.

On the asset side of the banks' balance sheets, holdings of securities and of loans collateralized by securities rose sharply during the third quarter. Increases in these accounts reflected not only bank participation in the underwriting of new Government

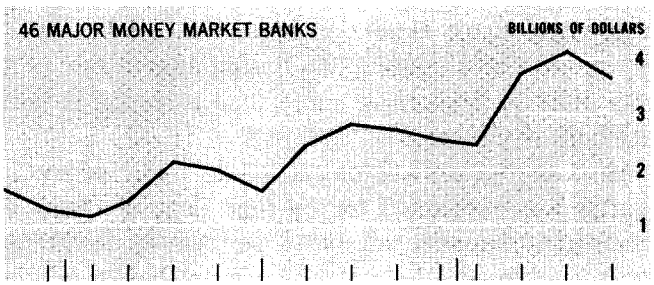
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3. JUNE 19, 1968 - SEPTEMBER 25, 1968

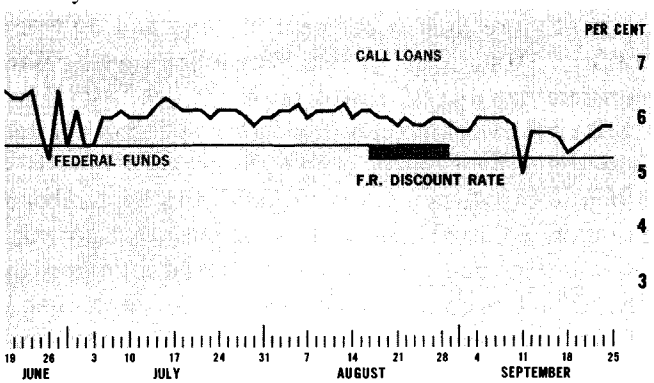
Reserves and borrowings



Basic reserve deficit



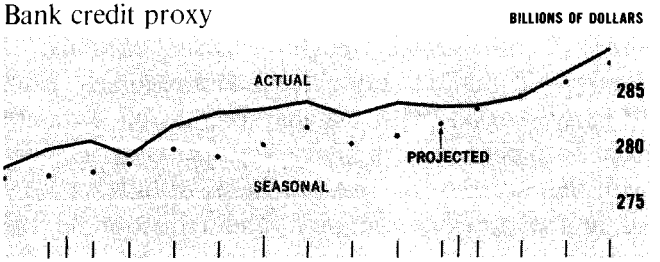
Money market rates



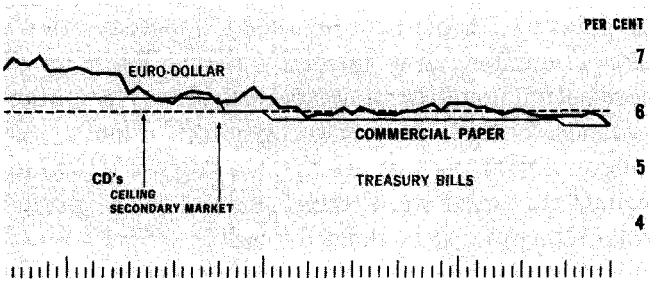
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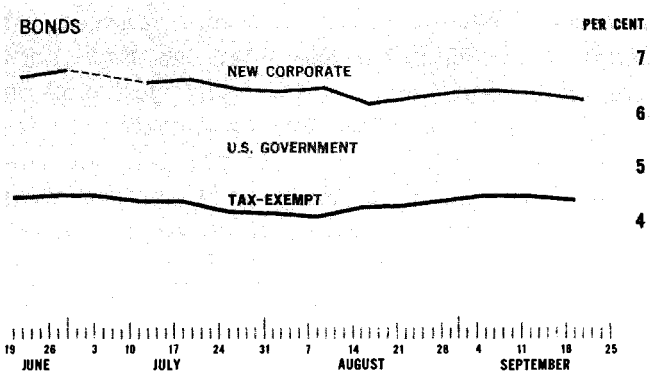
Bank credit proxy



Other short-term rates



Long-term rates



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securities issues and record offerings of tax-exempt securities but also bank purchases of such securities for portfolio. Other loans also increased, with special strength in consumer loans.

In the Treasury bill market, rates declined irregularly from June 20 until early August, with the market rate on 3-month bills falling from 5.40 per cent to a low of 4.89 per cent. The decline began with the System's massive purchases of bills on June 19 (described in the previous section). The reduction in the rate of interest on System repurchase agreements by ⅛ of a percentage point to 5⅝ per cent in early July and by another ⅛ percentage point to 5½ per cent on July 17, the day after a meeting of the Committee, was taken by many observers as signaling a more accommodative monetary posture—contributing to sizable demands for bills despite rising prices. Finally, the Treasury's announcement on July 31 that its August refunding would not include the usual short-term "anchor" issue spurred hopes for strong reinvestment demand for bills.

As bill yields dropped, however, the widening spread between these yields and dealers' financing costs left the bill market vulnerable to a reaction. When optimism over the prospects for declining interest rates diminished and when the New York City banks started to post higher dealer loan rates early in August, Treasury bill rates reversed direction quickly. The reduction of ¼ of a percentage point in the discount rate, announced on August 15, served to steady bill rates, and these rates fluctuated narrowly for the remainder of the period. On September 25 the market rate on 3-month bills was 5.11 per cent, down 29 basis points from June 20 and 81 basis points below the mid-May high. Other short-term rates posted similar net declines; rates offered by dealers on prime 4- to 6-month commercial paper, for example, declined from 6¼ to 5¾ per cent.

In the capital markets a brief period of profit-taking in the wake of the enactment of the fiscal restraint legislation, which had been heavily discounted in the markets for several days prior

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to final passage, soon gave way to ebullience amid expectations of lower interest rates in the months to come. Underwriters bid aggressively for new corporate and municipal issues, and institutional interest in such securities revived markedly. Government securities dealers added heavily to their inventories, encouraged by the reductions of ⅛ percentage point in the rates on System repurchase agreements on July 5 and July 17.

The buoyant atmosphere facilitated Federal Government financing operations, in which substantial amounts of new money were raised. First, in early July the Treasury sold $4 billion of tax-anticipation bills due in March and April 1969. In late July the FNMA offered to the public two issues of participation certificates totaling $800 million (in addition to $530 million placed directly with Treasury trust accounts). Both the 10-year, 6⅛ per cent certificates and the 20-year, 6.20 per cent certificates sold out quickly and moved to substantial premiums in secondary market trading. In connection with the refinancing of coupon issues maturing in August, the Treasury raised $1.7 billion of additional cash. It sold to the public $5.5 billion of 6-year, 5⅝ per cent notes, priced to yield 5.70 per cent, in the largest cash sale of an over-5-year issue in more than 20 years. The notes were heavily oversubscribed—with large subscriptions allotted at 18 per cent—and they went to a premium in early trading.

Dealers in particular subscribed heavily for the new notes—augmenting the large positions they had already built up in outstanding issues in anticipation of capital gains. Faced with the task of distributing such a large volume of the new notes, dealers occasionally grew restive with their exposure to changes in market conditions, and yields edged irregularly upward from early August until early September. On the whole, however, the yield rise was contained by dealers' continuing expectations of lower rates in the months ahead, by sporadic bank demand for the new 5⅝ per cent notes, and by a gradual reduction in the penalty cost of carrying inventories of securities after the re-

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duction in the discount rate on August 16. Dealers placed considerable amounts of securities with investors in August and September; this relieved the congestion and improved the atmosphere in the market. Yields declined a bit in the last 2 weeks of the period amid easier conditions in the money market and talk of an impending reduction in the prime lending rate of commercial banks, which finally occurred at the end of the period. Over the period as a whole, yields on long-term Treasury bonds declined an average of 7 basis points to 5.08 per cent (bottom right panel of Chart 3).

In other areas of the capital markets the greatest declines in yields were in the corporate sector, in which new public offerings in the third quarter totaled only slightly more than half the volume for the similar period in 1967. Yields on high-grade corporate bonds declined about 35 basis points over the period; new Aa-rated utility issues with 5 years of call protection were yielding about 6.40 per cent in late September, compared with 6.75 per cent just before passage of the fiscal restraint bill in June. In the market for tax-exempt bonds, on the other hand, flotations in the third quarter reached a record level, 50 per cent more than in the comparable period of 1967. The Bond Buyer's weekly index of yields on 20 municipal bonds declined 13 basis points on balance over the period to 4.30 per cent on September 26.

Open market operations. System open market operations initially moved to accommodate tendencies for short-term interest rates to decline in the wake of passage of the Revenue and Expenditure Control Act by the Congress. In conjunction with the resulting easing of money market conditions, the Account Manager in July twice reduced the rate charged on System repurchase agreements with dealers in Government securities and bankers' acceptances—bringing the rate back to the level of the discount rate. Moreover, the System's accommodative posture, with its focus on interest rates, entailed the provision of a large volume of reserves as the banking system helped to underwrite

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large additions to U.S. Government debt and record flotations of bonds by States and municipalities, as well as rapid increases in consumer debt. In the face of the resultant surge in the bank credit proxy, the Account Manager responded to the proviso clause of the Committee's current economic policy directive on two occasions during the period—aiming for somewhat firmer conditions in order to resist excessive expansion of bank credit.

On balance, the System provided $441 million of reserves over the June 21–September 25 interval (table, page 235). Most of the net addition of reserves was through outright purchases of Treasury securities—including $2.1 billion of bills, against sales of $1.4 billion and redemptions of $278 million of maturing bills. The System also purchased outright $285 million of Treasury coupon securities. In providing additional reserves on a temporary basis, the Account Manager arranged $4.1 billion of repurchase agreements against Treasury and Federal agency securities during the interval. In the latter part of the period the System relied heavily on matched sale–purchase transactions to offset extraordinary supplies of reserves brought about by a combination of outside factors. The System sold and bought back a total of $4.7 billion of Treasury bills under such short-term arrangements during the period.

During the first 2 weeks after congressional passage of the revenue and expenditure control bill, conditions in the money market varied widely, with the Federal funds rate fluctuating around 6⅜ per cent early in each statement week and around 5½ per cent toward the end of each. In both of those weeks the System injected reserves to combat the early tautness and then refrained from absorbing reserves as more comfortable conditions emerged in the money market near the end of the statement week. On July 5, when a nationwide reserve need was again indicated, the Account Manager supplied reserves by repurchase agreements written at 5⅝ per cent, ⅛ percentage point below the rate that had been employed since April 30.

At its meeting on July 16, the Committee issued a directive

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calling for accommodation of the tendency toward somewhat less firm money market conditions that had developed since the preceding meeting. The next day, in accordance with discussion at the meeting, the Manager again cut the rate on repurchase agreements by ⅛ percentage point to 5½ per cent, thus realigning the rate with the discount rate. Market participants interpreted the move, coming on the heels of the Committee meeting, as evidence of a modification of monetary policy that, coupled with the economic slowdown anticipated, was expected to lead to a marked decline in interest rates in the months ahead.

In accordance with this judgment, dealers and underwriters aggressively built up their inventories of Government securities, CD's, and corporate and municipal bonds—financing the bulk of their acquisitions by borrowing at banks. It soon became apparent that the growth of bank credit was significantly exceeding the projections presented at the July 16 meeting of the Committee, and estimates of the increase in bank credit in July and August were revised upward over the next several weeks. Accordingly, the Account Manager began to permit some firming of money market conditions—having been freed to a degree from the normal constraints that a Treasury financing imposes on such action by the enthusiastic reception accorded the Treasury's offering of new 6-year notes. During the 3 weeks following the mid-July cut in the rate on repurchase agreements, the System made occasional outright purchases of Treasury bills and repurchase agreements at 5½ per cent, but it usually did so only after pressures on bank reserves had pushed the Federal funds rate up to 6¼ per cent. With undue tautness thus relieved, Federal funds traded primarily in a 6 to 6⅛ per cent range over the remainder of the 3-week period.

The combination of declining Treasury bill rates and firm money market conditions, as already indicated, widened the spread between bill yields and dealers' costs of financing inventories and left the market vulnerable to any change in expectations regarding the outlook for interest rates. And a correction

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did begin about August 8 as dealer loan rates mounted further and as doubts spread concerning the likelihood of any near-term easing of monetary policy. At its meeting on August 13 the Committee indicated its concern about the upward pressures on bill rates, which had been moderated but not contained by System injections of a sizable amount of reserves through repurchase agreements. The reductions in Federal Reserve discount rates to 5¼ per cent initiated on August 15 afforded additional relief without presaging immediate further easing moves. On the next 2 days the Account Manager arranged repurchase agreements at the new discount rate and also made some outright purchases of bills.

Together, the discount rate cut and open market operations produced a climate of reserve cost and availability in which the disparity between dealer financing costs and other short-term rates was significantly reduced, although not eliminated. While the remaining penalty cost of carrying positions encouraged distribution, dealers remained willing to hold heavy positions in hopes of lower interest rates in the future. Reflecting in part bank financing of these holdings and in part banks' additions to their own investment portfolios, the growth of bank credit continued to outstrip projections throughout August and September.

In view of the rapid growth of bank credit, open market operations by late August shifted their focus away from special concern with Treasury bill rates and again sought at the margin to resist excessive expansion of bank credit. During the last 2 weeks of the period under review, moreover, the Account Manager had to contend with a confluence of extraordinary factors providing reserves. Among these was the inauguration on September 12 of new procedures for calculating member bank reserves.[3] One consequence of the new procedures was that required reserves—based on average deposits for 2 weeks previously—averaged

[3] For details, see the Board's Policy Record for Apr. 23, 1968, p. 82, and the Federal Open Market Committee's Policy Record for Oct. 8, 1968, pp. 195-203.

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some $500 million less in the 2 weeks ended September 25 than they would have under former procedures. In these circumstances and to absorb a seasonal rise in reserves that was augmented by a sharp temporary drop in Treasury balances and foreign drawings on the System swap network, the System undertook very large-scale open market operations.

In view of the short-lived nature of the bulge in reserves and the considerable uncertainty over how banks would modify their behavior under the new accounting rules, the Account Manager proceeded cautiously, accomplishing most of the reserve absorption on a day-to-day basis. For this purpose matched sale–purchase transactions proved particularly useful, and the Trading Desk arranged a total of $4,715 million of such agreements in a 2-week interval. On Wednesday, September 11, the System absorbed $1,530 million through open market operations, a record amount for a single day.

The amounts of matched sale–purchase transactions outstanding ranged as high as $1,750 million, the level reached on September 18. These massive reserve absorptions provided clear evidence to the market of the System's desire to avoid an easing of money market conditions as a result of redundant reserves.

The Federal funds rate rose from 5⅜ per cent on Wednesday, September 18, to 5⅞ per cent a week later. When pressures intensified on the latter date, the System injected $362 million of reserves through outright purchases of Treasury bills.

SEPTEMBER 26–DECEMBER 31: MONETARY RESTRAINT INTENSIFIES AS INFLATIONARY PRESSURES PERSIST

The economic and financial environment. In the fourth quarter, with the economy continuing to advance more robustly and with prices rising faster than previously expected, a growing inflationary psychology was reflected in stepped-up business spending. In general, open market operations from September to mid-December sought to maintain firm conditions in the money and

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short-term credit markets, while not attempting to resist moderate upward pressures on other market rates. At times when growth in the bank credit proxy was persistently outpacing expectations, the Account Manager sought, under the authority of the proviso clause of the directive, to move toward still firmer conditions.

On December 17 System policy shifted toward considerably greater restraint. The move was signaled by an increase of ¼ of a percentage point in the discount rates of nine Reserve Banks —the other three quickly followed—and was confirmed by outright sales of bills by the Trading Desk in a firm money market pursuant to the directive issued at the Committee's December 17 meeting. Interest rates, which had edged upward from early August through November and had been climbing rapidly earlier in December, spurted in the wake of the System's firming actions. By the end of the year yields on most long-term debt securities were well above their previous historic highs.

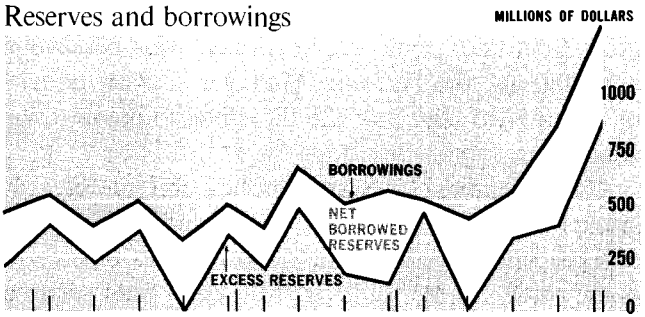
Inflationary pressures persisted in the fourth quarter, and the rate of unemployment sank to the lowest level since 1953. Consumer spending grew much more slowly than in the third quarter, and retail sales, while fluctuating appreciably over the period, tended to level off on a seasonally adjusted basis. But business spending for both inventories and fixed investment expanded sharply, and capital spending plans pointed to a further rise in 1969. During most of the fourth quarter, indicators suggested a worsening of the balance of payments situation. However, a sharp —and partly temporary—influx of funds in the last few weeks of the year produced a substantial payments surplus on the liquidity basis for the fourth quarter and a small surplus for the year as a whole.

The combination of monetary restraint and of heavy demands for credit produced a gradual, though irregular, firming of money and short-term credit market conditions over the last 3 months of the year. Member bank borrowing from the Reserve Banks rose from an average of $515 million in September to $765 mil-

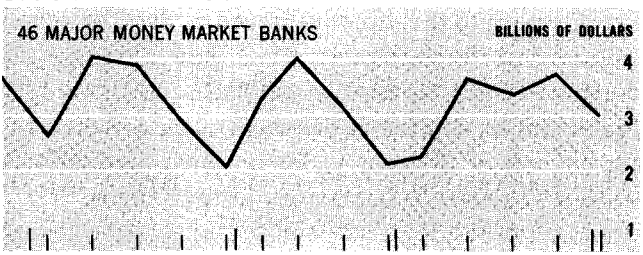
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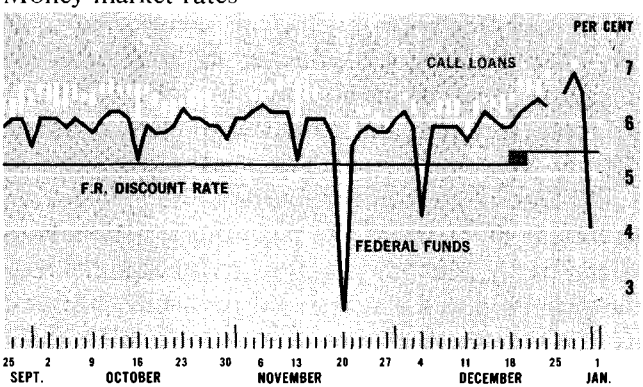
Reserves and borrowings



Basic reserve deficit



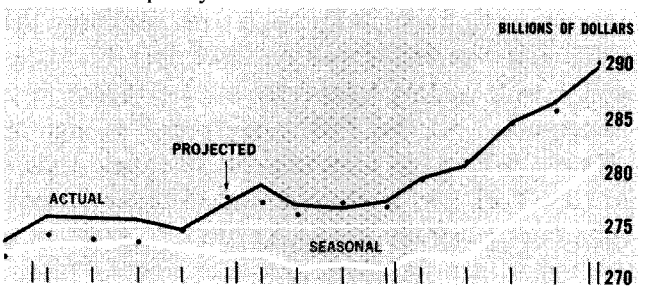
Money market rates



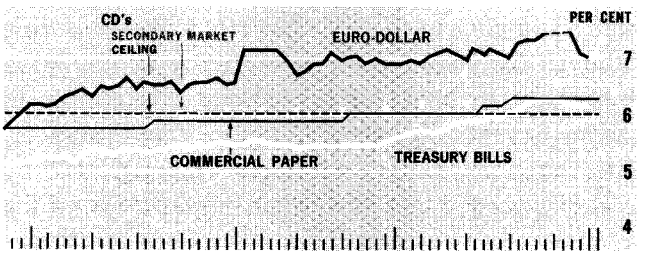
For notes see pp. 232-33.

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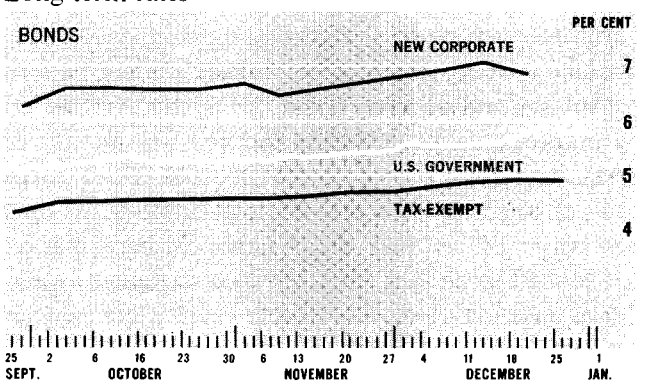
Bank credit proxy



Other short-term rates



Long-term rates



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lion in December, while net borrowed reserves increased from $132 million to $352 million (top left panel of Chart 4). The Federal funds rate generally fluctuated around 6 per cent until the increase in the discount rate announced on December 17. After that it rose rapidly, with trading frequently at rates above 6½ per cent and sometimes—near the end of the year—as high as 7⅛ per cent. Rates on loans to Government securities dealers posted by major New York City banks followed a similar pattern, with the new loan rates generally averaging from ¼ to ⅝ of a percentage point higher than the effective rate on Federal funds.

Within the context of a gradual increase in pressure, there was considerable variability in money market conditions during the period. Although the institution of new reserve computation procedures for all member banks on September 12 (referred to in preceding section) eventually helped to reduce excess reserves, the characteristic biweekly pattern of reserve management by country banks was succeeded by a somewhat similar cycle on the part of reserve city banks, which at times aggravated tendencies toward short-term variability in the money market. Given the privilege of carrying over reserve excesses, as well as deficits, into the next statement week, reserve city banks fell into a pattern of alternating surpluses and deficits. These swings had sizable effects on money market conditions during the first few months of the new reserve-computation procedures because most large banks tended to act in phase with one another, instead of some having excesses while others had deficiencies. Money market conditions often tended to be taut early in those statement weeks in which the large banks started with sizable reserve deficiencies and to be relatively comfortable early in alternate weeks when these banks began with large surpluses. In addition, as a consequence of the lagging of required reserves 2 weeks behind deposits, the amplitude of swings in the basic reserve positions of the major money center banks increased, necessitating larger adjustments in the reserve positions of these banks and consequently placing greater demands on the Federal funds market.

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Bank credit continued to expand rapidly, with the proxy series growing at an annual rate of 12 per cent during the last 3 months of the year; this was just a little below the average rate for the third quarter. Large-denomination CD's outstanding continued to grow rapidly until early December, when they began to run off sharply as an expected seasonal decline was reinforced by rising market rates that rendered CD offering rates noncompetitive at the Regulation Q maximums. Other time and savings deposits continued to grow throughout the period. The money supply grew faster than in the third quarter, and U.S. Government deposits declined substantially.

On the asset side of banks' balance sheets, there was increased growth in business loans, loans to nonbank financial institutions, and real estate loans. Consumer loans also remained strong. Securities loans declined, along with dealers' positions, as did the banks' own holdings of U.S. Government securities. Banks continued to invest heavily in non-Government securities until December, when they sharply reduced their rate of investment in such issues.

Short-term interest rates moved progressively higher from late September until late December. The Treasury bill market was kept under pressure by a variety of forces—firm money market conditions and the resultant high costs of financing heavy dealer inventories, a belief that the Federal Reserve was shading toward a firmer monetary policy in view of continuing inflationary developments in the economy, and the addition of $5 billion to the supply of bills outstanding through Treasury sales of tax-anticipation issues during the period. To be sure, there were intervals of temporary declines in bill rates as a result of investment demand and of outside influences, such as the rumors in mid-October of an impending break in the stalemated Vietnam peace talks in Paris and the Treasury's announcement on October 23 of a "rights" refunding, which encouraged some professional buying in expectation of demand from sellers of maturing rights. Rates on short-term bills edged down during most of No-

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vember as a result of heavy buying by foreign official accounts and by investors seeking a safe haven amidst the uncertain near-term outlook for interest rates. At the same time, professional selling continued to push up rates on longer-term bills.

All types of interest rates advanced sharply in December. The generally unexpected increase in the prime lending rate of major banks to 6½ per cent on December 2 strongly affected market psychology. The System's moves toward greater monetary restraint in mid-December and the further increase in the prime rate to 6¾ per cent immediately thereafter were followed by further sharp increases in bill rates brought on by price reductions as dealers attempted to reduce their inventories. At the higher rate levels, strong and broadly based demand for bills appeared after Christmas, and bill rates dipped; dealers were able to reduce their bill holdings by $1.4 billion over the final week of the year.

On balance, the bid rate on 3-month Treasury bills rose 116 basis points from September 26 to the end of the year—closing at 6.25 per cent. Yields on virtually all Treasury bills were well above the Regulation Q ceilings on comparable maturities of CD's at the year-end. Secondary market rates on CD's also rose steadily during the period, closing at 6.50 to 6.65 per cent on 3-month certificates, compared with the Regulation Q ceiling of 6 per cent applicable to new CD's. Aggressive bidding for Euro-dollars by banks that were losing CD funds—in the face of a reduction in the supply of Euro-dollars as American firms repatriated funds and European banks engaged in the usual year-end window dressing—contributed to a rise in the 3-month Euro-dollar rate from $5\frac{11}{16}$ per cent on September 25 to nearly 7½ per cent in late December. Rates on commercial paper rose more moderately during the period; the offering rate on 4- to 6-month paper placed through dealers increased from 5¾ per cent in late September to 6¼ per cent at the end of the year.

During most of the final quarter yields in the capital markets trended higher, reaching new historic highs by the year-end.

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Large volumes of municipal issues, especially, and of corporate issues were floated against a background of uncertainties surrounding the strength of the economy and its implications for monetary policy, the national elections, the Vietnam peace talks, and another international monetary crisis. Except for a sharp but short-lived rally sparked in mid-October by renewed hopes for the end of hostilities in Vietnam, yields remained under nearly steady upward pressure for 3 months beginning September 25.

The Treasury offered holders of issues maturing in November and December the right to exchange into the reopened 5¾ per cent note of November 1974 at par or into a new 18-month, 5⅝ per cent note priced to yield 5.73 per cent. The inclusion of the 6-year note came as a surprise to market participants in view of the uncertainties abounding, and underwriters showed little interest in the issue; nevertheless, public subscriptions totaled $1.3 billion, which was higher than generally anticipated. With an additional $2.5 billion of the public's holdings of the eligible issues exchanged into the shorter note, $1.8 billion of the maturing issues were redeemed. This attrition made it necessary for the Treasury to sell $2 billion of tax-anticipation bills in late November to rebuild the Treasury's cash balance.

Market yields rose sharply in the wake of the boost in the bank prime rate on December 2. And they rose even more sharply in the week following the increase in the discount rate announced on December 17 and the further rise in the prime rate the next day. After Christmas, however, a surge in year-end tax swapping and net demand at the record yields led to a partial recovery in prices of Government notes and bonds. On balance, from September 25 to December 31 yields on long-term Treasury issues rose some 67 basis points to an average of 5.75 per cent. Dealers reduced their holdings of Treasury coupon issues maturing in more than 1 year to $360 million at the end of December from the year's high of $1.5 billion in early August.

In the corporate and tax-exempt bond markets, a number of issues were postponed after the first increase in the prime rate

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in December. But the tax-exempt market was kept under pressure by sizable flotations of industrial revenue bonds before the January 1 effective date of legislation removing the tax-exemption privilege on issues of more than $5 million and by a large volume of undigested earlier offerings. Dealers succeeded in reducing their advertised inventories of tax-exempt issues by $300 million in December to $550 million at the end of the year. By then the Bond Buyer's index of yields on 20 tax-exempt bonds had risen 55 basis points from late September to 4.85 per cent. Yields of corporate bonds rose even more than that during the fourth quarter. The year's last new Aa-rated utility issue with 5 years of call protection was floated on December 5 at 7.10 per cent, about 70 basis points above the yield on similar issues late in September.

Open market operations. System open market operations from late September to mid-December were generally directed toward maintaining firm conditions in the money and short-term credit markets. As the period progressed and the economy continued to be stronger than had been expected, both short- and long-term interest rates moved up. Reflecting the tenor of the Committee's concern with the rate of bank credit growth, open market operations offered little resistance to the rate rise. Indeed, under the proviso clause, the Account Manager moved toward firmer money market conditions in October and again in late November and early December. After the increase in the discount rate announced on December 17, open market operations were aimed at attaining firmer money market conditions in such a manner as to make clear the System's determination to resist inflationary pressures.

On balance, the System provided $532 million, net, of reserves through open market operations over the September 26–December 31 interval (table). It purchased outright $3.4 billion of Treasury bills and $247 million of coupon issues. Repurchase agreements of $3.8 billion against Treasury and Federal agency securities were also arranged and terminated during the period.

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The System absorbed reserves through outright sales of $2.7 billion of bills and redemptions of $436 million of maturing bills. In addition, the Trading Desk arranged $3.9 billion of matched sale–purchase transactions, by far the heaviest use of this instrument in any quarter since its inception. Finally, for several days prior to the influx of corporate tax payments, the System purchased varying amounts of special certificates of indebtedness to tide the Treasury over seasonal low points in its cash balances. The total amounts of these special certificates held over the period December 10–17 ranged up to a high of $596 million.

Conditions in the money market firmed toward the end of September as a result of the reversal of the seasonal influences that had provided reserves in volume earlier in the month. Required reserves, under the new computation procedures, began to catch up with the mid-September rise in demand deposits at the same time that the Treasury was rebuilding its balances at the Reserve Banks and float was declining seasonally. Although some firming of money market conditions from the comfortable tone earlier in the month was appropriate, the System injected a substantial amount of reserves early in the period to combat tendencies toward undue tautness. Indeed, the System purchased outright $854 million of Treasury securities during the statement week ended October 2 and made overnight repurchase agreements on the September 30 statement date, when the availability of bank credit to dealers was somewhat curtailed. Nevertheless, Federal funds traded primarily at 6 per cent during the week, compared with 5⅜ to 5⅞ per cent over the two previous weeks.

During October the Account Manager sought to resist excessive growth of bank credit by allowing money market conditions to firm slightly on the average, within the limitations imposed by the Treasury refunding then under way, as called for by the proviso clause. In addition, frequent open market operations were undertaken to offset short-run variations in money market

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conditions that resulted from the new reserve-carryover provisions introduced September 12.

Operations in the weeks ending October 16 and 23 are illustrative of the pattern of monetary actions sometimes needed to deal with such fluctuations. Thus, in the week ending October 16 the System injected reserves in large volume to counter undue firmness in the money market created when banks attempted to cover deficiencies carried over from the preceding week as quickly as possible through various forms of borrowing. Because the banks were overly cautious and took this action early in the week, a condition of ease developed near the end of the statement week, and the System absorbed reserves in volume, by means of both outright sales and matched sale–purchase transactions. Nevertheless, these actions did not match the volume of excess reserves accumulated so the large banks carried over sizable amounts of excess reserves into the next statement week. As a result, bidding for Federal funds was relatively limited early in the October 23 statement period, so the System absorbed a substantial volume of reserves in an effort to promote money market firmness and encourage a larger volume of member bank borrowing over the weekend.

However, the banks were content to accumulate deficits, and borrowing remained quite light through Tuesday, October 22. Partly because of the low volume of borrowing early in the week, reserves available in the Federal funds market that day were not sufficient to meet the insistent deferred demands of deficit banks; hence, Federal funds were bid up to rates as high as 6½ per cent in the scramble for funds. The System then reversed direction and injected reserves to moderate the tightness. Similar patterns of alternating ease and tightness in the money market, which the System had difficulty in smoothing out completely, recurred in succeeding weeks.

Late in November open market operations were complicated by an unexpected bulge in float, a sharp decline in the Treasury's balance at the Reserve Banks, and heavy foreign drawings on

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the System's swap line stemming from massive speculation on an upward revaluation of the German mark and a devaluation of the French franc. In combination, these factors supplied reserves in very large volume, thereby tending to produce ease in the money market and to relax the pressures on the banks. In this situation the System was able to absorb reserves—without disrupting the securities market—by outright sales of Treasury bills to foreign accounts and by matched sale–purchase transactions with those accounts; additional reserves were absorbed by means of matched sale–purchase transactions with Government securities dealers.

Around the beginning of December the Account Manager satisfied seasonal needs for reserves by buying Treasury bills directly from foreign accounts, thus avoiding sales of bills for such accounts into the market at a time when short-term rates were already adjusting sharply higher. The System also arranged overnight repurchase agreements on December 2, the day the bank prime rate was boosted to 6½ per cent, with a view to facilitating the market adjustment to this unexpected event and to provide for an indicated reserve need.

After that brief injection of reserves, the System absorbed reserves steadily during the weeks ending December 11 and 18, a time of year when it usually had provided reserves to meet seasonal needs. The factors that had been instrumental in easing money market conditions late in November were still at work in the first half of December; increases in float (partly related to the influenza epidemic) were especially substantial, and the Treasury's balance at the Federal Reserve Banks declined sharply. There were indications, moreover, that bank credit was again outstripping expectations, thereby calling for implementation of the proviso clause. Accordingly, the System absorbed reserves each day during the 2-week period—employing matched sale–purchase transactions in the market as well as outright sales of bills in the market and to foreign accounts. Despite these large-scale absorptions of reserves the money market remained rela-

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tively comfortable, with Federal funds trading at rates around 5⅞ per cent.

Open market operations promptly confirmed the firmer stance of monetary policy that was signaled by the announcement on December 17 of an increase in the discount rate to 5½ per cent —along with the stand-fast on Regulation Q ceilings. With projections indicating the need to absorb some reserves, but with current money market conditions relatively firm, the System sold outright $187 million of Treasury bills into the market on December 19. This move was promptly interpreted in the market as confirming a policy of greater restraint. Having provided this signal, the System remained on the sidelines for the next 2 days while money market conditions tightened further and securities yields rose steeply as market participants reacted to the prospect of significantly greater monetary restraint.

During the remainder of the year open market operations sought to maintain the degree of restraint achieved after the increase in the discount rate, while cushioning somewhat the market's sharp reaction to the firmer policy stance. From December 24 to December 31 the System injected a large volume of reserves to combat the undue tautness in the money market that had resulted from the combined effects of the delayed rise in required reserves under the new computation procedures, of the Treasury's repayment of borrowing from the Reserve Banks, and of the rebuilding of the Treasury's balance. Extensive use was made of repurchase agreements as well as of outright purchases of Treasury bills, both in the market and from foreign accounts. Nevertheless, Federal funds traded at rates as high as 7⅛ per cent during the final week of the year, and a record high effective rate of 6⅞ per cent was reached. □

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REVIEW OF OPEN MARKET OPERATIONS IN FOREIGN CURRENCIES

The central bank defenses developed in recent years to protect the world payments system from disruptive speculative movements of funds were subjected to some of their severest tests in 1968—the March gold crisis, heavy pressures on sterling, a political and economic crisis in France, and massive speculation on a revaluation of the German mark. To deal with these and other possible strains the defenses were strengthened during the year. Thus bolstered, the international financial system weathered the successive storms and continued to facilitate a growing volume of world trade, even against the background of persisting payments imbalances among major trading countries.

During the year the Federal Reserve and the U.S. Treasury participated in concerted action to restrain speculation in the gold and exchange markets and in major packages to bolster the official reserves of countries whose currencies were under speculative attack. In early March the United States joined in the $900 million package mobilized in support of the Canadian dollar—at the same time granting Canada complete exemption from all the restraints on U.S. capital outflows under the President's January 1 program. In response to the March gold rush and sharp intensification of currency fears, the United States and the other members actively participating in the gold pool convened an emergency meeting in Washington on March 16 and 17 to consider steps for curbing the speculative excesses. Agreement was reached at that meeting to end official intervention in the London gold market and to separate private and official transactions in gold into two distinct circuits. These new arrangements not only insulated official gold stocks from further inroads by private speculators but also, in conjunction with the Stockholm Agreement on Special Drawing Rights, reaffirmed worldwide support for maintaining the present official price of gold and the existing currency parities.

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Among the decisions taken at the Washington meeting was an agreement to increase international credit facilities for the United Kingdom, with the Federal Reserve participating through an increase in the reciprocal currency arrangement with the Bank of England. At the same time the entire Federal Reserve swap network was enlarged, and on March 18 it was more than double the size of a year earlier. In the calmer atmosphere following the Washington meeting private demand for gold subsided, and both sterling and the Canadian dollar rebounded sharply as speculative pressures receded. When heavy speculative selling engulfed the French franc in the summer and fall, the Federal Reserve approved increases totaling $900 million in the swap line with the Bank of France, which raised that facility to $1 billion. The U.S. Treasury also extended a credit line to the Bank of France. By the end of 1968 the Federal Reserve swap network stood at $10.5 billion, an increase of nearly $3.5 billion for the year.

Apart from the very substantial increases in short-run defenses against currency speculation, a major step was taken to shield sterling over the longer term from pressures arising out of conversion of sterling balances by sterling-area countries. On September 9, after the monthly meeting of central bankers at Basle, the Bank for International Settlements and a group of 12 central banks announced that a $2 billion medium-term credit facility was being made available immediately to the Bank of England for that purpose.

At the opening of 1968 U.S. authorities had just over $2 billion of outstanding foreign currency commitments under central bank swaps and forward sales to the market. These heavy commitments had arisen in connection with the speculative flows of funds during the 1967 sterling crisis that culminated in the devaluation of the pound in November and during the subsequent period of uncertainty. Some $1.8 billion of these obligations took the form of drawings by the System on its reciprocal

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TABLE 1: FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Other party to arrangement	Amount of facility (in millions of dollars equivalent)	
	Dec. 31, 1967	Dec. 31, 1968
Austrian National Bank	100	100
National Bank of Belgium	225	225
Bank of Canada	750	1,000
National Bank of Denmark	100	100
Bank of England	1,500	2,000
Bank of France	100	1,000
German Federal Bank	750	1,000
Bank of Italy	750	1,000
Bank of Japan	750	1,000
Bank of Mexico	130	130
Netherlands Bank	225	400
Bank of Norway	100	100
Bank of Sweden	200	250
Swiss National Bank	400	600
Bank for International Settlements:		
Dollars/Swiss francs	400	600
Dollars/authorized European currencies other than Swiss francs	600	1,000
Total	**7,080**	**10,505**

currency facilities to cover reserve gains of continental European central banks. Although a substantial reflow of funds from continental European currencies in early 1968 enabled the U.S. authorities to make some reduction in these obligations, it nevertheless was necessary to employ sizable nonmarket transactions in order to avoid their undue prolongation. Through the use of foreign exchange obtained in connection with the Canadian and U.S. drawings on the International Monetary Fund, from issuance of U.S. Treasury securities, and in special transactions, Federal Reserve obligations under the swap arrangements were reduced to less than $600 million by early March.

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During the March gold crisis the United States incurred new swap debts and undertook new forward commitments to the market. However, in the quieter atmosphere following the Washington meeting it proved possible to liquidate these obligations as well as some further System swap drawings that had been undertaken in the spring. In liquidating some $1.3 billion of swap obligations the Federal Reserve and the Treasury purchased a substantial amount of foreign exchange from the central banks concerned as they replenished dollars sold in the exchange market. The System also obtained a substantial amount of exchange in connection with the French and British drawings on the IMF in June and from the U.S. Treasury, which issued new foreign-currency-denominated securities. Thus, by July 16 all Federal Reserve and Treasury obligations undertaken in swap transactions had been repaid. Moreover, during the spring and summer months the $155 million of outstanding U.S. forward commitments to the market were liquidated, and the U.S. Treasury redeemed in advance of maturity a $50 million equivalent mark-denominated security.

The events of the latter part of 1968 were dominated by deep-seated fears arising from the May crisis in France, by persistent apprehension over the lack of sustained improvement in the British trade position, and by a growing belief in the inevitability of a revaluation of the mark. Heavy speculation in marks erupted in late August and gave rise to unprecedentedly large shifts of funds into Germany before the assault receded. The respite proved temporary, however, and the inflows resumed on an even more massive scale in November, when the German Federal Bank purchased some $2.8 billion in the market as speculative funds moved into Germany, at heavy cost to French and British official reserves. The German Federal Bank's vigorous efforts to channel the speculative inflows to the market helped to moderate pressures on the Euro-dollar market. In the speculative rush of late August the System and the Treasury, participating jointly, sup-

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ported the German Federal Bank's efforts by selling marks forward in the market, and these obligations were liquidated in due course. During the November rush for marks, the System reactivated its swap line—drawing marks to finance spot sales of that currency in New York. At the same time the System drew on its line with the Swiss National Bank to absorb most of that bank's dollar accumulation.

After mid-November the German authorities took measures to reduce the payments surplus and to restrain speculation while making clear their determination not to revalue the mark. These decisions were supported by the Group of Ten nations in a communiqué following a special meeting in Bonn on November 20–22. After the meeting President de Gaulle rejected any devaluation of the French franc and announced new austerity measures in support of the existing franc parity. When trading resumed on November 25, considerable apprehension remained in the market as traders assessed steps taken by the respective authorities in defense of their existing currency parities. Nevertheless, the speculative fever abated considerably.

In order to encourage a reflow of funds from Germany, the German Federal Bank provided outright forward marks to the market and offered attractive swap rates to German commercial banks. In support of these operations the System also sold marks forward—covering market commitments with swap drawings on the German Federal Bank. These measures helped to generate a substantial reflux of funds from Germany, and by the year-end almost the entire speculative inflow had been reversed. Late in December the System was able to begin acquiring cover for its market commitments in forward marks. At the end of 1968 Federal Reserve commitments under all swap lines stood at $432.1 million; drawings outstanding were in Swiss francs and German marks.

During the year other countries made substantial use of the Federal Reserve swap facilities. The Bank of England had emerged from the November 1967 devaluation with sizable commitments

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under the Federal Reserve swap arrangement. After further drawings and some repayments, the commitment stood at $1.2 billion by June 19, at which time it was liquidated, largely through a drawing on the IMF. Subsequently—in July and during the November exchange market upheaval—the Bank of England made further drawings on the swap line, and by the year-end it had total swap commitments of $1,150 million with the Federal Reserve. The Bank of England also had substantial commitments outstanding to the U.S. Treasury under special credit arrangements.

The Bank of France also made substantial use of its swap line with the Federal Reserve System—drawing on the facility for the first time in June. Drawings reached a peak of $611 million in November, but after the French decision to hold firm on the existing franc parity, reflows of funds developed and by the year-end the Bank of France had reduced its swap obligation to the System to $430 million. The Netherlands Bank and the National Bank of Denmark also drew on their lines for the first time; each employed moderate amounts, which were repaid before the year-end. The Belgian National Bank also drew dollars from the System, but it was able to pay off nearly all of its obligations before the year-end.

With the massive movements of funds into and out of European currencies, the Euro-dollar market was subjected to considerable churning during the year. On the occasions when mark revaluation rumors led to large inflows into Germany and to substantial dollar accumulations on the part of the German Federal Bank, that bank effectively channeled its dollar intake out into the Euro-dollar market. The Swiss National Bank also rechanneled large amounts of dollars taken in at midyear and at the year-end. Several other central banks operated in their respective forward markets so as to moderate flows into and out of their money markets and thereby ease the effects of these flows on the Euro-dollar market.

For its part, the System, through its arrangement with the BIS,

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TABLE 2: FOREIGN CURRENCY TRANSACTIONS OF THE FEDERAL RESERVE, 1968

In millions of dollars equivalent

Currency	Operations initiated by the System									Swap operations initiated by others	
	Transactions under swap lines					Other transactions					
	Drawings	Repayments	Disbursements of swap-acquired balances	Acquisitions of funds for repaying swaps		With U.S. Treasury		With others[1]			
				From U.S. Treasury	From others	Purchases	Sales	Purchases	Sales	Drawings	Repayments
Belgian franc	107.1	212.9	107.1	10.0	202.5	5.1	0.5	6.9	8.7	210.5	203.0
Pound sterling	.....	.....	.....	.....	.....	200.0	243.2	203.0	5.4	2,045.0	1,945.0
Canadian dollar	.....	.....	.....	.....	.....	.....	5.7	.....	.....	250.0	250.0
Danish krone	.....	.....	.....	.....	.....	.....	.....	.....	.....	25.0	25.0
French franc	.....	.....	.....	.....	.....	.....	1.0	.....	3.6	765.0	335.0
German mark	412.1	650.0	340.0	122.5	457.1	37.6	52.3	164.3	111.8	[2]643.0	[2]909.0
Italian lira	175.0	675.0	175.0	50.0	625.1	.....	.....	.....	.....	.....	.....
Dutch guilder	15.0	185.0	15.0	100.4	83.9	10.0	.....	41.9	30.9	54.7	54.7
Swiss franc	498.0	828.0	498.0	288.3	535.9	.....	.....	60.8	28.0	.....	.....
Total	**1,207.2**	**2,550.9**	**1,135.1**	**571.2**	**1,904.5**	**252.7**	**302.7**	**476.9**	**188.4**	**3,993.2**	**3,721.7**

[1] Includes forward as well as spot transactions; excludes Italian lira forward operations.
[2] By BIS.

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made dollars available to the Euro-dollar market on two occasions. In late June, when Euro-dollar rates were rising and sterling was under speculative pressure, the BIS placed $111 million of funds drawn from the System to minimize those pressures. Again, in early December, the BIS placed $80 million in the Euro-dollar market, drawing the funds from the Federal Reserve, at a time when Euro-dollar rates were rising and pressures were converging briefly on the pound. In both instances, the BIS drawings were quickly repaid.

STERLING

Late in 1967 the pound strengthened following reports that the British Government was planning sizable cuts in welfare and defense-spending programs to backstop its devaluation package. These cuts were announced on January 16, and although their major impact was not to take effect until 1969–70, as Britain would phase out its military operations east of Suez, a significant reduction in programmed spending—by some £300 million—was scheduled for 1968. The trade figures for both December 1967 and January 1968 showed major improvements over the predevaluation deficits, and export orders were reported to be on an encouraging uptrend.

Toward the end of January the sterling rate moved firmly above $2.4100, and during both January and February there was a steady demand for sterling that enabled the Bank of England to liquidate a large volume of maturing forward commitments that had been made prior to devaluation. In those months, however, the Bank of England was not able to make any reductions in its outstanding Federal Reserve swap debt, which at the end of 1967 stood at $1,050 million compared with $1,350 million by the time of devaluation. In addition, the Bank of England continued to make use of credits from the U.S. Treasury.

But U.K. official reserves were soon subjected to new erosion as a result of a combination of adverse developments. After 3 years of disappointed hopes, the market maintained a wait-and-see

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attitude concerning sterling's prospects. Hectic speculation in the gold market from November until mid-March kept the exchanges on edge, and sterling reacted sensitively to each new threat to the international financial system. Against this psychological background, and the nagging fear that the government's program to control expenditures and limit private demand would be thrown off course by labor or political unrest, sterling remained generally on the defensive. The forward sterling discount widened sharply at times, not only discouraging any inflow of interest-sensitive funds, but also contributing to withdrawals from London of maturing short-term placements of foreign funds. In addition, several sterling-area countries, having suffered an exchange loss on their reserves as a result of the devaluation, reconsidered the question of diversifying their reserves and began shifting a portion of their holdings out of sterling and into other reserve assets.

In the backwash of the gathering storm in the gold market, the pound dipped below its $2.40 parity for the first time on March 4. The following week, amid the climactic scramble for gold in London, the February trade figures for the United Kingdom were announced; these showed a heavy deficit, with imports at record levels. The next day—the last day of the gold pool operations—sterling tumbled to $2.39. The closing of the London gold market on Friday, March 15, in advance of a meeting in Washington of representatives of the central banks active in the gold pool, was accompanied by a declaration of a bank holiday the same day. With London financial markets closed, there was very little dealing in sterling either on the continent or in New York. However, when isolated trades began to appear at rates below the $2.38 floor, the Federal Reserve—under arrangements worked out with the Bank of England—made small purchases in New York that quickly restored the rate to $2.3825.

On March 17, the Washington communiqué of the Governors of central banks participating in the gold pool announced several important decisions in support of sterling and the exchange markets in general. Specifically, the Governors "agreed to cooperate

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fully to maintain the existing parities as well as orderly conditions in their exchange markets . . . [and] to cooperate even more closely than in the past to minimize flows of funds contributing to instability in the exchange markets." Taking note of the importance of the pound sterling in the international monetary system, they also announced that the total of credits immediately available to the U.K. authorities (including the IMF standby) would be raised to $4 billion. As part of this increase, the Federal Reserve swap arrangement with the Bank of England was increased by $500 million to $2 billion. At the same time the British authorities announced that the London gold market would remain closed for the remainder of March.

On Monday, March 18, the decisions set forth in the communiqué brought about a clear change of atmosphere in the exchanges. The demand for sterling, in particular, was strong and the rate rebounded to above par. The next day the British Government announced the long-awaited 1968–69 budget, calling for very substantial increases in indirect taxes on consumer purchases, a sharp rise in the selective employment tax (on employment in service industries), and a 1-year tax on investment incomes, among other provisions. At the same time the government announced that it would seek legislation to limit annual wage increases to 3½ per cent and to defer or suspend price or wage increases for up to a year. In the wake of a favorable market response to the budget and the Washington communiqué, on March 21 the Bank of England reduced its discount rate by ½ percentage point to 7½ per cent, the first reduction since the move to 8 per cent at the time of devaluation. Along with the strengthening of spot sterling, discounts on the forward pound narrowed from the 10 to 12 per cent per annum range for 3-month contracts, where they had been on March 13 to 15, to 4 per cent per annum by early April.

Despite the improved atmosphere in the latter half of March—featured by the successful conclusion of the Group of Ten talks in Stockholm, which ironed out the last major differences on the

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SDR facility—the month as a whole had been costly to U.K. reserves. The Bank of England drew $50 million on its swap with the Federal Reserve (bringing the amount outstanding to $1,100 million) while making use of other sources of credit, including the U.S. Treasury.

April was a much quieter month for sterling and for international financial markets in general. Nevertheless, another monthly report of a large British trade deficit at a time when observers were looking for clear signs that devaluation was beginning to work created an uneasy undertone in the market, and this grew more pronounced in May. The spot rate gradually drifted below par, and the forward discount began to widen again, reaching nearly 7 per cent by the end of May. At the same time Euro-dollar rates, which had dropped back from the peaks reached at the time of the mid-March gold crisis, began to rise once again, with the rate on 3-month deposits moving from just under 6 per cent in early April to more than 7 per cent by the end of May. As a result, the covered incentive to move foreign funds out of local authority deposits into Euro-dollars shot up to nearly 6 per cent, adding to the strains on sterling that reemerged in May.

During the April–May period, U.S. banks—spurred by tightening credit conditions in this country—turned heavily to the Euro-dollar market in search of funds. Although the sharp run-up in Euro-dollar rates increased the incentive to switch out of pounds, developments in the United Kingdom were also causing concern. Setbacks for the Labor Party in by-elections, reports of dissension in labor ranks over the continuation of the austerity program, and fears—subsequently borne out—that the next monthly trade figures would again look bleak, all added to market pessimism. In mid-May the crisis in France added a new dimension of uncertainty to the international monetary situation and helped to demoralize the market even further. As a result of these various disturbing factors, the pattern of heavy pre-weekend selling of sterling reemerged in May for the first time since devaluation, and at heavy cost to U.K. reserves.

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In order to bolster the official reserves in May, the Bank of England drew $345 million on the Federal Reserve swap line and made use of further credits from the U.S. Treasury as well as other international assistance. The bank repaid $245 million of the swap drawings in early June. Subsequently, after a further small drawing on the Federal Reserve that was soon reversed as pressures eased, the Bank of England's swap debt stood at $1.2 billion in mid-June.

At that point it was announced that the United Kingdom would draw the full $1.4 billion available under the standby credit with the IMF to repay outstanding short-term credits to central banks. A substantial part of this IMF drawing was used on June 19 to reduce the $1.2 billion of drawings then outstanding under the Federal Reserve arrangement. The remainder of these drawings was paid down on the same date by means of Federal Reserve and U.S. Treasury purchases of sterling on a covered or guaranteed basis from the Bank of England. To permit such purchases by the Federal Reserve, the Authorization for System Foreign Currency Operations was amended to increase from $200 million to $300 million equivalent the amount of sterling that could be held on a covered or guaranteed basis for System working balances. Thus, as of the end of June the $2 billion swap arrangement between the Federal Reserve and the Bank of England had reverted to a fully available standby basis (although certain other credit facilities, including those from the U.S. Treasury, were still in use).

Official confirmation on July 8 that 12 central banks and the BIS were prepared to participate in a new multilateral credit facility—amounting to $2 billion—to offset reductions in the sterling balances of sterling-area countries helped to turn market sentiment, which until that period had been increasingly discouraged. More important, June trade figures, showing reduced imports, seemed to offer the first tangible evidence that devaluation was working. Combined with a number of other encouraging developments at home and abroad, these announcements

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stimulated widespread buying of sterling, which lifted the spot rate above $2.3950 by the end of July. However, heavy reserve losses at the end of June and in the first week of July had required the Bank of England to reinstitute drawings on the Federal Reserve swap arrangement, and despite sizable reserve gains in the last 3 weeks of July, outstanding drawings amounted to $350 million at the month-end.

Hopes for further improvement in the trade account helped to sustain demand for pounds through early August, and the Bank of England was able to reduce its swap drawings by $50 million to $300 million. But these hopes were dashed with the publication of July trade results showing that the previous month's gains had been reversed. Shortly afterward, Soviet intervention in Czechoslovakia brought new uncertainties, which were soon compounded by mark revaluation rumors, which in turn cast new doubts on sterling. The pressures thus generated carried through early September, by which time the spot rate was back close to the floor and the Bank of England had increased its drawings on the Federal Reserve to $400 million.

As in earlier months, the market's appraisal of sterling turned heavily on the latest trade figures. Relatively favorable results for August and September were thus important factors in sterling's improved showing through the end of October. The temporary subsiding of mark revaluation rumors and the announcement in early September that final agreement had been reached on the new sterling balances arrangement were further elements in sterling's stronger market performance during this period.

A sharp run-up in sterling rates, following President Johnson's announcement of a bombing halt in North Vietnam, was abruptly halted by the new outbreak of mark revaluation rumors in early November. The sterling market remained roughly balanced at about $2.39 during the first 2 weeks of November despite uneasiness over the implications for the domestic economy of the government's announcement of new instalment credit restric-

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tions. But news on November 13 of a doubling of the U.K. trade deficit for October left sterling fully exposed to the mounting pull of funds into Germany in anticipation of an imminent mark revaluation. Before the end of November the Bank of England had been forced to extend heavy support to hold sterling at $2.3827 and had increased its outstanding drawings on the Federal Reserve by $750 million, raising the total to $1,150 million.

During the Bonn meeting of November 20–22, foreign exchange dealings were suspended in London, as in several other major European centers. Meanwhile, the U.K. authorities acted to bolster their austerity program through indirect tax increases, tightened credit curbs, and a 50 per cent deposit requirement against imports of manufactured and semimanufactured goods.

Although speculation abated and markets were steadier once the Bonn meeting was over, considerable uneasiness remained. When trading resumed on November 25, demand for pounds was limited to modest covering of short positions. Moreover, in the early part of December, sterling was subjected to renewed selling pressure by the market's apprehensions over heightened tensions in the Middle East and by reports suggesting disagreement within the British Government regarding the austerity program. Higher interest rates in the United States added to the market pressures.

In this atmosphere, the Bank of England sustained substantial losses in support of spot sterling, and forward discounts again widened sharply. By midmonth, however, the market had become heavily oversold, and traders—spurred by expectations that the next set of trade figures would show substantial improvement, as in fact was the case—moved to cover short positions. The rebound enabled the Bank of England to recover most of its losses earlier in the month, but the market then turned cautious once again. On balance, very little of the substantial reflux of funds from Germany found its way back into sterling, with the result that the Bank of England's commitments to the Federal Reserve remained at $1,150 million at the year-end.

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GERMAN MARK

During the early part of 1968 funds flowed heavily from Germany, as German banks responded to the pull of relatively attractive interest rates in the Euro-dollar market and foreign borrowers turned to German financial markets for long-term funds. The substantial outflow depressed the mark rate and enabled the System to repurchase the small amount of marks used in market intervention late in 1967 and to obtain further amounts sufficient to complete the liquidation of the System's outstanding $350 million swap debt to the German Federal Bank by early March. The $750 millon reciprocal swap facility thus reverted to a fully standby basis.

But Germany's trade account remained very strong during the early months of 1968, as it had throughout 1967. It was evident, moreover, that Germany's resurgent growth, as well as its accompanying stimulus to activity in other Common Market countries, was being accomplished with few strains on Germany's productive potential. Although persistent capital outflows depressed the spot mark early in the year, the market remained aware of the underlying strength in the current account and of the potential for a rapid reversal of direction with a new outbreak of speculative demand. During the gold crisis that began to erupt in early March, speculation on a revaluation of the mark touched off such a burst of speculative demand and consequent heavy flows of funds to Germany. On Friday, March 15, with unprecedented uncertainties in the exchanges arising out of the closing of the London gold market and the emergency central bank meeting convening in Washington over the coming weekend, speculation seemed to focus on the mark, and funds flowed into Germany from all over Europe and from the United States. The Federal Bank's intake of $400 million that day raised its gross spot intake in March to some $800 million, including a moderate amount through the Federal Reserve Bank of New York.

These large shifts of funds into marks would have severely

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aggravated the strains then being felt in the Euro-dollar market and the pressures on sterling had the Federal Bank not immediately reoffered the dollars to German commercial banks on a swap basis for repurchase later at attractive rates. Initially in the first week of March, the Federal Bank offered swap rates equivalent to a premium on the forward mark of 2 per cent per annum, more than ½ percentage point below the market. Subsequently the bank varied its rates to moderate the reflow, and by the month-end it had raised the total of its swap sales to an amount that about offset the gross spot inflow earlier in March. The System participated in the market swap operation, as it had done in November 1967, by reactivating its swap line with the German Federal Bank to absorb $300 million from that bank.

The firm support for existing currency parities that emerged from the Washington meeting helped to reassure the highly nervous markets. News of the large general expansion in the Federal Reserve swap network, including an increase in the line with the German Federal Bank to $1,000 million, contributed importantly to that reassurance. Under these circumstances the underlying liquidity of the Frankfurt market was quickly manifest, and the spot mark moved lower through the end of March. In order to maintain an orderly market as the earlier heavy speculation unwound, the Federal Bank sold a sizable amount of spot dollars.

During the spring, confidence in currency parities was strengthened by President Johnson's new peace initiative in Vietnam and the Stockholm Agreement on a plan for SDR's. Moreover, rising interest rates in the United States and in the Euro-dollar market after the ½ point increase in Federal Reserve discount rates to 5½ per cent exerted a strong pull on German short-term funds. At the same time the German Federal Bank continued its easy monetary policy to encourage the investment of excess funds abroad, and as capital outflows developed, it sold substantial amounts of spot dollars, permitting the spot mark to slide gradually lower. The authorities also concluded new market swaps with the German commercial banks to facilitate investment of short-term funds abroad by these banks. Thus a very substantial

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part of the dollars that had flowed in as a result of the maturing of the March swap contracts were channeled out.

In April the System began to reduce its swap debt to the Federal Bank; using marks acquired from a correspondent and some marks from balances, it reduced the $300 million swap obligation by $25 million. International currency uncertainties flared up again in May, however, triggering a new round of mark revaluation rumors as apprehensions over the failure of the U.K. trade position to show improvement were compounded by uneasiness over further delay in enactment of the proposed U.S. tax surcharge. Speculative demand for marks boosted the spot rate sharply, and the German authorities again purchased dollars. But the buying was not sustained; in fact, it quickly dissipated after a flat denial of any revaluation plans was issued by Dr. Karl Blessing, President of the German Federal Bank. At the end of May the market responded favorably to another official statement, which explicitly encouraged German commercial banks to export capital and stressed that the authorities would provide sufficient domestic liquidity for further business expansion despite the flow of funds abroad. Thus, with official approval and ample resources available, foreign borrowers placed additional issues in the German capital market.

One notable example of the broadly equilibrating influence of the outflow from Germany was the Canadian Government's 5-year borrowing of 250 million marks in late May. The borrowing not only served to bolster Canadian official reserves and to offset Germany's current-account surplus but also afforded the Federal Reserve the opportunity to purchase a sizable amount of German marks. The Federal Reserve purchased from Canada $25.2 million equivalent of the proceeds of the borrowing and used them, together with $25 million more acquired from the market, to reduce its swap debt to the German Federal Bank to $225 million equivalent.

The flow of German capital seeking employment abroad stepped up in June when the Federal Bank sold sizable amounts of dollars in the market, partly in response to conversion of the

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mark proceeds of Canadian and Mexican long-term borrowings. In the latter part of that month the persistent demand for dollars depressed the spot mark to parity, and since marks were readily available, the Federal Reserve and the Treasury purchased marks in the New York market against outstanding commitments. In addition, the System obtained $50 million of marks from the German Federal Bank when that Bank replenished dollars sold to France in connection with the French drawing on the IMF. These marks, together with market purchases, were used to reduce System swap obligations in marks by $100 million to $125 million as of June 21. Finally, near the end of June the U.S. Treasury issued to German banks special mark-denominated securities equivalent to $125.1 million. These securities were issued in conjunction with agreements reached with the German Government to neutralize part of U.S. troop-stationing costs in Germany. The System purchased these marks and used them to liquidate the last $125 million outstanding under the swap line with the Federal Bank.

Selling of marks continued unabated through early August, partly reflecting reflows abroad from German banks after midyear. By early August the spot mark had declined to $0.2486½, the lowest level since the 1961 revaluation, and the German Federal Bank had continued to supply spot dollars to the market. In the New York market both the Federal Reserve and the Treasury made sizable purchases of marks. On August 9, the Treasury used its recent purchases to redeem in advance of maturity a $50.3 million equivalent, 22-month note held by the German Federal Bank.

Toward the end of August new rumors of an imminent revaluation of the mark again touched off heavy speculative demand. Within days the spot mark had risen virtually to its ceiling, and the German Federal Bank had begun to take in huge amounts of dollars. The bank's market purchases amounted to $1.7 billion in the period August 27–September 6. Some of the inflow represented conversions of sterling and French francs, but a large

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part came from the Euro-dollar market. From the outset, the Federal Bank moved to neutralize the potentially disruptive effect of these inflows, as it had in the past, by making dollar/mark swaps available at rates that provided a sizable incentive to German banks to channel the funds to the Euro-dollar market. U.S. authorities assisted in these efforts by selling some $33.8 million equivalent of marks in the forward market in New York. After the monthly central bank meeting in Basle on the weekend of September 7–8, the demand for marks declined as speculative influences receded. The German Federal Bank continued with its swap sales, and by the end of September it had returned to the market virtually all of the funds it had taken in from the earlier speculative inflow.

The market atmosphere remained quiet through most of October—encouraging renewed capital outflows and consequent substantial sales of dollars by the German Federal Bank. As the spot rate declined, the Federal Reserve Bank of New York made modest purchases of marks for Treasury account, and the System and the Treasury paid off maturing August–September forward sale commitments.

Market expectations of an eventual revaluation of the mark persisted, however, and by the end of October this undercurrent was reflected in a strengthening of the spot rate. In early November rumors of an imminent revaluation of the mark and devaluation of the French franc again swept the exchanges. These rumors triggered a huge demand for marks, and by November 15 the German Federal Bank had purchased nearly $2 billion. Although the momentum behind the speculation was being generated mainly in Europe, the heavy demand reflected purchases by U.S. firms as well. To meet some of the demand in New York, the Federal Reserve Bank of New York sold $47 million of marks on behalf of the Federal Reserve. These sales were covered by a $40 million drawing on the swap line with the German Federal Bank and from balances.

Once again the German Federal Bank acted to recycle the funds by concluding market swap sales of dollars at attractive

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rates. After swapping out some $1 billion of its spot gains, however, the Federal Bank took action to curb the tendency of German banks to resell the spot dollar proceeds of the swaps rather than hold the funds in dollar investments—thereby in effect obtaining outright forward cover as a result of the swaps. The German authorities indicated that they would conclude further swap sales of dollars only if the banks invested the spot dollar proceeds in U.S. Treasury bills. But the German banks and their customers had become interested mainly in acquiring outright forward cover in marks, and they chose not to engage in swap transactions with the Federal Bank on these terms; instead, they bid for spot marks and sought forward cover through swaps in the market.

Speculative buying of marks continued with full fury on Monday, November 18, when the regular monthly meeting of central bankers at Basle ended without the official statement that the market had expected, and speculators remained convinced that the next move would be an upward revaluation of the mark. On November 18 and 19 the Federal Bank purchased $850 million, bringing gross purchases in November to more than $2.8 billion. On November 19, in an effort to calm the market, the German authorities issued a formal communiqué stating that the mark would not be revalued and, to reduce the German trade surplus, announced new tax measures that would raise export prices while lowering import costs.

After a holiday on Wednesday, November 20, trading in Germany was effectively suspended for the 2 days before the weekend as the Finance Ministers and central bank Governors of the Group of Ten nations met in emergency session in Bonn. On November 22, the Group of Ten nations issued a communiqué fully supporting the German Government's decision to stand firm at the existing mark parity, its new tax measures, and the Federal Bank's decision to impose 100 per cent reserve requirements on new foreign-owned mark deposits held in German banks. The monetary move, which was designed to discourage further spec-

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ulative inflows, reinforced the ban already in effect on interest payments on foreign-owned sight or time deposits denominated in marks. The German authorities also initiated legislation authorizing the licensing of mark deposits by foreigners with German banks.

When trading resumed in Frankfurt on November 25, substantial amounts of funds began to flow from Germany as market expectations of a revaluation receded and long positions were liquidated. To encourage these and subsequent reflows, the Federal Bank offered outright forward cover back into marks at a 3 per cent per annum premium for 3-month maturities. The Federal Reserve backed up the German Federal Bank's operations, offering outright cover to the market at the same rates for the same maturities. By the end of November the Federal Bank had resold $880 million spot and sold $246 million of outright forward marks. The System's outright forward sales reached $72.5 million equivalent; all were covered by swap drawings, which raised Federal Reserve swap debt in marks to $112.1 million equivalent.

On December 2 the Federal Bank and the Federal Reserve discontinued outright sales of forward marks, concluding that such sales had served their purpose of encouraging capital outflows and assuring the market that there would be no parity change. The Federal Bank offered instead to undertake swaps with its banks at improved rates and for a wider range of maturities. Earlier the authorities had dropped their requirement that the proceeds of the swaps be invested in U.S. Treasury bills and now requested only that investments match the maturities of the official swap contracts. German banks responded to the improved incentives—enabling the authorities to roll over into 1969 the very large December maturities of earlier swaps. Moreover, German banks also purchased very substantial amounts of spot dollars, as foreigners withdrew funds from Germany and commercial leads and lags began to unwind. These heavy outflows from Germany enabled the Federal Reserve to begin accumulating German marks to cover outstanding System commitments.

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FRENCH FRANC

Late in 1967 the French current account began to recover from the modest deficit that had emerged during the preceding year. With this favorable development in the background, the franc remained above par ($0.2025½) during the early months of 1968. Nevertheless, there were occasional periods of pressure on the franc, arising from reactions to the new U.S. balance of payments program announced on January 1, shifts of funds into the Euro-dollar market by French banks, and the March speculative stampede into gold. By the end of April the franc had drifted to a level just above par, from which there was little change well into May.

On May 17, however, student rioting broke out, followed shortly by labor strikes in Paris and similar disorders elsewhere in France. Within days the strikes had virtually paralyzed the French economy, and on May 20 the absence of personnel forced nearly all French banks to close. For all practical purposes, this also closed the Paris exchange market and complicated the delivery of francs bought and sold in exchange dealings in other countries. Trading in spot francs continued in those markets, but at a sharply lower volume.

With the French markets closed, the Bank of France called upon the Federal Reserve Bank of New York to help maintain franc quotations within declared limits by purchasing spot francs for the Bank of France account. Subsequently, the Bank of France made parallel arrangements to cover European markets through the BIS. For a few days the franc fluctuated just above its floor ($0.2010½), but as the political crisis deepened, the rate fell to the floor level and had to be heavily supported. Even though banks were closed in France, speculative flows from France to Switzerland and into the Euro-dollar market grew to substantial volume, and at the end of May the French Government imposed exchange controls over resident capital transfers abroad; nonresident transactions remained free of controls, however.

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In early June the selling abated somewhat after President de Gaulle's call for national elections raised hopes that a beginning had been made toward restoring order in France. Evidence of a scattered return to work by French workers also helped to improve the atmosphere. Moreover, the Bank of France was able to resume its regular activities and make its presence felt in support of the franc on the continent. French commercial banks began operating again, and on June 7 the Paris bourse opened its doors for the first time since May 20.

But the reopening of normal channels of foreign exchange dealings brought with it further selling of francs. Despite the gradual return to work by French workers during the month of June, it was feared that the large wage increases necessary to bring an end to the work stoppage might initiate a wage-price spiral that could seriously weaken French international competitiveness. As a result, selling of francs stepped up, based in large part on a precipitate reversal of commercial leads and lags despite the exchange controls imposed at the end of May. The French Government's announcement of a program of temporary import quotas and export subsidies to bolster the franc did little to stem the speculative tide. But the sweeping victory of the Gaullist forces in the elections at the month-end cleared away one area of uncertainty besetting the market, and although the selling of francs persisted thereafter, the market fever abated.

For May the Bank of France announced a reserve loss of $307 million, and in June a further loss of $203 million was recorded. But sizable credit operations had also been initiated. In June the Bank of France bolstered its reserves by drawing the full $100 million then available under its swap line with the Federal Reserve, the first drawing by that bank since the inception of the arrangement in March 1962. In addition, France drew $885 million from the IMF—representing its gold tranche and other drawing rights resulting from previous Fund use of French francs supplied by France under the General Arrangements to Borrow. (As described in other sections of this report, the Federal Re-

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serve was able to acquire certain currencies drawn by France, and it used them to reduce System drawings on swap lines with other central banks.) Thus the cost of official support for the franc in May and June came to $1.5 billion. Part of this reserve loss took the form of gold sales by the French authorities to replenish dollar balances, including $220 million of gold sold to the U.S. Treasury.

With the announcement of the June reserve figures in early July, Finance Minister Couve de Murville (later named Premier) strongly reaffirmed the government's intention to defend the franc parity. As evidence of that resolve, the French authorities broadened their defense of the franc to include an increase in the Bank of France discount rate from 3½ to 5 per cent, a tightening of exchange controls, and new taxes. Shortly thereafter, on July 10, the Bank of France announced a $1.3 billion package of new credits from the Federal Reserve, the central banks of Belgium, Germany, Italy, and the Netherlands, and the BIS. The Federal Reserve participation took the form of a $600 million increase in the swap line with the Bank of France, which raised that facility to $700 million.

Despite these stabilizing measures, the market remained skeptical about the future of the franc, particularly in view of the inflationary potential of the wage increases in June. Pressure on the franc continued throughout the summer, and it was aggravated by recurring rumors of a revaluation of the German mark. Selling pressures eased only temporarily after publication, in mid-September, of the French Government's 1969 budgetary plans. At the same time removal of the exchange controls imposed in May had only a short-lived favorable impact.

During the summer the Bank of France drew a further $390 million on the expanded swap facility. Net drawings at September 30 amounted to only $450 million, however, since the Bank of France had repaid $40 million of its drawings in the summer following a sale of gold to the U.S. Treasury; during the third quarter France sold a total of $240 million of gold to the United

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States. The French authorities also made use of other international credit facilities.

October was a generally quieter month, and the Bank of France was able to repay $75 million of its swap debt to the System and to reduce obligations under other international credits. The respite was short-lived, however. The outbreak of renewed speculation in marks in early November gave rise to a massive outpouring of funds from France, with heavy losses to French official reserves. The French authorities responded by tightening monetary policy—including an increase in the discount rate to 6 per cent and placement of a ceiling on short-term bank credit growth. On November 18, after the November 16-17 monthly meeting of the central bankers at Basle, Premier Couve de Murville went on nationwide television to declare that France was assured of "all the help she might need or will need in the future" and promised large cuts in planned government spending to bolster the franc.

But the markets remained convinced that the franc faced imminent devaluation, and heavy selling continued. To meet the pressures, the Bank of France drew further on the Federal Reserve swap facility, raising its debt under that line to $611 million, and also drew funds from other participants in the July credit package. In view of the continuing feverish speculation, the French authorities decided to close the Paris financial markets during the period of the Bonn meeting (November 20-22). Although the New York market remained open, there were only scattered quotations for spot francs at deep discounts below parity, and forward quotations were essentially unobtainable as the market believed that a devaluation of the franc was certain to follow the meeting.

At the conclusion of the Bonn meeting a new central bank credit facility for France in the amount of $2 billion was announced. U.S. participation in the new credits took the form of a $300 million increase in the Federal Reserve swap line—raising the total to $1 billion—and a $200 million facility ex-

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tended to the Bank of France by the U.S. Treasury. The next day President de Gaulle confounded market expectations by rejecting devaluation of the franc, and on November 24 he set forth a new program to defend the existing franc parity. The new plan included a sharp cut in the government budget deficit, further monetary curbs, price restraints, and tax adjustments to improve the French competitive position—all backed up by stringent exchange controls.

When trading resumed on Monday, November 25, there was some immediate covering of short positions and the Bank of France began to take in dollars. In subsequent days the Bank of France continued to gain reserves, as the newly imposed exchange controls stopped capital outflows and French exporters complied with regulations requiring them to repatriate export proceeds within a short period of time. In early December further restrictions required French importers to abrogate a substantial portion of their contracts to purchase forward cover in foreign exchange, and French banks were obliged to sell to the Bank of France the currencies held as cover against those contracts.

As a result of these moves the Bank of France continued to gain reserves, which it used in part to repay official borrowings. By the year-end the bank had liquidated a total of $181 million of its swap debt to the Federal Reserve—lowering those commitments to $430 million. The bank had also repaid substantial credits drawn from other countries of the European Economic Community and from the BIS. At the same time the French authorities made further gold sales, bringing those to the United States to $600 million for the year.

SWISS FRANC

The Federal Reserve had drawn heavily on its Swiss franc swap lines in 1967 to absorb inflows of funds seeking refuge in Switzerland from currency uncertainties in the wake of the Middle East conflict, the crisis in sterling, and massive specu-

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lation in gold. By the end of that year Federal Reserve swap drawings amounted to $250 million on the Swiss National Bank and $400 million on the BIS. Moreover, as part of the concerted central bank effort to restrain speculation, the Federal Reserve and the U.S. Treasury jointly had underwritten $65.5 million of forward franc sales in the market by the Swiss National Bank in December 1967. Thus, at the beginning of 1968, total U.S. swap and forward market commitments in francs stood at $715.5 million equivalent.

Early in 1968 a substantial but largely seasonal reflux of funds from Switzerland developed as Swiss commercial banks moved to rebuild their dollar investments. The spot franc rate dropped sharply, and the Swiss National Bank extended sizable support by selling dollars in the spot market. The National Bank covered these sales by purchasing dollars from the Federal Reserve in exchange for francs. The System used these francs, along with modest franc balances obtained in the market and from special transactions, to reduce its swap obligations in Swiss francs by $343 million through early March.

At the same time the Federal Reserve was able to pay off an additional $175 million of its drawings on the BIS and the Swiss National Bank through issuance by the U.S. Treasury of a $100 million equivalent Swiss franc security to the Swiss National Bank and by purchasing $75 million equivalent of Swiss francs from that bank. (The Swiss National Bank simultaneously purchased $25 million of gold from the U.S. Treasury.) Thus, by March 8 the Federal Reserve swap debt in Swiss francs was reduced to $132 million equivalent, with $77 million outstanding to the Swiss National Bank and $55 million to the BIS. Earlier, in February, the U.S. authorities also paid off the first $10 million of maturing forward sales contracts falling due to the market; this left $55.5 million still outstanding, divided evenly between the System and the Treasury.

The speculative upsurge in the gold market in March was accompanied by a strengthening in the spot franc, although the

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advance was dampened by the demand for dollars by holders of Swiss francs who wished to buy gold in London. On March 15, with the London gold market closed and traders unsure of the outcome of the weekend meeting in Washington, the demand for Swiss francs intensified. The Swiss National Bank indicated to the market that it would henceforth sell francs at the official upper intervention point of $0.2328¼, rather than the unofficial limit of $0.2317½ in effect in recent years. The National Bank did take in some dollars at the new intervention point that day, but the amounts were not large. Demand for francs was heavier in the forward market, however, and the Swiss National Bank, acting jointly for the Federal Reserve and the Treasury, sold a total of $56 million equivalent of forward francs, raising U.S. forward commitments to the market to $111.5 million.

The news of the decisions taken at the Washington meeting calmed the market considerably. One result of that meeting was a further increase in the Swiss franc swap facilities with the Swiss National Bank and with the BIS of $200 million each. As a result, the resources available under each arrangement were raised to $600 million. In succeeding weeks, the liquidity positions of Swiss banks remained relatively easy, and with the exchange markets generally calmer during April, it proved possible for the Federal Reserve and the U.S. Treasury to liquidate $43 million equivalent of maturing Swiss franc forward contracts, thereby reducing these commitments to $68.5 million.

The month of May brought a strengthening of the spot franc. Early in the month, market uncertainties arising from a spate of rumors of a revaluation of the mark and growing apprehensions over sterling generated speculative demand for francs. In addition, there were indications that Italian interests were buying francs to liquidate credits that were becoming expensive relative to loan rates elsewhere. Later in the month the political and economic upheaval in France pushed the Swiss franc still higher. By the end of May, the flight of French capital to Switzerland had lifted

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the Swiss franc to its ceiling and the Swiss National Bank had taken in a sizable amount of dollars. The System subsequently absorbed most of that intake by drawing $73 million under the swap facility with the Swiss National Bank—raising Federal Reserve commitments to the Swiss National Bank to $150 million. On the other hand, the remaining $55 million equivalent of Federal Reserve swap debt in Swiss francs to the BIS was fully repaid in May through a U.S. Treasury swap of sterling against Swiss francs with the BIS.

In June quotations for the Swiss franc moved irregularly lower after the middle of the month, as the Swiss National Bank provided swap facilities to help Swiss banks meet their midyear liquidity needs. Such short-term swaps by the Swiss National Bank reached a total of $430 million, and the bank rechanneled the entire amount of the dollar proceeds to the Euro-dollar market, both directly and through the BIS. Toward mid-June, the System acquired $15 million of francs from a correspondent and with these francs reduced its commitments to the Swiss National Bank to $135 million by June 18. In addition, the U.S. authorities liquidated $3.0 million of maturing forward commitments to the market—using francs purchased from the Swiss National Bank.

In July money and credit conditions in Switzerland tightened, as heavy seasonal withdrawals of currency drained liquidity from Swiss banks and as midyear swaps between the central bank and the commercial banks ran off. Swiss banks bid strongly for francs to meet month-end needs, and interest rates on 1-week money climbed to 8 to 10 per cent per annum. With no immediate prospect of liquidating Swiss franc swap commitments through market transactions, the U.S. authorities moved to wind up these commitments by other means. In early July the U.S. Treasury issued to the BIS a 3-month certificate of indebtedness denominated in Swiss francs equivalent to $54.7 million. The Treasury used these francs to reverse its third-currency swap of sterling for francs with the BIS. Subsequently, on July 16, the Treasury

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issued to the Swiss National Bank a 3-month franc-denominated certificate for $133.7 million equivalent; the System used nearly all of these francs, together with balances on hand, to repay fully the $135 million commitment still outstanding under the swap line with the Swiss National Bank. The $600 million facility with the bank thus reverted to a fully available standby basis. Also during the month the System and the Treasury were able to liquidate at maturity $29.5 million of forward contracts with the market.

At the end of July credit conditions in Switzerland tightened still further, triggering heavy repatriations of funds into Switzerland, and the Swiss National Bank took in a large amount of dollars. The System subsequently absorbed nearly all those gains by reactivating its swap line with the Swiss National Bank—drawing a total of $145 million by August 1. The substantial injection of francs resulting from these inflows into the Swiss money market brought an end to the squeeze and an easing in the spot rate, which lasted well into August. Accordingly, in August, the System and the Treasury paid off the last $36 million of forward franc commitments to the market that dated back to late 1967 and early 1968.

After mid-August the Soviet invasion of Czechoslovakia and the uncertainties generated by a renewed flare-up of speculation in German marks brought a sharp jump in demand for Swiss francs. However, the franc rate did not reach the Swiss National Bank's upper intervention point, and in early September the spot rate eased somewhat as funds began to move out of Switzerland into Germany. Later in that month, end-of-quarter liquidity demands resulted in a firming of the franc, but Swiss banks sold only a small amount of dollars to the National Bank. In view of the relatively higher rates available on Euro-dollars the banks met their liquidity needs primarily by rediscounting money market paper with the Swiss National Bank rather than by liquidating dollar assets. In these circumstances, the Swiss National Bank covered the dollar needs of the Swiss Confederation

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and the dollar requirements for exchange transactions with other countries through purchases of dollars from the Federal Reserve, thereby providing the System with francs needed to meet short-term obligations. Thus, by early October the Federal Reserve had reduced its outstanding swap debt to the Swiss National Bank by $105 million to $40 million equivalent.

The Swiss money market remained tight in October, and late in the month the Swiss National Bank had to take in dollars. The Federal Reserve absorbed these gains by drawing $80 million equivalent on the swap line with the National Bank—raising its swap debt to $120 million equivalent by early November. Subsequently the spot franc dipped lower and traded quietly through mid-November, despite the heavy speculation in the exchanges focused on the German mark, French franc, and sterling. When international currency uncertainties intensified severely during the 3-day meeting of the Group of Ten in Bonn, the Swiss franc rose to the ceiling and the Swiss National Bank took in some $215 million. The Federal Reserve absorbed most of the Swiss National Bank's intake of dollars by drawing an additional $200 million equivalent on its swap line with that bank. These drawings raised the System's indebtedness under the swap facility with the Swiss National Bank to $320 million equivalent.

In December, as in past years, the Swiss authorities offered short-term swaps to Swiss commercial banks repatriating funds for year-end needs. The banks made very heavy use of this facility, with total swaps rising to $746 million. Following past procedure the Swiss authorities rechanneled these dollars back to the Euro-dollar market in order to prevent the disturbance of that market that would otherwise have occurred.

CANADIAN DOLLAR

The Canadian dollar came under heavy speculative attack during the early months of 1968. Although Canada's trading position remained strong, market sentiment had been shaken

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by the devaluation of sterling and the subsequent gold rush. The market was particularly disturbed by apprehensions that the new U.S. balance of payments program announced on January 1 would adversely affect U.S. direct investment in Canada and the balance of short-term capital flows between the two countries, despite Canada's continued free access to the U.S. bond market under the new program. In February political uncertainties added to market tensions as the Canadian Government encountered temporary difficulties in obtaining legislative approval for its anti-inflationary fiscal program. Official reserve losses were heavy in January and February, and the Canadian authorities accordingly reinforced their reserve position by drawing $250 million under the $750 million swap facility with the Federal Reserve and $426 million from the IMF. At the same time the Bank of Canada's discount rate was raised to 7 per cent effective January 22.

In early March, as the gold rush resumed, there was continuing heavy pressure on the Canadian dollar. Against the background of speculative pressures, fiscal measures designed to limit domestic demand were reintroduced into—and subsequently passed by—Parliament. Domestic measures were immediately supported by a bolstering of Canada's international credit lines. New international credits of $900 million—over and above the $500 million still available under the Federal Reserve swap line—were made available by the U.S. Export-Import Bank, the German Federal Bank, the Bank of Italy, and the BIS. At the same time the U.S. Government made clear its wholehearted support for Canada's program to defend the $0.9250 parity by granting Canada a complete exemption from the restraints on capital flows announced in the President's January 1 program.

The Canadian Minister of Finance assured the U.S. Government that this exemption would in no way impair the effectiveness of the President's balance of payments program. In addition, the Finance Minister announced Canada's intention to

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invest holdings of U.S. dollars—apart from working balances—in U.S. Government securities that do not constitute a liquid claim on the United States. Effective March 15, the Bank of Canada raised its discount rate by ½ percentage point to 7½ per cent. On the previous day most Federal Reserve Banks had announced a ½-point rise in discount rates.

These strong measures to protect the Canadian dollar began to exert their full effect as soon as the March 16-17 Washington meeting cleared away doubts about central banks' resolve to defend the existing international payments system. The Bank of Canada immediately announced that it would cooperate in the policies set forth in the Washington communiqué. It was also announced that the Bank of Canada's swap facility with the Federal Reserve had been increased to $1,000 million, providing further assurance of the capacity of the Canadian authorities to maintain the existing parity. The market response was favorable and the Canadian dollar began to strengthen.

The market was also helped by news of a large calendar of Canadian borrowings in New York, which suggested sizable forthcoming demand for Canadian dollars. Moreover, a Province of Quebec loan placed in Europe also suggested that Canadian borrowers could tap new capital resources in Europe, where monetary conditions had eased as a result of official policy actions designed to foster renewed business expansion on the continent.

With a sharp turnabout in market sentiment toward the Canadian dollar, the Canadian authorities began recouping reserves in the second half of March and thus offset some of the losses sustained early in that month. Buying pressure gathered momentum in April, as demand for Canadian dollars was strengthened by the conversion of export earnings, which had been at a very high level since the beginning of the year. Thus, the Canadian dollar strengthened gradually, and official reserves increased substantially in April and May. In May and June the Government of Canada sold new issues of bonds in the United

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States, Italy, and Germany in a total amount of $262 million equivalent. As the exchange market situation continued to improve in late June, the Bank of Canada repaid $125 million of its $250 million of obligations under the Federal Reserve swap line and on July 1 reduced its discount rate by ½ percentage point to 7 per cent.

After a brief lull early in July, there was renewed buying of Canadian dollars as banks began to undo forward positions against the Canadian dollar, which had been undertaken during the peak of the speculative attack in January. The Bank of Canada took in dollars while gradually permitting the spot Canadian dollar to advance to its effective ceiling ($0.9324). Against this favorable background, the Bank of Canada announced on July 26 that it was lowering its discount rate by a further ½ percentage point to 6½ per cent. With this announcement the Canadian authorities also revealed that the Bank of Canada had repaid the final $125 million outstanding on its swap line with the System, thereby placing the entire $1,000 million facility on a standby basis. At the same time it was reported that the $100 million short-term facility with the BIS and the facilities of $150 million each with the Bank of Italy and the German Federal Bank had been terminated without having been utilized.

The Canadian dollar was at or near its effective ceiling throughout August. It then dipped for a time in September after the Bank of Canada reduced its discount rate to 6 per cent early in that month. But demand soon resumed in connection with conversion of borrowings abroad and the spot rate moved back to its ceiling before the month-end. By the end of September Canada's gold tranche with the IMF was reconstituted to the full $185 million.

The Canadian dollar continued to benefit from optimistic market appraisals through the closing months of 1968. In mid-December, an exchange of letters took place between U.S. and

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Canadian Treasury officials, restating the exemption of Canada from all U.S. balance of payments programs and the basic principle that it would not be Canada's intention to achieve increases in its exchange reserves through borrowing in the United States. Implementation of this principle does not require that Canada's reserves be limited to any particular figure.

On December 18 the Bank of Canada raised its discount rate by ½ percentage point to 6½ per cent following announced increases in Federal Reserve discount rates. For the month of December the Bank of Canada gained some further reserves. Thus, despite a major crisis early in 1968, Canada's gold and foreign exchange reserves—including the net creditor position with the IMF—rose by $332 million for the year as a whole.

DUTCH GUILDER

Late in 1967 there were heavy flows of funds to the Netherlands, generated mainly by the sterling crisis but also by a brief liquidity squeeze in the Amsterdam market at the year-end. The Federal Reserve drew several times on its swap line with the Netherlands Bank, and by early January 1968 System commitments had reached $185 million. Moreover, the Treasury executed special temporary swaps with the Netherlands Bank for $126 million equivalent, to provide cover for that bank's spot dollar accumulations. As part of the concerted central bank effort in November 1967 to restrain speculation, the Netherlands Bank initiated forward sales of guilders totaling $37.5 million on behalf of the Federal Reserve and U.S. Treasury. Thus, U.S. authorities' short-term commitments in guilders reached a peak of $348.5 million on January 4, 1968.

Liquidity conditions in Amsterdam improved significantly with the new year, and Dutch banks responded by moving excess funds back into the Euro-dollar market. In mid-January, outflows from Amsterdam were sufficiently large for the Netherlands Bank to provide support for the guilder. The Netherlands

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Bank then restored its dollar position through purchases from the Federal Reserve Bank of New York acting for account of the U.S. Treasury. Through these transactions the Treasury obtained $23 million equivalent of guilders, which were used to reduce Treasury commitments under its swap with the Netherlands Bank to $103 million equivalent.

These outflows from the Netherlands were short-lived, however, and the Federal Reserve was able to make only a modest start in repaying its commitments outstanding under the swap with the Netherlands Bank. Moreover, the Dutch balance of payments, which had been in modest surplus in 1967, showed no signs of shifting into deficit. To avoid an undue prolongation of the short-term guilder commitments incurred by the System and the Treasury, a variety of special transactions were undertaken. On January 29 the U.S. Treasury issued to the Netherlands Bank a 12-month certificate of indebtedness denominated in guilders equivalent to $65.7 million. The Treasury used $55.7 million equivalent plus a small amount in balances to reduce its swap commitments to $47 million. The Federal Reserve purchased the balance of the guilders and used them to reduce its swap indebtedness to the Netherlands Bank to $165 million.

On February 21 the Treasury repaid its remaining $47 million equivalent of swap commitments to the Netherlands Bank with guilders purchased from that bank. In turn the Netherlands Bank purchased $23.5 million in gold from the Treasury. Shortly afterward, Canada made its drawing from the IMF; this drawing included $30 million equivalent of guilders, which the Bank of Canada converted to U.S. dollars through the Netherlands Bank. This reduced the Dutch dollar position enough for the U.S. authorities to purchase sufficient guilders to liquidate the $37.5 million in forward contracts maturing in late February and early March. Finally, the U.S. Treasury drawing from the IMF included $100 million equivalent of guilders, which were used by the Federal Reserve to make a further reduction in its swap obligation with the Netherlands Bank. As of March 8

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Federal Reserve swap debt to the Netherlands Bank was thus reduced to $65 million.

Demand for both spot and forward guilders swelled once again in the wake of the March gold rush. The Netherlands Bank purchased about $100 million through March 15 but swapped out a sizable amount of this intake—selling the dollars spot and repurchasing them forward—in order to mop up excess domestic liquidity. To absorb the bulk of the Dutch reserve gains, the Federal Reserve Bank of New York, acting for the account of the U.S. Treasury, concluded a special 45-day swap for $65 million with the Netherlands Bank. In addition to market swaps, the Netherlands Bank offered guilders forward on an outright basis, to limit the tendency for costly forward premiums to result in sales of spot dollars to the central bank. The Federal Reserve and the Treasury underwrote this operation, by each taking over $20.9 million equivalent of guilder forward commitments to the market—in the 1-, 2-, and 3-month maturity ranges. These combined operations by the Dutch and U.S. authorities helped to reassure the market and restrained further heavy inflows of funds.

The March 16–17 Washington meeting of the gold pool central banks marked a major turning point. (One of the agreements reached that weekend was a further increase in the swap facility between the Federal Reserve and the Netherlands Bank to $400 million.) Speculative influences abated, and the guilder market resumed a more normal trading pattern. The forward premium on guilders narrowed, restoring attractive yield incentives in favor of Euro-dollar investments, and a sizable reflux from the Netherlands soon developed. Moreover, commercial firms became buyers of foreign exchange to rebuild balances and to meet current requirements. With this reversal of pressures in the guilder market, the Netherlands Bank sold a substantial amount of spot dollars during the remainder of March and into April—replenishing those losses through purchases from the U.S. Treasury and the Federal Reserve.

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The Treasury used the guilders so obtained to liquidate its $65 million special swap with the Netherlands Bank in advance of maturity, and by the end of April the System had also purchased sufficient guilders to repay the last of its swap drawing with the Netherlands Bank. The U.S. authorities were also able to liquidate the forward guilder contracts falling due to the market in April and May. The last $10.7 million of these obligations were covered in early June, when the United States purchased from France part of the guilder proceeds of the French drawing from the IMF.

Moreover, additional conversions of guilders drawn from the IMF by France and the United Kingdom reduced the dollar balances of the Netherlands Bank to the extent that the bank in turn drew a total of $54.7 million under the swap line with the Federal Reserve to replenish its holdings. This was the first time the Netherlands Bank had drawn on its swap line with the Federal Reserve since the inception of the swap arrangement in 1962. In addition, the Netherlands Bank bolstered its dollar balances by selling $30 million of gold to the U.S. Treasury.

Although the guilder drifted lower in July and August, the Netherlands Bank took in sufficient dollars to make a $24.9 million swap repayment in early September. The downward drift of the spot rate continued into late summer, as the Dutch current account weakened and as Dutch funds moved into U.S. corporate securities. A slight rise in Euro-dollar rates in early October contributed to a further decline in the guilder rate so that by mid-October it had reached $0.2744¼—its lowest level since the 1961 revaluation. During the course of the decline, however, the Netherlands Bank provided only occasional and modest market support. In fact, in mid-October the bank was able to restore the full swap facility with the Federal Reserve to a standby basis by repaying the $29.8 million outstanding balance of the June drawing.

The downtrend ended when the money market in Amsterdam tightened in the latter half of October. However, the spot guilder

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rate held steady as an increasing demand for marks more or less outweighed the influence of the tight money market. At that time the Netherlands Bank increased its dollar balances by selling $25 million of guilders to the U.S. Treasury, which used them to make an advance repurchase of its obligation to the IMF. After the Bonn meeting on November 20-22, the demand for marks eased abruptly and the spot guilder strengthened.

Year-end liquidity requirements in the Netherlands resulted in a further firming of the guilder throughout December. Pressures were modest, however, and were relieved through market purchases of dollars by the Netherlands Bank, largely on a swap basis; the bank's swap purchases for December totaled $84 million. Just before Christmas the Netherlands Bank raised its discount rate ½ percentage point to 5 per cent, explaining that the move was made in response to the rise in rates abroad, a weaker trend in the Dutch current account, and the danger of renewed inflationary tensions in the Dutch economy.

ITALIAN LIRA

Italian official reserves increased substantially in 1967, as Italy's balance of payments showed unexpected strength during the year and the sterling crisis induced large repatriations of funds in the fall. The Federal Reserve absorbed the bulk of these inflows through swap drawings on the Bank of Italy totaling $500 million, which were still outstanding at the end of 1967. Early in 1968 the spot lira eased seasonally but not enough to provide the Federal Reserve with the opportunity to acquire lire in volume through market transactions. In late February and early March, however, the Federal Reserve acquired $75 million equivalent of Italian lire and $100 million equivalent of German marks from the proceeds of Canadian and U.S. drawings on the IMF; the marks were converted into lire with the Bank of Italy, and the combined proceeds were used to reduce the swap debt to the Bank of Italy to $325 million in early March.

As a new wave of speculation on the London gold market

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spread to the exchange markets in March, inflows of funds to Italy developed, but these quickly tapered off when the Bank of Italy permitted a rapid rise in the spot rate. The spot lira moved sharply lower after the Washington meeting, but there was no significant reflux of funds from Italy as that country's external position remained strong. With little change in the market pattern through April and with the usual spring and summer build-up of Italian official reserves in prospect, the Italian authorities asked the System to absorb $175 million of their dollar holdings by a swap drawing toward the end of April, again raising Federal Reserve swap debt in lire to $500 million.

During the spring, however, the increase in Italian official reserves did not develop as expected. A brief period of labor and student unrest, together with political uncertainties arising out of the resignation of Premier Moro, may have induced some outflows of funds. More important, however, were relatively easy credit and liquidity conditions, which encouraged large capital outflows, particularly to the Euro-bond market. Such outflows of long-term funds from Italy continued into the summer, largely offsetting the normal rise of reserves during the tourist season.

These developments, along with the French and U.K. drawings on the IMF in June, provided the opportunity for the Federal Reserve to liquidate the full amount of its outstanding swap obligations to the Bank of Italy by early July. The currency packages put together by the IMF for France and the United Kingdom provided for $369 million of lire. Of this amount, the System purchased $141.5 million equivalent directly from the drawing central banks, and the bulk of the remainder was converted into dollars by the Bank of Italy—depleting its dollar holdings. Moreover, in the absence of a large seasonal increase in reserves, it became clear that the swap drawing effected in anticipation of such reserve increases no longer seemed necessary. Therefore, the System purchased an additional $351.1 million equivalent of lire from the Bank of Italy and used these lire, together with some $7.6 million equivalent acquired from a cor-

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respondent and in the market, to liquidate completely its remaining swap debt to the Bank of Italy. The $750 million reciprocal currency facility was thereby placed on a fully standby basis. Subsequently in October, the Federal Reserve and the Bank of Italy agreed to increase their reciprocal currency facility by $250 million to $1 billion, bringing it fully into line with the System's reciprocal currency arrangements with other major countries.

As the Italian balance of payments moved into its period of seasonal weakness, the lira tended to ease through late October. In November the speculative upheaval in Europe brought the lira under selling pressure as Italians covered commitments in marks. But normal trading patterns resumed after the Bonn meeting, and the spot rate held narrowly above par in routine markets through the close of the year.

Since early 1965, the U.S. Treasury has assumed technical commitments in forward lire, related to the dollar/lira swaps transacted by the Italian authorities with the Italian commercial banks. Earlier operations of this type had been conducted in 1962-64. The Federal Reserve joined in these commitments in November 1965, under an authorization to participate to the extent of $500 million. No opportunity subsequently appeared to terminate these Federal Reserve commitments through a reversal in the Italian banks' forward positions. Consequently, in line with System policy of limiting exchange operations to relatively short-term needs, in April 1968 the Federal Reserve transferred to the Treasury the total of its technical forward commitments in lire, which amounted to $500 million. During the year the Treasury took on a small amount of new technical forward commitments through the Italian authorities. Such commitments, as they have fallen due, have been rolled over by the Italian authorities.

BELGIAN FRANC

The Belgian National Bank gained substantial amounts of dollars in 1967 during the Middle East conflict and the subsequent

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sterling crisis. The Federal Reserve drew on the swap line to absorb some of these gains, and at the opening of 1968, System drawings of $105.8 million equivalent were still outstanding. Moreover, the Federal Reserve and the U.S. Treasury jointly had $11.8 million of outstanding commitments from forward sales of francs to the market through the Belgian National Bank in late 1967, as part of the concerted central bank effort to maintain orderly markets after the devaluation of sterling. In addition to these short-term obligations the U.S. Treasury had issued a $60.4 million medium-term franc-denominated note to the Belgian authorities.

In late January 1968 the Belgian National Bank purchased $25 million from the System to cover moderate losses in market support and to meet anticipated dollar requirements of the Belgian Government. The Federal Reserve used the franc proceeds to reduce its swap indebtedness to $80.8 million. In February, however, market conditions were briefly reversed, and the Belgian central bank once again purchased dollars, which the System covered by drawing $7.5 million equivalent of francs on the swap. Subsequently, the System was able to make further reductions in its Belgian franc commitments. Late in February it acquired $13.5 million of francs from the Belgian National Bank, when that bank needed dollars, and $30.2 million equivalent following Canada's IMF drawing. Moreover, the System acquired $10 million of Belgian francs in connection with the U.S. Treasury's drawing on the IMF. These francs were used to make swap repayments, and by March 8 such commitments had been reduced to $34.5 million equivalent. The remainder of the Treasury's $15 million Belgian franc drawing was used in the liquidation of System and Treasury forward contracts, and on March 8, $5 million equivalent remained outstanding.

On March 7 the National Bank cut its discount rate by ¼ percentage point to 3¾ per cent to promote a lower level of interest rates in Belgium and to stimulate domestic economic activity. But in the following week a violent burst of speculation

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in the gold and foreign exchange markets pushed the franc to the National Bank's upper intervention point. By March 15 the bank had taken in nearly $60 million. The Federal Reserve absorbed most of this inflow by additional drawings on the swap line; by March 19, System drawings outstanding reached $80.1 million.

In the calmer atmosphere immediately following the Washington meeting, however, Belgian banks soon began to channel funds back into dollar investments. As the National Bank provided occasional support in the spot market and replenished its dollar holdings through purchases from the System, gradual progress was made in reducing Federal Reserve swap debt in francs. At one stage, however, the System covered $33 million of Belgian official dollar holdings through a swap drawing that was soon reversed, and by early June swap obligations were lowered to $43.1 million. Moreover, the System and the Treasury purchased sufficient francs from the Belgian National Bank to liquidate the remainder of their forward franc commitments with the market.

In June, the French and British drawings on the IMF contained Belgian francs that the drawing countries converted into dollars with the Belgian National Bank. After these conversions the Belgian central bank replenished its dollar balances by purchasing dollars from the Federal Reserve. The System thus obtained sufficient francs to liquidate completely its outstanding swap debt in francs, including a $21 million further drawing on the Belgian National Bank that had become necessary.

During the summer months, the spot Belgian franc continued to edge downward as a result of the economic recovery and the maintenance of relatively low levels of short-term interest rates in Belgium, compared with the attractive yields in the Euro-dollar market. In July the spot franc dipped below par ($0.02000), and the Belgian National Bank intervened to slow the decline. As part of this operation, that bank utilized $20 million under its Federal Reserve swap line, the first such utilization since

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1963. Selling of francs continued intermittently through late summer, especially during the period of heavy pressure on the French franc. The selling was not severe, however, and in the latter part of September the Belgian National Bank repaid the $20 million of credits drawn earlier under the swap line with the Federal Reserve—thus restoring the entire $225 million facility to a standby basis.

Selling pressures resumed near the end of September and carried into October. Part of the outflows from Belgium reflected spot sales of francs by some U.S. corporations, which refinanced in Belgium dollar credits employed earlier in direct investments in that country. During most of October the authorities held the spot franc moderately above its official floor ($0.019851) and covered market losses with drawings on the Federal Reserve swap line. By the end of October, drawings by the Belgian National Bank totaled $120.5 million.

November's speculative upheaval in Europe gave rise to heavy selling of francs. These pressures cost the Belgian authorities substantial support losses, although they lightened considerably in the quieter atmosphere after the Group of Ten meeting at Bonn. The Belgian central bank drew $65 million under its swap line with the Federal Reserve in November and another $5 million in December to cover the cost of official exchange market support. In early November and late December the U.S. Treasury purchased a total of $216 million of Belgian francs from the Belgian authorities; $60.4 million equivalent of these francs were used to redeem in advance of maturity a 2-year note issued to the National Bank in 1967 (leaving no further U.S. obligations in Belgian francs), and the balance was paid to the IMF to help reconstitute the U.S. gold tranche position with the Fund. For its part, the Belgian central bank used the dollar proceeds of the Treasury's franc purchases to replenish its reserves and repay a total of $183 million of its swap debt to the Federal Reserve—leaving $7.5 million still outstanding at the end of 1968.

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In the meantime, effective December 19, the Belgian National Bank had raised its discount rate to 4½ per cent from 3¾ per cent, to help stem short-term capital outflows and in response to evidence of money market strains associated with larger domestic borrowing requirements. Subsequently the spot franc strengthened, reaching par just before the year-end.

OPERATIONS IN OTHER CURRENCIES

In 1968 the National Bank of Denmark drew for the first time on its $100 million reciprocal currency arrangement with the Federal Reserve. In June the bank drew $25 million to meet cash requirements largely associated with conversion of the Danish krone portion of drawings on the IMF by France and the United Kingdom, and with some shifts of funds into dollars by Danish commercial banks. The drawing was repaid at maturity in September.

EURO-DOLLAR MARKET

Euro-dollar rates eased sharply in early 1968 despite the announcement on January 1 of the more stringent U.S. balance of payments program. Sizable reflows of funds from France, Germany, and Switzerland added to market supplies, and the heavy pressure on the Canadian dollar produced substantial shifts of funds to the Euro-dollar market. At the same time, continuing wide discounts on forward sterling made short-term investments in sterling unattractive, diverting more funds into Euro-dollars.

In early March the speculative upheaval in the gold market inflamed market apprehensions over currency parities and the general stability of the international financial structure. In this atmosphere the 3-month Euro-dollar rate jumped to 7 per cent, as funds were withdrawn to continental centers. Once again, however, the central banks of Germany, the Netherlands, and Switzerland, acting in concert with U.S. authorities, took measures to rechannel funds to the Euro-dollar market, and by mak-

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ing forward exchange available curbed the tendency for mounting forward premiums on major continental currencies to pull additional funds from the Euro-dollar market. The German Federal Bank, for example, resold nearly $800 million in swap operations through March 31. In addition, by March 15 the Netherlands Bank had made available $41.8 million of forward guilders—partly in swap transactions but also on an outright basis—and the Swiss National Bank had made available $56 million equivalent of forward francs. The Federal Reserve underwrote the forward commitments in guilders and Swiss francs and participated in the German operations by drawing $300 million on its swap line to absorb dollars from the Federal Bank, thereby providing cover for part of that bank's forward purchases of dollars.

News of the decisions taken at the Washington meeting in March strongly bolstered market confidence in currency parities. (At that time the Federal Reserve swap facility with the BIS under which dollars can be made available for placement in the Euro-dollar market was increased to $1 billion.) Prospects for stability were further improved late in the month by President Johnson's peace initiative and the agreement at Stockholm on a plan for SDR's. With these favorable developments in the background, Euro-dollar rates dropped back from their mid-March peaks.

Nevertheless, in April interest rates in the United States moved up, and those on Euro-dollars also rose, exerting a strong pull on short-term funds from Europe. Substantial amounts of funds flowed into the Euro-dollar market from the continent, notably from Germany where the 3-month interbank loan rate of about 3½ to 3¾ per cent per annum was indicative of the relatively low money market rates in that country. Moreover, in May large amounts of funds were drained from London as growing apprehensions over the pound led to sharply widened discounts on forward sterling, creating an unusually large interest incentive for shifting funds into dollars on a covered basis. At the same

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time the prevailing uncertainties discouraged uncovered investments in sterling. The outflows from France that began after mid-May seem also to have gone largely into dollars. On the demand side, branches of U.S. commercial banks took on an increased volume of Euro-dollar liabilities and passed the funds on to their head offices.

With the approach of midyear there were indications of a possible developing squeeze of exceptional stringency in Switzerland, and the Swiss National Bank acted to relieve potential strains through market swap operations with commercial banks. The Swiss central bank bought $430 million on a short-term basis from Swiss commercial banks and rechanneled the dollar proceeds to the Euro-dollar market, both directly and through the BIS—thereby averting stress in that market. The System backed up that operation by placing $111 million in the Euro-dollar market through the BIS. Expectations of easier monetary conditions in the United States appeared soon after the passage of the income tax surcharge, and once midyear pressures were out of the way, Euro-dollar rates eased considerably.

Early in July, with funds readily available after the midyear adjustments by continental banks, U.S. banks increased their borrowings of Euro-dollars sharply, with total takings reaching $7.0 billion. During the rest of the month these borrowings were allowed to run off somewhat, to a level of approximately $6.2 billion at the month-end, only to be followed by a further sharp rise in August. Late in August the outburst of speculation over a revaluation of the German mark resulted in a heavy flow of funds—some of which came out of Euro-dollars—into German official reserves. The German authorities moved quickly to push these funds out again through dollar/mark swap operations with German commercial banks. Moreover, heavy drains on French reserves also tended to supply funds to the market in early September. Consequently, funds remained readily available in the market, and interest rates declined somewhat.

During October the Euro-dollar market was generally much

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quieter, as were the exchange markets. On the other hand, interest rates began to move up in sympathy with somewhat firmer monetary conditions in the United States.

The speculative upheaval in the exchange markets in November caused only moderate strains in the Euro-dollar market, as the German Federal Bank once again moved immediately to rechannel a major portion of its dollar intake out into the market through swaps. Moreover, the Federal Bank's outright sales of forward marks in the first few days after the Bonn meeting encouraged additional reflows from Germany; this operation was backed up in New York, where the Federal Reserve sold forward marks.

Nevertheless, in early December Euro-dollar rates again began to move up sharply as U.S. domestic interest rates advanced. Pressures were apparent particularly in the shorter maturities—reflecting not only the generally tighter monetary conditions in the United States but also the usual seasonal pressures associated with year-end positioning by European banks. At the same time, exchange market sentiment regarding sterling was softening once again, and as discounts on forward sterling widened, a substantial incentive developed in favor of Euro-dollars over U.K. investments. To avoid any undue additional strain on the pound in view of approaching year-end repatriations of funds to the continent, the BIS, using dollars drawn on its swap line with the Federal Reserve, placed $80 million in the Euro-dollar market.

Although Euro-dollar rates rose further in the latter part of December, the increase reflected by and large the higher levels of U.S. rates (following the ¼ percentage point increase in Federal Reserve discount rates on December 18 and the further rise in prime loan rates of U.S. banks to 6¾ per cent), and conditions in the Euro-dollar market remained orderly. Reflows from Germany continued. At the same time, repatriations of funds by Swiss commercial banks for domestic year-end needs were again

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accommodated without undue strain on the market, thanks to the swap operations of the Swiss National Bank. The Swiss commercial banks undertook $746 million of swaps with the National Bank, and the Swiss central bank in turn rechanneled the dollars so obtained back into the Euro-dollar market, both directly and through the BIS. In the latter part of December, takings by branches of U.S. banks dropped sharply—to a total of about $6.0 billion—but U.S. corporations took a substantial amount of dollars out of Europe, partly in response to interest-rate considerations and partly to comply with provisions of the Commerce Department's program. □

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Special Studies by the Federal Reserve System

Reappraisal of the Federal Reserve discount mechanism. Work on the fundamental reappraisal of the Federal Reserve discount mechanism, originally announced in the 1965 ANNUAL REPORT, was highlighted in 1968 by the publication in July of the report of the System's Steering Committee. This report set forth the conclusions and recommendations of that committee, which had been appointed to reappraise and, where necessary, recommend redesign of Federal Reserve lending facilities. The report was adopted unanimously by the three members of the Board of Governors and the four Federal Reserve Bank Presidents who made up the Steering Committee. As of the end of 1968, however, the Board had not acted on the Committee's recommendations.

The Committee's report was made available in July so that comments and suggestions of the banking community and the public at large could be considered before the Board published any revision of Regulation A, its rule governing lending to member banks. Study of the comments and suggestions received and of the revisions deemed desirable in the published proposals is now under way. It is expected that a proposed revision of Regulation A will be published in the Federal Register in the spring of 1969, after which another period will be provided for general comment before a redesigned discount mechanism is implemented.

In addition to the final report of the Steering Committee itself, a summary report on the research undertaken in connection with the study and various of the individual research papers have been made available to the public upon request. A number of other research papers are in the process of publication; the availability of these papers will be announced in the Federal Reserve *Bulletin*. Papers currently available include the following:

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"Report on Research Undertaken in Connection with a System Study," by Bernard Shull
"The Discount Mechanism in Leading Industrial Countries Since World War II," by George Garvy
"Evolution of the Role and Functioning of the Discount Mechanism," by Clay J. Anderson
"A Review of Recent Academic Literature on the Discount Mechanism," by David Jones
"A Study of the Market for Federal Funds," by Parker Willis
"The Secondary Market for Negotiable Certificates of Deposit," by Parker Willis
"Reserve Adjustments by the Eight Major New York Banks During 1966," by Dolores Lynn
"Discount Policy and Open Market Operations," by Paul Meek
"The Redesigned Discount Mechanism and the Money Market," by Robert C. Holland and George Garvy
"Summary of the Issues Raised at the Academic Seminar on Discounting," by Priscilla Ormsby
"Discount Policy and Bank Supervision," by Benjamin Stackhouse

U.S. Government securities market study. The final report of the Steering Committee of the joint Treasury-Federal Reserve study of the U.S. Government securities market has been completed and forwarded to the U.S. Treasury and the Federal Open Market Committee.

Foreign operations of member banks. The principal part of the study of the foreign operations of member banks was completed in 1968. This part of the study provides a description and analysis of the broad range of international activities that have developed in U.S. commercial banks in recent years; the examination encompasses the operations and activities of head offices of U.S. banks and of their branches abroad, and the uses and roles of so-called Edge and Agreement corporations and their subsidiaries and affiliates. A second part of the study, which focuses principally on the supervisory responsibilities of the Federal Reserve in this area of banking activity, was still in preparation at the end of the year.

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Econometric model construction. Work continued during 1968 on the development of econometric models designed to trace the effects of monetary policy on economic activity. Further progress was made on the quarterly econometric model of the economy being developed by economists on the Board's staff and a group of university economists led jointly by Professor Modigliani of the Massachusetts Institute of Technology and Professor Ando of the University of Pennsylvania. Price and wage equations were added to the model, and there were some important revisions in the consumption and housing equations in the light of recent data. A start was made at using sectors of the model to help in analyzing the current economic situation. A paper explaining the response to fiscal policy in the model and one discussing "The Channels of Monetary Policy" as depicted in the model were presented at the December 1968 meetings of the American Economic Association and the American Finance Association.

The current version of the model, like the preliminary version completed last year, suggests that both monetary and fiscal policies have powerful effects on the economy, though the time lag between a change in policies and the economic effect of the change is longer for monetary policy than for fiscal policy. The response of money income to changes in monetary policies is stronger in this model than in a number of other models, while the response to changes in fiscal policies is about the same in the current version of this model as it is in other models.

Progress was also made during 1968 on the construction of models to explain in greater detail the behavior of institutions and individuals in financial markets. A preliminary version of a monthly model of the money market was developed, and a progress report on this research was presented at the December 1968 meetings of the Econometric Society. Work on the aggregate behavior of nonbank financial intermediaries also was carried forward.

In the development of econometric models to explain the portfolio adjustments of individual commercial banks, particular

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emphasis was placed this year on the estimation of time lags between changes in monetary policy and the effect of such changes on the size and composition of bank portfolios. Work in this area progressed to the point where it became possible to begin examining the implications of models developed for individual banks for the behavior of the banking system. □

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International Liquidity

In 1968 the Federal Reserve continued its active participation in discussions and negotiations concerning international liquidity. The main developments in this field related to Special Drawing Rights and gold.

Special Drawing Rights. In August 1964 the Ministers and the central bank Governors of the Group of Ten countries participating in the General Arrangements to Borrow, following completion of a study of international liquidity by their deputies, said in a published statement, "The continuing growth of world trade and payments is likely to entail a need for larger international liquidity. This need may be met by an expansion of credit facilities and, in the longer run, may possibly call for some new form of reserve asset." (The 1964 ministerial statement and the report prepared by the deputies were published in full in the Federal Reserve *Bulletin* for August 1964, pages 975–91.) In the following years further studies, followed by actual negotiations, focused on whether provision should in fact be made for the establishment of a new reserve asset, and if so, what form such a new asset should take. The further work done on these questions through 1967 was summarized in the ANNUAL REPORTS of the Board of Governors for 1965, 1966, and 1967.

Both questions were answered at the annual meeting of the Board of Governors of the International Monetary Fund held at Rio de Janeiro in September 1967 when approval was given to the Outline Plan for a system of Special Drawing Rights (SDR's). The Outline Plan stated the principles that would govern the creation, distribution, and use of SDR's. The text of the Outline Plan was published in the Federal Reserve *Bulletin* for November 1967 (pages 1877–82), and a summary of its main features and underlying principles appeared in the ANNUAL REPORT of the Board of Governors for 1967 (pages 311–17).

By early 1968 the Executive Directors of the IMF had advanced far toward completion of the task of putting the Outline Plan into legal language. The Ministers and the Governors of

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the central banks of the Group of Ten, meeting in Stockholm at the end of March 1968, reached a consensus on the most controversial issues posed by an amendment to the IMF Articles of Agreement, under which the SDR system would be established. The detailed text of the amendment was recommended by the Executive Directors of the Fund on April 16, 1968, and approved by the Fund's Board of Governors on May 31, 1968.

In the form in which the SDR plan was approved by the Fund, its fundamental principles were unchanged from those embodied in the Outline Plan of September 1967. When SDR's are created, they will be allocated among participants in proportion to each participant's quota in the Fund. A participating country may use SDR's to meet a balance of payments deficit or a decline in its reserves resulting from shifts by other countries in the composition of their reserves. The countries that are to receive the SDR's and therefore to provide convertible currency in return will be designated by the Fund, unless the country using SDR's has made arrangements under provisions that enable one or more participants to agree voluntarily to accept SDR's. Under the provisions governing voluntary agreements, a country may use any amount of SDR's (provided it has a need to do so, for either of the purposes just mentioned, and subject to later application of the reconstitution provision, which is explained below) to obtain its own currency held by other participants; a participant may also obtain currencies other than its own, provided that such exchanges of SDR's against currency would contribute to the accomplishment of one or more objectives prescribed by the Fund from a list of possible objectives specified in the amendment. The provisions governing voluntary agreements will be helpful to any country, but particularly to the United States, whose currency is held in significant amounts by other countries. Under the other procedure for using SDR's—that is, designation by the Fund of countries to receive SDR's from, and to provide currency to, a country using SDR's—the countries designated will normally be those having relatively strong balance of payments and reserve

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positions, although under certain circumstances the Fund may, in its designations, include countries outside this category.

Under the rules, each participating country is obligated to accept SDR's from other participants and to provide currency, only up to the point at which its holdings are equal to three times its cumulative allocations. This is what might be called each country's total "holding" obligation. (Any member may accept a larger amount, either *ad hoc* or by agreement with the Fund.) If a participating country went into deficit, and used all its cumulative allocations, then swung into strong and continuing surplus, it would have to accept SDR's—so long as it remained in the same payments position, and some other countries continued to use SDR's—until its total accumulation equaled three times its cumulative allocations.

The use of SDR's is subject to the reconstitution provision. This provision requires that during the initial basic period (which, like subsequent basic periods, is likely to be 5 years in length, although the Fund may decide otherwise) each participant's average holdings of SDR's must be at least 30 per cent of its average net cumulative allocations.

Under Article XVII of the existing Articles of Agreement, the amendment providing for the SDR facility, as well as for certain changes in existing Fund rules and practices, will enter into force when three-fifths of the members, having four-fifths of the total voting power in the Fund, have accepted it. Given the existing Fund membership of 111 countries, the three-fifths rule means that 67 member countries must accept the amendment before it can enter into force. As of April 11, 1969, 45 member countries, representing 62.4 per cent of the total voting power, had accepted the amendment. Of these 45 countries, 25, with 53.6 per cent of total quotas, had deposited the instruments of participation required by Section 1 of the proposed new Article XXIII. The United States was one of these 25, having been the first member country both to approve the amendment and to deposit its instrument of participation. With strong bipartisan support the bill authorizing U.S. acceptance of the SDR amend-

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ment and U.S. participation in the SDR system was approved by Congress late in the spring of 1968 and was signed into law by the President on June 19, 1968.

Gold: The two-tier system. From the early part of 1961 until March 1968 the dollar price of gold in the London gold market fluctuated within a relatively narrow range a little over $35 per ounce. This comparative price stability in the leading private market for gold, in a range just slightly above the official U.S. price of $35 per ounce, reflected a policy of official intervention to hold the price within that range. During most of this period such intervention was conducted on behalf of a consortium of countries known as the "gold pool." The gold pool and its market-intervention policy were established following a wave of speculative gold buying in October 1960 that pushed the price in the London market to more than $40 per ounce.

The devaluation of the pound sterling in November 1967 touched off a series of waves of speculative buying of gold, perhaps based initially on the belief that sterling devaluation might force devaluation of the U.S. dollar, that is, a rise in the official U.S. gold price, which would mean a rise in the price of gold in free markets. Speculative buying continued as expectations of a change in gold-pool intervention policies became widespread; rising losses from official gold stocks made the support policy seem less and less credible.

On Friday, March 16, 1968, the London gold market was closed by order of the Bank of England. On that weekend the Governors of the central banks of the seven active members of the gold pool—Belgium, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the United States—met in Washington. On March 17, they issued a communiqué. In this document the Governors announced termination of their sales of gold to private gold markets, reaffirmed adherence to the $35 per ounce price of gold for official transactions, and stated that ". . . as the existing stock of monetary gold is sufficient in view of the prospective establishment of the facility for Special Drawing Rights, they no longer feel it necessary to buy gold from the

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market." (For the full text of the communiqué, see the Federal Reserve *Bulletin* for March 1968, page 254.)

Central banks of other IMF countries were informed of the action and were invited to support the principles of the March communiqué. Assurance of support was subsequently received from the overwhelming majority of these monetary authorities.

The gold pool policy of stabilizing the market price of gold had been based on the belief that if the market price diverged too widely from the official price, doubts about the viability of the official price might arise abroad even in official circles. The fact that by mid-March 1968 the SDR plan was close to adoption meant that the monetary authorities of the world, taken as a group, would soon have available a means for increasing reserves that did not depend upon either additional stocks of gold or an increase in the value of existing stocks of gold. With the establishment of the SDR system there would therefore be less and less reason to question the possibility of maintaining the official price of gold at $35 per ounce. As a result there would also be much less reason than before for concern about the price of gold in free markets.

Establishment of the two-market system for gold in March 1968, although done under the pressure of a speculative crisis, was a logical step in the evolution of the international monetary system away from dependence on gold. As the Governor of the Bank of Italy pointed out in his annual report for 1967, "The Washington decisions, while meeting current needs, form part of the continuous process which has been reducing the monetary function of gold, first within individual economies and then on the international plane." To say that the monetary functions of gold will be further reduced under the SDR system is not to argue that gold should be, or will be, demonetized. It simply means that if, as may reasonably be expected, the bulk of future additions to international reserves consist of SDR's, the size of the gold component, relative to total reserves, will gradually decline over time. □

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Legislation Enacted

Elimination of gold reserve requirement against Federal Reserve notes. An Act of Congress approved March 18, 1968 (Public Law 90–269), eliminated the provision of Section 16 of the Federal Reserve Act under which the Federal Reserve Banks were required to maintain reserves in gold certificates of not less than 25 per cent against Federal Reserve notes.

Direct purchases by Federal Reserve Banks of Government obligations. An Act of Congress approved May 4, 1968 (Public Law 90–300), extended through June 30, 1970, the authority of Reserve Banks, under Section 14(b) of the Federal Reserve Act, to purchase direct or fully guaranteed obligations of the United States directly from the United States.

Truth in lending. The Truth in Lending Act (a portion of the Consumer Credit Protection Act), approved May 29, 1968 (Public Law 90–321), requires the Board of Governors to prescribe regulations to assure a meaningful disclosure of credit terms so that consumers will be able to compare more readily the various credit terms available and avoid the uninformed use of credit.

Special Drawing Rights certificates. The Special Drawing Rights Act, approved June 19, 1968 (Public Law 90–349), mainly for the purpose of authorizing U.S. participation in the Special Drawing Rights facility to be established within the International Monetary Fund, contains incidental provisions authorizing (1) the Secretary of the Treasury to sell to the Reserve Banks certificates against the Special Drawing Rights of the United States and (2) the Reserve Banks to use such certificates for specified purposes.

Defense production. An Act of Congress approved July 1, 1968 (Public Law 90–370), extended through June 30, 1970, the termination date of certain provisions of the Defense Pro-

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duction Act of 1950, including Section 301, which is the basis for guarantees of loans for defense production.

Bank protection. The Bank Protection Act of 1968, approved July 7, 1968 (Public Law 90–389), requires the Board of Governors and the other Federal supervisors of financial institutions whose deposits are federally insured to establish minimum standards with respect to installation, maintenance, and operation of security devices and procedures for use by such institutions in guarding against loss of funds by theft.

Margin requirements for securities traded over the counter. An Act of Congress approved July 29, 1968 (Public Law 90–437), amended the Securities Exchange Act of 1934 to authorize the Board of Governors (1) to extend the coverage of margin requirements to credit that banks and other lenders may extend for the purpose of purchasing and carrying securities traded over the counter (as distinguished from those traded on the national securities exchanges) and (b) to permit brokers and dealers to extend credit on such securities, subject to margin requirements.

"Tender offers" with respect to securities of State-chartered member banks. An Act of Congress approved July 29, 1968 (Public Law 90–439), amended the Securities Exchange Act of 1934 to require disclosure of certain information with respect to (1) acquisitions of more than 10 per cent of a class of equity securities registered pursuant to the 1934 Act, (2) the making of so-called "tender offers" (or solicitations favoring or opposing such offers), and (3) the replacement of a majority of the directors of an issuer in connection with such acquisitions or tender offers. Under the 1934 Act, the Board of Governors is responsible for implementing these requirements with respect to registered securities issued by State-chartered member banks.

Housing and urban development; real estate loans by national banks; member bank underwriting of certain municipal revenue bonds. The Housing and Urban Development Act of 1968, ap-

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proved August 1, 1968 (Public Law 90–448), amended various laws relating to housing and urban development and enacted several new laws designed to assist in providing housing for low and moderate income families. Numerous provisions of the Act relate directly to the activities of the Reserve Banks and their member banks. In summary, such provisions:

(1) make the Reserve Banks depositaries for the Government National Mortgage Association, a new Federal instrumentality;

(2) expand the powers of national banks in the area of real estate loans by amending Section 24 of the Federal Reserve Act (a) to authorize such banks, without limitation, to make loans or purchase obligations guaranteed by the Secretary of Housing and Urban Development under the portion of the Act described as the "New Communities Act of 1968," (b) to authorize such banks to purchase a participation (as distinguished from the entire interest) in a loan secured by a first lien on improved real estate or on forest tracts, (c) to extend from 24 to 36 months the permissible maturity of loans by such banks to finance commercial building construction, and (d) to authorize such banks to accept a second lien on real estate as security for a loan if the bank relies primarily on the creditworthiness of the borrower or other security as collateral for repayment of the loan;

(3) expand the powers of national banks under paragraph Seventh of Section 5136 of the Revised Statutes (and to that extent remove Federal limitations on the power of State-chartered member banks) to authorize such a bank (a) to underwrite and deal in (i) obligations, participations, or instruments of or issued by the Government National Mortgage Association, without limitation on amount, and (ii) so-called "revenue obligations" of investment grade that are issued by a State or a political subdivision thereof, or an agency of either, for housing, university, or dormitory purposes, in an amount not to exceed, as to each such issuer, 10 per cent of the bank's capital and surplus, and (b) to purchase for its own account stock issued by corpora-

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tions created pursuant to Title IX of the Act for the purpose of providing housing for low or moderate income families and to invest in partnerships or joint ventures formed by such corporations pursuant to that Title; and

(4) expand the powers of national banks by adding a paragraph Ninth to Section 5136 of the Revised Statutes to authorize such banks to issue securities guaranteed by the Government National Mortgage Association backed by a pool of mortgages insured under the National Housing Act or Title V of the Housing Act of 1949, or insured or guaranteed under the Servicemen's Readjustment Act of 1944 or chapter 37 of title 39 of the United States Code. (In connection with the latter, Section 21 of the Banking Act of 1933 was amended to remove a criminal prohibition against banks issuing such securities.)

Interest on deposits; reserves of member banks; open market operations; Reserve Bank advances. An Act of Congress approved September 21, 1968 (Public Law 90–505), extended through September 21, 1969, the flexible authority of the Board of Governors, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board in regulating the maximum rates of interest or dividends payable by insured banks and savings and loan associations on deposit or share accounts. The Act makes permanent the authority of the Reserve Banks to purchase in the open market direct or fully guaranteed obligations of Federal agencies and the authority of the Board to require member banks to maintain a reserve ratio for time deposits of not less than 3 and not more than 10 per cent. The Act also grants (1) the supervisory agencies referred to above the authority to prescribe regulations governing all aspects of payment of interest on deposits, including advertising, and (2) the Reserve Banks the authority to make advances (a) to member banks on the security of any obligations eligible for Reserve Bank purchase (including Federal agency issues), and (b) to any person on the security of obligations of Federal agencies (previously, the security was limited to direct obligations of the United States).

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Legislative Recommendations

Lending authority of Federal Reserve Banks. Under present law, when a member bank borrows from its Reserve Bank on collateral other than obligations that are eligible for purchase by Reserve Banks (mainly U.S. Government obligations) or short-term promissory notes of the member bank's customers that meets certain "eligibility" requirements, it must pay interest at a rate not less than ½ of 1 percentage point higher than the Reserve Bank's basic discount rate. For several years the Board of Governors has urged legislation that would permit a member bank, subject only to regulations by the Board, to borrow on any security satisfactory to its Reserve Bank without the necessity of paying a higher rate of interest simply because the security is "ineligible" for the basic rate.

The need for enactment of such legislation has increased as member banks have reduced their holdings of U.S. Government securities and broadened the scope of their lending in order to meet the expanding credit demands of their customers. Many of these loans cannot qualify as security for Federal Reserve advances except at the "penalty" rate of interest, although their quality may be equal to that of presently "eligible" paper.

To enable the Federal Reserve System always to be in a position to carry out promptly and efficiently one of its principal responsibilities—the extension of credit assistance to enable the banking system to meet the legitimate needs of the economy—and to avoid penalizing those uses of credit that generate sound paper that is not "eligible" under existing law, the Board again urges legislation that would authorize the Reserve Banks to extend credit on sound collateral without regard to the present "eligibility" provisions.

"Par clearance." Most banks pay the face amount of all checks presented to them for payment; this practice is frequently described as "par clearance." In a few areas of the country, how-

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ever, many small banks deduct a so-called "exchange charge" from the face amount of checks presented by mail and remit only the balance. In such circumstances the drawee bank shifts all or a portion of the expense incurred by it in connection with the collection process to the payee of the check or to an indorsee. In the Board's view there is no justification for the increased costs, delays, and inefficiencies that result when banks do not pay all checks at their face amount.

The trend of legislation in this area at the State level has been toward requiring banks to pay the face amount of checks drawn on them. In recent years, Florida, Minnesota, Mississippi, North Dakota, and South Dakota have enacted legislation along these lines. Despite the progress in this direction that has been made at the State level, the Board favors enactment by the Congress of a requirement that all federally insured banks pay at par all checks drawn on them.

Reserve requirements. For several years the Board has favored legislation that would (1) authorize it to fix required reserve percentages on a graduated basis according to the amount of a bank's deposits and (2) make such requirements applicable to all federally insured banks (rather than to member banks only).

The reasons for such changes in the structure of bank reserve requirements have become stronger with the passage of time. Thus, in the Board's judgment, the differences between reserve city and "country" banks, in both size and functions, have decreased substantially, and the division of member banks into such categories has become arbitrary to the point where such division is a major obstacle to the development of a more equitable system of reserve requirements. Since deposits in nonmember banks are part of the country's money supply just as are those in member banks, nonmember banks should be subject to the federally imposed reserve requirements applicable to member banks.

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Under present law, the Board has authority to establish a system of graduated reserves. However, implementation of such authority on the most rational and equitable basis is impaired by the outmoded differentiation between reserve city and "country" banks and by the lack of authority in the Board to make reserve requirements applicable to nonmember banks.

In the event that the Congress should consider that extending the coverage of federally imposed reserve requirements to nonmember banks is impractical at this time—even if accompanied by granting such banks access to Federal Reserve discount facilities —the Board recommends that the Congress remove the impediment to adoption by the Board of the most rational and equitable reserve requirements for member banks. This would be accomplished by legislation establishing a system of graduated reserve requirements on the basis of the amount of a bank's demand deposits.

Purchase of obligations of foreign governments by Federal Reserve Banks. Under present law, balances that the Reserve Banks acquire in foreign central banks in connection with the System's foreign currency operations may be invested in prescribed kinds of bills of exchange and acceptances. On occasion these investment media have not been conveniently available. To facilitate economic use of such balances, for several years the Board has favored enactment of legislation that would permit Reserve Banks to invest in obligations of foreign governments or monetary authorities that will mature within 12 months and are payable in a convertible currency.

Loans to bank examiners. Title 18 of the U.S. Code, "Crimes and Criminal Procedure," prohibits loans to a bank examiner by any bank that the examiner is authorized to examine. For several years the Board has favored modification of this prohibition to permit, under appropriate safeguards, a federally insured bank to make a home mortgage loan to a bank examiner in an amount not exceeding $30,000.

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Bank holding companies and bank subsidiaries. In 1968 the Board engaged in an intensive study of the problems presented by the recent trend toward the formation of one-bank holding companies. The Board has favored inclusion of one-bank holding companies within the coverage of the Bank Holding Company Act since before its original enactment in 1956, and the Board continues to believe that such companies should be brought within the purview of the Act.

However, its recent study has led the Board to conclude that expansion of the coverage of the Act should be accompanied by legislation under which banks would have greater freedom to offer new services either directly, or through wholly owned subsidiaries, or through affiliates in a holding company system, subject to administrative approval of entry and of acquisitions to prevent involvement in operations that would be inconsistent with the purposes of the Act.

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Litigation

Collateral Lenders Committee et al.* v. *Board of Governors of the Federal Reserve System. On February 1, 1968, the Board announced its adoption of Regulation G, "Credit by Persons Other Than Banks, Brokers, or Dealers for the Purpose of Purchasing or Carrying Registered Equity Securities," effective March 11, 1968. On March 1, 1968, plaintiffs, a group of lenders whose loans for the purpose of purchasing registered equity securities would thereby become subject to the margin requirements applicable to banks, brokers, and dealers, sought a declaratory judgment that Regulation G was invalid and unconstitutional, and a permanent injunction against the Board's enforcement of Regulation G as to plaintiffs.

A 5-day temporary restraining order against the Board was granted on March 1. Extension of this order beyond March 5 was refused by the Court, and on March 11, 1968, the effective date for the Board's Regulation G, the Court denied plaintiffs' motion for preliminary injunction and ruled that Section 7(d) of the Securities and Exchange Act of 1934, 15 U.S.C.A. § 78g(d), pursuant to which the Board promulgated Regulation G, as well as Regulation G itself, was constitutional and valid. The Court concluded that in promulgating Regulation G the Board had fully complied with applicable administrative law requirements and that there had been no violation of plaintiffs' procedural or substantive due process of law rights; it also concluded that plaintiffs had failed to establish any irreparable injury by application to them of Regulation G and that any injury to plaintiffs was overweighed by the immediate and irreparable injury that would occur to the national economy and the investing public if the effectiveness of Regulation G were delayed. Certain of the plaintiffs appealed to the U.S. Court of Appeals for the Second Circuit the lower court's order in favor of the Board. These appellants voluntarily dismissed their appeal on September 25, 1968, and an order of dismissal was entered by the Court of Appeals.

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United States* v. *Girard Trust Bank and The Fidelity Bank, both of Philadelphia, Pennsylvania. On August 12, 1968, the Board approved a merger of Girard Trust Bank, Philadelphia, Pennsylvania, and The Doylestown National Bank & Trust Company, Doylestown, Pennsylvania, and the merger of The Fidelity Bank, Philadelphia, Pennsylvania, and Doylestown Trust Company, Doylestown, Pennsylvania. On September 10, 1968, suits were filed on behalf of the United States to enjoin consummation of the proposed mergers, the complaint in each case alleging that consummation of the merger would violate Section 7 of the Clayton Act in that such consummation "may be substantially to lessen competition or tend to create a monopoly." However, the issues raised by the suits were rendered moot by action of the Girard Trust Bank and The Fidelity Bank, in November 1968, in terminating the merger agreements.

Suits arising out of closing of San Francisco National Bank. On January 22, 1965, the San Francisco National Bank, San Francisco, California (SFNB), was declared insolvent by the Comptroller of the Currency, and the Federal Deposit Insurance Corporation was appointed receiver of the bank. The Federal Reserve Bank of San Francisco, pursuant to the provisions of Section 10(b) of the Federal Reserve Act and of the Board's Regulation A, had provided credit assistance to SFNB, through advances and discounts. During the latter part of 1964 and the first few weeks of 1965, the Federal Reserve Bank, pursuant to the statute and regulation cited, received collateral for these advances from SFNB in the form of certain Government bonds and promissory notes.

In November 1965 certain depositors of SFNB filed suit against the Federal Reserve Bank in the U.S. District Court, San Francisco, alleging superior rights to the collateral held by the Federal Reserve Bank and seeking a declaration of unlawful preference, subordination, and constructive trust. On motion filed by the Federal Reserve Bank, the District Court dismissed the

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complaints—holding, in part, that in making advances to SFNB the Federal Reserve Bank was acting primarily as an instrumentality of the United States and thus was protected from suit by the Federal Tort Claims Act and that the exercise of the discount function by the Federal Reserve Bank was the performance of a discretionary governmental function that was not subject to judicial review. Four of the cases decided in favor of the Federal Reserve Bank were appealed to the U.S. Court of Appeals for the Ninth Circuit and argued before that Court in March 1968.

While these and numerous other cases involving parties other than the Federal Reserve Bank, but also arising out of the closing of SFNB, were pending before the Court of Appeals, negotiations were undertaken looking to a settlement of the several cases. In December 1968 the Federal Reserve Bank, together with the Federal Deposit Insurance Corporation, numerous creditors of SFNB, and other parties involved, signed an agreement of settlement that assured creditors of the SFNB approximately 52 cents on the dollar and provided for dismissal of the appeals involving the Federal Reserve Bank and other litigants. The agreement was approved by the U.S. District Court on December 26, 1968, and on January 13, 1969, an order dismissing the pending appeals was entered by the U.S. Court of Appeals.

Baker Watts & Co. et al.* v. *Saxon. Following rejection by the U.S. District Court of the District of Columbia of an interpretation by the Comptroller of the Currency purporting to authorize national banks to underwrite and deal in governmental securities known as "revenue bonds" (see ANNUAL REPORTS for 1966, page 314, and 1967, page 335), an appeal from that decision was taken to the U.S. Court of Appeals for the District of Columbia by the Port of New York Authority, one of the plaintiffs in the lower court. In March 1968 the Court of Appeals affirmed the District Court's decision.

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Bank Supervision and Regulation by the Federal Reserve System

Examination of member banks. National banks, all of which are members of the Federal Reserve System, are subject to examination by direction of the Board of Governors or the Federal Reserve Banks. However, as a matter of practice they are not examined by either, because the law charges the Comptroller of the Currency directly with that responsibility. The Comptroller provides reports of examination of national banks to the Board of Governors upon request, and each Federal Reserve Bank purchases from the Comptroller copies of reports of examination of national banks in its district.

State member banks are subject to examinations made by direction of the Federal Reserve Bank of the district in which they are located by examiners selected or approved by the Board. The established policy is to conduct at least one regular examination of each State member bank, including its trust department, during each calendar year, with additional examinations if considered desirable. In most States joint examinations are made in cooperation with the State banking authorities, while in others alternate independent examinations are made. All but 37 of the 1,262 State member banks were examined during 1968.

The Board of Governors makes its reports of examination of State member banks available to the Federal Deposit Insurance Corporation, and the Corporation in turn makes its reports of insured nonmember State banks available to the Board upon request. Also, upon request, reports of examination of State member banks are made available to the Comptroller of the Currency.

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In its supervision of State member banks, the Board receives, reviews, and analyzes reports of examination of State member banks and coordinates and evaluates the examination and supervisory functions of the System. It passes on applications for admission of State banks to membership in the System; administers the disclosure requirements of the Securities Exchange Act of 1934 with respect to equity securities of banks within its jurisdiction that are registered under the provisions of the 1934 Act; and under provisions of the Federal Reserve Act and other statutes, passes on applications for permission, among other things, to (1) merge banks, (2) form or expand bank holding companies, (3) establish domestic and foreign branches, (4) exercise expanded powers to create bank acceptances, (5) establish foreign banking and financing corporations, and (6) invest in bank premises an amount in excess of 100 per cent of a bank's capital stock.

By Act of Congress approved September 12, 1964 (Public Law 88–593), insured banks are required to inform the appropriate Federal banking agency of any changes in control of management of such banks and of any loans by them secured by 25 per cent or more of the voting stock of any insured bank. In 1968, 48 such changes in ownership of the outstanding voting stock of State member banks were reported to the Reserve Banks as changes in control of these member banks. In addition, reports of 24 loans secured by 25 per cent or more of the stock of a State member bank were forwarded to the System. Arrangements continue among the three Federal supervisory agencies for appropriate exchanges of reports received by them pursuant to the Act. The Reserve Banks send copies of all the reports they receive to the appropriate district office of the Federal Deposit Insurance Corporation, the Regional Administrator of National Banks (Comptroller of the Currency), and the State bank supervisor.

Upon receipt of reports involving changes in control of State member banks, the Reserve Banks are under instructions to for-

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ward such reports promptly to the Board, together with a statement (1) that the new owner and management are known and acceptable to the Reserve Bank or (2) that they are not known and that an investigation is being made. The findings of any investigation and the Reserve Bank's conclusions based on such findings are forwarded to the Board.

By Act of Congress approved July 3, 1967 (Public Law 90–44), each member bank of the Federal Reserve System is required to include with (but not as part of) each report of condition and copy thereof a report of all loans to its executive officers since the date of submission of its previous report of condition. Since the Board's 1967 ANNUAL REPORT was released, member banks have submitted the following data as required by law:

Period covered (condition report dates)	Total loans to executive officers		Range of interest rate charged (per cent)[1]
	Number	Amount (dollars)	
Oct. 4, 1967—Dec. 30, 1967	8,211	14,364,199.32	1–12
Dec. 31, 1967—Apr. 18, 1968	8,804	16,039,841.36	2–18
Apr. 19, 1968—June 29, 1968	7,264	14,861,950.15	2–18
June 30, 1968—Oct. 20, 1968	9,886	19,861,431.82	3–18
Oct. 21, 1968—Dec. 31, 1968	(2)	(2)	(2)

[1] The rate of 18 per cent reflects the inclusion of rates of 1½ per cent per month charged on credit-card and check-credit plans.
[2] Compilation of data for condition report of Dec. 31, 1968, has not been completed.

Federal Reserve membership. As of December 31, 1968, member banks accounted for 44 per cent of the number of all commercial banks in the United States and for 63 per cent of all commercial banking offices, and they held approximately 82 per cent of the total deposits in such banks. State member banks accounted for 14 per cent of the number of all State commercial

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banks and 40 per cent of the banking offices, and they held 60 per cent of total deposits in State commercial banks.

Of the 5,978 banks that were members of the Federal Reserve System at the end of 1968, there were 4,716 national banks and 1,262 State banks. During the year there were net declines of 42 national and 51 State member banks. The decline in the number of national banks reflected 54 conversions to branches incident to mergers and absorptions and 12 conversions to nonmember banks. The decline was offset in part by the organization of 14 new national banks and the conversion of 6 nonmember banks to national banks. The decrease in State member banks reflected mainly seven conversions to branches incident to mergers and absorptions and 40 withdrawals from membership.

At the end of 1968 member banks were operating 14,352 branches, 703 more than at the close of 1967; this included 684 *de novo* establishments.

Detailed figures on changes in the banking structure during 1968 are shown in Table 19, pages 388 and 389.

Bank mergers. Under Section 18(c) of the Federal Deposit Insurance Act (12 U.S.C. 1828(c)), the prior written consent of the Board of Governors of the Federal Reserve System must be obtained before a bank may merge, consolidate, or acquire the assets and assume the liabilities of another bank if the acquiring, assuming, or resulting bank is to be a State member bank.

In deciding whether to approve an application, the Board is required by Section 18(c) to consider the impact of the proposed transaction on competition, the financial and managerial resources and prospects of the existing and proposed institution, and the convenience and needs of the community to be served. The Board is precluded from approving "any proposed merger transaction which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any

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part of the United States." A proposed transaction "whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade," may be approved only if the Board is able to find that the anticompetitive effects of the transaction would be clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

Before acting on each application the Board must request reports from the Attorney General, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on the competitive factors involved in each transaction. The Board in turn responds to requests by the Comptroller or the Corporation for reports on competitive factors involved when the acquiring, assuming, or resulting bank is to be a national bank or an insured nonmember State bank.

During 1968 the Board disapproved one and approved 14 applications, and it submitted 99 reports on competitive factors to the Comptroller of the Currency and 73 to the Federal Deposit Insurance Corporation. As required by Section 18(c) of the Federal Deposit Insurance Act, a description of each of the 14 applications approved by the Board, together with other pertinent information, is shown in Table 21 on pages 392 through 413.

Statements and orders of the Board with respect to all bank merger applications, whether approved or disapproved, are released immediately to the press and the public and are published in the Federal Reserve *Bulletin*. These statements and orders set forth the factors considered, the conclusions reached, and the vote of each Board member present.

Bank holding companies. During 1968, pursuant to Section 3(a)(1) of the Bank Holding Company Act of 1956, the Board approved nine applications for prior approval to become a bank holding company. Pursuant to the provisions of Section 3(a)(3)

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of the Act, the Board approved applications by 19 bank holding companies, involving acquisition of shares in 33 banks, and denied two applications. To provide necessary current information, annual reports for 1967 were obtained from all registered bank holding companies pursuant to the provisions of Section 5(c) of the Act.

Statements and orders of the Board with respect to applications to form or to expand bank holding companies, whether approved or disapproved, are released immediately to the press and the public and are published in the Federal Reserve *Bulletin*. These statements and orders set forth the factors considered, the conclusions reached, and the vote of each Board member present.

Foreign branches of member banks. At the end of 1968, 26 member banks had in active operation a total of 373 branches in 57 foreign countries and overseas areas of the United States; 14 national banks were operating 353 of these branches, and 12 State member banks were operating 20 such branches. The number and location of these foreign branches were as shown in the tabulation on the opposite page.

Under the provisions of the Federal Reserve Act (Section 25 as to national banks and Sections 9 and 25 as to State member banks), the Board of Governors during the year 1968 approved 96 applications made by member banks for permission to establish branches in foreign countries and overseas areas of the United States.

During the year, member banks opened branches overseas as follows: The Valley, Anguilla; Buenos Aires, Cordoba, and Rosario, Argentina; Marsh Harbour and Nassau, Bahamas; Bridgetown, Barbados; Liège, Belgium; Road Town, Tortola, British Virgin Islands; Concepción, Chile; Barranquilla, Bogota, Cali, and Medellin, Colombia; Salcedo and Santiago, Dominican Republic; London, England; Guayaquil and Quito, Ecuador; Paris, France; Duesseldorf, Frankfurt am Main, and Munich, Germany; Athens and Piraeus, Greece; Guatemala City,

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[Table referred to on opposite page.]

Latin America	*177*
Argentina	33
Bahamas	8
Barbados	1
Bolivia	2
Brazil	15
Chile	18
Colombia	17
Dominican Republic	7
Ecuador	7
El Salvador	1
Guatemala	3
Guyana	1
Honduras	3
Jamaica	2
Leeward Islands	3
Mexico	5
Nicaragua	2
Panama	21
Paraguay	6
Peru	8
Trinidad and Tobago	5
Uruguay	2
Venezuela	4
Virgin Islands (British)	3
Europe	*80*
Austria	1
Belgium	9
Germany	14
France	7
Greece	5
Ireland	2
Italy	2
Europe—Cont.	
Netherlands	5
Switzerland	3
United Kingdom	32
Africa	*3*
Liberia	1
Nigeria	2
Near East	*6*
Dubai	1
Lebanon	3
Saudi Arabia	2
Far East	*72*
Hong Kong	12
India	11
Indonesia	4
Japan	12
Korea	3
Malaysia	5
Okinawa	2
Pakistan	4
Philippines	5
Singapore	8
Taiwan	2
Thailand	2
Vietnam	2
U.S. overseas areas and trust territories	*35*
Canal Zone	2
Guam	2
Puerto Rico	17
Truk Islands	1
Virgin Islands	13
Total	**373**

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Guatemala; Comayaguela, Honduras; Hong Kong; Bombay and Madras, India; Djakarta, Indonesia; Dublin, Ireland; Kingston, Jamaica; Amsterdam and Rotterdam, Netherlands; Belfast, Northern Ireland; Changuinola and Panama City, Panama; Asunción, Paraguay; Lima, Peru; San Juan, Puerto Rico; Basseterre and Sandy Point, St. Kitts; San Fernando, Trinidad and Tobago; Charlotte Amalie, Christiansted, and Frederiksted, Virgin Islands.

Acceptance powers of member banks. During the year the Board approved the applications of five member banks, pursuant to the provisions of Section 13 of the Federal Reserve Act, for increased acceptance powers. Four banks were granted permission to accept drafts or bills of exchange drawn for the purpose of furnishing dollar exchange as required by the usages of trade in such countries, dependencies, or insular possessions of the United States as may have been designated by the Board of Governors. One bank was granted permission to accept commercial drafts or bills up to 100 per cent of paid-up and unimpaired capital stock and surplus.

Foreign banking and financing corporations. At the end of 1968 there were five corporations operating under agreements with the Board pursuant to Section 25 of the Federal Reserve Act relating to investment by member banks in the stock of corporations engaged principally in international or foreign banking. Three of these "agreement" corporations have head offices in New York, and one has its head office in Miami, Florida. The four corporations were examined during the year by examiners for the Board of Governors. The fifth "agreement" corporation is a national bank in the Virgin Islands and is owned by a State member bank in Philadelphia.

During 1968, under the provisions of Section 25(a) of the Federal Reserve Act, the Board issued final permits to 10 corporations to engage in international or foreign banking or other international or foreign financial operations, and 10 corporations

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commenced operations. At the end of the year there were 56 corporations in active operation under Section 25(a): 30 have home offices in New York City; five in Philadelphia; three each in Boston, Chicago, and San Francisco; two each in Detroit and Seattle; and one each in Cleveland, Pittsburgh, Norfolk, Winston-Salem, Atlanta, Dallas, Los Angeles, and Portland. One of the corporations in Seattle has five active branches in Hong Kong, and one of the corporations in Philadelphia operates a branch in London. Examiners for the Board of Governors examined 49 of these corporations during 1968.

Bank Examination Schools and other training activities. In 1968 the Bank Examination School conducted four sessions of the School for Examiners, five sessions of the School for Assistant Examiners, and one session of the School for Trust Examiners. The Bank Examination School was established in 1952 by the three Federal bank supervisory agencies, and since 1962 has been conducted jointly by the Federal Reserve System and the Federal Deposit Insurance Corporation.

Since the establishment of this program, 3,769 persons have attended the various sessions. This number includes representatives of the Federal bank supervisory agencies; the State Banking Departments of California, Connecticut, Idaho, Indiana, Kentucky, Louisiana, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia, Washington, and Wyoming; the Treasury Department of the Commonwealth of Puerto Rico; and 17 foreign countries.

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Federal Reserve Banks

Examination of Federal Reserve Banks. The Board's Division of Federal Reserve Bank Operations examined the 12 Federal Reserve Banks and their 24 branches during the year, as required by Section 21 of the Federal Reserve Act. In conjunction with the examination of the Federal Reserve Bank of New York, the Board's examiners also audited the accounts and holdings related to the System Open Market Account and foreign currency operations conducted by that Bank in accordance with policies formulated by the Federal Open Market Committee, and rendered reports thereon to the Committee. The procedures followed by the Board's examiners were surveyed and appraised by a private firm of certified public accountants, pursuant to the policy of having such reviews made on an annual basis.

Earnings and expenses. The accompanying table summarizes the earnings, expenses, and distribution of net earnings of the Federal Reserve Banks for 1968 and 1967.

EARNINGS, EXPENSES, AND DISTRIBUTION OF NET EARNINGS OF FEDERAL RESERVE BANKS, 1968 AND 1967

In thousands of dollars

Item	1968	1967
Current earnings	2,764,446	2,190,404
Current expenses	242,350	220,121
Current net earnings	2,522,096	1,970,283
Net addition to current net earnings	8,520	2,094
Net earnings before payments to U.S. Treasury	2,530,616	1,972,377
Dividends paid	36,960	35,028
Payments to U.S. Treasury (interest on F.R. notes)	2,463,629	1,907,498
Transferred to surplus	30,027	29,851

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Current earnings of $2,764 million in 1968 were 26 per cent higher than in 1967, reflecting increases of $501 million on U.S. Government securities, $51 million on foreign currencies, and $22 million on discounts and advances.

Current expenses were $22 million more than in 1967, or 10 per cent. Statutory dividends to member banks amounted to $37 million, an increase of $2 million from 1967. This rise in dividends reflected an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Federal Reserve Banks.

Payments to the Treasury as interest on Federal Reserve notes totaled $2,464 million for the year, compared with $1,907 million in 1967. This amount consists of all net earnings after dividends and the amount necessary to bring surplus to the level of paid-in capital.

At the request of the Treasury Department, Bureau of the Mint, the System began separating the silver coin from clad coin (the three-layered coin that contains no silver, which was authorized by the Coinage Act of 1965) of the 10¢ and 25¢ denominations. The separation process at the Reserve Banks yielded approximately 501 million silver coins at a face value of about $65 million. The cost to the System for performing the operation, including the acquisition and maintenance of equipment, was $320,000, of which $120,000 was expended for the purchase of coin separating machines in addition to those furnished by the Mint.

Expenses of the Federal Reserve Banks also include costs of $717.98 for six regional meetings incident to the Treasury Department savings bond program.

A detailed statement of earnings and expenses of each Federal Reserve Bank during 1968 is shown in Table 7 on pages 374 and 375 and a condensed historical statement in Table 8 on pages 376 and 377.

Holdings of loans and securities. The accompanying table shows holdings, earnings, and average interest rates on loans and securities of the Federal Reserve Banks during the past 3 years.

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Average daily holdings of loans and securities during 1968 amounted to $51,935 million—an increase of $5,518 million over 1967. Holdings of acceptances decreased $31 million, whereas there were increases of $5,158 million in U.S. Government securities and $391 million in discounts and advances.

The average rates of interest on holdings were up from 4.33 per cent to 5.22 per cent on discounts and advances, from 4.62 per cent to 5.75 per cent on acceptances, and from 4.66 per cent to 5.17 per cent on U.S. Government securities.

RESERVE BANK EARNINGS ON LOANS AND SECURITIES, 1966–68

Item and year	Total	Discounts and advances	Acceptances	U.S. Govt. securities[2]
	In millions of dollars			
Average daily holdings:[1]				
1966	42,612	649	117	41,846
1967	46,417	178	104	46,135
1968	51,935	569	73	51,293
Earnings:				
1966	1,885.8	29.2	5.8	1,850.8
1967	2,164.6	7.7	4.8	2,152.1
1968	2,687.4	29.7	4.2	2,653.5
	In per cent			
Average rate of interest:				
1966	4.43	4.50	4.96	4.42
1967	4.66	4.33	4.62	4.66
1968	5.17	5.22	5.75	5.17

[1] Based on holdings at opening of business.
[2] Includes Federal agency obligations.

Volume of operations. Table 9 on page 378 shows the volume of operations in the principal departments of the Federal Reserve Banks for 1965–68.

Discounts and advances increased sharply over the previous year in both number and dollar amount, and the number of banks borrowing rose to 1,310 from 1,104 in 1967.

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Volume continued to rise in most of the other operations, particularly in food stamps redeemed and in transactions in U.S. Government securities.

Loan guarantees for defense production. Under the Defense Production Act of 1950, the Departments of the Army, Navy, and Air Force, the Defense Supply Agency of the Department of Defense, the Departments of Commerce, Interior, and Agriculture, the General Services Administration, the National Aeronautics and Space Administration, and the Atomic Energy Commission are authorized to guarantee loans for defense production made by commercial banks and other private financing institutions. The Federal Reserve Banks act as fiscal agents of the guaranteeing agencies under the Board's Regulation V.

During 1968 the guaranteeing agencies authorized the issuance of three guarantee agreements covering loans totaling $51 million. Loan authorizations outstanding on December 31, 1968, totaled $72 million, of which $21 million represented outstanding loans and $51 million additional credit available to borrowers. Of total loans outstanding, 71 per cent on the average was guaranteed. During the year approximately $77 million was disbursed on guaranteed loans, most of which are revolving credits.

Authority for the V-loan program, unless extended, will terminate on June 30, 1970.

Table 11 (page 379) shows guarantee fees and maximum interest rates applicable to Regulation V loans.

Foreign and international accounts. Assets held for foreign account at the Federal Reserve Banks increased $615 million in 1968. At the end of the year they amounted to $21,826 million: $11,183 million of earmarked gold; $9,120 million of U.S. Government securities (including securities payable in foreign currencies); $216 million in dollar deposits; $109 million of bankers' acceptances purchased through Federal Reserve Banks; and $1,198 million of miscellaneous assets. The latter item consists mainly of dollar bonds issued by foreign countries and inter-

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national organizations. Assets held for international organizations, including IMF gold deposits, declined $1,317 million to $8,121 million.

In 1968 new accounts were opened in the names of the Central Bank of Brazil; Central Bank of Cyprus; Bank of Lebanon; Central Bank of Malta; Bank of Mauritius; Sultan of Muscat and Oman; Board of Commissioners of Currency, Singapore; Central Bank of Trinidad and Tobago; and Central Bank of Uruguay.

New gold collateral loan arrangements amounted to $15 million in 1968. All drawings during the year under these loan arrangements were repaid by the end of the year. Loans on gold are made to foreign monetary authorities to help them meet dollar requirements of a temporary nature.

The Federal Reserve Bank of New York continued to act as depositary and fiscal agent for international organizations. As fiscal agent of the United States, the Bank continued to operate the Exchange Stabilization Fund pursuant to authorization and instructions of the Secretary of the Treasury. Also on behalf of the Treasury Department, it administered foreign assets control regulations pertaining to assets in the United States of North Vietnam, Cuba, Communist China, and North Korea, and their nationals, and to transactions with those countries and their nationals.

Bank premises. During 1968, with the approval of the Board, properties adjacent to the Boston, Richmond, and San Francisco Reserve Banks and to the Denver, Omaha, and Los Angeles Branches were acquired for future expansion, and a site was obtained for a new building for the Baltimore Branch.

Table 6 on page 373 shows the cost and book value of bank premises owned and occupied by the Federal Reserve Banks and of real estate acquired for banking-house purposes.

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Board of Governors

Building annex. In accordance with the Board's authorization as reported last year, plans for an annex to its present building were developed and subsequently approved by the Fine Arts Commission and the National Capital Planning Commission.

In addition, an agreement was entered into between the Board of Governors and the Department of the Interior whereby the Board will build a self-liquidating, underground garage for the use of Federal Reserve and Department of the Interior employees under the present Department parking lot adjoining the Board site on the north, and the National Park Service of the Department of the Interior, with the Board cooperating, will develop the surface as a park in accordance with its present designation as National Park Service land.

Income and expenses. The accounts of the Board for the year 1968 were audited by the public accounting firm of Lybrand, Ross Bros. & Montgomery.

ACCOUNTANTS' OPINION

Board of Governors of the
Federal Reserve System:

We have examined the balance sheet of the Board of Governors of the Federal Reserve System as of December 31, 1968, and the related statement of assessments and expenses for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the balance sheet and related statement of assessments and expenses present fairly the financial position of the Board of Governors of the Federal Reserve System at December 31, 1968 and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Lybrand, Ross Bros. & Montgomery

Washington, D.C.
January 30, 1969

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Federal Reserve Bank of St. Louis

Board of Governors of the Federal Reserve System

Balance Sheet
December 31, 1968

Assets

Operating Fund:		
Cash		$ 2,046,449
Miscellaneous receivables and advances		19,925
Stockroom and cafeteria inventories at first-in, first-out cost		34,929
Total operating fund		2,101,303
Property Fund:		
Land and improvements		792,852
Building and building construction		4,894,481
Furniture and equipment		1,153,966
Total property fund		6,841,299
		$ 8,942,602

Liabilities and Fund Balances

Operating Fund:		
Current liabilities:		
Accounts payable and accrued expenses	$ 642,395	
Income taxes withheld	483,158	
Accrued payroll	73,031	
		$ 1,198,584
Fund balance:		
Balance, January 1, 1968	(155,866)	
Excess of assessments over expenses for the year ended December 31, 1968	1,058,585	
		902,719
Total operating fund		2,101,303
Property Fund:		
Fund balance:		
Balance, January 1, 1968	6,285,038	
Additions	568,583	
Property adjustments and disposals	(12,322)	
Total property fund		6,841,299
		$ 8,942,602

The accompanying notes are an integral part of the financial statements.
[See page 362 for notes.]

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Board of Governors of the Federal Reserve System

Statement of Assessments and Expenses for the Year Ended December 31, 1968

Assessments Levied on Federal Reserve Banks:		
For Board expenses and additions to property		$14,198,200
For expenditures made on behalf of the Federal Reserve Banks		18,811,038
Total assessments		33,009,238
Expenses:		
Expenditures for printing, issue and redemption of Federal Reserve Notes, paid on behalf of the Federal Reserve Banks		18,811,038
For the Board:		
Salaries	$7,952,415	
Retirement and insurance contributions	1,650,120	
Travel expenses	369,055	
Legal, consultant and audit fees	187,637	
Contractual services	440,245	
Printing and binding—net	437,649	
Equipment and other rentals	752,144	
Telephone and telegraph	181,284	
Postage and expressage	153,780	
Stationery, office and other supplies	103,486	
Heat, light and power	62,878	
Operation of cafeteria—net	75,688	
Repairs, maintenance and alterations	83,741	
Books and subscriptions	29,980	
System membership, Center for Latin American Monetary Studies	28,100	
Miscellaneous—net	62,830	
		12,571,032
For property additions		568,583
Total expenses		31,950,653
Excess of Assessments Over Expenses		$ 1,058,585

The accompanying notes are an integral part of the financial statements.

[See page 362 for notes.]

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Board of Governors of the Federal Reserve System

Notes to Financial Statements

Accounting methods

The Board has consistently followed the practice of not providing for depreciation on fixed assets. Acquisitions are charged to expense and proceeds from sales of fixed assets are recorded as income. The property accounts are increased or reduced at full cost, with corresponding increases or decreases in the property fund balance when property is acquired or sold.

Assessments and expenditures made on behalf of the Federal Reserve Banks for the printing, issuance and redemption of Federal Reserve notes are recorded on the cash basis and produce results which are not materially different from those which would have been produced on the accrual basis of accounting.

Long-term leases

The Board leases outside office space at an annual rental of $298,415 under a lease expiring in 1972. This lease may be terminated with six months notice after 1969.

Construction

The cost of the new Federal Reserve North Building and North Garage, as estimated by the architect, will be approximately $20,000,000. According to present plans this amount will be expended over the next three years.

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Monetary Policy and the Economy

During 1969 the Federal Reserve moved to a very restrictive monetary policy in an effort to slow the expansion of aggregate money demands in the economy and to dissipate deeply rooted expectations of continuing inflation. Progress in controlling inflation was sought as a step toward both attaining sustainable noninflationary growth in the domestic economy and improving the relative competitiveness of the United States with other trading nations.

The intensity of monetary restraint is suggested by the marked slowdown that developed in the rates of growth of the money stock and bank credit. During the second half of 1968 these two variables had increased at seasonally adjusted annual rates of 7 and 15 per cent, respectively. But over the corresponding period of 1969 the growth rate for each dropped to less than 1 per cent.

The policy of monetary restraint was conducted against a background of generally taut fiscal policy, although the over-all degree of fiscal restraint slackened somewhat during the year. Moreover, at certain times when the Congress was deliberating over various items of tax legislation —notably in the spring and again near the year-end—prospects for continued fiscal restraint became quite uncertain. Nevertheless, Federal purchases of goods and services were considerably less expansive than in 1968, and a significant slowing in total economic activity developed as the year progressed, even though price and wage increases remained sizable and inflationary psychology persisted.

Constraints on the supply of lendable funds, continued strong demands for funds, and widespread anticipation of further inflation led to very large increases in interest rates. Near the year-end market interest rates generally reached their highs for the year, in most cases from 2 to 3 percentage points above the levels prevailing just before monetary policy began to tighten in late 1968.

DOMESTIC DEVELOPMENTS

During the first half of 1969 the rate of growth in real gross national product slowed somewhat further, extending the adjustment that had become evident during the second half of 1968. Although the rate of inventory accumulation was reduced in the early months of 1969, however, final demands for goods and services remained strong. There were

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sizable increases in consumer spending, in business outlays for fixed investment, in State and local government purchases, and in residential construction—even though housing starts were beginning to decline. With increases in aggregate spending well maintained, unemployment remained at a low level and upward pressures on costs and prices intensified.

As inflationary pressures and expectations became more pervasive, monetary policy moved toward a more restrictive stance. The initial shift toward restraint had occurred near the end of 1968 with an increase of ¼ of a percentage point in the Federal Reserve discount rate to 5½ per cent. This change was accompanied by a tightening of open market policy, which was gradually carried further during 1969. In early April the Federal Reserve raised the discount rate again—this time by ½ percentage point, to 6 per cent—and increased reserve requirements against demand deposits by ½ percentage point for both reserve city and country banks.

Following the initial tightening in December 1968, yields on market instruments that compete with large negotiable time certificates of deposit (CD's) moved well above the ceiling rates on CD's at major money market banks. Since the Federal Reserve did not raise the rate ceilings, holders of maturing CD's were encouraged to transfer such funds to higher-yielding market securities. This curtailment of their resources induced banks to stiffen credit terms and to engage in portfolio adjustments that tightened financial markets more broadly. At the same time, to cover the heavy attrition in CD's and still remain in a position to accommodate customer takedowns of the large backlog of outstanding loan commitments, major banks moved aggressively to tap alternative sources of funds. These included expanded day-to-day borrowing of Federal funds, somewhat longer-term borrowing of Euro-dollars from foreign branches, sales of assets under repurchase agreements, and the issuance of commercial paper through affiliates.

Net redemptions of CD's in early 1969 had occurred primarily at a small number of large city banks that possessed the capacity to turn readily to nondeposit sources of funds. Since the volume of funds so obtained expanded very rapidly, questions were raised at the time whether the policy of monetary restraint was really being effective. However, the effects of CD attrition were soon reinforced by the tightening of more general monetary controls over the supply of bank reserves. As a result, growth in the money stock moderated; net outflows of time and

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savings deposits and liquidation of securities spread to banks outside the money centers; bank liquidity was reduced; and the costs of obtaining funds from nondeposit sources escalated.

In the face of this squeeze, the rate charged by banks on loans to prime business customers was raised in three steps from 6¾ per cent in late 1968 to 8½ per cent in mid-1969, and banks strengthened their loan-rationing procedures. Over approximately the same period, growth of total loans and investments at banks averaged only 4 per cent at a seasonally adjusted annual rate, and growth of the money stock only 4.3 per cent, down from the corresponding averages of 15 and 7 per cent mentioned above for the second half of 1968.

The increased pressure on the banking system during the first half of 1969 was instrumental in pushing market yields sharply higher. However, upward pressure on rates was also being exerted by increased demands for funds as borrowers sought credit outside the banking system—particularly in the rapidly expanding commercial paper market. While total credit in the economy grew less rapidly over the first 6 months of 1969 than it had in the latter half of 1968, the change was more than accounted for by Federal debt repayments financed out of the large fiscal surplus. Private nonfinancial sectors raised more funds, net, than they had in the second half of 1968.

As monetary restraint was intensified, major banks expanded their use of nondeposit sources of funds. This led the Board of Governors to adopt several regulatory amendments designed to restrict access to these sources. In particular, the Board's actions eliminated the use of loan repurchase agreements and substantially increased the marginal cost of Euro-dollar borrowings (by imposing a 10 per cent reserve requirement on borrowings above a base level, as described in the footnote on page 52). The Board also proposed to narrow the exemption of Federal funds transactions from bank reserve-requirement and rate-ceiling constraints, but final action was not taken on this proposal until early 1970. A further action proposed, but not adopted in 1969, would have applied Regulation Q ceilings to bank sales of commercial paper through their subsidiaries and holding company affiliates, to the extent that these funds were used to finance the banks' own activities.

In the second half of 1969 interest rates showed steep, further advances to new highs as deposit attrition at banks remained large, open market policy continued to maintain a tight rein on bank reserves, and Federal Reserve regulatory proposals and actions indicated the

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possibility of further restraint on bank funds. Moreover, with the effects of persistent monetary restraint on bank lending and investment policies tending to become cumulative, there was virtually no further growth, on balance, in the money and bank credit aggregates. And bank liquidity was reduced to the lowest levels of the post-World-War-II period. At the same time, with loan funds at banks sharply curtailed, nonfinancial businesses were forced to meet an increasing share of their continuing needs for funds through reductions in liquid assets. In the process, corporate liquidity ratios also dropped sharply to new lows for the postwar period.

Liquidity pressures on nonbank thrift institutions (savings and loan associations and mutual savings banks) also increased after mid-1969. During the first half of the year growth in net savings at these institutions had slowed only moderately as compared with the latter half of 1968, despite the sizable further rise in interest rates on market instruments. But as the year wore on and market rates rose still further, holders of claims on nonbank thrift institutions became increasingly sensitive to the widening spread between returns on such claims and returns on securities. Consequently, net savings growth at these institutions deteriorated sharply after midyear.

To help offset the effects of this reduced intermediation on flows of funds to mortgage markets, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Bank Board (FHLBB) continued to channel a large volume of funds into housing finance. In contrast to the first half, however, when FNMA and the FHLBB were also active suppliers of funds, even a sizable further growth in these flows was not sufficient to prevent a net reduction in total funds supplied to mortgage markets.

During the closing months of the year, the severity of the general financial squeeze showed clearly in the performance of the securities markets. At that time, despite continued constraints on the supply of funds and marked advances in interest yields, several types of borrowers whose liquidity positions had come under particular strain pressed actively to sell securities. Expanded market financing by the FNMA and the FHLBB represented one such source of pressure. In addition, nonfinancial corporations were expanding their borrowing in both the commercial paper and the bond markets. And banks were broadening their efforts to sell commercial paper. In the face of these

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general market strains, it was much more difficult than usual for the market to accommodate the volume of both refinancing and net cash borrowing by the Treasury, even though such operations were not especially large.

Strains exerted by the cumulative effects of monetary restraint were perhaps greatest in the market for State and local government securities. In earlier years commercial banks had been by far the dominant investor group in this market. During much of the latter half of 1969, however, banks were net liquidators of a sizable volume of municipal debt. To distribute new municipal issues, it was therefore necessary for underwriters to turn increasingly to individuals. But funds from individuals could be attracted in volume only at sharply higher yields, and as yields rose to levels above the legal rate ceilings of many State and local governments, many such units that wanted to borrow were effectively excluded from the bond market. To cope with this cutback in longer-term financing, units in need of funds drew heavily on their liquid asset positions, expanded their borrowing in short-term markets, and/or sought upward revisions in legal rate ceilings. Even so, a substantial part of the financing that State and local governments had planned was not accommodated, and a significant number of capital projects had to be deferred.

Other sectors of the economy also reflected the effects of restrictive policy more clearly during the latter half of 1969. In fact, in the fourth quarter growth of aggregate output, as measured by real GNP, came to a halt, and for the full year real GNP grew by less than 3 per cent. Slower economic activity was also reflected in the Board's index of industrial production, which declined moderately over the last 5 months of the year; in retail sales, which showed no year-over-year growth after adjustment for price increases; and in housing starts, which declined further.

On the other hand, upward pressures on prices and costs remained generally strong throughout the year. For all of 1969, prices—as measured by the GNP deflator—rose by 4.7 per cent, an exceptionally rapid rate. Along with demand pressures another factor contributing to the sustained advance in prices was the strong upward course of unit labor costs. Growth in output per manhour was small, and upward pressures on wages were strong. With wage and other costs rising and profit margins tending to erode, businesses sought to recoup added costs through higher prices.

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INTERNATIONAL DEVELOPMENTS

Abroad, 1969 was a year of strongly rising demand in most countries. Consequently U.S. exports increased considerably, despite the adverse effects of a long port strike. But U.S. imports increased at about the same rate as exports, and other current payments grew more than receipts. Therefore, the net export balance of goods and services fell below the already low level to which it had dropped in 1968.

Outflows of U.S. private capital in various forms continued to be restrained by governmental programs, including the foreign credit restraint program administered by the Federal Reserve, and were affected also by the growing pressures on liquidity of banks and businesses in this country. Nevertheless the identified outflows of such capital were somewhat larger than in 1968. Inflows of foreign long-term capital into the United States were smaller than the year before, as financial markets abroad tightened and the U.S. stock market weakened.

Extremely large international flows of liquid capital occurred in 1969. These reflected two very different sets of forces—the one stemming from monetary and credit conditions in the United States, the other growing out of international market expectations of changes in exchange rates between the German mark and other currencies. The borrowing of Euro-dollar funds by U.S. banks, noted above, drew a very large volume of funds out of national money and credit markets in other countries and contributed greatly to strength of the dollar in exchange markets. High interest rates in the Euro-dollar market also attracted some funds of short-term investors, American and foreign, out of holdings in this country into deposits in that market. Until September, anticipation of a revaluation of the German mark caused funds to move into Germany from this country and others. After a new parity for the German mark was established in October, the closing months and weeks of the year saw a reversal of much of these movements.

As 1969 ended, the international monetary system appeared to have entered a period of relative stability. The interplay of several factors contributed to this: the strength of the dollar in foreign exchange markets; the continued successful functioning of the two-tier gold system, and a drop in the private market price of gold back to $35 an ounce by the year-end; and the preparations for inauguration of a new international reserve instrument, Special Drawing Rights (SDR's).

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Moreover, the realignments in 1969 of the German and French currency parities, the improvement in the British balance of payments in 1969 stemming in part from the devaluation of sterling in November 1967, and expectations that the introduction of SDR's would facilitate balance of payments adjustments in the future, all contributed to growth of confidence in the stability of the international monetary system.

Nevertheless, a large imbalance remained to be corrected between too-small U.S. net exports of goods and services and too-large potential net outflows of capital from this country. In 1969, as a result of Eurodollar borrowing, the actual U.S. balance of payments measured on the basis of official reserve transactions was comfortably in surplus. Without that borrowing, U.S. international settlements would have been seriously adverse—and in fact the 1969 balance of payments deficit measured on the liquidity basis was exceptionally large. □

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Principal Federal Reserve Policy Actions, 1969: Digest

Period, or announcement date	*Action*	*Purpose*
January through March	Directed that System open market operations be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets that had developed following the mid-December 1968 increase in the discount rate, with provisions for modification of operations depending on the course of bank credit developments.	To foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.
April	Directed that System open market operations be conducted with a view to maintaining firm conditions in money and short-term credit markets, taking account of the effects of other possible monetary policy action, with provision for modification of operations depending on the course of bank credit developments.	To foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.
April 3	Discount rates increased from 5½ to 6 per cent at 11 Reserve Banks, effective April 4. (By April 8, the 6 per cent rate was in effect at all Reserve Banks.)	To contribute to a reduction of inflationary pressures in the economy.
	Increased reserve requirements against net demand deposits at all member banks—from 16½ to 17 per cent on deposits under $5 million and from 17 to 17½ per cent on deposits over $5 million at each reserve city bank and from 12 to 12½ per cent on deposits under $5 million and from 12½ to 13 per cent on deposits over $5 million at each country bank—effective in the reserve computation period beginning April 17 and applicable to average deposits in the period April 3–9 inclusive.	To contribute to a reduction of inflationary pressures in the economy.

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April 4	Issued revised 1969 guidelines, effective immediately, covering foreign credits and investments by U.S. banks and other financial institutions, representing a modification of guidelines announced December 23, 1968.	To continue the program of voluntary restraints in effect since 1965, while permitting additional flexibility to finance U.S. exports and resolving some serious equity problems.
Late April through May	Directed that System open market operations be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets that had developed following the early-April announcement of increases in the discount rate and reserve requirements, with provision for modification of operations depending on the course of bank credit developments.	To foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.
June through December	Directed that System open market operations be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets, with provision for modification of operations depending on the course of bank credit developments.	To foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.
July 24	Amended rules governing member bank reserves (Regulation D), effective July 31, to assure that certain officers' checks issued in connection with transactions with foreign branches were included as deposits for purposes of computing reserve requirements.	To limit certain transactions involving member banks and foreign branches that had resulted in what the Board considered an unwarranted reduction in required reserves.
	Amended rules governing member bank reserves (Regulation D) and payment of interest on deposits (Regulation Q), effective July 25, to bring certain member bank liabilities on repurchase agreements within the coverage of such rules.	To forestall the recent and contemplated use by some member banks of repurchase agreements to avoid reserve requirements and the rules governing payment of interest on deposits.

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Principal Federal Reserve Policy Actions, 1969: Digest—Continued

Period, or announcement date	*Action*	*Purpose*
August 13	Amended rules governing member bank reserves (Regulation D) and foreign branches of member banks (Regulation M), effective September 4, to establish a 10 per cent marginal reserve requirement on certain foreign borrowings, primarily Euro-dollars, by member banks and on the sales of assets by member banks to their foreign branches.	To moderate the flow of foreign funds between U.S. banks and their foreign branches and also between U.S. and foreign banks by removing a special advantage to member banks that had used Euro-dollars not subject to reserve requirements for the purpose of adjusting to domestic credit restraint.
December 17	Announced revised guidelines covering foreign credit and investments by U.S. banks and other financial institutions.	To continue the program of voluntary restraints in effect since 1965, while, in keeping with the Government's efforts to stimulate U.S. exports, giving greater and more explicit recognition to the established priority for export financing.
December 24	Authorized Federal Reserve Banks, effective immediately and until April 1, 1970, to provide, in accordance with certain specified principles, emergency credit facilities to nonmember depositary institutions, if the need should arise.	To provide, as a matter of general policy, the procedures for making available emergency credit to nonmember depositary institutions in difficulty as to the adequacy of their liquidity reserves as a result of substantial attrition of savings.

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Credit Markets and Financial Flows

Demands for credit remained strong in most sectors of the economy in 1969 as economic activity continued to expand, prices rose rapidly, and business capital investment rose to new record levels. In view of the inflationary character of economic developments and of widespread expectations of further inflation, the Federal Reserve pursued a policy of monetary restraint throughout the year. The resulting constraint on the supply of lendable funds relative to demand led to further sharp increases in interest rates, which were at postwar highs by the year-end. Expansion of total bank credit slowed substantially during the year, even after allowance for expanded use by banks of nondeposit sources of funds, and the money stock grew by only 2.5 per cent, with most of the growth occurring in the first half.

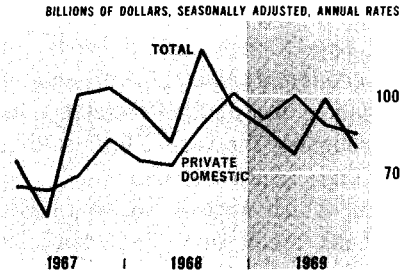
During the year rising interest rates on market securities, in conjunction with regulatory restrictions on rates payable at depositary institutions, progressively limited the availability of institutional credit as funds were shifted out of deposit-type instruments and into higher yielding market securities. Commercial banks in particular were affected by such shifts. Their share of the total flow of credit extended to nonfinancial borrowers dropped sharply in 1969. Even though their deposit inflows also slowed during the year, other depositary institutions were better able to maintain their share of total credit supplied, because they placed more reliance on nondeposit sources of funds; for example, savings and loan associations borrowed heavily from the Federal home loan banks. As the year progressed, however, the availability of credit directly through the securities markets also became more limited.

In the first half of the year, funds raised by nonfinancial sectors from all sources declined substantially as compared with the total for the latter half of 1968; but this reduction represented a shift from borrowing to repayment of debt by the U.S. Government as the budget moved into surplus. Borrowing by private sectors increased slightly. In the second half of the year, however, demands for funds by private sectors showed a substantial decline in response to the increased cost and reduced availability of credit and to the slower growth in economic activity. But the U.S. Government was a net borrower of funds in this period, and total funds raised by all sectors increased somewhat.

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TOTAL FUNDS RAISED AND SUPPLIED

1. Volume raised by nonfinancial sectors



2. Shares in funds supplied by selected institutions

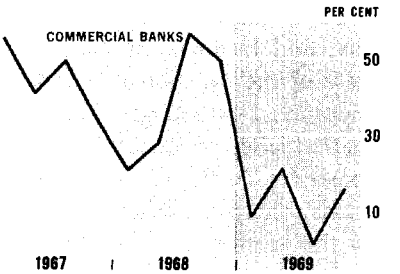


TABLE 1: SELECTED BORROWING BY SECTOR AND TYPE

Flow of funds data, in billions of dollars; half-years at seasonally adjusted annual rates.

Sector, and type of instrument	1967	1968	1969	1968		1969	
				1st H	2nd H	1st H	2nd H
U.S. Government:							
Public debt issues	8.9	10.3	−2.8	12.1	8.5	−17.9	7.3
Budget agency issues	4.1	3.0	−2.6	2.7	3.5	−.4	−4.7
Federally sponsored credit agencies.[1]	−.6	3.2	8.9	4.5	2.0	6.3	11.6
State and local govt. issues	7.7	9.9	8.8	6.7	13.1	9.3	8.3
Nonfinancial corporate business:							
Bonds and stocks	17.0	12.1	15.3	12.8	11.3	14.9	15.8
Mortgages	4.5	5.8	4.3	4.9	6.8	4.5	4.1
Open market paper	1.5	1.6	2.7	.3	3.0	3.8	1.7
Consumers:							
Consumer instalment debt	3.4	9.0	8.1	7.7	10.1	8.9	7.4
Mortgages	11.7	16.0	16.9	16.0	16.0	17.5	16.5

[1] Not included in the budget.

TABLE 2: BANK CREDIT

Seasonally adjusted net changes, in billions of dollars

Item	1967	1968	1969	1968		1969	
				1st H	2nd H	1st H	2nd H
Total loans and investments	36.0	38.1	9.2	11.3	26.8	7.9	1.3
U.S. Govt. securities	6.1	1.8	−9.8	.7	1.1	−5.3	−4.5
Other securities	12.7	10.1	−.8	2.5	7.6	.5	−1.3
Total loans	17.2	26.2	19.7	8.1	18.1	12.7	7.0
Business	7.7	9.6	9.0	3.3	6.3	6.4	2.6
Real estate	4.6	6.6	5.1	3.0	3.6	3.4	1.7
Consumer	1.8	4.9	3.3	1.8	3.1	1.8	1.5
Other	3.1	5.1	2.3	....	5.1	1.1	1.2

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BANK RESERVES, DEPOSIT FLOWS, AND INTEREST RATES

3. Bank reserves and borrowings 4. Interest rates

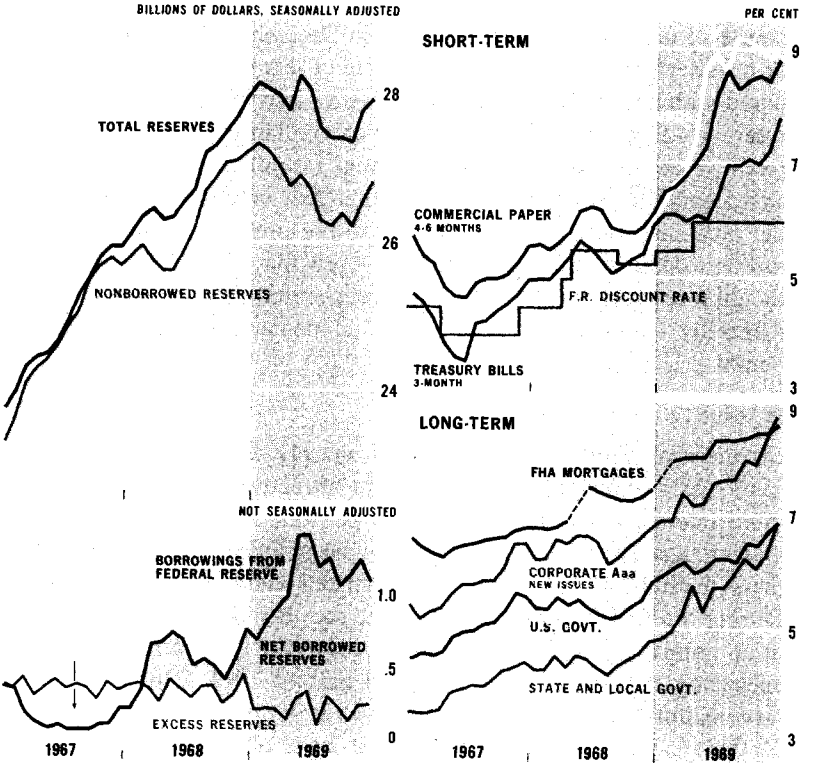


TABLE 3: SELECTED MONETARY AGGREGATES

Seasonally adjusted annual rate of change, in per cent

Item	1967	1968	1969	1968		1969	
				1st H	2nd H	1st H	2nd H
Member bank deposits	11.8	9.0	−4.0	4.4	13.4	−3.5	−4.6
Member bank deposits plus liabilities to foreign branches	11.7	9.8	−1.7	5.7	13.5	−.2	[1] −3.2
Time and savings deposits at banks	15.9	11.5	−5.3	5.3	17.3	−4.0	−6.7
Money stock	6.6	7.2	2.5	7.2	7.0	4.3	.6
Savings accounts at nonbank thrift institutions	9.4	6.3	3.3	6.1	6.4	5.0	1.7

[1] Beginning on May 28, 1969, the following data were collected: Euro-dollars borrowed directly or through brokers and dealers, liabilities to own branches in U.S. territories and possessions, commercial paper sold by bank holding companies or other bank affiliates, and loans sold under repurchase agreement to the nonbank public. If funds raised from these sources during the second half of 1969 were added to member bank deposits and liabilities to foreign branches, the resultant rate of change would be −1.2 per cent.

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FIRST HALF OF YEAR

During the first half of 1969 the Federal Reserve continued on the course of monetary restraint initiated in December 1968. Total reserves of member banks rose at an annual rate of less than 1 per cent as compared with nearly 11 per cent in the latter half of 1968. Nonborrowed reserves—those provided by sources other than by member bank borrowing—actually declined at an annual rate of almost 4 per cent, in sharp contrast to a rate of growth that had exceeded 10 per cent in the preceding half year. In addition to the pressure exerted on banks through open market operations, in April the Federal Reserve raised the discount rate from 5½ to 6 per cent and increased reserve requirements by ½ of a percentage point on demand deposits at member banks.

DEPOSIT FLOWS DECLINE

Commercial bank deposits declined sharply during the first half of 1969. As market yields became more attractive relative to the maximum interest rates that banks were permitted to offer on their time and savings deposits, funds began to be withdrawn or diverted from these instruments for investment in higher yielding market securities. During the first half of the year total member bank deposits declined at an annual rate of 3.5 per cent, as compared with a rate of increase exceeding 13 per cent in the second half of 1968. Nonbank depositary institutions were affected to a much lesser extent by such shifts out of their savings accounts in the first half, although deposit inflows at savings and loan associations and mutual savings banks did slow to an annual rate of 5 per cent as compared with more than 6 per cent in the latter part of 1968.

The decline in commercial bank deposits during this period occurred largely in time and savings deposits, most of which reflected outflows of CD's in denominations of $100,000 or more. By early December 1968 short-term market rates had risen to levels at which maximum offering rates on CD's allowable under Regulation Q ceilings were no longer competitive, and sizable attrition of CD's ensued. Over the first half of 1969, outstanding CD's at large commercial banks declined by $7.5 billion, seasonally unadjusted, or by about one-third of the amount outstanding at the end of 1968. The bulk of this attrition took place at large banks in the major financial centers where depositors tend to be

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more interest-sensitive; banks in New York City and Chicago, which held about 35 per cent of the outstanding CD's at the end of 1968, accounted for 60 per cent of the run-off of CD's during the first half of 1969. Toward midyear, however, banks outside New York and Chicago began to account for an increased share of the attrition.

Time and savings deposits other than CD's also were influenced by rising market rates of interest. At large banks, time and savings deposits held by individuals and businesses (exclusive of their holdings of large negotiable CD's) grew during the first quarter at about one-half of the rate for the last 6 months of 1968 and then declined on balance over the second quarter. At country banks, net inflows of total time and savings deposits dwindled fairly steadily over the first 6 months of 1969 and for the period the inflow was only about half as large as in the latter half of 1968.

Rising market rates of interest and the growing squeeze on the availability of funds also induced private holders to economize on their cash balances. During the first half of the year the money stock—currency and privately held demand deposits—grew at an annual rate of 4.3 per cent, down sharply from the 7.0 per cent rate in the second half of 1968. Privately held demand deposits rose at an annual rate of 3.7 per cent, about half the rate of growth in the latter part of 1968, whereas currency in the hands of the public continued to expand rapidly—at an annual rate of 6.5 per cent. Demand deposits held by the Federal Government remained essentially unchanged on balance.

BANKS SEEK OTHER SOURCES OF FUNDS

In view of these deposit outflows individual banks increased their borrowing at the discount window and in the Federal funds and Euro-dollar markets and issued other nondeposit liabilities. Borrowings from Federal Reserve Banks rose rather steadily over the first half to an average of about $1.4 billion in June; this was almost double the highest monthly average reached in the latter part of 1968. In the Federal funds market —where excess reserves of banks are bought and sold on a day-to-day basis—the volume of funds traded through New York rose to a daily average of around $9.0 billion in May and June, as compared with about $7.5 billion in December 1968. The cost of these funds also rose markedly, reaching an average of 8.90 per cent in June, well above the

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maximum of around 6.00 per cent that banks had paid on such borrowings in the second half of 1968.

Banks also increased sharply their borrowings in the Euro-dollar market. The total of such borrowings doubled in the first half and by the end of June had reached almost $14.3 billion. Banks had to pay increasingly higher rates to obtain these funds; Euro-dollar rates generally ranged from 10 to 12 per cent in June, depending on maturity, as compared with 6 to 7 per cent in December 1968.

As these sources became more scarce and more costly, banks sought increasingly to raise funds through the sale of commercial paper by bank holding companies, affiliates, and subsidiaries, the proceeds of which were transferred to banks by purchases of bank loans. By mid-year about $1.2 billion of such paper was outstanding. Banks also borrowed through the sale of loans to the nonbank public, subject to repurchase agreements; by June 30 such outstandings had reached about $850 million.

During the first half of the year the Board of Governors proposed several amendments to its regulations affecting borrowing in the Euro-dollar and Federal funds markets, most of which became effective later in the year. On June 26 the Board proposed that a 10 per cent reserve requirement be established on borrowings of U.S. banks from their foreign branches to the extent that these borrowings exceed the daily-average amounts outstanding in the 4 weeks ending May 28, 1969; this proposal was designed to moderate the inflow of Euro-dollars to U.S. banks from their foreign branches. On June 27 it issued a proposal to narrow the categories of "Federal funds" transactions that are exempt from Regulations D (governing reserves of member banks) and Q (governing payment of interest on deposits by member banks). On May 29 the Board had also proposed an amendment to Regulation D designed to ensure that checks resulting from transfers involving foreign branches are not used to effect reductions in required reserves.

CREDIT RESTRICTED AT DEPOSITARY INSTITUTIONS

With their lendable funds becoming more limited in the face of continued strong demands for credit, depositary institutions undertook substantial adjustments in their investment portfolios. Banks reduced their liquidity; cut back sharply on acquisitions of longer-term U.S. Government, Federal agency, and municipal securities; sold loans out-

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right; and tightened their terms and conditions of lending. Total loans and investments at commercial banks expanded at an annual rate of only 4 per cent during the first half, well below the exceptionally rapid rate—15 per cent—in the previous 6 months.

During the first half banks reduced their holdings of U.S. Government securities by more than $5 billion—largely Treasury bills and short-term notes and bonds—and virtually ceased their acquisitions of other securities. Large banks, in fact, made substantial reductions in their holdings of municipal issues over the first half. Consequently, by midyear total liquid assets held by banks had dropped sharply, and the ratio of these assets to deposit and other liabilities had fallen to a lower level than at any time during the period of monetary restraint in late 1966. In addition, the accommodation of new loan demands was partially satisfied by outright sale of existing loans by banks; such sales to others than banks and bank-related affiliates and subsidiaries amounted to about $750 million by midyear.

Banks also began in this period to tighten the terms and conditions of lending. For example, they raised the prime rate three times—from 6¾ per cent to 7 per cent in early January, to 7½ per cent in mid-March, and to 8½ per cent in early June. As a result, expansion of total bank loans slowed during the first half of the year. Among the major categories, only loans to businesses continued to expand rapidly. Growth in such loans increased at about the same fast pace as in the latter part of 1968—and even picked up somewhat if loan sales are included—as corporate demands for funds intensified and banks continued to make a large volume of new loan commitments to businesses. The advance in real estate loans began to moderate in the second quarter, accompanied by a decline in housing starts. Expansion of consumer loans slowed, as did growth of total consumer credit from all sources. And security loans, which had expanded rapidly in the autumn of 1968, declined on balance during the first half of 1969 as dealers reduced their positions, in response to the high cost of carrying inventories of securities and to expectations that interest rates would rise further.

Nonbank thrift institutions were able to increase substantially their net acquisitions of credit market instruments in spite of somewhat reduced net inflows of funds to their savings accounts. Savings and loan associations—the dominant residential mortgage lender—relied heavily on borrowings from the Federal home loan banks (FHLB) in order to

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increase their net takings of mortgages. At mutual savings banks net acquisitions continued to grow—but less rapidly than in the latter half of 1968, as both mortgage lending and acquisitions of corporate bonds were reduced. Moreover, the growing pressure on available funds resulted in a slowing of new-commitment activity in the mortgage area as the year progressed. After April the backlog of outstanding mortgage commitments at both types of institutions began to decline.

At life insurance companies, the contractual nature of fund inflows significantly insulated such intermediaries from the type of pressure experienced by depositary institutions. But there was a substantial rise in policy loans at insurance companies—as policy holders faced increased costs and reduced availability of credit from other sources. Hence, these companies were able to maintain funds for other investments at the level of the second half of 1968 only by reducing their cash balances. As a result, they became more cautious about making new commitments and about scheduling takedowns of funds.

PRESSURES IN SECURITIES MARKETS INTENSIFY

As economic activity remained strong and bank loans came under increasing restraint, nonfinancial businesses turned more and more to the issuance of market securities and shorter-term paper to obtain needed funds. Plant and equipment expenditures were rising sharply and internal funds generation was slowing somewhat; hence, total corporate financing requirements were rising on balance. The volume of funds raised through bond and stock offerings in the first half of 1969 was significantly larger than that in the second half of 1968; stock issues accounted for about two-thirds of the increase, despite the lack of buoyancy in average stock prices—which reached a peak in December 1968 and then declined by 7 per cent through June 1969. Offerings of bonds and stocks by large industrial companies were relatively small, but both public utility and communications companies and small to medium-sized industrial companies issued debt in volume. Corporations borrowed heavily in the commercial paper market as well—raising about $4 billion at a seasonally adjusted annual rate, or $1 billion more than in the previous 6 months.

Borrowing by State and local governments was significantly affected by the pressures that developed in securities markets and by the drying up of demand for these securities by commercial banks—ordinarily the

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principal institutional purchasers of municipal debt. Rising market rates of interest on long-term municipal securities resulted in a sizable cutback in the issuance of such debt in the first quarter; net long-term borrowing in that period amounted to $4 billion, annual rate, less than one-half the exceptionally high rate in the fourth quarter of 1968. Many governmental units were forced to postpone or cancel planned borrowing because of interest rate ceilings. To a considerable extent, the reduced volume of long-term borrowing was offset by a sharp rise in the flotation of short-term debt by units having authority to enter this market and not subject to restrictive rate ceilings. As a result, total market issues declined only moderately during the first quarter.

Early in the second quarter yields on municipal securities declined, largely as a result of expectational factors, and the volume of long-term borrowing increased significantly from the unusually low first-quarter rate. At the same time, municipal demands on the short-term market dropped from the peak rates of the first quarter, but they were still quite high. However, a renewal of upward pressures on interest rates as the quarter progressed resulted in more cutbacks and postponements of long-term borrowing plans, with short-term or interim financing being substituted in some instances.

Federal Government demands on credit markets were substantially reduced in the first half of 1969 relative to a year earlier. Although the budget showed a deficit of $2 billion in the first quarter, this was less than one-fourth of that in the comparable quarter a year earlier. Moreover, in the second quarter the budget swung into substantial surplus, reflecting a sharp year-over-year gain in revenues—attributable to receipts from the tax surcharge as well as higher incomes—and constraint on expenditures. Hence, the Federal Government, on balance, repaid debt in volume. At seasonally adjusted annual rates, there was a turnaround from net borrowing of $12 billion in the latter half of 1968 to net repayment of $18.3 billion in the first half of 1969.

On the other hand, federally sponsored credit agencies not included in the budget increased their demands on securities markets. Net debt issuance by these agencies aggregated $6.3 billion, annual rate, in the first half, more than three times the volume in the second half of 1968. The Federal home loan banks and the Federal National Mortgage Association accounted for a substantial portion of this borrowing, as they sought funds to channel to the mortgage market.

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INTEREST RATES ADVANCE

With demands for credit remaining in excess of the available supply in nearly all financial markets, most market rates of interest rose further. Banks, facing persistent loan demands and reduced availability of lendable funds, not only raised their prime lending rates but also bid up rates paid on Federal funds and Euro-dollars as they aggressively sought funds in these markets.

Other short-term rates also rose substantially. Corporate demands for funds spilled over into the commercial paper market, and bank affiliates began to issue commercial paper, with the result that rates on 4- to 6-month paper had advanced to more than 8.50 per cent by the end of June, an increase of more than 2 percentage points during the first half. Yields on Treasury bills and short-term Federal agency issues changed relatively little through the spring; large sales of Treasury bills by banks were readily absorbed by the market as the demand for bills was increased in large part by the shifting of investor funds out of large CD's and into other market instruments, and also by demands for bills by many investors who wished to increase their liquidity positions because of financial uncertainties. However, as a result of continued sales of bills by banks, as well as reduced demands by some institutional investors, bill yields rose to an average that was about 50 basis points higher in June than the December 1968 average.

In long-term markets upward pressures on interest rates were substantial as banks withdrew from the market and other investors remained cautious in anticipation that tighter market conditions might follow. By the end of June the average yield on municipal bonds had risen more than 80 basis points from the level prevailing in December 1968. Rates on corporate Aaa new issues (with 5-year call protection) and secondary market yields on home mortgages insured by the Federal Housing Administration rose by about 80 and 85 basis points, respectively. Yields on long-term Government bonds, however, increased relatively little, with no bonds being issued by the Treasury because of the 4¼ per cent statutory rate ceiling on such instruments.

SECOND HALF OF YEAR

During the second half of 1969 both total and nonborrowed reserves of member banks declined slightly—at annual rates of about 4 and 2.5 per cent, respectively—as the policy of restraint in Federal Reserve

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open market operations was continued. Moreover, on July 24 and August 12 the Board of Governors of the Federal Reserve System adopted amendments to its Regulations D and M, proposed earlier in the year; these amendments were designed to moderate borrowing by member banks in the Euro-dollar market and to prevent reductions in required reserves through transfers involving their foreign branches. Also on July 24 the Board took action to narrow the scope of member bank liabilities under repurchase agreements that are exempt from Regulations D and Q. On October 29 it announced that it was considering amendment of its rules governing the payment of interest on deposits (Regulation Q) to apply to funds received by member banks from the issuance of commercial paper or similar obligations by banks' affiliates.

All of these pressures led banks to maintain their borrowings at the Federal Reserve Banks at about the high level reached in the early summer. Banks also relied increasingly on the Federal funds market, and about $10 billion of these funds were traded through New York on a daily-average basis during December, or about $1.0 billion more than at midyear. The Federal funds rate in December averaged close to 9 per cent, about the same as in June.

Total borrowing by U.S. banks in the Euro-dollar market rose sharply further in July, but remained essentially unchanged at an average level of about $15.5 billion during the balance of the second half, probably to some extent in response to Board actions concerning such borrowing. Rates on Euro-dollars dropped slightly from those prevailing in June and averaged from 10 to 11 per cent in December, depending on maturity.

After borrowing through sales of loans under repurchase agreement became subject to Regulations D and Q in late July, such net borrowings from the nonbank public declined steadily to a level of about $200 million at the end of the year. But outstanding commercial paper issued by bank holding companies or other bank affiliates rose sharply, by an additional $3 billion in the second half.

DEPOSIT FLOWS TO INTERMEDIARIES CURTAILED FURTHER

As market rates of interest continued to increase, the availability of deposit funds at major types of depositary institutions became more restricted. The outflow of total deposits at member banks was some-

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what larger than in the first half—at an annual rate of nearly 5 per cent—and funds obtained by these banks from nondeposit sources failed to offset fully this decline; total member bank deposits plus nondeposit funds fell at an annual rate of about 1 per cent during the second half. Net inflows at nonbank thrift institutions were cut sharply during the latter half of the year.

Declines in outstanding time and savings deposits at commercial banks—at an annual rate of more than 6.5 per cent in the second half —continued to account for a large part of the reduction in total deposits after midyear. CD attrition began to moderate from the rapid pace of the first half, however, as the volume of maturing issues declined and deposits of foreign official holders, which are not subject to interest rate ceilings under Regulation Q, increased. The run-off in CD's during the second half was approximately $4.5 billion, seasonally unadjusted, or about 60 per cent of that earlier in the year. In contrast to the first half, the bulk of this attrition took place outside the major financial centers; banks outside New York City and Chicago experienced more than 90 per cent of the run-off, or more than twice their share earlier in the year. The additions to time deposits of foreign official holders in the fourth quarter, mainly at banks in New York City, appeared to reflect in part a shifting of balances previously held in the form of Euro-dollar deposits with foreign branches of U.S. banks.

Net withdrawals of time and savings deposits other than CD's became increasingly important in the decline in total time and savings deposits at commercial banks. At large banks, seasonally unadjusted outflows of consumer-type time and savings deposits were, on the average, about 20 per cent greater than the total for the second quarter. And at country banks the progressively reduced inflows, seasonally unadjusted, of the first half of the year turned to sizable net outflows during the second half.

Banks also lost demand deposits, on balance, during the second half; the decline in such deposits privately held more than offset the rise in those held by the U.S. Government. Growth in currency in the hands of the public, however, was fairly well sustained, so the reduction in privately held demand deposits was more than offset in the money stock statistics. The total money stock rose slightly—at an annual rate of less than 1 per cent—during the second half of the year.

Net inflows of funds to thrift institutions continued to decline dur-

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ing the second half of the year, as yields on market securities rose further above the rates paid on savings accounts. Both savings and loan associations and mutual savings banks experienced substantial outflows during the July and October interest-crediting periods, and net inflows remained depressed in other months of the second half. As a result, deposits at these institutions grew at a seasonally adjusted annual rate of only 1.7 per cent, about one-third the rate in the first part of the year.

RESTRICTION OF INTERMEDIARY CREDIT CUMULATES

With lendable funds becoming increasingly limited and with liquidity already at very low levels by midyear, commercial banks were obliged to curtail their lending activity further. In adjusting their asset portfolios to the reduced supply of funds, they continued to rely on liquidation of securities and on more intense rationing of loans, and after midyear total bank credit rose only slightly further.

Again the bulk of the liquidation of security holdings by banks, which totaled almost $6 billion, was in U.S. Government securities—mainly Treasury bills and short-term notes and bonds. However, banks did reduce their portfolios of other securities—generally municipal issues—as holdings of short-term U.S. Government securities were probably approaching minimum amounts needed for pledging requirements and other purposes. Outright sales of loans by banks to others than banks or bank-related affiliates and subsidiaries continued, reaching a level of about $1.2 billion outstanding by the year-end, about $500 million more than at midyear.

Banks also reported further significant tightening in their lending terms and conditions. There were substantial cutbacks in the dollar amount of new commitments made, and total bank loans rose at an annual rate of only about 5 per cent, about half that of the already reduced pace in the first 6 months. Inclusion of loans sold to bank holding companies, affiliates, and subsidiaries would raise the annual rate to about 6.5 per cent, still well below the pace of expansion earlier in the year.

The further slowing in bank loans was evident in virtually all major loan categories. Business loans, which had risen rapidly in the second half of 1968 and the first half of 1969, grew at a sharply reduced rate

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after midyear. Expansion of real estate loans slowed substantially further—in line with the continued declines in housing starts and in residential construction activity—as did growth in consumer loans.

At nonbank thrift institutions net acquisitions of mortgages declined, but by less than would have been suggested by the reduction in net savings inflows. Flows of funds from mortgage repayments remained moderate, in view of the reduced over-all level of real estate activity and of the limited volume of repayments owing in part to assumptions of outstanding mortgages when existing properties were transferred. Net extensions of mortgage credit by these intermediaries were financed by reductions in liquidity positions, by record borrowing by savings and loan associations from the Federal home loan banks, and in the case of mutual savings banks by putting money into mortgages at the expense of securities. New mortgage commitment activity was cut back further, and outstanding commitments at the year-end were well below the end-of-1968 level.

Growth in total mortgage debt, seasonally adjusted, continued to decline from the record rate reached in the fourth quarter of 1968. However, mortgage credit supplied by FNMA and, to a lesser extent, expanded lending by the Government National Mortgage Association became increasingly important factors in holding total net residential mortgage lending for the full year close to the level in 1968.

PRIVATE SECURITY ISSUES MODERATE

Private nonfinancial borrowing in security markets declined in the second half from the advanced pace registered earlier. The reduction was attributable in large part to the further increase in cost and the reduced availability of credit. Net new issues of long-term securities by State and local governments, at an annual rate of $4.5 billion, were slightly below the already reduced rate for the first half of the year. Many governmental units were forced to defer long-term financing because their ceiling rates were below market levels. Even some units that had had their ceilings raised earlier in the year were limited in the extent to which they could finance programs by borrowing, as reductions in bank holdings of municipal issues and investor concern over provisions in the proposed tax reform bill—related to the tax treatment of interest income on municipal securities—contributed to a substantial further increase in rates on these securities. While some governmental units

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borrowed at short term, or reduced their liquid assets, and/or used other sources of funds, growth in aggregate expenditures of State and local governments nevertheless moderated in the second half of the year.

Flotations of corporate securities in this period were somewhat above the exceptionally high rate of the first half. While public offerings of bonds by corporations rose somewhat, the increase was offset by the developing tightness in private placements. Equity offerings advanced sharply and were unusually large in view of the continued decline, on balance, in average stock prices. Although gross corporate security offerings were a record for the full year, maintenance of a high and rising level of net investment during the second half put added pressure on corporate financial positions. Because declining profits were restraining growth in internal funds and bank loans were increasingly difficult to obtain, corporations relied on further issuance of commercial paper and other sources of funds.

The Federal Government was a net borrower of funds during the second half, whereas it had made net repayment of debt earlier in the year. Three factors in particular caused the budget surplus to decline to a seasonally adjusted annual rate of $5 billion, or roughly one-half that in the first 6 months; these were enlarged Federal expenditures, the earlier ending of make-up payments on 1968 tax liabilities, and the slower growth in incomes—and consequently, tax receipts. Continuing a pattern evident in the first half, federally sponsored agencies outside the budget offered a sizable volume of debt issues to raise new money, mainly in connection with FHLB and FNMA borrowing in support of the mortgage market. When combined with borrowing in the budget, net funds raised by the Federal sector in total amounted to about $14 billion at a seasonally adjusted annual rate. This compares with net repayment at an annual rate of $11 billion in the first half of the year.

INTEREST RATES RISE TO POSTWAR HIGHS

Most interest rates in both short- and long-term markets rose substantially further over the second half of the year. Continued large demands for funds by banks kept rates high in the Federal funds market and pushed rates up further in the commercial paper market. Treasury bill yields came under substantial upward pressure as the Treasury raised new cash through additional bill sales at a time when commercial banks and other intermediaries were reducing liquidity positions; yields on

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3-month Treasury bills rose to new highs and averaged about 7.80 per cent in December, 140 basis points above the June level.

Interest rates also continued to press upward in capital markets. With commercial banks reducing their holdings of municipal securities and individual investors concerned over tax reform and the future course of interest rates, municipal yields advanced more than 1 percentage point in the second half—reaching a record average of 6.90 per cent in December. Corporate Aaa new issues (with 5-year call protection) were also marketed at new highs in the latter part of the year—increasing about 120 basis points, to 8.75 per cent in December. Continuing strong demands for construction and the reduced availability of mortgage credit combined to push up interest rates on mortgages in the second half. However, despite upward adjustments in some cases, ceiling constraints on conventional and Government-underwritten mortgages tended to limit the over-all rise in rates on home loans. Long-term U.S. Government bond yields followed the upward trend in interest rates and increased about 60 basis points during the period to a year-end level of approximately 6.80 per cent. □

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Demands, Resource Use, and Prices

Expansion of aggregate output in the United States slowed markedly in 1969 and halted in the fourth quarter. For the full year, growth in real GNP amounted to 2.8 per cent, compared with 4.9 per cent in 1968; except for 1967 this was the smallest increase since the recession year of 1961. In large measure the slowing reflected the sustained pressure exerted by the restrictive fiscal and monetary policies that had been adopted to dampen persistent inflation and inflationary expectations. Nevertheless, inflationary pressures remained strong throughout 1969. Prices, as measured by the implicit GNP deflator, advanced 4.7 per cent, the largest rise since 1951; increases had amounted to 4.0 per cent in 1968 and 3.2 per cent in 1967.

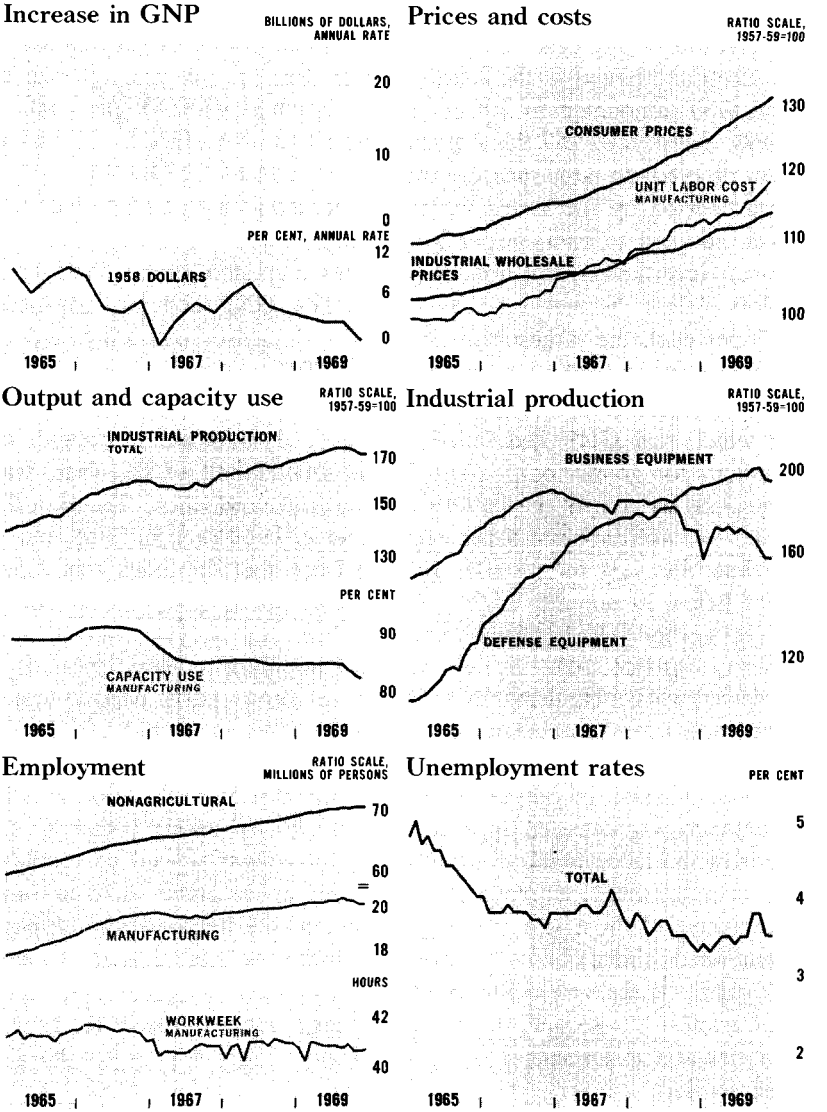
The fourth quarter of 1969 was the first since the spring of 1967 in which real GNP had failed to rise. The diminishing strength of demand for goods, particularly in the second half of the year, was especially evident in the pattern of industrial production. The Board's index averaged about 4.5 per cent higher in 1969 than in 1968, but it declined in every month after July. In December the index was 2 per cent below its summer high and was only about 1.5 per cent above a year earlier. Although some of the decline after midyear was attributable to a major strike in the electrical equipment industry, most of it reflected weakening demands for consumer goods, particularly automobiles and other durable goods, and reductions in output of defense equipment and materials.

As expansion of output diminished, the capacity utilization rate in manufacturing declined appreciably and signs of easing began to appear in the labor market. Growth in employment slowed perceptibly. In manufacturing, employment was lower in December than in June (exclusive of those not working because of the major work stoppage mentioned above) and the average workweek was shorter. Unemployment claims were rising. But the over-all unemployment rate, which had risen in the second and third quarters, changed little in the fourth quarter and in December was only slightly higher than it had been a year earlier.

Unit labor costs in the private nonfarm economy rose steeply in 1969—nearly 6.5 per cent according to preliminary estimates, compared with 4 per cent in 1968. The rise in output per manhour for the

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ECONOMIC DEVELOPMENTS



Monthly data, except quarterly for GNP and capacity utilization in manufacturing. Data are seasonally adjusted, except for consumer prices and industrial wholesale prices. Sources: GNP, Dept. of Commerce; prices, employment, workweek, and unemployment rates, Dept. of Labor; unit labor costs, Bureau of Census; industrial production and capacity utilization in manufacturing, Federal Reserve.

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year was small, and average wage rates continued to advance sharply, although a little less so than in 1968. In manufacturing the gain in output per manhour was appreciably larger than for the private nonfarm economy as a whole and the increase in unit labor costs was about the same as in 1968.

The sustained strength of inflationary pressures reflected a number of interacting influences. Demands continued strong in markets for some important goods, particularly for machinery and equipment and for metals. Until late in the year, labor markets were tight, demands for labor were strong, and consumer incomes were rising sharply. Increases in consumer prices were being used as a floor in wage negotiations as workers endeavored not only to catch up with earlier price advances but also to improve their standard of living. Profit margins were under pressure, and producers and distributors made efforts to recoup sharply rising unit labor costs and advancing nonlabor costs—including materials—through higher selling prices. The pervasive nature of inflationary expectations affected labor's wage demands, employer willingness to grant sizable settlements, and business pricing policies. Finally various other factors also affected prices—for the most part tending to raise them. These included such diverse developments as the strength of demands in Western Europe and Japan—which placed pressure on prices of internationally traded commodities—and unexpectedly low U.S. supplies of both beef and pork, which boosted prices of foods.

DEMANDS

In the first half of 1968 real GNP had increased at an annual rate of 6.3 per cent, an exceptionally rapid pace, but by the fourth quarter of that year expansion was down to a 3.5 per cent rate. This slowing continued during 1969, and in the fourth quarter the expansion halted. Indeed, a prolonged work stoppage in the electrical equipment industry contributed to a slight absolute decline in real GNP (Table 4). The deceleration of expansion in 1969—in both current and constant dollars—reflected successively smaller increases in final sales as the year progressed. The rate of inventory accumulation fluctuated within a relatively moderate range, but it was larger in the second half of the year than in the first.

The slowing in expansion of final sales was evident in most major categories of spending (Table 5). Early in the year sizable increases

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in consumer spending, business fixed investment and residential construction, and State and local government purchases added up to a large advance in total final sales. In the second half, on the other hand, the rise in consumer spending was much smaller and so was that in State and local government purchases; business fixed investment was not quite so strong as in the first half; and residential construction activity declined. Federal purchases edged down over the year, except for a rise in the third quarter, when there was a pay increase for both civilian and military personnel.

Exports of goods and services—which had been adversely affected in the first quarter of 1969 by the prolonged strike of longshoremen at East Coast and Gulf ports—gained strength in the second half of the

TABLE 4: GROSS NATIONAL PRODUCT

Item	1967	1968	1969	1969[1]			
				I	II	III	IV
	In billions of dollars						
Total	793.5	865.7	932.1	908.7	924.8	942.8	952.2
Inventory change	7.4	7.3	8.0	6.6	6.9	10.7	7.7
Final sales	*786.2*	*858.4*	*924.1*	*902.1*	*917.9*	*932.0*	*944.5*
Private[2]	695.5	758.9	822.2	800.5	817.3	828.8	842.2
Federal	90.7	99.5	101.9	101.6	100.6	103.2	102.3
	Change from preceding period: In billions of dollars						
Total	43.6	72.2	66.4	16.2	16.1	18.0	9.4
Inventory change	−7.4	−.1	.7	−3.9	.3	3.8	−3.0
Final sales	*51.1*	*72.2*	*65.7*	*20.1*	*15.8*	*14.1*	*12.5*
Private[2]	38.2	63.4	63.3	20.4	16.8	11.5	13.4
Federal	12.9	8.8	2.4	−.3	−1.0	2.6	−.9
	In per cent, at annual rates						
GNP in current dollars	5.8	9.1	7.7	7.3	7.1	7.8	4.0
GNP in 1958 dollars	2.5	4.9	2.8	2.5	2.0	2.1	−.5
GNP implicit deflator (1958=100)	3.2	4.0	4.7	4.7	5.1	[3]5.6	4.4

[1] Quarterly figures are at seasonally adjusted annual rates.
[2] Adjusted to include State and local governments.
[3] Excluding Federal pay increase, 4.3 per cent.
NOTE.—Basic data from Dept. of Commerce.

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TABLE 5: GROSS NATIONAL PRODUCT: FINAL SALES

Change from preceding period, in billions of dollars, except for saving rate

Item	1967	1968	1969	1969			
				I	II	III	IV
Total final sales	51.2	72.2	65.9	20.1	15.8	14.1	12.5
Personal consumption expenditures	26.0	44.3	39.4	11.3	10.8	7.0	9.7
Durable goods	2.2	10.3	6.3	2.1	2.2	−.8	.6
Nondurable goods	8.2	15.5	13.2	4.3	3.5	3.0	3.6
Services	15.6	18.6	19.7	4.9	5.1	4.8	5.4
Addendum: Saving rate (per cent)	*7.4*	*6.5*	*6.0*	*5.3*	*5.3*	*6.7*	*6.4*
Fixed investment	2.0	10.4	12.5	5.2	1.9	2.0	1.6
Residential structures	.0	5.2	2.0	1.4	−.6	−1.3	.2
Nonresidential	2.1	5.1	10.5	3.8	2.5	3.3	1.4
Net exports of goods and services	−.1	−2.7	−.4	.3	.1	1.1	.0
Exports	2.8	4.4	4.7	−3.0	9.5	.7	.8
Imports	2.9	7.1	5.1	−3.3	9.4	−.3	.7
Govt. purchase of goods and services	23.3	20.2	14.4	3.3	2.9	4.1	1.3
Federal	*12.9*	*8.8*	*2.5*	*−.3*	*−1.0*	*2.6*	*−.9*
Defense	11.7	5.6	1.3	−.3	−.5	1.8	−1.1
Other	1.3	3.1	1.3	.1	−.5	.8	.2
State and local	10.3	11.4	12.0	3.7	3.8	1.5	2.2

NOTE.—Basic data from Department of Commerce.

year. But imports also advanced until near the end of 1969, and for the year as a whole the merchandise trade surplus barely matched the very small balance of 1968. Over-all net exports of goods and services were smaller than in 1968 because of a reduction of about $0.5 billion in the surplus on services.

GOVERNMENT

Federal fiscal developments made a significant contribution to the slowing of economic expansion in 1969. A major turn in fiscal policy had occurred with enactment of the Revenue and Expenditure Control Act of 1968 in late June of that year. This Act imposed a 10 per cent surcharge on corporate income taxes, retroactive to January 1, and on most individual income taxes, retroactive to April 1. In addition, it provided for restraints on some expenditures. The Act was to be in effect until mid-1969.

As a result of those actions, the Federal fiscal position as measured in the national income accounts (NIA) shifted from a large deficit to a large surplus in 1969. In the first half of calendar year 1968 the Federal deficit had amounted to about $9 billion, annual rate, but by the fourth quarter the Federal fiscal position (NIA basis) was in balance.

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For the full calendar year 1968, the deficit amounted to about $5 billion, compared with almost $13 billion in 1967. In calendar year 1969 the surcharges on both corporate and individual income taxes were extended at 10 per cent from midyear to the year-end, spending was subject to further restraint, and a surplus of about $10 billion emerged. Total receipts for the year increased by $25 billion while total expenditures rose by $10 billion.

Another striking development in 1969, apart from the over-all fiscal position, was the virtual cessation of growth in direct Federal demands on resources. Federal purchases of goods and services rose by less than $3 billion for the calendar year 1969, a far smaller increase than in either of the two preceding years. Moreover, the rise in such purchases from late 1968 to late 1969 amounted to only about $0.5 billion, annual rate, even including the sizable pay increase in the third quarter (Table 4). Spending for defense, apart from the pay increase for the military, drifted down throughout 1969—reflecting the reduction in activity in Vietnam.

Federal expenditures other than for goods and services increased by about $8 billion in the calendar year 1969, moderately less than in 1968. More than half of the increase was in transfer payments, mostly social security benefits. Most of the remainder was in interest on the public debt and in grants-in-aid to State and local governments.

State and local government purchases of goods and services increased by $12 billion in the calendar year 1969; the rate of growth—12 per cent—was a little less than in 1968. But expansion in the July–December period was only about half as large as in the first 6 months (Table 5). In large part this slowdown reflected developments in the capital markets. Commercial banks—which are usually the major institutional purchaser of municipal securities—were net sellers of such securities in the second half of the year and interest rates rose to record highs. Many States and municipalities were impelled to trim borrowing and capital spending either because legal interest rate ceilings were below prevailing market rates or because they were unwilling to borrow at the current market rates.

BUSINESS FIXED INVESTMENT

Business spending on fixed investment was the principal stimulus to over-all expansion in 1969. The increase for the year—12 per cent—was double that for 1968 and was the largest for any broad category

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of final demand. Moreover, such spending maintained its upward momentum much better in the second half of 1969 than did other major sectors of demand, and year-end surveys indicated plans for a substantial further rise in 1970, particularly in the first half of the year. More than half of the 1969 increase, however, represented higher prices, both for structures and for producers' durable equipment.

Spending on plant and equipment turned out to be somewhat smaller than had been indicated by an official survey of intentions early in the year. But the shortfall represented mainly the failure of actual spending to match anticipations in the first two quarters, and it probably resulted primarily from delays in construction schedules and in equipment deliveries, given the high rate of resource use in these industries. Tight financial markets and less buoyant views about prospects undoubtedly contributed to some cutbacks, but in the aggregate these cutbacks appear to have been marginal. The President's recommendation—made in late April but not enacted until close to the year-end—that the investment tax credit be repealed as of April 18 apparently exerted only a limited effect on spending in 1969.

Factors underlying the sizable expansion in spending for fixed capital included optimism about sales prospects, rising prices of plant and equipment, and sharply increasing unit labor costs. In some major industries—electric utilities, for example—existing capacity was being pressed, and the need for more capacity was obvious. In others, technological advance was the major stimulus to expenditure programs. Altogether, about half of total capital spending in 1969 was for expansion of capacity and half was for modernizaton and cost reduction. The strength of these various incentives is underscored by the fact that profits after taxes were up only slightly from 1968 to a total of $50.5 billion for 1969 and that such profits were declining after the first quarter of the year.

In manufacturing, however, the extent of the rise in outlays—12 per cent—was somewhat surprising in view of the rather moderate rate of capacity utilization in that sector in recent years. This rate in 1969 averaged less than the rate of approximately 85 per cent in 1968, and by the end of the year it had declined to about 81 per cent. Only 3 years earlier, in 1966, manufacturing industries had been using their capacity at an average rate of more than 90 per cent. From the end of 1966 to the end of 1969, manufacturers had increased their capacity about 16 per cent, while their output had risen by only 8 per cent.

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BUSINESS INVENTORY ACCUMULATION

Businesses accumulated inventories at a relatively moderate rate in 1969, about in line with the historical average relationship of inventory investment to GNP. Nevertheless, by the end of the year—as sales and new orders slowed—inventory levels appeared to be more burdensome than they had been at the beginning of the year. In November and December, the over-all inventory/sales ratio for manufacturing and trade rose to the level of early 1967, which was a period of slowing in inventory accumulation.

Producers of consumer goods began to reduce output in the second half of the year in response to weaker consumer demands. The declines were not sufficient to bring inventories back into line with sales, however, and by late 1969 the inventory/sales ratio for retail establishments had risen to the highest level in many years. Auto stocks relative to sales were at a record high. Inventories of other consumer durable goods—including appliances and television sets—also remained fairly high relative to sales, despite the cuts in production and a strike at a major producer of electrical products.

Additions to inventories of durable goods manufacturers were sizable in 1969. Most of this rise occurred in the machinery and transportation equipment (particularly aerospace) industries, and mainly in work in process. Expansion in stocks of materials was relatively small, as manufacturers appeared to be holding these in line with current output. Even though output of defense equipment was drifting down, stocks in the defense-related industries continued to rise until late in the year.

RESIDENTIAL CONSTRUCTION

About 1.5 million private farm and nonfarm housing units were started in 1969, approximately the same number as in 1968. The rate of starts had risen irregularly through most of 1968. In 1969, however, after peaking at an unusually high rate—1.7 million units—in the first 3 months, the number moved substantially downward. In the fourth quarter the rate averaged 1.3 million units, more than one-fifth below the first-quarter level.

Outlays for new residential construction, which lag the pattern of starts, declined after the first quarter, but for 1969 as a whole they were about 7 per cent larger than in 1968. The increase reflected

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primarily higher costs and, to some extent, increased activity in additions and alterations—which, along with nonhousekeeping units, account for about one-fourth of the residential construction total. Indeed, the increase in additions and alterations in the fourth quarter offset a further decline in outlays for new dwelling units.

The persistent decline in starts through most of 1969 resulted primarily from the limited availability of mortgage financing. Competing demands for funds were very strong, and monetary policy was restrictive. The limited ability of the thrift institutions—savings and loan associations and mutual savings banks—to compete for funds in a period when interest rates were rising to new highs resulted in greatly reduced inflows of funds in the second half of the year, as described earlier in this REPORT. However, considerable support for residential mortgage markets was provided by FNMA through its free-market commitment auctions, and by the FHLB, which accounted for a record volume of advances to savings and loan associations. Reflecting for the most part such support, the rate of single-family housing starts tended to stabilize in the fourth quarter at the reduced third-quarter rate—at a level that was appreciably above the low in the final quarter of 1966.

One important feature of the year as a whole was a further increase in the number of multifamily units started. Even though these shared in the decline after the early part of the year, they reached a record total for 1969 and accounted for 44 per cent of all housing starts, compared with the previous high of 40 per cent in 1968. Investors in multifamily units were often better able to compete for financing than were purchasers of single-family units, particularly since such financing frequently incorporated various forms of equity-type participations and also because it was generally less restricted by the usury laws of some States. Late in the year, however, the rate of multifamily starts declined sharply.

Demands for housing continued very strong in the face of advancing prices and development costs and record interest rates. Vacancy rates fell to the lowest level in over a decade. The supply of new housing was augmented by a sharp further year-over-year expansion in shipments of mobile homes to a total for the year of nearly 400,000 units. These units, which are factory-produced and are low-priced, are not included in the statistics on housing starts nor reflected in residential construction expenditures.

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CONSUMER EXPENDITURES AND INCOME

Consumer spending on goods and services increased 7.5 per cent from 1968 to 1969, compared with an increase of 9 per cent the year before. But prices advanced more rapidly in 1969 than in the earlier period, and the physical volume of consumer takings was up only 3 per cent following an increase of more than 5 per cent in 1968. Real takings of durable goods increased 5 per cent for the year, while those of nondurable goods rose only 1.3 per cent and services, 3.8 per cent. In all three cases the 1969 advances were significantly smaller than in 1968.

Consumer spending was relatively strong in the first half of 1969, but growth slowed considerably in the second half, with the third quarter particularly sluggish. Employment gains were large early in the year, and wages and salaries and total personal income continued to increase rapidly. Growth in disposable (after-tax) income slowed in the first quarter, however, when large final settlements began to be made on 1968 income tax liabilities, including retroactive payments on the surcharge for the second quarter of 1968. Nevertheless, the increase in consumer spending was sizable and was made possible in part because consumers reduced their saving rate to 5.3 per cent from the 6.0 per cent level maintained in the second half of 1968. In the second quarter of 1969 consumer spending again increased by a sizable amount, as a large rise in disposable income provided support to consumer demands while the saving rate was unchanged from its first-quarter level.

The third-quarter increase in consumer spending was the smallest of the year, even though disposable income—bolstered by the Federal pay raise and by the earlier ending of large tax payments on 1968 liabilities—showed an exceptionally large rise. The saving rate increased sharply to 6.7 per cent, from 5.3 per cent in the first half of the year. (This increase of 1.4 percentage points in the saving rate represented almost $9 billion, annual rate, of disposable income and a roughly equivalent amount of consumer spending foregone.) The weakness in the consumer sector in the third quarter is indicated not only by current-dollar figures but also by the fact that there was virtually no rise in the physical volume of purchases. Real takings of durable goods were off a little, those of nondurable goods were unchanged, and growth of services was not so rapid as earlier.

Expansion of both personal and disposable income slowed con-

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siderably in the fourth quarter, largely because gains in employment and in wages and salaries were much smaller than they had been earlier in the year. But the increase in consumer spending was larger than in the third quarter, as the saving rate declined.

For the second half of 1969 as a whole, consumer demands can best be characterized as sluggish. Real takings of durable goods were down a little, with weakness evident in demands for furniture and appliances and particularly for new automobiles late in the year. Although about 8.5 million new domestic autos were sold in 1969, only slightly fewer than in 1968, the sales rate was down to about 8 million units in the fourth quarter; and in December sales were at an annual rate of 7.7 million units. Sales of imported autos continued to rise and for the year totaled more than 1 million units; this number was 6 per cent higher than in 1968 and accounted for 11 per cent of total auto sales.

Weakness of consumer demand in the second half appears to have reflected a combination of influences. Perhaps most important was the pervasive effect of the steep rise in consumer prices; rapid price increases completely offset income gains for many employees—in fact, real average weekly earnings in manufacturing declined slightly over the year—and provoked some consumer resistance to purchases. Growing concern about employment and income prospects in 1970, as indicated in various surveys of consumer attitudes, also tended to limit spending. And a decline in the volume of housing units completed and in sales of existing houses adversely affected demands for furniture and other household durable goods. Finally, declining prices of common stocks probably exerted some dampening influence on the over-all propensity of consumers to spend.

LABOR MARKET

Demands for labor were very strong early in 1969, reflecting the vigorous expansion of final demand. Increases in employment in the first quarter were the largest since the 1965–66 period, and the unemployment rate reached a post-Korean-war low of 3.3 per cent in February. As the year progressed, however, growth of employment moderated, and in the latter part of 1969 insured unemployment rose as employment in the manufacturing sector declined.

Manufacturing employment rose at a rapid pace in the first 6 months of 1969, but declined between June and December as output of autos

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TABLE 6: CHANGES IN NONFARM PAYROLL EMPLOYMENT

Thousands of persons

Period	Total	Manufacturing	Nonmanufacturing
6 months ended:			
December 1968	1,059	168	891
June 1969	1,425	240	1,185
December 1969	356	−185	541

NOTE.—Adjusted for seasonal variation.

and other goods softened, defense-related employment edged down, and a major strike interrupted production in the electrical equipment industry. Reflecting the reduction in demand, the average factory workweek declined to about 40.5 hours in the last quarter of the year, 0.3 hour less than in the same period a year earlier.

Employment also declined after midyear in construction activities and in the Federal Government, but neither sector recorded a large reduction. Growth in employment in trade, services, and State and local government slowed after midyear, but the slowing was moderate and followed a period of relatively large increases.

There were marked differences in the incidence and pattern of unemployment changes in 1969. Easing demand for labor was most noticeable in the industrial sector—where the labor force is made up largely of men. For men aged 25 years and over the jobless rate rose from a post-World-War-II low of 1.6 per cent in the first quarter to 1.8 per cent in the fourth quarter. Reflecting both more layoffs and longer spells of unemployment, the number of persons drawing unemployment insurance benefits began to rise after midyear and in December reached the highest level for any month since the summer of 1967.

Among women and younger workers, unemployment changes were more uneven during the year, and joblessness among such "secondary" workers was not appreciably higher at the year-end than in the first quarter. The decline to relatively low unemployment rates among women and younger workers, after a rise in September, was instrumental in lowering the over-all unemployment rate to 3.5 per cent in November and December after it had risen from 3.4 per cent in the first quarter of the year to 3.6 per cent in the third.

The civilian labor force increased by 2.0 million persons on the average between 1968 and 1969—the largest gain since 1947. The rise was substantially more than might normally be expected from popula-

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tion growth and long-term increases in participation rates and was probably a function of strong demands early in the year, buttressed by the desire of secondary workers to maintain or raise family income at a time of rapid price increases. Reflecting in part the latter factor, the average number of adult women in the labor force increased by nearly 1.2 million; this number accounted for about three-fifths of the net rise in the civilian labor force.

Continuing the large increases of the prior 2 years, another half a million men aged 20 years and over were added to the labor force in 1969. The bulk of this expansion was a result of the continued flow into the labor market of young men born during the post-World-War-II baby boom. The teenage labor force—male and female—rose by 350,000, the largest increase since 1966, when 650,000 teenagers entered. The size of the armed forces changed little from 1968 to 1969.

WAGES AND COSTS

Hourly earnings rose a little less rapidly in the 12 months ending in December 1969 than over the preceding year. However, increases were still very large—6.8 per cent for production and nonsupervisory workers on private nonfarm payrolls and 5.4 per cent for manufacturing production workers. Despite the large current-dollar increases in wages, the average production worker was no better off in 1969 than in 1968 after allowance for the rise of consumer prices. In fact, average weekly earnings in constant dollars have increased only slightly since 1965, and even these gains have been offset by higher Federal income and social security taxes.

There was a strong emphasis on large and immediate wage increases in collective bargaining settlements during 1969. The renewed emphasis on wage rates was attributable to some extent to the efforts of skilled workers to regain former wage differentials and to the growing influence of younger workers, who tend to be more interested in current income than in retirement pay or other deferred benefits. But the main factor underlying large wage boosts was the continued and, indeed, accelerated rise of consumer prices. Wage settlements were large for both union and nonunion workers and for both public and private employees.

Union contracts signed in 1969 provided a median first-year wage boost in excess of 8 per cent. In some of these instances, of course, wages had lagged behind price increases in earlier years of extended

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contracts, and workers were bargaining for a "catch-up" in wages. It should be noted that collective bargaining activity was at a relatively low level in 1969; the number of workers covered by major contracts negotiated during the year was only 2.4 million, compared with 4.6 million in 1968 and an estimated 5 million expected in 1970. Reflecting in part this reduced level of bargaining activity, there was a slight drop in the rate of growth of compensation per manhour (which includes both wages and fringe benefits). For the private nonfarm economy, compensation per manhour rose by about 7 per cent between 1968 and 1969 compared with nearly 7.5 per cent in the prior year.

Usually, any decline—however slight—in growth of compensation per manhour provides an opportunity for pressures on unit labor costs to subside. However, presently available statistics suggest that in 1969 there was less than a 1 per cent increase in output per manhour in the private nonfarm economy whereas the increase in 1968 in that sector had amounted to 3.3 per cent. Inasmuch as productivity increased only a little in 1969, most of the rise in compensation costs was reflected in higher costs per unit of output. Such costs are estimated to have risen 6.4 per cent in 1969—the largest increase since 1956.

In the manufacturing sector the productivity performance was better, and unit labor costs rose less in 1969 than in the private nonfarm economy as a whole. Output per manhour in manufacturing rose by about 2.5 per cent, about as much as in 1968 but less than the long-term trend.

PRICES

As already indicated, inflationary pressures were strong throughout 1969, even though expansion of real output was moderating (and at a standstill late in the year) and despite signs of easing in the second half in the demand for manpower and the use of industrial resources. All of the broad measures of prices showed substantially larger increases over the year than during 1968. Indeed, the increases were the largest since 1951 for both consumer prices and the implicit GNP price deflator and were the largest since 1956 for wholesale prices of industrial commodities. For farm products and processed foods and feeds, the increase was the largest since 1950 with the single exception of 1965. Moreover, the advance in comprehensive measures of prices over the fourth quarter was not much different from the pace early in the year (Table 7). The extent of the inflationary upsurge of recent years is indicated by the

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fact that the consumer price index—so critical in wage negotiations—rose by more than 18 per cent during the 4 years from December 1965 to December 1969. This was about as large an increase as had occurred over the preceding decade.

Numerous factors contributed to the rapid rise of prices in 1969. Consumers' dollar incomes were rising rapidly during much of the year, and demands in several important sectors of the economy remained strong—strong enough to put pressure on available resources. These sectors included producers' goods, total construction, and—in the consumer sector—such services as medical care, home maintenance services, and other labor-intensive services.

A major contributory factor was the steep rise in unit labor costs for the private nonfarm economy as a whole and the lesser—but still significant—increase in unit labor costs in manufacturing, as discussed earlier in this REPORT. Rising prices of materials and of transportation also affected over-all costs. And booming economies in Western Europe and Japan added to upward pressures on prices of internationally traded materials.

Of the other contributory factors that emerged during the year, the most important related to supplies of foods. In the spring an unexpected decline in cattle marketings relative to demand boosted prices of beef precipitously, and retail prices remained high for the remainder of the year. In the autumn pork was in very short supply as a result of an unexpectedly small pig crop in the spring, and wholesale and retail prices

TABLE 7: PRICE CHANGES

Per cent

Index	Year				1969 annual rate			
	1966	1967	1968	1969	Dec.-Mar.	Mar.-June	June-Sept.	Sept.-Dec.
Wholesale prices, total	1.7	.8	2.8	4.8	6.9	5.4	1.4	5.3
Industrial commodities[1]	1.8	1.9	2.4	3.8	6.2	.7	3.6	4.6
Foods and foodstuffs[1]	1.3	−2.4	4.0	8.1	9.4	18.7	−4.4	8.2
Consumer prices, total	3.3	3.1	4.7	6.1	6.1	6.4	5.3	6.2
Foods	3.8	1.2	4.3	7.2	4.0	10.1	6.4	7.5
Other commodities	1.9	3.2	3.7	4.4	5.6	4.1	2.4	5.4
Services	4.9	3.9	6.1	7.4	8.1	6.8	7.5	6.3
GNP implicit deflator[2]	3.5	3.5	4.0	5.1	4.8	5.1	5.3	4.7

[1] Federal Reserve groupings.
[2] Quarters compared rather than months; seasonally adjusted data.
NOTE.—Annual changes calculated from December to December.

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of pork moved up sharply. Over the year ending December, wholesale prices of livestock were up 15 per cent. In addition to meats, supplies of eggs and some fresh vegetables were also short late in the year.

WHOLESALE PRICES

From December 1968 to December 1969 average wholesale prices of industrial commodities increased almost 4 per cent; materials rose more than 4 per cent and finished goods, excluding foods, about 3.5 per cent. Increases over the year were widespread among commodities; only a few showed declines. Prices of producers' goods rose faster than those of consumer goods—reflecting in large part continued strong demand for business equipment.

Costs of producers' goods were affected more than consumer goods by the sharp increase in prices of metals. The index for metals and metal products rose about 10 per cent over the year, by far the largest increase among the 13 major groups of industrial commodities. Within the broad metals group, prices of nonferrous metals rose 22 per cent and those of iron and steel and their products more than 7 per cent.

The price increase for the metals group compares with 4.8 per cent for nonmetallic minerals, which registered the second largest increase of the major industry groups. Prices rose in all of the major industries except lumber and wood products (which fell about 8 per cent after soaring 24 per cent over the preceding year), but some of the increases were relatively small. For example, prices of furniture and household durable goods, textiles and apparel, and chemicals and allied products all rose less than 2.5 per cent.

During the year prices of industrial commodities, as well as those of the normally more volatile farm products, rose at uneven rates. In the first quarter the rise in industrial prices was very rapid—more than 6 per cent at an annual rate—reflecting in part exceptional increases for nonferrous metals and for steel and steel products, and in part a record advance in prices of lumber and plywood caused by a rapid growth in demand coupled with strikes and other supply bottlenecks. In the second quarter the increase slowed to a rate of less than 1 per cent, as plywood and lumber prices plummeted, and steel and nonferrous metals rose more slowly. The rise in average wholesale prices was sustained at a rate of about 5.5 per cent, however, by a surge in prices of foodstuffs.

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In the third quarter there was another general round of steel price increases; nonferrous metals rose more briskly; and the decline in prices of lumber and plywood was smaller than in the second quarter. As a result, the rise in industrial commodity prices accelerated to an annual rate of 3.6 per cent. But wholesale prices of foods and foodstuffs declined from the very high level of June as cattle marketings increased. Wholesale prices of all commodities thus rose at a rate of only 1.5 per cent, which may have conveyed the unwarranted impression that inflationary pressures were already being significantly reduced.

In the fourth quarter, however, a rapid pace of price increase was resumed (Table 7). Prices of farm products and foods were up considerably over the quarter, with pork, eggs, and fresh vegetables all moving up sharply. For industrial commodities the price rise also accelerated, as prices of finished goods—including those of passenger cars and machinery and equipment—moved up faster.

CONSUMER PRICES

Consumer prices rose more than wholesale prices in 1969 largely because of exceptionally big increases in the prices of foods and services, which together account for more than one-half of the total weight of the consumer price index. Prices of services were about 7.5 per cent higher in December than a year earlier—reflecting sharp increases in costs of mortgage finance, medical care, insurance, and housekeeping services and home-maintenance. Rents and utility costs rose less sharply.

Among commodities, food prices rose faster than other groups and in December were 7.2 per cent above a year earlier; prices of meat, poultry, and fish were up 11 per cent. Apparel and shoe prices also rose rapidly over the year—by more than 5 per cent.

As in other recent years, prices of durable commodities rose less than those of nondurable goods. The increase for new passenger cars was about 2 per cent after adjustment for quality improvement. For household durable goods the increase amounted to about 3.5 per cent —with a much slower rate of advance in the second half of the year, reflecting in part the rather sluggish demand for furniture and appliances.

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International Payments and Reserves

Progress was made in 1969 toward establishing economic conditions in the United States and other countries that would help to reduce imbalances in international payments while fostering economic growth at sustainable rates. Toward the same end, changes in the exchange parities of certain important currencies were made. At the same time there was further development of international arrangements relating to gold, Special Drawing Rights (SDR's), and the traditional operations of the International Monetary Fund, and there was also continuing international discussion of whether a better working of the international monetary system might be promoted by some increase in the flexibility of exchange rates.

U.S. BALANCE OF PAYMENTS

Despite the persistence of widespread expectations that price inflation in the United States would continue, the slackening of demand pressures in this country during 1969 was an important factor in the moderate improvement that occurred after midyear in the balance of U.S. transactions in goods and services with the rest of the world. The volume of net exports, however, was still much too small to support the flow of resources to developing countries and the growth of U.S. private investments abroad. Balance in the country's international accounts in 1969 was maintained by a further massive inflow of private foreign capital, the major part of which came through the channel of short-term investments by foreigners in the Euro-dollar market linked with borrowings by U.S. banks from their foreign branches operating in that market. The underlying imbalance between the current and the long-term capital transactions of the United States with the rest of the world still remained to be overcome.

The current account of the U.S. balance of payments was adversely affected in the first half of 1969 by a prolonged dock strike at East Coast and Gulf ports, but in the course of the year merchandise exports gained some strength, and income on foreign investments rose considerably. These gains were offset, however, by a persistent albeit slackening rise in imports and by large interest payments on the increasing total of U.S. liabilities to the rest of the world.

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Governmental restrictions on major types of U.S. private capital outflows were eased somewhat in April, and further changes were made in December. The predominant influence on private capital flows, however, was higher interest rates, which attracted foreign liquid funds to the United States and also affected the flow of longer-term capital.

Recorded outflows of U.S. private capital were slightly larger than in the previous year, but there were probably large unrecorded capital outflows in the first three quarters, reflected in the extremely large negative residual item in the balance of payments accounts. These unrecorded outflows were only partly offset by return flows in the last weeks of the year. Some of the recorded and unrecorded outflows, subsequently reversed, were induced by speculation on a revaluation of the German mark, but a large part probably was drawn by high Euro-dollar interest rates. While such flows from the United States added to the supply of funds available to those U.S. banks that were borrowing in the Euro-dollar market, far more important in this respect were the movements of foreign short-term capital provided through this channel. Weakness in the U.S. stock markets, combined with the enhanced advantages of holding investible funds in more liquid forms with high yields, resulted in a reduction in foreign purchases of U.S. corporate stocks and of the corporate securities sold abroad to finance U.S. direct investments. These inflows of capital to acquire securities nevertheless remained very large by the standards of the years before 1968.

Liabilities to foreign monetary authorities were significantly reduced in 1969. In particular, acquisitions by foreign governments of non-liquid claims on the U.S. Treasury and of long-term deposits, which had served in 1968 to reduce the deficit as conventionally measured on the "liquidity" basis, were reversed in 1969, and this shift in direction of transactions accounted for a large part of the deterioration in the liquidity balance for the year.

TRANSACTIONS IN GOODS AND SERVICES

The balance on goods and services increased after the middle of 1969, reaching an annual rate of about $3 billion in the second half. For the year as a whole, net exports of goods and services were only $2 billion, about $0.4 billion less than in 1968 (Table 8). This result fell far short of the average surpluses of the earlier 1960's.

Merchandise exports in 1969 continued to perform reasonably well,

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TABLE 8: U.S. BALANCE OF PAYMENTS

Billions of dollars, seasonally adjusted

Item	1968	1969[p]	1969			
			I	II	III	IV[p]
Balance on goods and services	2.5	2.1	.3	.3	.7	.7
Goods	.6	.7	−.1	−(1)	.3	.5
Services, including investment income	1.9	1.4	.4	.3	.4	.2
Remittances and pensions	−1.2	−1.2	−.3	−.3	−.3	−.3
U.S. Government grants and capital, net	−4.0	−3.9	−.8	−1.2	−1.0	−.9
U.S. private capital flows, net	−5.2	−5.0	−1.4	−2.1	−1.3	−.3
Foreign capital flows, net, excl. U.S. liquid liabilities	8.6	3.9	1.6	.4	.3	1.5
Private, incl. international organizations	6.3	4.6	1.7	.6	.9	1.4
Foreign governments and central banks	2.3	−.7	−(1)	−.3	−.6	.2
Errors and omissions	−.6	−3.0	−1.2	−1.0	−1.0	.3
Balance on liquidity basis (deficit, −)	.2	−7.1	−1.7	−3.9	−2.6	1.1
Balance on liquidity basis, NSA	.2	−7.1	−1.3	−3.8	−3.0	1.0
Financed by changes in:						
U.S. reserve assets (increase, −)	−.9	−1.2	−(1)	−.3	−.7	−.2
Liquid liabilities to foreign commercial banks	3.4	9.3	3.1	4.7	1.6	−.1
Liquid liabilities to nonbanks[2]	.4	−.5	−.1	−.1	−.1	−.2
Liquid liabilities to reserve holders	−3.1	−.5	−1.7	−.5	2.2	−.5
Balance on official reserve transactions basis (deficit, −)[3]	1.6	2.7	1.1	1.2	−.9	1.3
Balance on official reserve transactions basis, NSA	1.6	2.7	1.7	1.2	−1.0	.8
Financed by changes in:						
U.S. reserve assets (increase, −)	−.9	−1.2	−(1)	−.3	−.7	−.2
Gold	1.2	−1.0	.1	−.3	−(1)	−.7
Reserve position in IMF	−.9	−1.0	−(1)	−.2	−.2	−.5
Convertible currencies	−1.2	.8	−.1	.2	−.4	1.1
Liabilities to foreign reserve holders	−.8	−1.5	−1.7	−.9	1.7	−.7
Liquid	−3.1	−.5	−1.7	−.5	2.2	−.5
Nonliquid	2.3	−1.0	+(1)	−.4	−.5	−.2

NSA—Not seasonally adjusted. [p] Preliminary

[1] Less than $50 million. [2] Including international organizations.

[3] In the accounts on this basis, "foreign capital flows" include changes in U.S. liquid liabilities to foreign commercial banks, to other private holders, and to international organizations, and exclude all transactions of foreign reserve holders.

NOTE.—Details may not add to totals because of rounding.

though the U.S. share of world exports of manufactures declined slightly. Exports advanced by about 8 per cent over the 1968 total, despite some loss of sales occasioned by the dock strike, and in the second half of 1969 they were 12 per cent higher than a year before. The year-to-year gain occurred despite a marked reduction in exports of agricultural products during the first half. As the year progressed, exports of machinery were especially strong and exports of coal and steel also advanced sharply. Exports of automotive products to Canada continued to rise as they have since the 1965 U.S.-Canadian automotive pact. Most of the export rise was in response to demands stemming from cyclically rising economic activity in the industrial countries.

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On the import side, there was a marked slowing in 1969 in the rate of intake of foreign goods as compared with the hectic pace of 1968, but the rise of 8 per cent still exceeded the rate of growth of our current-dollar GNP. Imports were rising in many major categories—most notably in capital goods, in autos from Europe and Japan as well as from Canada, and in other consumer goods. Imports of industrial materials and of foods were little changed from the already high levels of 1968. Thus, the momentum of import demand generated by the cyclical upswing appeared to be yielding, but only slowly, to efforts to stabilize the economy. The trade surplus for the year showed scant change from the $0.6 billion of 1968, though by the second half the annual rate had recovered to about $1.5 billion.

The decline in the balance on goods and services from 1968 to 1969 occurred principally in investment income flows. Income on U.S. private investments and assets abroad rose by $1 billion to about $8 billion, reflecting mainly higher earnings by foreign affiliates of U.S. firms. However, income paid to foreign holders of short-term and other claims rose by $1.4 billion, as interest rates rose and such holdings increased. Net changes in receipts and payments for other services were relatively minor. Military expenditures abroad rose somewhat faster than receipts from military sales, leaving the net payments balance on these military transactions at well over $3 billion.

TRANSFERS AND U.S. GOVERNMENT CREDITS

Private remittances, net, and U.S. Government pensions and other transfers were little changed in 1969, resulting in net payments of a little over $1 billion. U.S. Government grants (other than military) held at close to $1.7 billion. Disbursements under Government credits (including changes in related currency holdings) were down slightly for the year. Scheduled repayments on outstanding credits were about $0.2 billion higher, partly because the United Kingdom resumed repayment of postwar credits on schedule, but there was a negative shift of some $0.3 billion in nonscheduled receipts from foreign governments.

PRIVATE CAPITAL FLOWS

In 1969, as in the year before, the net flow of private capital was toward the United States and was undergoing marked changes in both size and composition. The net inflow in 1969 reached about $8 bil-

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lion, which far exceeded the nearly $5 billion of 1968, and was unparalleled, of course, in any earlier experience.

U.S. direct investors maintained a keen interest in expanding their productive facilities abroad, as evidenced by projections that indicated their expenditures for foreign plant and equipment would rise sharply in 1970. The financing of such investment through capital outflows from the United States, or from earnings retained abroad, has been limited by mandatory regulations since the beginning of 1968, but a great deal of leeway has been built up by the companies that stayed under their ceilings, and there was some loosening of the restraints in April 1969. Net corporate capital outflows associated with direct foreign investments (that is, capital outflows intended for direct investment less funds borrowed abroad) appear to have risen by about $0.4 billion in 1969. Sales of new issues abroad to finance direct investments were cut in half—from $2.1 billion to about $1 billion—but the companies made up for this difference by adding very little to balances held abroad out of the proceeds of such new issues, which they had done in 1968 to the extent of $1 billion.

U.S. banks increased their claims on foreigners subject to the Federal Reserve's foreign credit restraint program (pages 55–59) by a moderate amount during 1969, whereas they had reduced such claims substantially in the previous year. Claims on foreigners, reported by banks, of types not covered by the Federal Reserve restraint program also increased by a sizable amount in 1969.

U.S. net purchases of foreign securities amounted to about $1.4 billion in 1969, slightly more than in 1968. New foreign bond issues sold here (very largely by Canadian borrowers and international institutions) remained at about $1.6 billion, but there was some increase in U.S. purchases of foreign stocks.

While the outflow of U.S. private capital—influenced primarily by restrictions and tight credit conditions in the United States—did not change significantly in 1969, there was a dramatic shift in the behavior of foreign private investors. These investors were affected in several ways by the tightening of credit conditions in the United States and in most other countries during the year. One result was the greater difficulty encountered by U.S. companies seeking financing abroad for direct investments, as mentioned above. Similarly, after the early months of the year there was a reduced inflow into U.S. corporate stocks, resulting in a drop from a $2.1 billion inflow in 1968 to about

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$1.5 billion in 1969. Nevertheless, this rate of investment was still very high, and the continuation of the inflow in the winter when U.S. equity markets were declining indicated a persistent underlying demand. One type of long-term foreign capital inflow that grew significantly in 1969 was direct investments, which were estimated at a record high of $0.7 billion, about double the previous high of 1968. Taking into account all forms of foreign private investments in U.S. long-term assets, the inflow in 1969 was about $4.5 billion, compared with an extraordinary inflow of $6 billion in 1968.

The decline in inflows of long-term private foreign capital was far more than offset by an acceleration of the increase in liquid liabilities to foreign commercial banks and other private foreigners as reported by U.S. banks. Additions to such liabilities reached $8.8 billion in 1969, compared with an already high $3.8 billion in 1968. About $7 billion of the inflow took the form of an increase in liabilities of U.S. banks to their foreign branches, representing principally funds obtained in the Euro-dollar market. Liabilities to all commercial banks abroad, including these branches, rose by $9.3 billion through July, then rose more moderately until the final weeks of the year, when they dropped back to about the midyear level.

Some part of the funds borrowed in the Euro-dollar market may have represented deposits of U.S. residents attracted by the much higher deposit rates paid there than on deposits in banks in the United States. Other parts may have been derived from transfers of private nonbank foreign funds previously held in U.S. banks, which were reduced by $0.5 billion during the year, and from placements of funds by foreign central banks. However, the major supply factor in the market was the accumulation by private foreigners of dollar-denominated assets, typically purchased from foreign central banks, as an alternative to holding short-term investments or deposits denominated in other currencies.

In the first quarter of the year borrowing in the Euro-dollar market by U.S. banks was facilitated by a reflow of funds previously placed in German mark assets, and Euro-dollar interest rates moved up only moderately. By late April, however, renewed speculative flows into German marks, coupled with strong U.S. bank demand, were rapidly driving Euro-dollar interest rates to unprecedented highs. Although the speculative pressures were reversed in May, after the German authorities reiterated their intention not to revalue the currency upward, the demand

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by U.S. banks became intense in June. By that stage the pressure on reserves of a number of countries had become acute. In the United States there was some concern that large-scale use of Euro-dollars by some banks deflected the impact of domestic credit restraint. To remove the existing advantages with respect to reserve requirements of this means of adjustment, and to moderate the flow of funds between U.S. banks and their foreign branches and other foreign banks, on June 26 the Board of Governors proposed changes in Regulations M and D. The amendments finally adopted, which became effective in September, established a 10 per cent marginal reserve requirement on banks' borrowings from foreign branches and a reserve requirement on borrowings from unaffiliated foreign banks.[1] The banks were required to maintain the required reserves beginning in October.

Borrowings by U.S. banks through the Euro-dollar market moved within a relatively narrow range from about the end of July until near the year-end. At that time an extraordinarily large flow of funds to the United States produced a sharp drop in U.S. banks' liabilities to foreign branches. At the year-end liabilities to foreign branches were about $13 billion, which represented—as noted earlier—an increase of $7 billion for the year.

As a result of the year-end inflows, which apparently included also a considerable movement out of German marks, there was a surplus in the balance of payments measured on the liquidity basis in the fourth quarter, in contrast to very large deficits in the first three quarters when liquid liabilities accumulated. The deficit for the year on the liquidity basis amounted to $7.0 billion. This was a drastic change from the small surplus for 1968, but the deterioration can be traced in large part to such transient features as the reversal of "special" intergovernmental transactions, which accounted for more than $3 billion of the change and a net increase of perhaps $2 billion in unrecorded outflows.

[1] The marginal reserve requirement under Regulation M applies to a bank's net liabilities to its branches in excess of a reserve-free base amount, initially a May 1969 4-week average but subject to automatic reduction if average liabilities in a reserve-computation period fall below the base. Also covered are assets held by domestic offices at the time of the proposal and later sold to branches, and loans by branches to U.S. residents. An alternative reserve-free base equal to 3 per cent of total deposits subject to ordinary reserve requirements may be used by a bank; this base is not subject to automatic reduction. The special reserve requirement (under Regulation D) on borrowings from unaffiliated foreign banks is 10 per cent on the excess of such borrowings over 4 per cent of a bank's deposits, and 3 per cent up to that.

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As noted above, this probably included a circular flow of U.S. funds to the Euro-dollar market and back to U.S. banks, not entirely unwound at the year-end. The net balance of transactions other than "special" transactions or circular flows apparently worsened by about $2 billion.

OFFICIAL RESERVE TRANSACTIONS

As measured on the official settlements basis the U.S. balance of payments registered a surplus of nearly $3 billion in 1969. The principal factor in the difference between the liquidity deficit and this surplus was the very large inflow of private funds through the borrowings of U.S. banks, described above, which had the effect of reducing U.S. liabilities to foreign official accounts and, at a further stage, of increasing U.S. reserve assets.

During the year U.S. international reserve assets increased by $1.25 billion. The increase reflected purchases of nearly $1 billion of gold by the U.S. Treasury from foreign monetary authorities, the addition of $1 billion to the reserve position in the IMF, and a reduction of $0.75 billion in holdings of convertible foreign currencies as a result of net repayments of earlier central bank swap drawings, notably by the United Kingdom. The increase in U.S. gold holdings resulted primarily from purchases from France in the first half of the year and from Germany at the year-end. Developments in 1969 affecting gold markets are discussed on pages 62–64.

The net reduction in U.S. liabilities to foreign monetary authorities was $1.5 billion, compared with a decline of $0.75 billion in 1968. About $1 billion of the decline occurred in certain nonliquid claims on the U.S. Treasury and on U.S. commercial banks held by foreign monetary authorities; in 1968 such claims had increased by $2.3 billion.

FEDERAL RESERVE OPERATIONS IN FOREIGN CURRENCIES

Serious imbalances in international trade and payments kept the international financial system under strain in 1969—as in most recent years. Along with the developments in the U.S. balance of payments discussed above, particularly noteworthy were the persistence of large current-account surpluses for Germany and Japan and the continuation during part of the year of a large payments deficit for France. The U.K. balance of payments showed marked improvement, as the result of the

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November 1967 devaluation of the pound and subsequent policy actions restraining the British domestic economy.

By the end of the year important tendencies toward better balance had been set in motion by the devaluation of the French franc in August, which was accompanied by measures of domestic restraint, and by the revaluation upward of the German mark in October (following a 4-week period in which the exchange rate for the mark was allowed to float upward). But before these currency adjustments were initiated, massive speculative flows had occurred, especially into German marks—once in the spring and again in September after the French franc devaluation and before the German elections.

The French franc was under substantial selling pressure in the spring and early summer. Some other European currencies also experienced speculative buying and selling then and later, occasioned by expectations or fears that their parities might be adjusted along with that of one or the other of the major currencies. An additional cause of strain on the reserves of many continental European central banks during the first 7 months of 1969 was the massive flow of funds to the United States through the Euro-dollar market discussed above.

After the exchange rate for the mark was allowed to float at the end of September, a reverse flow of funds began—out of the German mark into other European currencies and the dollar. This flow continued to be heavy through the rest of the year.

As in earlier years, the Federal Reserve's foreign currency operations were aimed at cushioning the impact of destabilizing flows of international payments, in cooperation with foreign central banks and the U.S. Treasury. Foreign central banks continued to make substantial use of their swap facilities with the Federal Reserve during 1969. However, their repayments exceeded their drawings by $1.0 billion, and total drawings outstanding at the end of the year were reduced to $650 million. The Bank of France drew on the facility during the May speculative crisis, but by the end of June had repaid these and earlier drawings with the proceeds of gold sales and credits from other sources. Drawings were also made at times by the Netherlands Bank, the National Bank of Belgium, the National Bank of Denmark, and the Austrian National Bank, but these were all repaid by October. The Bank of England, which was able to retire a substantial amount of short-term indebtedness to foreign central banks during 1969, reduced its outstanding indebtedness under Federal Reserve swaps from $1,150

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million to $650 million. During the year the bank made new drawings on the facility during the periods of speculation on a mark revaluation in early May and in the summer.

The Federal Reserve, for its part, made less use of its network of swap facilities in 1969 than it had in any other year since 1963, the first full year of System foreign currency operations. This resulted from the fact that foreign reserve holdings in dollars were in many cases being reduced.

At the beginning of 1969 the Federal Reserve had about $430 million of swap drawings outstanding in German marks and Swiss francs. The mark drawings were fully repaid by the end of January as funds continued to flow out of marks in the unwinding of the November 1968 speculative episode. The Swiss franc drawings were sharply reduced in February and were fully liquidated in April with the proceeds of a Swiss franc-denominated U.S. Treasury security issued to the Swiss National Bank. In the spring the System drew again on the facilities with both the Swiss National Bank and the Netherlands Bank, but by September it had repaid all swap drawings.

In October the Federal Reserve drew $200 million of Swiss francs on the Swiss National Bank to cover increased dollar holdings of that bank resulting from repatriations by Swiss commercial banks as credit conditions tightened in Switzerland. It also drew $300 million of guilders on the Netherlands Bank as Dutch residents repatriated funds from Germany and speculative funds moved into guilders. By year-end the outstanding amount of these Federal Reserve swap drawings had been reduced to $330 million.

The Federal Reserve's reciprocal currency arrangements with 14 central banks and the BIS were increased by $475 million during 1969 to a total of $10,980 million. Facilities with the Bank of Norway, the National Bank of Denmark, the National Bank of Belgium, and the Austrian National Bank were increased and that with the Netherlands Bank decreased during the year.

FOREIGN CREDIT RESTRAINT PROGRAM

During 1969 the Board continued to administer that portion of the Government's balance of payments programs that applied to banks and other financial institutions, initially in accordance with guidelines revised on December 23, 1968, which were described in the ANNUAL REPORT for 1968.

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In issuing the revised guidelines in December 1968, the Board indicated its intention to review the program again early in 1969, particularly to determine whether additional flexibility for financing U.S. exports might be provided in the guidelines. During the first quarter of 1969, meetings were held in seven Federal Reserve Bank cities by representatives of the Board with officers of the Federal Reserve Banks and with representatives of banks and other financial institutions reporting to the Federal Reserve Banks under the program.

It was concluded that, while there was adequate capacity for the financing of exports under the existing aggregate ceiling, it would be possible to provide greater flexibility by giving relatively larger ceilings to small and medium-sized banks whose major interest in international lending was the financing of exports. At the same time, larger ceilings for these banks would reduce competitive inequities among reporting institutions. Accordingly, revised guidelines were issued by the Board on April 4, 1969.

For about half of the reporting banks, accounting for more than 90 per cent of total foreign assets reported, the ceilings remained at the level suggested by the guidelines issued in December 1968. The remaining banks, whose foreign assets were a relatively small proportion of their total assets, were permitted to calculate their ceilings at 1.5 per cent of total assets as of December 31, 1968. This provision added $400 million to the aggregate ceiling of the banks.

The guidelines for nonbank financial institutions remained essentially unchanged although the ceiling was increased from 95 per cent of the end-of-1967 base figure to 100 per cent of the base.

A continued restrictive monetary policy and high domestic demand for credit held down the banks' foreign lending and investment during 1969. In fact, these factors may have had a greater impact than the foreign credit restraint program in moderating the foreign activities of financial institutions. As described in the ANNUAL REPORT for 1968, the banks had reduced their foreign claims covered by the guidelines by $612 million in 1968, or by $212 million more than the objective set on January 1, 1968. These assets fluctuated during 1969 and at the year-end were $165 million above the total outstanding on December 31, 1968. At the end of 1969 such assets were about $75 million below the December 31, 1964, base figure (Table 9).

Nonbank financial institutions reduced their holdings of foreign assets subject to the guideline ceiling by $174 million in 1969 (Table

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10). Such holdings had declined by $240 million in 1968, considerably more than the targeted reduction of $100 million. Holdings of foreign assets not subject to the ceiling were increased by $1,055 million in 1969, compared with an increase of $632 million in 1968.

TABLE 9: FOREIGN CREDITS OF U.S. BANKS

Item	End of year				1969			
	1965	1966	1967	1968	Mar. 31	June 30	Sept. 30	Dec. 31
Number of reporting banks....	161	148	151	161	159	162	167	169
	Millions of dollars							
Total foreign credits subject to General Ceiling.....	9,652	9,496	9,865	9,253	9,127	9,502	9,115	[1]9,403
Change from previous date....	+156	−156	+369	−612	−126	+375	−387	[1]+288
Ceiling.....	9,973	10,360	10,409	9,729	9,706	10,102	10,135	[2]10,092
Net leeway for further expansion of credit.....	321	864	544	476	578	600	1,020	[3]689
Export term loans subject to ceiling[4].....	.....	.....	.....	.....	.....	.....	.....	16
Export-Term-Loan Ceiling.....	.....	.....	.....	.....	.....	.....	.....	1,614
Net leeway for further expansion of export term loans....	.....	.....	.....	.....	.....	.....	.....	1,598

[1] From Dec. 1, 1969, excludes export term loans.
[2] From Dec. 1, 1969, General Ceiling, excluding Export-Term-Loan ceiling.
[3] From Dec. 1, 1969, leeway under General Ceiling.
[4] Foreign credits with maturities of 1 year or longer that finance exports of U.S. goods and services

On December 17, 1969, in connection with a modest modification of the Government's balance of payments programs, the Board issued revised guidelines for banks and nonbank financial institutions. For the first time, a separate Export-Term-Loan Ceiling was established for credits with a maturity of 1 year or longer extended to finance exports of U.S. goods and services shipped or provided on or after December 1, 1969. Banks also were provided with a General Ceiling, equal to their adjusted ceiling as of November 30, 1969, within which they could make loans of any maturity and for any purpose. However, in using the General Ceiling, the banks were requested to continue to observe an absolute priority for export credits, and in making nonexport credits, to meet the needs of the developing countries. The General Ceiling continued to be reduced by repayments of nonexport term loans to residents of developed countries of continental Western Europe. In addition, repayments of export term loans outstanding

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when the revision was made were to be deducted from the General Ceiling and added to the Export-Term-Loan Ceiling.

The Export-Term-Loan Ceiling was calculated at 0.5 per cent of a bank's total assets as of December 31, 1968. Adoption of this formula

TABLE 10: FOREIGN ASSETS OF REPORTING NONBANK FINANCIAL INSTITUTIONS

Amounts shown in millions of dollars

Type of asset	Amount Dec. 31, 1969	Change from Dec. 31, 1968	
		Amount	Per cent
ASSETS SUBJECT TO GUIDELINE			
Deposits and money market instruments, foreign countries except Canada	15	1	9.8
Short- and intermediate-term credits, foreign countries except Canada[1]	205	−26	−11.2
Long-term investments, "other" developed countries:[2]			
Investment in financial businesses[3]	129	17	15.5
Investment in nonfinancial businesses[3]	9	1	12.4
Long-term bonds and credits	546	−67	−10.9
Stocks[5]	352	−101	−22.3
TOTAL holdings of assets subject to guideline	**1,257**	**−174**	**−12.1**
Adjusted base-date holdings[6]	1,491	−89	−5.6
ASSETS NOT SUBJECT TO GUIDELINE			
Investments in Canada:			
Deposits and money market instruments	220	91	70.9
Short- and intermediate-term credits[1]	168	21	14.1
Investment in financial businesses[3]	625	34	5.8
Investment in nonfinancial businesses[3]	44	(4)	−.1
Long-term bonds and credits	8,286	374	4.7
Stocks	1,319	−18	−1.3
Bonds of international institutions, all maturities	1,002	15	1.5
Long-term investments in the developing countries and in Japan:			
Investment in financial businesses[3]	26	3	14.6
Investment in nonfinancial businesses[3]	12	2	24.2
Long-term bonds and credits	787	17	2.2
Stocks	503	316	169.4
Stocks, "other" developed countries[7]	569	199	53.7
TOTAL holdings of assets not subject to guideline.	**13,563**	**1,055**	**8.4**

[1] Bonds and credits with final maturities of 10 years or less at date of acquisition.
[2] Developed countries other than Canada and Japan.
[3] Net investment in foreign branches, subsidiaries, or affiliates, in which the U.S. institution has ownership interest of 10 per cent or more.
[4] Less than $500,000.
[5] Except those acquired after Sept. 30, 1965, in U.S. markets from U.S. investors.
[6] Dec. 31, 1967, holdings of assets subject to guideline, less carrying value of equities included therein but since sold, plus proceeds of such sales to foreigners.
[7] If acquired after Sept. 30, 1965, in U.S. markets from U.S. investors.

added about $1.6 billion to the aggregate ceiling and distributed it more widely among banks. Twenty of the Nation's largest banks accounted for about three-quarters of the General Ceiling, which is calculated as a percentage of foreign assets. These banks received slightly

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more than one-half of the new Export-Term-Loan Ceiling. At the year-end reporting banks were about $700 million below the General Ceiling effective on that date, and they also had a leeway of $1.6 million within which to make export term loans (Table 9).

The guidelines for nonbank financial institutions contained only one substantive change. In view of Japan's strong reserve and balance of payments position, special treatment accorded to long-term investment in that country was terminated. Long-term loans and investments in Japan after January 1, 1970, were to be counted against the reporting institution's ceiling under the guidelines. Each institution's ceiling was revised to include any such loans and investments held on December 31, 1969.

INTERNATIONAL MONETARY ARRANGEMENTS AND THE IMF

Important developments in international monetary arrangements in 1969 centered in, or were closely related to, the structure and operations of the International Monetary Fund. The outstanding event, which marked the culmination of years of study and negotiation, was the launching of a system for the deliberate creation of international reserve assets. After completion of the process of amending the IMF Articles of Agreement to establish the legal framework for the system of Special Drawing Rights, the Fund in October made the decision to allocate SDR's for the first period, a period of 3 years beginning January 1, 1970.

The establishment of the SDR system and the decision to begin creation of SDR's were of landmark significance for orderly growth of international liquidity. Also important to the sound growth of international liquidity in the years ahead was the Fund's decision to recommend to its members a substantial increase in quotas.

A development that had immediate stabilizing effects was the settlement of the question of the circumstances under which the Fund will buy gold from South Africa. Toward the year-end, expectations that this question would soon be settled appeared to have reinforced other influences that had already caused a marked easing in free-market prices of gold during the summer and the autumn.

The year was also marked by open discussion of the possible desirability of a limited increase in the flexibility of exchange rates and by a decision of the IMF to continue its study of this subject.

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AMENDMENT OF THE ARTICLES OF AGREEMENT

In 1969 the IMF Articles of Agreement were amended for the first time since their entry into force on December 27, 1945. The main purpose of the amendment was to establish the legal framework for the system of SDR's. Certain changes in Fund rules and practices relating to its traditional operations were also made.

The Outline Plan for SDR's had been agreed upon at the annual meeting of the Fund's Board of Governors held at Rio de Janeiro in September 1967. At Stockholm, in March 1968, a consensus on controversial issues had been reached by the Ministers and the Governors of the central banks of the Group of Ten. On these bases, the detailed text of the amendment was prepared by the Executive Directors, recommended by them on April 16, 1968, and approved by the Fund's Board of Governors on May 31, 1968. The amendment entered into force on July 28, 1969, following its acceptance—as required under the Articles—by three-fifths of the Fund's member countries representing four-fifths of the total voting power.

The amended Articles of Agreement establish two separate accounts in the Fund, a General Account and a Special Drawing Account. The traditional operations and transactions of the Fund are carried out through the General Account, while the Fund's functions relating to SDR's are carried out through the Special Drawing Account. In order to become a participant in the Special Drawing Account, a member country of the Fund—and only Fund members are eligible to become participants—must deposit with the Fund an instrument setting forth that it undertakes all the obligations of a participant in that Account. But no member could become a participant until instruments of participation had been deposited by members having at least 75 per cent of total quotas in the Fund. This requirement was fulfilled on August 6, 1969.

The main features of the SDR system were summarized in the ANNUAL REPORT of the Board of Governors of the Federal Reserve System for 1968 (pages 329 and 330).

ALLOCATION OF SPECIAL DRAWING RIGHTS

The main event of the annual meeting of the IMF in 1969 was the approval by the Governors of the proposal by the Managing Director for the allocation of SDR's for the "first basic period."

SDR's come into existence via "allocation" of them to each member

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country that is a participant in the Special Drawing Account and that wishes to receive an allocation. A decision to allocate SDR's is made by the Board of Governors of the Fund on the basis of a proposal of the Managing Director concurred in by the Executive Directors—a decision to cancel SDR's would be made in the same way. A decision to allocate covers a basic period of 5 years (running consecutively), unless the Fund decides otherwise.

Before making any allocation proposal, the Managing Director "shall conduct such consultations as will enable him to ascertain that there is broad support among participants for the proposal." And before making the proposal for the first allocation, the Managing Director had to assure himself: that a collective judgment existed that there was a global need to supplement reserves; that a better balance of payments equilibrium had been attained; and that there was a likelihood of a better working of the balance of payments adjustment process in the future. (All these provisions form part of Article XXIV.)

On September 12 the Managing Director, having conducted the necessary consultations and having assured himself of the existence of the conditions just referred to, made a proposal to the Fund Governors, with the concurrence of the Executive Directors. The essential features of the proposal were as follows: (1) The first basic period would run for 3 years beginning on January 1, 1970; (2) allocations during this basic period would be made on January 1 in each of the years 1970 through 1972, on the basis of quotas on the day before the allocation dates; and (3) the total amounts of SDR's allocated on the three allocation dates would be approximately as follows: $3.5 billion, $3 billion, and $3 billion, respectively, or a total of about $9.5 billion for the 3 years.

On October 3 the Fund Governors, assembled in their annual meeting, approved the Managing Director's proposal. On January 1, 1970, in accordance with this decision and the terms of the Articles of Agreement as amended, the Fund allocated $3,414 million of SDR's to 104 participants. Of the total amount allocated the United States received $866.9 million of SDR's.

PROPOSED INCREASE IN QUOTAS

Under Section 2 of Article III of the Fund Agreement, the Fund is required to conduct periodically a general review of quotas and to propose an adjustment of them if it deems such action appropriate.

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Increases made following general reviews in 1958 and 1965 (together with additions of new members and occasional adjustments of individual quotas) raised total quotas from the original $7 billion to about $21 billion at the end of 1969.

In 1969, with another general review of quotas due in 1970 at the latest, a new factor was present in the weighing of the pros and cons of quota increases. This was the growing possibility of early activation of the SDR system, which gave rise to new considerations. On the one hand, some countries tended to feel that provision for unconditional liquidity in the form of SDR's (to the extent that SDR use is unconditional) would reduce the need for more conditional liquidity under larger quotas. On the other hand, the fact that SDR allocations are based on the quotas of participants tended to give every participant or potential participant in the SDR system a somewhat greater interest in enlarging its own quota (in the forthcoming new round of quota increases) than it would otherwise have had, although other considerations also strengthened the desire of some countries for larger quotas.

At its 1969 annual meeting the Board of Governors of the Fund requested the Executive Directors to submit an appropriate proposal by December 31 for the adjustment of members' quotas. In December the Executive Directors, having completed the fifth general review of quotas, submitted their proposal. If each member country were to avail itself of the maximum increase proposed for it, total Fund quotas would rise to $28.9 billion, an increase of 35.5 per cent from total quotas as of the end of December 1969. The U.S. quota could rise to $6,700 million from its present level of $5,160, an increase of 30 per cent.

Under the proposal, no increase will take place before October 30, 1970; and members will be able to consent to the proposed increases in their quotas at any time on or before November 15, 1971.

DEVELOPMENTS RELATING TO GOLD

Under the two-tier system of gold marketing established 2 years ago by the communiqué issued in Washington on March 17, 1968, by the central bank Governors of the seven active member countries of the then existing Gold Pool, central banks generally have neither sold gold in private gold markets nor bought gold there. (For the text of the

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communiqué see the Federal Reserve *Bulletin* for March 1968, page 254. The two-tier system was discussed in the ANNUAL REPORT of the Board of Governors for 1968, pages 331 and 332.) Since that time, and especially in the closing months of 1969, the question of the appropriate handling of newly mined South African gold and reserves within the framework of the two-tier system has been discussed among officials of the United States, South Africa, certain other countries, and the IMF.

On December 16 the U.S. Treasury, in a statement referring to those discussions, suggested that a basis for a satisfactory mutual understanding might be emerging and noted that it was anticipated that the discussions would subsequently be pursued in the framework of the IMF. The question was settled before the end of the year by an arrangement embodied in an IMF decision announced by the Fund on December 30. In its announcement the Fund said it would buy gold offered to it by South Africa whenever the latter indicates that the offer is in accord with the South African policy statement set forth on December 23 in a letter to the Managing Director. In a letter of December 24 to the Managing Director the U.S. authorities indicated their willingness to support IMF decisions to buy gold offered by South Africa under the conditions outlined in the South African letter, assuming that there is an understanding among Fund members generally that they do not intend to initiate official gold purchases directly from South Africa.

In general, the arrangement provides that when the market price of gold is $35 per ounce or less, the Fund will buy gold from South Africa in amounts related to South Africa's current needs for foreign exchange. In addition, the Fund may buy gold from South Africa in limited amounts when the market price is above $35 per ounce, under circumstances specified in the South African letter.

The three documents mentioned above—the IMF announcement, the South African letter, and the U.S. letter—were published in the Federal Reserve *Bulletin* for January 1970, pages 107–10.

Throughout the first 3 months of 1969, gold prices in private markets had advanced fairly steadily, reaching $43.80 per ounce on the London market in early March—the high for the year on that market. Factors contributing significantly to this rise were the general absence of new production coming into the market, increased tensions

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in the Middle East, and purchases by French residents increasingly concerned about the parity of the French franc.

In early June prices dropped to around $41 per ounce, probably because of the obvious imminence of ratification of the plan for SDR's, the rising cost of holding gold as interest rates advanced rapidly in all major European money markets and in the Euro-dollar market, and an increase in the amount of new gold production coming on the market with the waning of earlier strength in the balance of payments position of South Africa.

After a temporary firming in July to about $42, gold prices declined more or less steadily from early August to late October, at which time the price on the London market was about $40. The French devaluation in August, the general relaxation of tensions in foreign exchange markets after the revaluation of the German mark in October, and an increase in market offerings of newly produced gold by South Africa to finance its worsening balance of payments position —all of these contributed to the easing. Downward pressures on market prices of gold were reinforced by a growing belief that the question of South African gold sales to the IMF might be nearing settlement.

In early November gold prices began to decline quite rapidly, and by December 9 the price of gold on the London market had fallen to the official level. During the remainder of December the price ranged between $35 and about $35.30.

STUDY OF GREATER EXCHANGE-RATE FLEXIBILITY

The question whether somewhat greater flexibility should be introduced into the exchange-rate system has come increasingly to the fore in recent years. Most of the attention has centered on two proposals: one, some increase in the margins within which rates for currencies of IMF member countries may fluctuate in spot markets; and two, a system for parity-rate changes limited in their annual amounts, this system being known by such terms as the crawling peg, the sliding or gliding parity, and the self-adjusting peg. Promulgated initially by some of the academic economists who believe that systems of freely floating exchange rates (favored by many other economists) are undesirable, or unacceptable to government authorities, or both, these proposals have become of increasing interest to some businessmen and bankers, as well as to government officials, in many countries.

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One reason for the rise of interest in greater exchange-rate flexibility has been growing awareness that, under the Bretton Woods system of exchange-rate adjustment as it has evolved thus far, changes in rates are sometimes delayed too long and that such delays frequently result in prolonged periods of economic uncertainty and market disruption. Another reason, particularly influential among the U.S. businessmen and bankers who have become interested in these proposals, has been the belief that some increase in exchange-rate flexibility might from their point of view be preferable to the increase of direct restrictions on international transactions that many of them regard as likely to develop if payments imbalances are not adjusted more smoothly.

In their annual report for 1969 the Executive Directors of the IMF disclosed that in the past year they had discussed extensively the mechanism by which exchange rates can be changed, considering the subject "in the framework of the international adjustment process and with a view to a better working of the international monetary system." They plan to continue to study this subject. At the 1969 annual meeting the question of greater exchange-rate flexibility was touched on for the first time by many of the Fund's Governors. Although most of the speakers stressed the need for caution in considering fundamental changes in the existing exchange-rate system, all in effect endorsed the plan for further study of the subject by the Fund. □

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Part 2
Records, Operations, and Organization

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Record of Policy Actions of the Board of Governors

JANUARY 7, 1969

AMENDMENT TO REGULATION K, CORPORATIONS ENGAGED IN FOREIGN BANKING AND FINANCING UNDER THE FEDERAL RESERVE ACT.

Effective January 7, 1969, Regulation K was amended to reinstate a general consent for "Edge" and "agreement" corporations to make certain investments in foreign businesses.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

A previous general consent was eliminated temporarily from Regulation K in February 1968 in connection with the U.S. balance of payments program then in effect. As a result, all equity investments abroad by member banks and Edge or agreement corporations, as well as the holding by them of shares of a subsidiary that made any equity investment abroad, were subject to the specific approval of the Board of Governors. The Board now deemed it appropriate to reinstate its general consent for any Edge or agreement corporation to invest, directly or indirectly, in the shares of foreign corporations not doing business in the United States, provided that no such investment would cause the Edge or agreement corporation to have invested more than $500,000 in the shares, or to hold more than 25 per cent of the voting shares, of any such foreign corporation.

JANUARY 10, 1969

ADOPTION OF REGULATION P, MINIMUM SECURITY DEVICES AND PROCEDURES FOR FEDERAL RESERVE BANKS AND STATE MEMBER BANKS.

Effective January 13, 1969, a new Regulation P was adopted to implement the Bank Protection Act of 1968 with respect to Federal Reserve

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Banks and to State chartered banks that are members of the Federal Reserve System.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Maisel, and Sherrill. Votes against this action: None.

Absent and not voting: Messrs. Daane and Brimmer.

The new regulation: (1) provided minimum standards for security devices and procedures both to discourage robberies, burglaries, and larcenies involving financial institutions and to facilitate the identification and apprehension of persons committing such crimes; (2) established time limits for compliance and procedures for reporting on compliance; and (3) assured flexibility in the application of such standards to accommodate differing circumstances of individual banking offices.

JANUARY 27, 1969

DISAPPROVAL OF PROPOSED DISCOUNT RATE INCREASE.

The Board disapproved action taken by the executive committee of the Board of Directors of the Federal Reserve Bank of St. Louis on January 23, 1969, establishing a rate of 6 per cent (rather than 5½ per cent) on discounts for and advances to member banks under Sections 13 and 13a of the Federal Reserve Act, along with appropriately corresponding subsidiary rates on advances under other sections of the Act.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

The discount rate of the Federal Reserve Banks had been increased from 5¼ to 5½ per cent in December 1968, at which time the Board had reviewed carefully the arguments in favor of an increase of ½ percentage point, the amount of increase that had originally been

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voted by the directors of two Federal Reserve Banks, including St. Louis. The Board decided that a ¼ point advance, together with the firmer stance in open market policy that had just been adopted by the Federal Open Market Committee, would be sufficient in the economic circumstances then existing.

In proposing now that the discount rate be raised to 6 per cent, the St. Louis directors noted that such a move would place the rate closer to its historical relationship with other money market rates and would reduce the incentive for member banks to borrow from the Federal Reserve Banks. Further, in the opinion of the directors, the recent slowing that had occurred in the rate of growth of commercial bank credit reflected a rechanneling of funds around the banks, with little net effect on total credit extended in the economy, more than it represented evidence of monetary restraint. In their view a realignment of the discount rate with current market rates would indicate to the public that the Federal Reserve was in earnest in combating the prevailing strong inflationary expectations.

After consideration of the proposal the Board of Governors concluded that an increase in the discount rate at this juncture would not be appropriate in light of the imminent Treasury refinancing, the terms of which were to be announced within the next few days. Moreover, apart from the refinancing, the Board had reservations as to whether a discount rate increase, particularly one of as much as ½ percentage point, was called for by prevailing and prospective economic and financial conditions. The Board advised the St. Louis Bank, however, that its disapproval of the proposed rate increase should not be construed as indicating that the Board would not be prepared at a later date to consider whatever discount rate action the directors might believe to be justified, depending on all of the circumstances then existing. The Board noted that if there appeared to be a need for further monetary tightening, an adjustment could be made through use of one or more of the several instruments of monetary policy, including perhaps the discount rate, and that the Board would be considering these possibilities.

The effect of the Board's action was that the rates on discounts and advances contained in the existing rate schedule of the St. Louis Bank continued in effect.

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JANUARY 29, 1969

ADOPTION OF REGULATION Z, TRUTH IN LENDING.

Effective July 1, 1969, a new Regulation Z was adopted to implement Title I (Truth in Lending Act) and Title V (General Provisions) of the Consumer Credit Protection Act.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

The new regulation was designed to assure meaningful disclosure so that consumers would be able to compare more readily the various credit terms available to them and avoid the uninformed use of credit. It provided that in most cases the cost of consumer credit must be expressed in the dollar amount of finance charge and as an annual percentage rate computed on the unpaid balance of the amount financed. Other relevant credit information was also required to be disclosed.

The regulation also provided, as required by the Act, that a customer had a right in certain circumstances to cancel a credit transaction that involved a lien on his residence. Advertising of consumer credit terms was required to comply with specific provisions, and credit terms were not permitted to be advertised unless the creditor usually and customarily extended such terms.

Neither the Act nor the regulation was intended to control charges for consumer credit, or to interfere with trade practices except to the extent that such practices might be inconsistent with the purpose of the Act.

MARCH 17, 1969

AMENDMENTS TO REGULATION H, MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM.

Effective March 18, 1969, Regulation H was amended in certain technical respects.

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Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

The effect of these technical amendments was (1) to authorize Federal Reserve Banks, for good cause shown, to extend the time for publishing of reports of condition by State member banks, and (2) to permit or require a published report of condition to differ from the report submitted to the Reserve Bank in various respects. These amendments were necessitated by certain changes in the call report procedures that had recently been approved by the Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

MARCH 27, 1969

REVISION OF FOREIGN CREDIT RESTRAINT PROGRAM GUIDELINES.

Effective April 4, 1969, the guidelines covering foreign credits and investments by U.S. banks and other financial institutions were revised.

Votes for this action: Messrs. Martin, Mitchell, Brimmer, and Sherrill. Votes against this action: None.

Absent and not voting: Messrs. Robertson, Daane, and Maisel.

The voluntary foreign credit restraint program, in force since February 1965, had last been revised in December 1968, when guidelines for 1969 were issued. At that time the Board had concluded that U.S. balance of payments prospects for 1969 did not permit any basic change in the program. However, the Board announced that it was planning to reexamine the program early in 1969 to determine whether additional flexibility for financing U.S. exports might be provided in the guidelines. The current revisions in the guidelines were designed for that purpose and to reduce inequities in the program among banks of different size.

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APRIL 3, 1969

1. INCREASE IN RATES ON DISCOUNTS AND ADVANCES BY FEDERAL RESERVE BANKS.

Effective April 4, 1969, the Board approved actions that had been taken by the boards of directors of all of the Federal Reserve Banks except Boston establishing a rate of 6 per cent (rather than 5½ per cent) on discounts for and advances to member banks under Sections 13 and 13a of the Federal Reserve Act.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

Pursuant to the policy established by this action, the Board subsequently approved the same rate for the Federal Reserve Bank of Boston effective April 8, 1969.

Effective the same dates the Board approved for the respective Federal Reserve Banks a rate of 6½ per cent (rather than 6 per cent) on advances to member banks under Section 10(b) of the Federal Reserve Act. In addition the Board approved for most of the Banks increases in rates on advances to individuals, partnerships, and corporations other than member banks under the last paragraph of Section 13 of the Act.

(In accordance with the provisions of the Federal Reserve Act, the Federal Reserve Banks are required to establish rates on discounts for and advances to member banks at least every 14 days and to submit such rates to the Board for review and determination. Prior to this date the most recent rate changes were made in December 1968, as described on pages 95–97 of the Board's ANNUAL REPORT for 1968.)

2. AMENDMENT TO REGULATION D, RESERVES OF MEMBER BANKS.

Effective for the reserve computation period beginning April 17, 1969, and with applicability to average deposits for the period April 3–9, 1969, the Supplement to Regulation D was amended to increase by ½ percentage point the reserve requirement against demand deposits at all member banks.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Brimmer, and Sherrill. Vote against this action: Mr. Maisel.

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In December 1968, as recorded in the Records of Policy Actions of the Board of Governors and the Federal Open Market Committee contained in the Board's ANNUAL REPORT for 1968, the Federal Reserve System embarked on a policy of increased monetary restraint, in recognition of the continued excessive strength of economic expansion, the accompanying resurgence of inflationary expectations, and the adverse impact of rapidly rising domestic prices on the country's balance of payments. At that time the Federal Open Market Committee voted to foster firmer conditions in money and short-term credit markets, and the Board of Governors approved an increase in the Federal Reserve Bank discount rate from 5¼ to 5½ per cent. The Board had also considered the arguments for an increase of ½ percentage point in the discount rate and for an increase in reserve requirements, but it had concluded that the actions then taken were adequate in the current economic circumstances and that further steps should await an assessment of the impact of those firming actions.

Details of the intervening economic and financial developments may be found in the Record of Policy Actions of the Federal Open Market Committee beginning on page 95 of this ANNUAL REPORT. The actions now taken on the discount rate and on reserve requirements constituted a further move against inflation that was considered necessary in the light of those developments.

The reserve requirement action meant that the nearly 6,000 member banks of the Federal Reserve System had to set aside as reserves an additional $650 million, approximately $375 million at reserve city banks and $275 million at other member banks. The requirement at reserve city banks was raised from 16½ to 17 per cent on net demand deposits under $5 million and from 17 to 17½ per cent on net demand deposits over $5 million. The top rate of 17½ per cent was the highest since 1960. The increases for other member banks were from 12 to 12½ per cent on demand deposits under $5 million and from 12½ to 13 per cent on those over $5 million.

The new discount rate of 6 per cent was the highest in 40 years.

Governor Maisel, who voted for the discount rate increase but against the increase in reserve requirements, stated that he had no disagreement with the majority of the Board on either the ultimate goal being sought for the economy or with the view that demand for

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output and services was continuing to rise at an inflationary pace. However, current money market relationships had, for the preceding 5 months, led to modest growth in most monetary aggregates, a sharp rise in interest rates, and a rapid reduction of bank liquidity, and the existing relationships appeared to him proper to sustain a long period of noninflationary growth of money and credit. He concluded that until evidence arose that the demand for funds was leading to an undesirable upward shift in the rate of monetary expansion, an increase in reserve requirements was not called for.

APRIL 4, 1969

AMENDMENT TO REGULATION A, ADVANCES AND DISCOUNTS BY FEDERAL RESERVE BANKS.

Effective April 4, 1969, Regulation A was amended in respect to obligations eligible as collateral for advances.

Votes for this action: Messrs. Robertson, Mitchell, Daane, Maisel, and Brimmer. Votes against this action: None.

Absent and not voting: Messrs. Martin and Sherrill.

This action eliminated the authorization in Regulation A for Federal Reserve Banks to make 90-day advances to member banks on the security of certificates of interest issued by the Commodity Credit Corporation in a pool of notes evidencing loans made by the Corporation pursuant to a commodity loan program. Simultaneously the Board issued an amended interpretation relating to obligations eligible as collateral for advances, to add CCC certificates of interest in a price-support loan pool to the list of eligible obligations. The list included direct obligations of, and obligations fully guaranteed as to principal and interest by, the United States or any agency thereof.

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MAY 28, 1969

DISAPPROVAL OF PROPOSED DISCOUNT RATE INCREASE.

The Board disapproved action taken by the executive committee of the Board of Directors of the Federal Reserve Bank of St. Louis on May 22, 1969, establishing a rate of 7 per cent (rather than 6 per cent) on discounts for and advances to member banks under Sections 13 and 13a of the Federal Reserve Act, along with appropriately corresponding subsidiary rates on advances under other sections of the Act.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

The directors of the St. Louis Bank had proposed the action on the grounds that it would bring the discount rate into better alignment with relevant market interest rates and would reduce the incentive for member banks to make excessive use of the Federal Reserve discount window. The directors, who saw little evidence of a change in economic indicators to suggest a lessening of current inflationary pressures, also believed that an increase of 1 percentage point in the discount rate might help to convince the public that the Federal Reserve was serious in resisting the inflation and might therefore help to reduce inflationary expectations and hasten a turnaround in interest rates.

The St. Louis directors again proposed a 7 per cent discount rate on June 9 and June 12, 1969, for substantially the same reasons.

The Board decided to disapprove the proposed rate increase on the basis that it would be untimely in the light of prevailing conditions and uncertainties in financial markets. While the 6 per cent discount rate was generally out of line with short-term market interest rates, the Board noted that no difficulties appeared to have developed in member bank use of the discount window that administrative procedures could not deal with satisfactorily. The Board advised the Reserve Bank, however, that its decision to disapprove the proposed discount

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rate was taken without prejudice to any future consideration of such discount rate action as the Bank's directors might deem appropriate in the prevailing circumstances.

The directors of the following Reserve Banks also submitted proposed discount rate increases to the Board, for reasons generally similar to those given by the St. Louis directors, and these proposed rates were likewise disapproved by the Board, the action in each instance being by unanimous vote of the members present:

Bank	Date of directors' action	Proposed rate
Chicago	June 12	7
Boston	June 16	6½
Chicago	June 26	7
Kansas City	July 10	7
Chicago	July 24	7

The effect of the Board's actions was that the existing discount rate schedules of the respective Banks automatically continued in effect.

JUNE 2, 1969

AMENDMENTS TO MARGIN REGULATIONS.

1. Effective July 8, 1969, Regulations G, T, and U were amended principally to implement the provisions of P.L. 90–437, adopted in 1968, which authorized the Board to expand the margin regulations to cover credit extended for the purchase of over-the-counter stocks.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Maisel, and Sherrill. Votes against this action: None.

Absent and not voting: Messrs. Daane and Brimmer.

(With these amendments, the regulations were issued under new titles as follows: G, Securities Credit by Persons Other Than Banks, Brokers, or Dealers; T, Credit by Brokers and Dealers; and U, Credit by Banks for the Purpose of Purchasing or Carrying Margin Stocks.)

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Margin regulations limit generally the amount of credit that may be obtained to purchase securities. Previously, the requirements imposed by those regulations had applied to stocks that were registered on a national securities exchange. The main purpose of the amendments now adopted by the Board was to extend the margin regulations to cover credit extended for the purchase of certain over-the-counter stocks.

The amendments included the criteria that would be employed in selecting over-the-counter stocks that would become subject to margin requirements, and the Board announced that an initial list of such stocks subject to margin would be published on July 8, 1969, the date the amendments were to become effective.

The amendments also: (1) exempted from margin regulation bank loans to broker-dealers against inventory positions in over-the-counter stocks when such credit was used to make a bona fide market in those stocks; (2) broadened the definition of "creditor" in Regulation T to cover all brokers and dealers and thus bring under the new margin requirements all brokers and dealers handling over-the-counter accounts exclusively; (3) limited the exemption from margin regulation available through a special omnibus account to members of national stock exchanges and brokers and dealers registered with the Securities and Exchange Commission; and (4) clarified the application of Regulations G and U to loans on mutual funds.

Under the announced criteria, over-the-counter stocks subject to margin requirements would have characteristics similar to stocks registered on national exchanges.

The amendments provided that margin requirements would apply only to loans made after July 8, 1969, to purchase or carry over-the-counter stocks on the Federal Reserve list or debt securities convertible into such stocks.

Clarifying changes unrelated to implementing P.L. 90–437 included changes in one section of Regulation G regarding stock option and employee stock purchase plans. Governor Maisel dissented from these particular changes because he regarded them as a tightening rather than a clarification and his inclination was to relax in this area rather than tighten.

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2. Effective September 1, 1969, Regulations G, T, and U were amended to limit the amount of credit permitted to be extended in connection with the purchases of equity funding plans or programs.

Votes for this action: Messrs. Martin, Robertson, Mitchell, and Sherrill. Vote against this action: Mr. Maisel.

Absent and not voting: Messrs. Daane and Brimmer.

Equity funding plans or programs offer a customer a package of mutual fund shares and life insurance, the shares being pledged as collateral for a loan to pay the insurance premium. The Board concluded that there would be a serious potential for a new kind of credit expansion in the securities field if loans made in connection with such plans or programs were left entirely outside the margin regulations. On the other hand, the Board desired to permit the equity funding industry to continue to operate without serious dislocation, which dislocation seemed likely if the same margin requirement (80 per cent) were prescribed as for exchange-listed stocks. Accordingly, after consideration of comments received on proposed changes in the margin regulations, and after an oral presentation at which industry representatives were given an opportunity to present their views, the Board set the margin requirement for such plans or programs sold after August 31, 1969, at 60 per cent. This meant that a lender would be able to finance $40 in insurance premiums for every $100 in mutual funds bought by a customer.

Governor Maisel dissented because he felt that the potential for credit expansion and abuse was minor. The Board ought not to feel that it was derelict in its duty if it avoided regulating each possible area of credit use. This was particularly true when programs had desirable aspects and threatened no ill effects to the economy.

JUNE 16, 1969

AMENDMENT TO REGULATION Q, PAYMENT OF INTEREST ON DEPOSITS.

Effective August 1, 1969, Regulation Q was amended to incorporate regulations governing the advertising of interest paid on deposits by member banks of the Federal Reserve System.

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Votes for this action: Messrs. Robertson, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

Absent and not voting: Messrs. Martin and Mitchell.

The adoption by the Board of regulations governing the advertising of interest paid on deposits by member banks of the Federal Reserve System implemented the authority granted to the Board in the Act of September 21, 1968 (P.L. 90–505). Similar regulations were issued by the Federal Deposit Insurance Corporation and by the Federal Home Loan Bank Board with respect to institutions under their supervision.

The new rules, which superseded advertising guidelines set forth in a 1966 statement of policy, provided that any member bank that advertised a percentage yield on deposits based on 1 year was required to include an equally prominent disclosure of the simple interest rate, together with reference to the method of compounding. Advertising of percentage yields based on periods in excess of 1 year was prohibited.

JULY 1, 1969

ADOPTION OF SUPPLEMENT TO REGULATION Z, TRUTH IN LENDING.

Effective immediately, the Board adopted Supplement II to Regulation Z, which supplement set forth rules and procedures the Board would follow in granting exemption of State-regulated credit disclosures from Federal truth-in-lending requirements.

Votes for this action: Messrs. Martin, Robertson, Mitchell, and Maisel. Votes against this action: None.

Absent and not voting: Messrs. Daane, Brimmer, and Sherrill.

A section of the Federal Truth in Lending Act provided machinery under which the Board could exempt certain consumer credit transac-

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tions in States that have substantially similar State laws with adequate provision for enforcement. The Board's Regulation Z contained a statement that on or before July 1, 1969, the effective date of the regulation, the Board would promulgate and publish a supplement setting forth the procedures and criteria under which any State could apply for an exemption of certain State-regulated transactions.

The supplement now adopted set forth the rules and procedures the Board would follow in granting exemptions and also informed a State how to apply for such an exemption. It was noted that exemptions could be granted only with respect to the disclosure and rescission requirements of the law and Regulation Z and that advertising of credit must remain subject to the Federal jurisdiction under the Truth in Lending Act.

JULY 24, 1969

AMENDMENT TO REGULATION D, RESERVES OF MEMBER BANKS.

Effective July 31, 1969, Regulation D was amended to limit certain transactions involving member banks and foreign branches that had resulted in what the Board considered an unwarranted reduction in required reserves.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Maisel, Brimmer, and Sherrill. Votes against this action: None.

Absent and not voting: Mr. Daane.

The amendment required member banks to include in deposits used to compute reserve requirements all so-called "London checks" and "bills payable checks" used in settling transactions involving foreign branches. Such checks had been used to effect repayments of Eurodollar borrowings and to settle transactions among foreign branches of different member banks. A number of banks had issued such checks without including them in gross demand deposits, as is required for officers' (for example, cashiers') checks. At the same time, banks receiving such checks were allowed to deduct the amount from demand deposits used to compute reserve requirements. Use of these check

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devices resulted in reduced reserves for the one day the check was in the collection process and had afforded some member banks a special advantage in using Euro-dollars for adjustment to domestic credit restraint.

JULY 24, 1969

AMENDMENTS TO REGULATION D, RESERVES OF MEMBER BANKS, AND REGULATION Q, PAYMENT OF INTEREST ON DEPOSITS.

Effective July 25, 1969, Regulations D and Q were amended to narrow the scope of a member bank's liabilities under repurchase agreements (those involving sales of instruments with an agreement for subsequent repurchase) that are exempt from those regulations.

Votes for this action: Messrs. Martin, Robertson, Maisel, Brimmer, and Sherrill. Vote against this action: Mr. Mitchell.

Absent and not voting: Mr. Daane.

The previous exemptions from Regulations D and Q had permitted a member bank to exclude from deposits any indebtedness arising from a transfer of any assets under a repurchase agreement. Under the amendments now adopted, beginning August 28, 1969, every bank liability on a repurchase agreement entered into on or after July 25, 1969, with a person other than a bank became a deposit liability subject to Regulations D and Q if it involved: (1) any assets other than direct obligations of the United States or its agencies (and obligations fully guaranteed by them), or (2) a part interest in any obligation or obligations (including U.S. Government obligations).

Limitation of the exemption was considered necessary because of the recent and contemplated use by some banks of repurchase agreements to avoid reserve requirements and the rules governing payment of interest on deposits.

Governor Mitchell dissented on the grounds that repurchase agreements entered into by banks to achieve liquidity in a period of monetary restraint were no more inappropriate to monetary objectives than a

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sale of bank assets. In either case, in his opinion, restraint was not dissipated but was merely shifted in part from the bank and bank customers to market participants. Moreover, in his view the addition of this action to the other amendment to Regulation D announced today ran the risk of putting unduly severe pressures on some sectors of the banking system.

Subsequently, effective August 15, 1969, the Board issued a minor clarifying amendment to Regulations D and Q to permit member banks to continue to execute repurchase agreements on a part interest in U.S. Treasury or Federal agency obligations that are eligible for purchase by Federal Reserve Banks, and to classify their liability thereon as a nondeposit borrowing.

AUGUST 8, 1969

AMENDMENT TO REGULATION Z, TRUTH IN LENDING.

Effective immediately, Regulation Z was amended to clarify a provision relating to discounts granted by creditors on sales to their customers for prompt payment of bills.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Brimmer, and Sherrill. Votes against this action: None.
Absent and not voting: Messrs. Daane and Maisel.

Under the amendment, creditors offering discounts for prompt payment of single-payment transactions were required to state the "annual percentage rate" only if the discount exceeded 5 per cent. The amendment also simplified the computation of the "annual percentage rate" when that rate must be stated.

It had come to the Board's attention since Regulation Z went into effect on July 1 that many creditors had discontinued the use of discounts for prompt payment. This was especially true in agricultural types of credit, where there had been special difficulty with compliance. The amendment was designed to alleviate these problems.

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AUGUST 12, 1969

AMENDMENTS TO REGULATION D, RESERVES OF MEMBER BANKS, AND REGULATION M, FOREIGN ACTIVITIES OF NATIONAL BANKS.

Effective September 4, 1969, a 10 per cent marginal reserve requirement was established on certain foreign borrowings, primarily Euro-dollars, by member banks and on the sale of assets to their foreign branches.

Votes for this action: Messrs. Martin, Robertson, Maisel, Brimmer, and Sherrill. Votes against this action: Messrs. Mitchell and Daane.

Liabilities of U.S. banks to their foreign branches had more than doubled since the beginning of 1969—reaching a record of $14.6 billion during the week ending July 30. The purpose of the action now taken by the Board was to moderate the flow of foreign funds between U.S. banks and their foreign branches and also between U.S. banks and foreign banks by removing a special advantage to member banks that had used Euro-dollars not subject to reserve requirements to adjust to domestic credit restraint.

The amendments to Regulation M established a 10 per cent reserve requirement on net borrowings of member banks from their foreign branches to the extent that these borrowings exceeded the daily-average amounts outstanding in the 4 weeks ending May 28, 1969. This marginal requirement also applied to assets acquired by foreign branches from U.S. head offices of banks except for assets representing credits extended by head offices to nonresidents after June 26. To reduce potential inequities, the Board established a minimum base equal to 3 per cent of deposits subject to reserve requirements for any bank with a foreign branch regardless of its previous use of Euro-dollars.

The amendments to Regulation M also established a 10 per cent reserve requirement on branch loans to U.S. residents to the extent that such loans exceeded either the amount outstanding on June 25 or 26, 1969, or the daily-average amounts outstanding in the 4 weeks ending May 28, 1969. The choice of the base was at the option of the member bank. This amendment included three exemptions, as follows: It did not apply to any foreign branch with $5 million or less in credit

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outstanding to U.S. residents; to credit extended to enable a borrower to comply with requirements of the Office of Foreign Direct Investments, Department of Commerce; and to credit extended under lending commitments entered into before June 27, 1969.

The amendment to Regulation D established a 10 per cent reserve requirement on borrowings by member banks from foreign banks, with one exception: only a 3 per cent reserve was required against such deposits that did not exceed 4 per cent of a member bank's daily-average deposits subject to reserve requirements. This latter provision was designed to reduce inequities for banks without foreign branches that would have no reserve-free base under the Regulation M amendments.

The Board provided that the reserve-free base under the amendment establishing a reserve requirement on borrowings of U.S. banks from their foreign branches would be reduced when and to the extent that the liabilities of any bank to its foreign branches dropped below the original base during any period used to compute the reserve requirement.

Governors Mitchell and Daane dissented because they felt that the flows were attributable to tight monetary policy in the United States rather than to the Euro-dollar mechanism and that such flows would occur despite the regulation. Furthermore, in the absence of any evidence that the Euro-dollar flow was weakening over-all monetary policy, they objected to regulating unnecessarily one of the non-deposit sources of funds for banks.

AUGUST 15, 1969

AMENDMENT TO REGULATION J, COLLECTION OF CHECKS AND OTHER ITEMS BY FEDERAL RESERVE BANKS.

Effective October 1, 1969, Regulation J was amended in respect to tenders of defense in litigation involving Federal Reserve Banks.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Maisel, Brimmer, and Sherrill. Votes against this action: None.
Absent and not voting: Mr. Daane.

The purpose of the amendment was to provide a procedure under which a Federal Reserve Bank that is sued in connection with a cash

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item collected by it may recover from the sending bank expenses of such litigation and the amount of any adverse judgment by charging the account of the sending bank if the Reserve Bank has tendered defense of the suit to the sending bank and such tender has not been accepted.

OCTOBER 27, 1969

AMENDMENT TO REGULATION V, LOAN GUARANTEES FOR DEFENSE PRODUCTION.

Effective October 27, 1969, the Supplement to Regulation V was amended to provide that an agency guaranteeing a particular loan may from time to time prescribe a rate higher than 7½ per cent if it determines the loan to be necessary in financing an essential defense production contract.

Votes for this action: Messrs. Martin, Robertson, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

Absent and not voting: Mr. Mitchell.

The regulation had prescribed that the interest rate charged a borrower by a financing institution with respect to a guaranteed loan may not exceed 7½ per cent per annum. It had come to the Board's attention, however, that under existing conditions it might sometimes be impossible to arrange V-loan financing even at the prescribed maximum rate. The purpose of the amendment, therefore, was to permit a Government agency guaranteeing a loan under the Defense Production Act, as amended, to prescribe from time to time an interest rate higher than 7½ per cent if the guaranteeing agency determined that the higher rate was necessary to obtain V-loan financing of an essential defense production contract.

NOVEMBER 5, 1969

AMENDMENT TO REGULATION Q, INTEREST ON DEPOSITS.

Effective November 5, 1969, Regulation Q was amended: (1) to expand the categories of organizations on whose time deposits member banks

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of the Federal Reserve System may pay rates of interest in excess of those permitted generally, and (2) to provide an alternative method by which any exempt organization may transfer a certificate of deposit to a nonexempt holder.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

Previously a time deposit of a foreign government, a monetary or financial authority of a foreign government when acting as such, or an international financial institution of which the United States is a member was exempt from the interest rate limitations. The amendment exempted time deposits having a maturity of 2 years or less and representing funds deposited and owned by: (1) a foreign government, or an agency or instrumentality thereof engaged principally in activities that are ordinarily performed in the United States by governmental entities, (2) an international entity of which the United States is a member, or (3) any other foreign, international, or supranational entity specifically designated by the Board as exempt. This broadening of the categories of exempt organizations was consistent with the purposes of the underlying statute, that is, to encourage the maintenance of foreign governmental time deposits in American banks.

An alternative method of transferring to a nonexempt holder a certificate of deposit issued to an exempt organization also was provided. The alternative method carried the same safeguards as the method theretofore prescribed.

NOVEMBER 5, 1969

REVISION OF FOREIGN CREDIT RESTRAINT PROGRAM GUIDELINES.

Effective December 1, 1969, the guidelines covering foreign credits and investments by U.S. banks and other financial institutions were revised.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

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The revised guidelines continued the program of voluntary restraint that had been in effect since 1965. However, in keeping with the Government's efforts to help stimulate U.S. exports, the guidelines were now changed to give greater and more explicit recognition to the established priority for export financing.

Under the revised program each participating bank was to have a ceiling, separate from its general ceiling, exclusively for loans of 1 year or longer that financed U.S. goods exported on or after December 1, 1969. The guidelines for nonbank financial institutions continued to provide for a single ceiling. However, such an institution could exceed its ceiling moderately if the excess reflected new export credits that could not be accommodated under the ceiling. In addition, a nonbank institution that had had either a low ceiling or none at all could now hold certain covered foreign assets up to a total of $500,000.

The current modifications of the program had two objectives. The first was to direct greater attention to the existing priority for export financing, particularly long-term export loans, within the limits of total lending restraints. The second was to enhance the opportunities among U.S. financial institutions to compete for foreign lending business.

Announcement of the revised guidelines was made on December 17, 1969, to permit coordination with other parts of the Government interested in the U.S. balance of payments program.

NOVEMBER 6, 1969

AMENDMENT TO REGULATION Z, TRUTH IN LENDING.

Effective immediately, Regulation Z was amended to facilitate meaningful disclosure of credit terms in certain types of agricultural credit extensions.

Votes for this action: Messrs. Martin, Robertson, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

Absent and not voting: Mr. Mitchell.

The amendment provided that where the dates or amounts of payments or advances cannot be determined at the time of a credit trans-

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action because they are tied to the needs of the farmer—which change during the year—the creditor may disclose the method of computing the amount of the finance charge rather than a total dollar figure. At the same time the creditor may omit disclosure of the annual percentage rate, but he must disclose the number, amount, and due dates of the payments and the total amount to be repaid to the extent known.

A problem had arisen because some agricultural loans are made on terms governed by production and seasonal needs that cannot be determined at the time a credit transaction is arranged. In such cases the dates or amounts of advances or payments cannot be ascertained and consequently the amount of the finance charge, the repayment schedule, and sometimes the annual percentage rate must be estimated. These estimates are at best crude and often misleading, and in some cases physically impossible to make. The amendment was designed to meet these problems, reduce the burden on agricultural lenders, and insure the customer a clear and full description of his credit transaction.

NOVEMBER 10, 1969

AMENDMENT TO REGULATION R, RELATIONSHIPS WITH DEALERS IN SECURITIES UNDER SECTION 32 OF THE BANKING ACT OF 1933.

Effective January 1, 1970, Regulation R was amended to permit an officer, director, or employee of a member bank of the Federal Reserve System to be an officer, director, or employee of a securities company that confined itself to underwriting and dealing in securities a member bank itself may lawfully underwrite.

Votes for this action: Messrs. Martin, Robertson, Mitchell, Daane, Maisel, Brimmer, and Sherrill.
Votes against this action: None.

Section 32 of the Banking Act of 1933, which prohibits interlocking personnel relationships between member banks and securities companies, authorizes the Board of Governors to provide exemptions upon determining that such exemptions would not unduly influence the investment policies of the banks or the investment advice given to bank

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customers. Regulation R had provided an exemption for relationships between member banks and those securities companies that confined their business to types of obligations listed in the regulation. The effect of the amendment was to bring within the regulatory exemption general obligations of a State or political subdivision, obligations of the Government National Mortgage Association, and obligations issued by a State or political subdivision (or their agencies) for housing, university, or dormitory purposes. The first class of obligations had long been eligible for underwriting and dealing in by member banks, and the latter two classes became eligible upon the enactment of the Housing and Urban Development Act of 1968.

DECEMBER 18, 1969

AMENDMENT TO REGULATION F, SECURITIES OF MEMBER STATE BANKS.

Effective December 31, 1969, Regulation F was amended in a number of respects relating to the form and content of bank financial statements and proxy solicitation provisions.

> Votes for this action: Messrs. Robertson, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.
>
> Absent and not voting: Messrs. Martin and Mitchell.

The major purpose of the amendments was to implement the "net income" concept in bank income reports. The revisions were intended to make financial reports required by the regulation consistent with the format and instructions for the preparation of other financial reports that banks are required to publish.

Extensive revisions of the regulatory provisions relating to proxy solicitations were also included in the amendments. These were intended mainly to clarify the applicability of the various provisions of the regulation and to incorporate administrative practices adopted in the 5 years since Regulation F was first issued.

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DECEMBER 24, 1969

EMERGENCY CREDIT FACILITIES FOR NONMEMBER DEPOSITARY INSTITUTIONS.

Effective immediately and until April 1, 1970, Federal Reserve Banks were authorized to provide, in accordance with certain specified principles, emergency credit facilities to nonmember depositary institutions.

Votes for this action: Messrs. Mitchell, Daane, Maisel, Brimmer, and Sherrill. Votes against this action: None.

Absent and not voting: Messrs. Martin and Robertson.

The sharp further advance in market yields during the fourth quarter, unusually large net savings withdrawals at depositary institutions in the October quarterly reinvestment period, and preliminary reports of rather poor savings experience in some areas thus far in December had all created some concern about the possibility of substantially enlarged savings attrition at such institutions during late December and January. In those circumstances the Board believed that as a matter of general policy the Reserve Banks should be prepared, as in the summer of 1966, to provide emergency credit facilities to nonmember depositary institutions in difficulty as to the adequacy of their liquidity reserves.

Because the Federal Home Loan Bank System is responsible for providing a lender-of-last-resort accommodation to its members, the Board believed that it was more efficient for the Federal home loan banks to continue to exercise full responsibility for providing such assistance as long as their resources permitted. Accordingly, pending further exploration with the Federal Home Loan Bank Board, the Board advised the Federal Reserve Banks that they need be prepared to provide emergency credit assistance only to mutual savings banks, other banks, and savings and loan associations that are members of neither the Federal Reserve nor the Federal Home Loan Bank Sys-

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tems. Emergency credit to those types of institutions was to be provided in accordance with certain principles specified by the Board.

To provide for prompt implementation of such a program of emergency credit facilities, the Board advised the Federal Reserve Banks that, effective immediately and until April 1, 1970:

(a) member banks are permitted, pursuant to Section 19(e) of the Federal Reserve Act and Section 201.5 of Regulation A, to use as security for advances from your Bank, whether under Section 13 or Section 10(b) of the Act, assets acquired from mutual savings banks, other banks, and savings and loan associations that are members of neither the Federal Reserve nor the Federal Home Loan Bank Systems, but only in accordance with, and subject to, limitations specified by the Board; and

(b) your Bank is authorized, in accordance with the third paragraph of Section 13 of the Federal Reserve Act, in unusual and exigent circumstances to discount for the same types of nonmember institutions paper of the kinds described in that paragraph, subject, however, to the limitation therein contained and in accordance with, and subject to, limitations specified by the Board.

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Record of Policy Actions of the Federal Open Market Committee

The record of policy actions of the Federal Open Market Committee is presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of Section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each such action, and that it shall include in its ANNUAL REPORT to the Congress a full account of such actions.

In the pages that follow, there are entries with respect to the policy actions taken at the meetings of the Federal Open Market Committee held during the calendar year 1969, including the votes on the policy decisions made at those meetings as well as a résumé of the basis for the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings, rather than on data as they may have been revised later.

It will be noted from the record of policy actions that in some cases the decisions were by unanimous vote and that in other cases dissents were recorded. The fact that a decision in favor of a general policy was by a large majority, or even that it was by unanimous vote, does not necessarily mean that all members of the Committee were equally agreed as to the reasons for the particular decision or as to the precise operations in the open market that were called for to implement the general policy.

Under the Committee's rules relating to the availability of information to the public, the policy record for each meeting is released approximately 90 days following the date of the meeting and is subsequently published in the Federal Reserve *Bulletin* as well as in the Board's ANNUAL REPORT.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the

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Committee to execute transactions for the System Open Market Account. In the area of domestic open market activities the Federal Reserve Bank of New York operates under two separate directives from the Open Market Committee—a continuing authority directive and a current economic policy directive. In the foreign currency area it operates under an authorization for System foreign currency operations and a foreign currency directive. These four instruments are shown below in the form in which they were in effect at the beginning of 1969. No revisions were made in the foreign currency directive during the year; changes in the other instruments are shown in the records for the individual meetings.

CONTINUING AUTHORITY DIRECTIVE WITH RESPECT TO DOMESTIC OPEN MARKET OPERATIONS
(in effect January 1, 1969)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York

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at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed (1) $125 million or (2) 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York, whichever is the lower;

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

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate ¼ of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

CURRENT ECONOMIC POLICY DIRECTIVE
(in effect January 1, 1969)

The information reviewed at this meeting suggests that over-all economic activity is expanding rapidly and that upward pressures on prices and costs

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are persisting. Market interest rates have risen considerably further in recent weeks. Bank credit growth has been sustained by continuing strong expansion of time and savings deposits, while growth in the money supply has accelerated and U.S. Government deposits have declined. The U.S. foreign trade surplus remains very small and the over-all balance of payments apparently worsened in October and November. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining firmer conditions in money and short-term credit markets, taking account of the effects of other possible monetary policy action; provided, however, that operations shall be modified if bank credit expansion appears to be deviating significantly from current projections.

AUTHORIZATION FOR SYSTEM FOREIGN CURRENCY OPERATIONS
(in effect January 1, 1969)

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

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

Austrian schillings
Belgian francs
Canadian dollars
Danish kroner
Pounds sterling
French francs
German marks
Italian lire
Japanese yen

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Mexican pesos
Netherlands guilders
Norwegian kroner
Swedish kronor
Swiss francs

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

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

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

(3) Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $300 million equivalent.

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

(1) Commitments to deliver foreign currencies to the Stabilization Fund, up to $1 billion equivalent;

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

(3) Other forward commitments to deliver foreign currencies, up to $550 million equivalent.

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

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	225
Bank of Canada	1,000
National Bank of Denmark	100
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000
Bank of Italy	1,000
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	400
Bank of Norway	100
Bank of Sweden	250
Swiss National Bank	600
Bank for International Settlements:	
System drawings in Swiss francs	600
System drawings in authorized European currencies other than Swiss francs	1,000

3. Unless otherwise expressly authorized by the Committee, all transactions in foreign currencies undertaken under paragraph 1(A) above shall be at prevailing market rates and no attempt shall be made to establish rates that appear to be out of line with underlying market forces.

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

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

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

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

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

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

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

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

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

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

FOREIGN CURRENCY DIRECTIVE
(in effect January 1, 1969)

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

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

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

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

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

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

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

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

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

C. To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension, (2) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, and (3) market rumors of a character likely to stimulate speculative transactions. Whenever exchange market instability threatens to produce disorderly conditions, System transactions may be undertaken if the Special Manager reaches a judgment that they may help to re-establish supply and demand balance at a level more consistent with the prevailing flow of underlying

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payments. In such cases, the Special Manager shall consult as soon as practicable with the Committee or, in an emergency, with the members of the Subcommittee designated for that purpose in paragraph 6 of the Authorization for System foreign currency operations; and

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

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

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

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MEETING HELD ON JANUARY 14, 1969

Authority to effect transactions in System Account.

According to the preliminary Commerce Department estimates, expansion in real gross national product moderated to an annual rate of 3.8 per cent in the fourth quarter of 1968 from 5.0 per cent in the third quarter and more than 6 per cent in the first half of the year. However, the pace of advance in average prices—as measured by the GNP deflator—increased in the fourth quarter. Staff projections suggested that the rate of expansion in economic activity would slacken further in the first half of 1969.

Growth in consumer spending slowed sharply in the fourth quarter as the increase in disposable income remained moderate and the rate of personal saving rose. Growth in Federal outlays on goods and services continued to slacken. At the same time, the rate of business inventory accumulation increased substantially, and both business spending on plant and equipment and residential construction outlays advanced considerably.

In December retail sales declined markedly—perhaps partly because of an influenza epidemic—and reached their lowest level since the spring of 1968. However, industrial production and nonfarm payroll employment continued to rise rapidly, and the unemployment rate remained at the low level of 3.3 per cent to which it had fallen in November. With tight conditions persisting in labor markets, average wage rates in all major industry groups advanced considerably further.

Average wholesale prices of industrial commodities rose during the month ending in mid-December to a level 2.5 per cent above a year earlier, and an unusually large number of increases in such prices were announced subsequently. The consumer price index advanced substantially further in November and was 4.8 per cent above its year-earlier level—the largest increase in any 12-month period since 1951.

The staff projections for the first half of 1969 suggested that increases in consumer spending would remain moderate—partly because of the effects on disposable income of higher social security taxes and retroactive payments on 1968 income taxes—and that the rate of inventory accumulation would decline as businesses adjusted

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to the slower growth in final sales. It appeared likely that there would be little further rise in Federal outlays, with a sizable surplus emerging in the fiscal position of the Government, and that residential construction activity would be increasingly limited by the reduced availability of mortgage funds. On the other hand, prospects were for continued rapid growth in business capital outlays.

With respect to the U.S. balance of payments, in the last week of December there was an exceptionally large volume both of foreign official transactions that reduced U.S. liquid liabilities and of inflows of private funds, including a sizable volume of funds drawn from the Euro-dollar market by direct-investment affiliates of U.S. corporations. These inflows were large enough to produce a substantial, although probably temporary, surplus in the fourth quarter in the payments balance on the liquidity basis of calculation.[1] The surplus on the official reserve transactions basis was lower in the fourth quarter than in the third, in part because there was a year-end decline in Euro-dollar liabilities of U.S. banks to their foreign branches as a counterpart of the private capital inflows. In early January liabilities to foreign branches increased sharply and interest rates in the Euro-dollar market, which had reached record levels in late 1968, rose further.

For the full year 1968, despite a sharp deterioration in the merchandise trade balance, there was a small surplus in the over-all payments balance on the liquidity basis and a larger one on the official settlements basis; on both bases, substantial deficits had been incurred in 1967. While data were still preliminary and incomplete, it appeared that the elements making for the shift to surplus in 1968 included a heavy volume of foreign private long-term investment in the United States, particularly in equity securities; a reduction in net use of U.S. funds for direct investment abroad that was apparently larger than

[1] The balance on the "liquidity" basis is measured by changes in U.S. reserves and in liquid U.S. liabilities to all foreigners. The balance on the "official reserve transactions" basis (sometimes referred to as the "official settlements" basis) is measured by changes in U.S. reserves and in liquid and certain nonliquid liabilities to foreign official agencies, mainly monetary authorities. The latter balance differs from the former by (1) treating changes in liquid U.S. liabilities to foreigners other than official agencies as ordinary capital flows, and (2) treating changes in certain nonliquid liabilities to foreign monetary authorities as financing items rather than ordinary capital flows.

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the $1 billion required by the Commerce Department guidelines; and a larger net inflow of bank-reported claims than was required under the Federal Reserve guidelines, in contrast to the outflow of 1967. Also affecting the liquidity balance was a substantial volume of special transactions with foreign governments; and affecting the official settlements balance was a large net inflow of liquid funds through foreign branches of U.S. banks and other foreign banks. With respect to U.S. merchandise trade, the surplus for the first 11 months of 1968 totaled only about $300 million, compared with about $3.5 billion for the full year 1967.

On the day of this meeting the Treasury was auctioning $1.75 billion of tax-anticipation bills due in June for payment on January 20. The Treasury was expected to announce around the end of January the terms on which it would refund notes and bonds maturing in mid-February, of which about $5.4 billion were held by the public.

Open market operations since the December 17, 1968, meeting of the Committee had been directed toward attaining firmer conditions in money and short-term credit markets, while taking account of the increase from 5¼ to 5½ per cent in Federal Reserve Bank discount rates announced on the day of that meeting. The System absorbed reserves early in the interval and again near the close. But in the intervening period it supplied reserves to cushion an unduly sharp market reaction to the increase in restraint and to cope with substantial year-end strains. The effective rate on Federal funds fluctuated widely—with some trading at rates as high as 7⅛ per cent, a new record, at the end of December—but was mostly in a range of 6¼ to 6⅝ per cent, considerably above the range of previous weeks. In the single week ending January 1 member bank borrowings averaged $1.3 billion, a 16-year high; and in the 4 weeks ending January 8 they averaged $815 million, compared with an average of $515 million in the preceding 4 weeks. Average excess reserves also increased substantially in the interval, however, so that the rise in net borrowed reserves was relatively moderate.

Interest rates on both short- and long-term Treasury securities rose to new highs in the week following the mid-December meeting of the Committee, and although these yields subsequently declined somewhat, they remained well above earlier levels. The market rate on 3-

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month Treasury bills, for example, advanced from 5.94 per cent on December 16 to a peak of 6.29 per cent on December 24 and then declined irregularly to 6.13 per cent on the day before this meeting. Yields on other short-term market instruments also rose considerably on balance. In markets for corporate and municipal bonds, yields fluctuated in a rather narrow range around the highs reached in mid-December. New-issue volume in December was unusually small for corporate bonds; for municipal bonds, it was below the monthly average for the year largely because of the withdrawal of several scheduled offerings.

Net inflows of deposits to nonbank financial intermediaries slackened somewhat in November and apparently also in December. Yields on home mortgages in the secondary market continued to advance and by early January were close to the high that had been reached in the preceding June.

Since late November most major banks had been offering the maximum permissible rates under Regulation Q for large-denomination negotiable certificates of deposit (CD's) of all maturities. But as short-term market rates of interest continued to rise, CD's became progressively less competitive, and during December and early January there were declines in the volume outstanding—particularly at large money market banks—of considerably greater than seasonal dimensions. However, inflows of consumer-type time and savings deposits remained substantial during much of December, and on the average total time and savings deposits at banks increased at about the relatively rapid rate of November. The money stock expanded in December at an estimated annual rate of about 6 per cent—roughly half the November rate—although it bulged sharply around the turn of the year.

The prime lending rate of commercial banks, which had been raised to 6½ per cent on December 2, was advanced to 6¾ per cent on December 18—the day after the increase in discount rates was announced—and then to a record 7 per cent on January 7. In December, according to preliminary estimates, growth in business loans slowed considerably, as did bank acquisitions of municipal securities. However, the sharp decline in bank holdings of Treasury securities that had occurred in November was not repeated in December. Total

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bank credit, as measured by the bank credit proxy—daily-average member bank deposits [2]—rose from November to December at an annual rate of about 13 per cent, compared with 11 per cent in the previous month and 13 per cent in the second half of 1968. After adjustment for changes in the daily average of U.S. bank liabilities to foreign branches—which increased slightly in November but fell sharply in December—the proxy series expanded at an annual rate of about 11.5 per cent in both months.

Staff projections suggested that if existing Regulation Q ceilings and prevailing money market conditions were maintained there would be further large declines in the volume of CD's outstanding and a marked slowing of inflows of consumer-type time and savings deposits. The average level of the money stock was expected to be considerably higher in January than in December because of the sharp but largely temporary increase in late December and early January. With respect to bank credit, the staff projections suggested that the proxy series would expand in January at an annual rate in the range of zero to 3 per cent. After adjustment for the marked increase in U.S. bank liabilities to foreign branches that had already occurred in early January, growth in the credit proxy was projected in a range of 2 to 5 per cent. For February, prospects were for continued run-offs of CD's and no significant increase in the rate of bank credit growth.

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[2] In recent years the Committee has been making use of daily-average statistics on total member bank deposits as a "bank credit proxy"—that is, as the best available measure, although indirect, of developing movements in bank credit. Because they can be compiled on a daily basis with a very short lag, the deposit figures are more nearly current than available bank loan and investment data. Moreover, average deposit figures for a calendar month are much less subject to the influence of single-date fluctuations than are the available month-end data on total bank credit, which represent estimates of loans and investments at all commercial banks on one day—the last Wednesday—of each month. For statistics on daily-average member bank deposits, see the table in the statistical section of the Federal Reserve BULLETIN (on page A-17 of the January 1969 issue). Some brief comments on the relation between the member bank deposit series and the bank credit statistics are given in the note on p. 1460 of the October 1966 BULLETIN.

As indicated in that note, movements in total member bank deposits and in commercial bank credit can diverge for various reasons, including changes in nondeposit liabilities of banks. Because changes in U.S. bank liabilities to foreign branches recently have been an important source of divergence from time to time, an "adjusted" proxy series, taking approximate account of such changes, is now also being calculated for Committee use.

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In the Committee's discussion it was noted that, despite the indications of slowing in the rate of economic expansion, upward pressures on prices persisted and inflationary expectations remained widespread. It also was noted that the recent improvement in the U.S. balance of payments, while encouraging, did not imply that a sustainable equilibrium had been achieved, particularly in view of the marked deterioration in the U.S. trade surplus during 1968.

The Committee agreed that under these circumstances it would be desirable at present to maintain the existing degree of monetary restraint. The fact that the Treasury would be announcing a refunding around the end of January also was mentioned as militating in favor of an unchanged policy. The sharp slowing of growth in bank credit projected for January and February was generally considered to be appropriate, especially in light of the high growth rates of recent months. The view was expressed, however, that it would be undesirable to curtail bank credit drastically for an extended period.

The Committee decided that open market operations should be directed at maintaining the prevailing firm conditions in money and short-term credit markets, with the proviso that operations should be modified—to the extent permitted by the forthcoming Treasury refunding—if bank credit expansion appeared to be deviating significantly in either direction from current projections. Comments were made as to the desirability, on the one hand, of moderating any undue liquidity pressures that might develop and, on the other hand, of also moderating any tendency toward easing of money market conditions that might be brought about by seasonal forces.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that expansion in real economic activity has been moderating, with slower growth in consumer outlays but higher rates of business inventory accumulation and capital expenditures. Upward pressures on prices and costs, however, are persisting. Since the mid-December firming of monetary policy, most interest rates have risen further and, with the outstanding volume of large-denomination CD's declining sharply, bank credit expansion has slowed. Growth in the money supply moderated somewhat on average in December from its rapid November pace. The U.S. foreign trade surplus remains very small but near

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the end of the year unusual capital inflows had a markedly favorable effect on the over-all balance of payments. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the forthcoming Treasury refunding, if bank credit expansion appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Robertson, Sherrill, and Treiber. Vote against this action: Mr. Morris.

Absent and not voting: Mr. Hayes. (Mr. Treiber voted as his alternate.)

Mr. Morris dissented from this action because he thought the directive as adopted could be consistent with an unduly restrictive monetary policy. In his judgment the current state of the economy called for a substantial moderation of bank credit growth from the 13 per cent rate that had prevailed over the second half of 1968, but not for so sharp a change as was implied by the projections for January and February.

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MEETING HELD ON FEBRUARY 4, 1969

Authority to effect transactions in System Account.

According to the information reviewed at this meeting, expansion in real economic activity had been moderating but upward pressures on prices and costs were persisting. Staff projections continued to suggest that the rate of expansion in economic activity would slow further in the first half of 1969.

Available weekly figures indicated that retail sales, which had declined in December, rose in January to about the November level. Tentative estimates implied that industrial production increased further in January but at a slower rate than in late 1968. The labor market continued tight, and the number of persons receiving unemployment compensation remained small.

There were widespread increases in wholesale prices of industrial commodities from mid-December to mid-January, and the average of such prices rose considerably further. The rate of advance in the consumer price index slowed somewhat in December, partly for seasonal reasons, but the index for that month was 4.7 per cent above its year-earlier level.

Growth in real GNP had moderated to an annual rate of 3.8 per cent in the fourth quarter of 1968 from 5.0 per cent in the third quarter. Expansion in consumer and Federal Government expenditures on goods and services slowed, but there were substantial increases in business capital outlays, residential construction activity, and inventory accumulation. The staff projections for the first half of 1969 suggested that consumer spending would expand only moderately faster than in the fourth quarter, partly because growth in disposable income would be limited by higher social security taxes and retroactive income tax payments. In line with the recently released Federal budget figures, Government purchases of goods and services were projected to remain at the fourth-quarter level. The projections also implied that residential construction activity would be increasingly restricted by the reduced availability of mortgage funds; that the current surge in business capital outlays would slow by the second

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quarter; and that the rate of inventory accumulation would level off in the first quarter and then decline.

Longer-range staff projections prepared for this meeting suggested that in the second half of 1969 growth in real GNP would remain at a reduced rate and inflationary pressures would diminish. These projections incorporated the budget estimates of Federal expenditures and assumed that the income tax surcharge, which under existing legislation was scheduled to expire on June 30, 1969, would be continued at least through the end of the year. They also assumed that a substantial degree of monetary restraint would be maintained. It was noted that the budget estimates implied that fiscal policy would become less restrictive after midyear even if the surtax were continued.

Preliminary data indicated that the U. S. balance of payments on the liquidity basis had reverted to deficit in January, following the substantial surplus recorded in the fourth quarter of 1968. Although little detailed information was available, it appeared likely that the strike of longshoremen, which had begun with the expiration of the Taft-Hartley Act injunction on December 20, was one factor affecting the January balance adversely. In December the balance on merchandise trade was in deficit, and for 1968 as a whole there was a trade surplus of only about $100 million, compared with about $3.5 billion in 1967. Exports were 10 per cent higher in 1968 than in 1967, but imports increased by nearly 25 per cent.

The over-all payments balance on the official settlements basis was in substantial surplus in January as a result of a sharp increase in liabilities of U.S. banks to their foreign branches, which more than offset the marked decline that had occurred just before the year-end. To a large extent this heavy inflow of liquid funds through the Euro-dollar market reflected outflows from Germany that were encouraged by the policies of the German Federal Bank and by the ebbing of speculation on a revaluation of the mark.

On January 29 the Treasury announced that in exchange for securities maturing in mid-February, of which about $5.4 billion were held by the public, it would offer two new issues—a 15-month, 6⅜ per cent note and a 7-year, 6¼ per cent note, priced to yield 6.42 and 6.29 per cent, respectively. The initial market reaction to the offering was mixed and trading activity associated with the new issues was relatively limited.

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System open market operations since the January 14 meeting of the Committee had been directed toward maintaining the firmer conditions achieved in money and short-term credit markets following the mid-December increase in Federal Reserve discount rates. Federal funds continued to trade mostly in a range of 6¼ to 6⅝ per cent. Borrowings by large banks in the major money centers were relatively light in the 3 weeks ending January 29, both because seasonal forces tended to shift reserves toward these centers and because the sizable inflows of Eurodollars were concentrated at such banks. For all member banks borrowings averaged about $790 million, not much changed from the $810 million average of the previous 4 weeks. Average excess reserves fell sharply, however, and net borrowed reserves increased considerably.

Interest rates on various types of short-term securities, which had declined somewhat from their late-December highs in the first half of January, subsequently changed little on balance. The market rate on 3-month Treasury bills moved down from 6.13 per cent on the day before the previous meeting to 6.01 per cent a week later and then advanced to 6.19 per cent on the day before this meeting. Yields on long-term securities fluctuated near their recent highs during most of the period, although lately they had come under renewed upward pressure as a result of limited investor interest in new corporate and municipal bond offerings. The volume of new bond issues was relatively large in January, but a smaller volume appeared to be in prospect for February.

Yields on home mortgages in the secondary market rose further in January and late in the month exceeded the high that had been recorded in the preceding June. Average contract interest rates on conventional mortgages had reached postwar record levels in December, the latest month for which data were available. Effective January 24 the regulatory maximum contract rate on federally underwritten home mortgages was increased from 6¾ to 7½ per cent. Net inflows of deposits to nonbank financial intermediaries had moderated further in December, and withdrawals during the turn-of-the-year interest-crediting period were somewhat larger than a year earlier.

The volume of large-denomination CD's outstanding at banks continued to decline sharply in January as short-term market interest rates remained at levels relative to the Regulation Q ceilings that placed

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banks at a competitive disadvantage in their efforts to replace maturing CD's. The CD attrition was heaviest at large money market banks. Net inflows of other time and savings deposits weakened, partly because of withdrawals after the year-end interest-crediting date, and total time and savings deposits declined at an annual rate of about 10.5 per cent from December to January. Expansion in private demand deposits and the money stock moderated—the latter to an annual rate of about 4.5 per cent from 7.5 per cent in the previous month—as U.S. Government deposits rose.

Business loans at banks increased markedly in January. However, other loans declined slightly, net acquisitions of municipal securities remained at a reduced rate, and holdings of Treasury securities declined considerably. Total bank credit, as measured by the proxy series—daily-average member bank deposits—was estimated to have declined at an annual rate of 4.5 per cent from December to January, compared with growth at about a 13 per cent rate in the previous month and also over the second half of 1968 as a whole. After adjustment for changes in the daily average of U.S. bank liabilities to foreign branches—which, as noted earlier, increased substantially in January—the proxy series declined at an annual rate of about 1.5 per cent.

Some slowing of the growth of business loans from the rapid January pace was expected in February. Staff projections suggested that if existing Regulation Q ceilings and prevailing money market conditions were maintained, the run-off of CD's outstanding would continue at a rapid rate—although not so rapid as in January, mainly because it appeared that the volume of CD's maturing would be smaller than in that month —and that inflows of other time and savings deposits would improve only moderately from January. The projections for February implied that U.S. Government deposits would rise substantially further and that private demand deposits and the money stock would decline somewhat. The bank credit proxy was projected to decline from January to February at an annual rate of 3 to 6 per cent. After adjustment for the increase in U.S. bank liabilities to foreign branches that had occurred over the course of January, the decline in the proxy series was projected to fall in a range of zero to 3 per cent.

The Committee agreed that current and prospective economic conditions did not call for a change in monetary policy at this time, and that

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in any case the Treasury refunding now under way militated against a change in policy. Some members, noting the decline in the bank credit proxy experienced in January and the small further decline projected for February, expressed concern about the risk that the current stance of policy might have unduly restrictive consequences and thus might have to be reversed shortly. While others thought that current bank credit developments were not unduly restrictive, particularly in light of the rapid expansion in the latter part of 1968, there was general agreement that a resumption of bank credit growth, although at a moderate rate, would be desirable before long.

The Committee decided that open market operations should be directed at maintaining the prevailing firm conditions in money and short-term credit markets. The proviso was added that operations should be modified, to the extent permitted by the Treasury refunding, if bank credit appeared to be deviating significantly from current projections. It was suggested that the allowable deviation in bank credit before the proviso was to be implemented should be smaller if the deviation were in a downward direction than in the opposite case. It also was suggested that, if the proviso clause were implemented in the direction of less firm money market conditions, care should be taken to avoid giving misleading signals about the basic stance of monetary policy.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that expansion in real economic activity has been moderating, but that upward pressures on prices and costs are persisting. Prospects are for some further slowing in economic expansion in the period ahead. Market interest rates recently have fluctuated near the highs reached around the turn of the year. Bank credit contracted slightly in January on average, as the outstanding volume of large-denomination CD's continued to decline sharply, inflows of other time and savings deposits slowed, and growth in the money supply moderated. The U.S. balance of payments on the liquidity basis appears to have reverted to deficit in early 1969, but large inflows of Euro-dollars have had the effect of keeping the official settlements balance in surplus. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic

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growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of the current Treasury refunding, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the Treasury refunding, if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Hayes, Brimmer, Daane, Galusha, Hickman, Kimbrel, Maisel, Mitchell, Morris, Robertson, and Sherrill. Votes against this action: None.

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MEETING HELD ON MARCH 4, 1969

1. Authority to effect transactions in System Account.

Growth in real GNP was now estimated by the Commerce Department to have moderated somewhat more in the fourth quarter of 1968 than indicated earlier, and staff projections suggested that it would moderate further in the first half of 1969. However, upward pressures on prices and costs were persisting, and it appeared that expectations of continuing inflation were still an important factor underlying business spending decisions.

In February, according to available weekly data, retail sales were about unchanged from January—when, in turn, they had risen to a level close to that of the preceding November. Tentative estimates indicated that industrial production continued to increase at a slower rate than in late 1968. In January nonfarm employment rose substantially further, and the unemployment rate was unchanged at the low level of 3.3 per cent. The labor market remained tight, and average hourly earnings of production workers continued upward at a rapid rate.

Average wholesale prices of industrial commodities increased considerably further from mid-January to mid-February, but by less than in the preceding month when, according to revised data, the largest monthly increase in more than 13 years had been recorded. In January average consumer prices continued to advance at a rapid pace, particularly after allowance for the usual seasonal declines in prices of some major commodities.

Revised Commerce Department estimates indicated that growth in real GNP had moderated from an annual rate of 5.0 per cent in the third quarter of 1968 to 3.4 per cent in the fourth quarter, rather than to 3.8 per cent as had been shown in the preliminary report. The slackening in the fourth quarter was attributable largely to a marked slowing of the rise in consumer and Federal expenditures on goods and services; business outlays on plant and equipment and on inventory accumulation had increased considerably, as had residential construction activity.

The staff projections for the first half of 1969 suggested that growth in disposable income would be held down by the increase in social

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security tax rates that became effective January 1 and by retroactive payments on 1968 personal income tax liabilities. It was expected that the rate of personal saving would decline from its high fourth-quarter level and that consumer spending would rise at a pace moderately faster than in the fourth quarter. Federal purchases were projected to remain close to the fourth-quarter level. The projections also implied that as the first half of the year progressed residential construction activity would be increasingly limited by the reduced availability of mortgage funds; that the rapid current expansion in business capital outlays would slow; and that the rate of inventory accumulation would be reduced.

Preliminary data indicated that there had been a substantial deficit in the U.S. balance of payments on the liquidity basis in the first 2 months of 1969. But the extent to which both payments and receipts had been affected by the longshoremen's strike—which began on December 20 and ended in mid-February in New York and later at certain other Atlantic and Gulf Coast ports—was not clear. On the official settlements basis a large surplus was recorded in January, as liabilities of U.S. banks to their foreign branches rose sharply to a new high. In February, however, a deficit apparently developed on the official settlements basis, as net inflows of Euro-dollars through foreign branches were substantially smaller. Interest rates in the Euro-dollar market advanced considerably further to new record levels in February.

On February 27 the Bank of England raised its discount rate by 1 percentage point to the 8 per cent level that had been maintained for about 4 months after the devaluation of sterling in November 1967. This action was taken to reinforce Britain's policy of severe domestic credit restraint and was officially described as consistent with the recent marked increases in short-term interest rates in international financial markets. Shortly thereafter, discount rates were raised by the Bank of Sweden from 5 to 6 per cent, and by the Bank of Canada from 6½ to 7 per cent.

The Treasury refunding of notes and bonds maturing in mid-February was accorded an unenthusiastic reception by the market. Of the $5.4 billion of maturing issues held by the public, about $2 billion, or 36 per cent, were redeemed for cash; $2.6 billion were exchanged for the new 15-month, 6⅜ per cent note; and $885 million were exchanged

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for the new 7-year, 6¼ per cent note. Subsequently, on February 25, the Treasury auctioned a $1 billion strip of bills consisting of five issues maturing in 1 to 5 months. Banks, which were allowed to pay for the new bills through credits to Treasury tax and loan accounts, successfully bid for the bulk of the issue.

Most interest rates had risen on balance since the previous meeting of the Committee. To a large extent the advances reflected growing expectations—particularly after recent congressional testimony by Federal Reserve and administration officials—that monetary restraint would be maintained in an effort to contain inflationary pressures. The higher rates also reflected anticipations of a possible near-term increase in the prime lending rate of banks and perhaps also in the Federal Reserve discount rate. Yields in capital markets moved up to or above their earlier peaks, despite the somewhat smaller volumes of new corporate and municipal issues offered in February and scheduled for March. In the mortgage market interest rates rose further to new postwar highs, as demands for mortgage loans remained strong and, according to available data for early February, net inflows of funds to thrift institutions continued to moderate.

Most short-term interest rates also rose in the period, but rates on Treasury bills maturing within 6 months changed little on balance. For example, the market rate on 3-month Treasury bills was 6.17 per cent on the day before this meeting, compared with 6.19 per cent 4 weeks earlier. During the interval the 3-month bill rate had declined to around 6.00 per cent—reflecting substantial liquidity demands for shorter-term bills and relatively limited dealer inventories—but it subsequently rose again, particularly after the increase in the discount rate of the Bank of England.

System open market operations since the previous meeting of the Committee had been directed at maintaining firm conditions in the money and short-term credit markets. Conditions in the money market tended to tighten during the period as a result of the cumulative reduction in bank liquidity and a seasonal shift in reserves away from the major money market banks. This tendency was not fully offset by System action, however, because shorter-term bill rates were under downward pressure for much of the period. Federal funds traded mainly in a range around 6¾ per cent, up from a range centering closer to 6½

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per cent in the previous period. Member bank borrowings averaged $835 million in the 4 weeks ending February 26, compared with about $790 million in the previous 3 weeks. Average excess reserves were little changed, so net borrowed reserves also increased.

With short-term market interest rates remaining high relative to maximum rates payable by banks on large-denomination CD's, the volume of such CD's outstanding declined considerably further in February—although by less than in January when the amount maturing was larger. During the first 2 months of the year the rate of expansion in consumer-type time and savings deposits was well below that in comparable periods of other recent years, and in both months total time and savings deposits contracted at an annual rate in the neighborhood of 10 per cent. Growth in private demand deposits and in the money stock moderated further in February; for January and February together the money stock rose at an annual rate of less than 3 per cent, about half the rate of the second half of 1968. U.S. Government deposits increased sharply further in February to their highest average level in several months.

Although moderating in February, growth in business loans remained rapid. Other loans, which had declined slightly in January, increased substantially. In accommodating the large loan demand, banks stepped up the rate at which they had been liquidating holdings of Treasury securities, and for the first time since April 1968, they failed to increase their holdings of municipal securities. In February total bank credit, as measured by the adjusted proxy series—daily-average member bank deposits, adjusted to include changes in the daily average of U.S. bank liabilities to foreign branches—rose 2 per cent from January, at an annual rate, and was about unchanged from December.

Staff projections suggested that if prevailing money market conditions and existing Regulation Q ceilings were maintained the volume of large-denomination CD's outstanding was likely to decline at about the same pace in March as in February. It was expected that total time and savings deposits would contract further from February to March, but at a slower rate than in the previous month. Growth in the money stock was projected to accelerate temporarily on the average in March, when it was anticipated that U.S. Government deposits would be drawn down sharply.

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With respect to bank credit, the projections suggested that the adjusted proxy series would decline at an annual rate of 3 to 6 per cent from February to March, if U.S. bank liabilities to foreign branches were unchanged on the average in March from the level to which they had risen by the end of February. It appeared likely that loan demands would remain strong, and banks were expected to continue to liquidate holdings of U.S. Government securities and to limit their participation in the market for municipal securities.

The Committee agreed that, in light of the persistence of inflationary pressures and expectations, the existing degree of monetary restraint should be continued at present. The members decided that open market operations should be directed at maintaining on balance about the prevailing firm conditions in money and short-term credit markets, subject to the proviso that operations should be modified if bank credit appeared to be deviating significantly from current projections.

Some concern was expressed about the projection that the bank credit proxy would decline in March after 2 months of no net growth, and about the risks that undue liquidity pressures might develop. The Committee agreed that the proviso clause should be implemented in the direction of firmer money market conditions only if bank credit appeared to be growing at more than a moderate rate. It also agreed that the clause should be implemented in the direction of less firm conditions if bank credit appeared to be contracting any more rapidly than projected, so long as such action did not tend to create the impression that the basic stance of monetary policy had been relaxed.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that expansion in real economic activity has been moderating, but that upward pressures on prices and costs are persisting. Prospects are for some further slowing in economic expansion in the period ahead. Most market interest rates have edged up on balance in recent weeks. In the first 2 months of the year bank credit changed little on average, as investments contracted while loan demands, especially from businesses, remained strong. The outstanding volume of large-denomination CD's continued to decline sharply and inflows of other time and savings deposits slowed. Growth in the money supply moderated as U.S.

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Government deposits rose considerably. It appears that a sizable deficit re-emerged in the U.S. balance of payments on the liquidity basis in January and February and, with Euro-dollar inflows moderating, a deficit also reappeared in the balance on the official settlements basis in February. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining on balance about the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Mitchell, Robertson, Scanlon, and Sherrill. Votes against this action: None.

2. Amendments to authorization for System foreign currency operations.

The Committee amended paragraphs 1 and 2 of the authorization for System foreign currency operations in a number of respects at this meeting. On recommendation of the Special Manager, the limit on outright holdings by the System of authorized foreign currencies specified in the paragraph previously numbered as 1B(2)—but, after other amendments made at this meeting, renumbered as 1B(3)—was increased from $150 million to $250 million equivalent. In addition, clarifying amendments were made in the introductory text to paragraph 1, in paragraphs 1B and 1C(1), and in paragraph 2. Except for the changes resulting from these amendments, the Committee renewed the authorization in the form outstanding at the beginning of the year 1969.

As amended, paragraphs 1 and 2 of the authorization read as follows:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market

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Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto:

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

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

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

(1) Currencies purchased spot, including currencies purchased from the Stabilization Fund, and sold forward to the Stabilization Fund, up to $1 billion equivalent;

(2) Currencies purchased spot or forward, up to the amounts necessary to fulfill other forward commitments;

(3) Additional currencies purchased spot or forward, up to the amount necessary for System operations to exert a market influence but not exceeding $250 million equivalent; and

(4) Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $300 million equivalent.

C. To have outstanding forward commitments undertaken under

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paragraph A above to deliver foreign currencies, up to the following limits:

(1) Commitments to deliver foreign currencies to the Stabilization Fund, up to the limit specified in paragraph 1B(1) above;

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

(3) Other forward commitments to deliver foreign currencies, up to $550 million equivalent.

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

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	225
Bank of Canada	1,000
National Bank of Denmark	100
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000
Bank of Italy	1,000
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	400
Bank of Norway	100

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Sweden	250
Swiss National Bank	600
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,000

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Mitchell, Robertson, Scanlon, and Sherrill. Votes against this action: None.

With respect to the increase in the limit on outright holdings of foreign currencies, the System's current holdings were close to the previous limit of $150 million. That limit had been established in 1963, at a time when the foreign exchange operations of the Federal Reserve had not yet assumed the scale of more recent years. The Committee concurred in the judgment of the Special Manager that more leeway was now desirable to permit acquisitions from time to time of foreign currencies that were likely to prove useful in future operations.

The amendment to the introductory text of paragraph 1 consisted of the addition, after the words "to the extent necessary to carry out the Committee's foreign currency directive," of the phrase "and express authorizations by the Committee pursuant thereto." This amendment was for the purpose of making clear that the language of the authorization extended not only to operations undertaken under the specific language of the foreign currency directive but also to those undertaken under express authorities given by the Committee, for which provision was made at a number of points in the directive.

The main amendment to paragraph 1B involved a clarification of the form of authorization for foreign currency transactions undertaken in connection with System "warehousing" operations for the Stabilization Fund. While the forward commitments associated with such ware-

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housing operations were separately authorized in paragraph 1C(1), the spot holdings had been subsumed under general language in 1B authorizing holdings "up to the amounts necessary to fulfill outstanding forward commitments." As amended, the authorization contained a new paragraph 1B(1) separately covering the spot holdings in question. Concurrently, a number of other conforming and clarifying changes were made in 1B and in 1C(1).

The amendment to paragraph 2, which affected the table contained in that paragraph listing authorized swap arrangements, involved the incorporation of more precise descriptions of the System's two swap arrangements with the Bank for International Settlements.

3. Review of continuing authorizations.

This being the first meeting of the Federal Open Market Committee following the election of new members from the Federal Reserve Banks to serve for the year beginning March 1, 1969, and their assumption of duties, the Committee followed its customary practice of reviewing all of its continuing authorizations and directives. The action taken with respect to the authorization for System foreign currency operations has been described in the preceding portion of the record for this date.

The Committee reaffirmed its continuing authority directive for domestic open market operations and its foreign currency directive in the forms in which both were outstanding at the beginning of the year 1969.

Votes for these actions: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Mitchell, Robertson, Scanlon, and Sherrill. Votes against these actions: None.

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MEETING HELD ON APRIL 1, 1969

Authority to effect transactions in System Account.

According to the information reviewed at this meeting, expansion in real GNP had moderated somewhat further in the first quarter from the 3.4 per cent annual rate of increase recorded in the fourth quarter of 1968. It appeared, however, that the expansion had slowed less than had been anticipated in earlier projections, and that the slowing was attributable to a decline in the rate of business inventory accumulation; the pace of advance in final sales was estimated to have increased. Moreover, it now appeared that activity in coming months also would be stronger than expected earlier. Substantial upward pressures on prices and costs persisted, and inflationary expectations remained widespread.

Previous projections of economic activity had been revised upward largely because a Commerce–SEC survey, taken in February, indicated that businesses planned a large increase in their outlays on new plant and equipment in 1969—to a total about 14 per cent above 1968. In addition, retail sales data for February and revised figures for earlier months suggested that growth in consumer expenditures had stepped up more from the low fourth-quarter rate than anticipated. The most recent data, in which new seasonal adjustment factors had been incorporated, indicated that retail sales had reached a new record level in January and that they had continued at about that level in February.

Nonfarm employment again expanded sharply in February, and unemployment remained at the low rate of 3.3 per cent which it had reached in December. Average hourly earnings of production workers continued to increase at a rapid pace. The consumer price index rose considerably further in February, to a level about 4.7 per cent above a year earlier. From mid-February to mid-March average wholesale prices of industrial commodities increased substantially; since mid-December such prices had advanced at an annual rate of more than 6 per cent.

Projections for the second quarter suggested that growth in real GNP would remain at about the first-quarter pace. Another decline in

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the rate of business inventory accumulation—such as had held down over-all growth in the first quarter—was not expected, but it appeared likely that the expansion in various major categories of final sales would slow. According to the Commerce–SEC survey, a sizable part of the anticipated 1969 increase in plant and equipment outlays would be concentrated in the first quarter. Moreover, it seemed likely that consumer spending would rise less rapidly in the second quarter than in the first, when a sharp decline in the rate of personal saving apparently had occurred. Federal purchases of goods and services were projected to remain relatively stable in the second quarter, and residential construction activity was expected to turn down as a result of reduced availability of mortgage credit.

Data available through mid-March suggested that a very large deficit had been incurred in the first quarter in the U.S. balance of payments on the liquidity basis. One major contributing factor was a substantial deficit in the merchandise trade balance for February, as imports began to recover more rapidly than export shipments after the dock strike ended in New York in mid-February. Also, it seemed likely that outflows of corporate capital funds, data for which were not yet available, were substantial. On the other hand, in the first 2 months of the year foreign net purchases of U.S. equity securities were sizable, and bank-reported claims on foreigners were reduced more than seasonally.

In contrast to the deficit on the liquidity basis, it appeared that a large surplus would be recorded for the first quarter on the official settlements basis, as a result of substantial inflows of liquid funds through banks abroad. Liabilities of U.S. banks to their foreign branches again expanded rapidly in the first half of March, after increasing only slightly in February. Interest rates in the Euro-dollar market advanced to a new high in early March but subsequently changed little.

Most major foreign currencies were under some selling pressure during March. Financial markets in most industrial countries had tightened in recent months, in part because of domestic demand pressures but also in some instances in reaction to capital outflows resulting from the restrictive stance of U.S. monetary policy and high Euro-dollar interest rates.

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On March 25 the Treasury auctioned a $1.8 billion strip of bills consisting of additions to outstanding issues maturing in about 6 to 12 weeks. Commercial banks, which were allowed to make payment for the new bills through credits to Treasury tax and loan accounts, bid aggressively in the auction and were awarded the bulk of the offering. The financing was expected to cover the Treasury's cash requirements from market sources for the balance of the fiscal year.

Long-term interest rates had risen further since the previous meeting of the Committee in an atmosphere of continuing concern about inflationary pressures in the economy. Yield increases were especially pronounced in the corporate and the municipal bond markets where new issues were accorded generally unenthusiastic receptions and a number of offerings were either postponed or reduced in size. In late March a somewhat improved tone emerged in the capital markets, reflecting in part rumors of progress in the Vietnam peace talks.

Movements in short-term interest rates had been mixed since early March. Rates on most Treasury bills had declined to the lowest levels since mid-December, as continuing strong liquidity demands, augmented by sizable seasonal demands, impinged on limited dealer inventories. The market rate on 3-month Treasury bills had fallen to slightly below 6 per cent after mid-March and at the time of this meeting was 5.99 per cent, compared with 6.17 per cent 4 weeks earlier. Market rates on other short-term securities had declined less or had risen in recent weeks. On March 17 most large commercial banks raised their prime lending rate from 7 per cent to a new record high of 7½ per cent.

System open market operations since the previous meeting of the Committee had been directed at maintaining firm conditions in the money and short-term credit markets. With Treasury bill rates under downward pressure, the System met reserve needs mainly through short-term repurchase agreements and purchases of Treasury coupon-bearing securities rather than by buying bills in the market. The effective rate on Federal funds continued to fluctuate in a range centering around 6¾ per cent. Member bank borrowings averaged $835 million in the 4 weeks ending March 26, the same as in the previous 4 weeks. Excess reserves declined somewhat and net borrowed reserves increased correspondingly.

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In March total bank credit, as measured by the adjusted proxy series —daily-average member bank deposits, adjusted to include changes in the daily average of U.S. bank liabilities to foreign branches—was estimated to have declined from February at an annual rate of 6.5 per cent, after changing little over the first 2 months of the year. Banks continued to liquidate holdings of U.S. Government securities during March but added somewhat on balance to holdings of other securities. Total bank loans declined during the month—reflecting large reductions in security loans and in loans to nonbank financial institutions and a substantial slowing in the growth of business loans after mid-month. Also, some part of the March decline in loans may have reflected sales of loans by U.S. banks to foreign branches. In the first quarter as a whole banks financed a net growth in loans, which was particularly sizable for business loans, mainly by liquidating holdings of Government securities.

The volume of large-denomination CD's outstanding declined considerably further in March, as yields on competing short-term debt market instruments remained above the maximum interest rates payable on such CD's under Regulation Q. Consumer-type time and savings deposits expanded moderately, however, and total time and savings deposits—which had declined at a rapid rate in January and February—were about unchanged in March. Private demand deposits also changed little, and the money stock expanded at a 2 per cent annual rate—about the same as in the first 2 months of 1969 and well below the growth rate over the second half of 1968. U.S. Government deposits declined substantially, following sizable increases earlier in the year.

Loan demands at banks were expected to rebound in April, partly in connection with needs to finance income tax payments. Staff projections suggested that the adjusted bank credit proxy would grow from March to April at an annual rate of 2 to 6 per cent if prevailing money market conditions and existing Regulation Q ceilings were maintained. This projection assumed that there would be some further increase in Euro-dollar liabilities of U.S. banks to their foreign branches.

Total time and savings deposits at banks were expected to change little again from March to April. It appeared probable that the pace

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of the run-off of large-denomination CD's outstanding would moderate after mid-April when Treasury bill rates were likely to decline seasonally. However, growth in consumer-type time and savings deposits was projected to slow as a result of withdrawals following the quarterly interest-crediting period and in connection with income tax payments. It was expected that U.S. Government deposits would rise considerably from March to April, that private demand deposits would remain about unchanged, and that the money stock would expand only slightly faster than in the first quarter.

Prior to this meeting the boards of directors of eight Reserve Banks had acted, subject to the approval of the Board of Governors, to increase discount rates from the present level of 5½ per cent. It was reported to the Committee that the Board of Governors planned to take action on discount rates within a few days, and concurrently to consider the desirability of an increase in member bank reserve requirements, to be effective shortly after mid-April. The staff had prepared alternative projections of the adjusted proxy series that took account of other possible monetary policy action. These projections suggested that bank credit would be weaker than otherwise in April if open market operations were directed at maintaining the firmer money market conditions expected to ensue from such action and if existing Regulation Q ceilings were continued.

It was the consensus of the Committee that some further monetary policy action was called for at this time in light of the greater-than-expected pace of the economic expansion and the continuation of pervasive inflationary pressures and expectations. An increase in discount rates was generally considered to be appropriate, but differing views were expressed regarding the desirability of an increase in reserve requirements at present. In one view both actions, along with supportive open market operations, were needed to make clear the System's determination to resist inflationary pressures. An alternative view was that, while an increase in reserve rquirements might prove desirable at a later time, it was not required at present.

With respect to open market operations, a majority of the Committee agreed that such operations should be directed at maintaining firm conditions in money and short-term credit markets, and at confirming the effects on those markets of any other monetary policy

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actions that might be taken. The proviso was added that operations should be modified if bank credit appeared to be deviating significantly from current projections. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that, while expansion in real economic activity has moderated somewhat further, current and prospective activity now appears stronger than earlier projections had indicated. Substantial upward pressures on prices and costs are persisting. Most long-term interest rates have risen further on balance in recent weeks, but movements in short-term rates have been mixed. In the first quarter of the year bank credit changed little on average, as investments contracted while loans expanded further. In March the outstanding volume of large-denomination CD's continued to decline sharply; inflows of other time and savings deposits were moderate; and growth in the money supply remained at a sharply reduced rate. It appears that a sizable deficit re-emerged in the U.S. balance of payments on the liquidity basis in the first quarter but that the balance on the official settlements basis remained in surplus as a result of further large inflows of Euro-dollars. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in money and short-term credit markets, taking account of the effects of other possible monetary policy action; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.
>
> Votes for this action: Messrs. Martin, Bopp, Brimmer, Clay, Daane, Mitchell, Robertson, Scanlon, Sherrill, and Treiber. Votes against this action: Messrs. Coldwell and Maisel.
>
> Absent and not voting: Mr. Hayes. (Mr. Treiber voted as his alternate.)

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Messrs. Coldwell and Maisel dissented from this action for different reasons. Mr. Coldwell noted that the directive favored by the majority could be interpreted as calling for no monetary firming unless the Board acted in the coming period with respect to discount rates or reserve requirements. Since he believed that greater monetary restraint was imperative under current circumstances, he favored adopting a directive that called unconditionally for the attainment of firmer conditions in money and short-term credit markets.

Mr. Maisel believed that, insofar as the Committee's action reflected a desire to affect the prevailing inflationary psychology directly, it represented a shift from the Committee's proper concern with flows of credit and money to an improper target not readily susceptible to such influence. He particularly objected to the directive as adopted because he thought that operations under it were likely to depress flows of the monetary aggregates to rates below those that seemed to him to be desirable and maintainable for a considerable period, and that such operations would thus be inconsistent with the gradualist approach to the ultimate objective of price stability that he favored.

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MEETING HELD ON APRIL 29, 1969

Authority to effect transactions in System Account.

Preliminary estimates of the Commerce Department indicated that in the first quarter real GNP expanded at an annual rate of 2.9 per cent —only slightly slower than the 3.4 per cent growth rate of the fourth quarter of 1968—and that average prices, as measured by the GNP deflator, increased a little faster than in late 1968. Staff projections suggested that real GNP would expand about as rapidly in the second quarter as in the first and that upward pressures on prices would continue strong.

In March retail sales rose further, according to the advance report. Industrial production also reached a new high as output of many final products and materials increased. The labor market remained tight, although nonfarm employment expanded less rapidly than it had earlier in 1969 and the unemployment rate edged up to 3.4 per cent from the 3.3 per cent level of preceding months.

Average wholesale prices of industrial commodities, which had advanced substantially in the first quarter, rose only slightly further from mid-March to mid-April. To a considerable extent the slowing of the rise reflected declines in prices of lumber and plywood following extremely large advances earlier; among other industrial commodities price increases continued widespread. The consumer price index rose more in March than in any other month since February 1951, partly because of a sharp advance in homeownership costs, including mortgage interest charges, property taxes, insurance, and repairs.

According to the preliminary GNP figures for the first quarter, there were large increases in final sales—particularly in business outlays on plant and equipment and in consumer expenditures—and a substantial decline in the rate of business inventory accumulation. The advance in consumer spending was associated with a sizable reduction in the rate of personal saving, as growth in disposable income slowed. Residential construction outlays also expanded appreciably further, although housing starts declined substantially in February and March from the very high January rate. Federal purchases of goods and services increased only slightly in the quarter.

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While the staff projections for the second quarter suggested that GNP would continue to expand at about the pace of the first quarter, they contemplated a different pattern of change among the major components. Specifically, it was expected that inventory accumulation would remain at about the first-quarter rate, instead of slowing substantially as in the first quarter, and that net exports of goods and services would rise significantly as a result of a faster recovery in exports than in imports following the end of the longshoremen's strike. At the same time, it was anticipated that growth in business fixed investment and in consumer spending would slow, that residential construction outlays would turn down, and that Federal expenditures would rise only slightly further.

For the second half of 1969, staff projections suggested that expansion in real GNP would slow further but that upward pressures on prices were likely to persist. Both the lagged effects of monetary restraint and a restrictive stance of fiscal policy were expected to contribute to the slowing of expansion in real activity. The administration recently had announced that it planned to reduce Federal outlays in the fiscal year 1970 from the January budget estimates. In addition, it had proposed that the surtax on incomes be continued at 10 per cent through the end of the calendar year 1969, and then be reduced to 5 per cent; and that the 7 per cent investment tax credit be repealed effective April 21. The repeal of the investment tax credit, if enacted, was not expected to have much effect on capital spending until late in 1969, and the influence of the surtax on spending seemed likely to moderate as the end of the year approached. Nevertheless, it now appeared that the Federal fiscal position would be more restrictive in the second half of the year than had been anticipated earlier.

The latest data on the U.S. balance of payments in the first quarter confirmed earlier estimates of a very large deficit on the liquidity basis and a large surplus on the official settlements basis. Both imports and exports declined from the fourth quarter of 1968 as a result of the longshoremen's strike, but exports fell more and the trade balance was in substantial deficit. In addition, there was a large outflow of corporate capital funds, reversing in part the net inflow of the fourth quarter. On the other hand, foreign purchases of U.S. equity securities remained sizable in the quarter—although the rate apparently dimin-

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ished in March—and bank-reported claims on foreigners declined more than seasonally.

The first-quarter surplus on the official settlements basis was primarily the result of a huge expansion of liabilities of U.S. banks to their foreign branches. While such liabilities declined substantially in late March, they subsequently increased to a new high in April. Interest rates in the Euro-dollar market changed little after late March at levels close to earlier peaks.

In foreign exchange markets demands for German marks increased sharply in the latter part of April as a result of revived expectations of a revaluation, and the British pound came under some brief selling pressure. The French franc was under pressure throughout April, in part because of uncertainties associated with the national referendum scheduled for April 27. However, the initial reaction in the market to the negative vote in the referendum and to the resignation of President de Gaulle was relatively mild.

A number of industrial countries had taken restrictive public policy measures in recent months, for domestic or balance of payments reasons. The latest of these measures included increases in central bank discount rates in Germany and the Netherlands, to help dampen re-emerging inflationary pressures, and in Belgium and Denmark, mainly to limit capital outflows resulting from high interest rates abroad. Also, in mid-April the British Government announced a restrictive budget for the fiscal year beginning April 1, in light of the absence of sufficient improvement in the payments balance of the United Kingdom.

The U.S. Treasury was expected to announce on the day after this meeting the terms on which it would refund notes maturing in mid-May, of which about $3.8 billion were held by the public. It was generally anticipated that bonds maturing in mid-June, of which about $2.1 billion were publicly held, would be included in the refunding.

The Treasury's cash balances at both commercial banks and Federal Reserve Banks had been drawn down to very low levels prior to the mid-April tax date, and in the period April 8–16 the Treasury financed part of its cash needs temporarily through sales to the Federal Reserve

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of special certificates of indebtedness.[1] The Treasury redeemed all outstanding special certificates on April 17 and subsequently rebuilt its cash balances to relatively high levels.

Commercial bank credit and the money stock, both of which had changed relatively little over the first quarter, rose substantially in the first half of April. For the month as a whole the adjusted bank credit proxy—daily-average member bank deposits, adjusted to include changes in the daily average of U.S. bank liabilities to foreign branches—was tentatively estimated to have increased at an annual rate of about 7 per cent from March, following a decline of similar magnitude in the previous month. There was a sharp, although temporary, increase in bank holdings of Treasury bills during the statement week ending April 2, as banks were awarded nearly all of the $1.8 billion strip of bills auctioned by the Treasury in late March. In addition, a marked upsurge in bank loans—especially to businesses, nonbank financial institutions, and securities dealers—occurred around the mid-month tax date.

The early-April bulge in private demand deposits and the money stock apparently was associated in part with temporary technical factors relating to Euro-dollar flows and the 4-day Easter holiday in Europe. Private demand deposits subsequently declined and by late April were estimated to be close to their end-of-March level. However, the money stock was tentatively estimated to have increased at an annual rate of nearly 15 per cent from March to April, as a result of the higher average level of such deposits in recent weeks. U.S. Government deposits also were estimated to have expanded by a sizable amount on the average in April.

The volume of large-denomination CD's outstanding was reduced further in the first half of April—reflecting in part the use by corporations of proceeds of maturing CD's to help finance large tax payments. Available data suggested that there were sizable net outflows of consumer-type time and savings deposits at banks—and also at other thrift institutions—following the interest-crediting period and around the

[1] The volume of such certificates held by the Federal Reserve totaled $151 million on April 8, $519 million on April 9, $490 million on April 10, $976 million on April 11 through 13, $514 million on April 14, $502 million on April 15, and $627 million on April 16.

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midmonth tax date. In April as a whole, total time and savings deposits at banks were estimated to have declined slightly from their March average.

On April 3 the Board of Governors announced an increase in Federal Reserve Bank discount rates from 5½ to 6 per cent, effective April 4, and an increase of ½ of a percentage point in member bank reserve requirements against demand deposits, effective April 17. System open market operations subsequently were directed at maintaining the firmer conditions in money and short-term credit markets that were consistent with those actions. Pressures in the money market were intensified around the middle of April by massive shifts of reserves away from money center banks—shifts that stemmed in part from the rundown in the Treasury's cash balances. Moreover, open market operations were modified in the direction of greater firmness as the period progressed, when it became increasingly clear that bank credit was expanding at a pace significantly in excess of the range projected at the time of the previous meeting. The effective rate on Federal funds, which had fluctuated around 6¾ per cent in March, rose to the 7¾ to 7⅞ per cent area in mid-April and again late in the month. Member bank borrowings averaged slightly more than $1 billion in the 4 weeks ending April 23, compared with an average of about $835 million in the previous 4 weeks. Net borrowed reserves increased somewhat more than borrowings, as excess reserves declined further on the average.

Most short-term interest rates had risen following the announcement on April 3 of the increases in discount rates and member bank reserve requirements. Market rates on Treasury bills maturing within 6 months continued under upward pressure through the midmonth tax date—reflecting sizable sales by banks and higher dealer financing costs—but they receded from their peaks after mid-April under the influence of strong seasonal demands. The market rate on 3-month Treasury bills, for example, reached a high of 6.22 per cent on April 16, but by the day before this meeting it had declined to 6.00 per cent, about the same as 4 weeks earlier. Rates on most other short-term instruments advanced during the month, in many instances to new highs.

Long-term interest rates had moved down in recent weeks, as rumors of progress in the Vietnam peace negotiations and indications of in-

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creasingly restrictive fiscal and monetary policies fostered growing expectations that inflationary pressures would be contained. A large volume of new corporate and municipal bonds was marketed during April, including a number of issues that had been postponed earlier. Bond yields leveled out late in the month, partly as a consequence of these offerings and of expectations that a new intermediate-term issue would be included in the Treasury's forthcoming refunding.

Business loan demands at banks, which had been enlarged in April by needs to finance tax payments, were expected to moderate in May. Staff projections suggested that the adjusted bank credit proxy would decline at an annual rate of 2 to 5 per cent from April to May if prevailing conditions were maintained in money and short-term credit markets. It appeared likely that the run-off of outstanding CD's would continue and that consumer-type time and savings deposits would expand at a low rate. Private demand deposits and the money stock were projected to decline slightly on the average from April to May, and a reduction also was anticipated in U.S. Government deposits.

In the Committee's discussion a number of members expressed the view that it would be desirable at present to maintain at least the existing degree of monetary restraint in light of the persistence of strong inflationary pressures, and some question was raised as to whether restraint was being pursued with sufficient vigor. At the same time, recognition was given to the likelihood that the combined restrictive effects of current fiscal and monetary policies would become visible in economic developments later in the year, and the view was advanced that such a prospect argued against a further intensification of monetary restraint now.

The Committee agreed that in any event the forthcoming Treasury refunding militated against a change in monetary policy at this time. It decided that open market operations should be directed at maintaining the firmer conditions in money and short-term credit markets that had been achieved, with the proviso that operations should be modified, insofar as the Treasury financing permitted, if bank credit appeared to be deviating significantly from current projections. Some members suggested that any doubts arising in the conduct of operations should be resolved on the side of restraint. In addition, concern was voiced about the unexpectedly large increases now estimated for April in both bank

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credit and the money stock. While it was the consensus of the members that those increases probably reflected temporary factors to an important extent, the view was expressed that the proviso clause should be implemented quite promptly if bank credit developments in May suggested the contrary.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that expansion in real economic activity has moderated only slightly since the fourth quarter of 1968. At the same time, substantial upward pressures on prices and costs are persisting. Long-term interest rates have generally declined in recent weeks, but most short-term rates have risen somewhat. In the first quarter of the year bank credit changed little on average and the money supply grew at a sharply reduced rate. In early April both measures increased substantially, influenced in part by large tax-date borrowing and deposit bulges around Easter. The outstanding volume of large-denomination CD's has continued to decline and there was a net outflow of consumer-type time and savings deposits from banks and other thrift institutions in the first half of April. A sizable deficit re-emerged in the U.S. balance of payments on the liquidity basis in the first quarter but the balance on the official settlements basis remained in surplus as a result of large inflows of Euro-dollars. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, while taking account of the forthcoming Treasury refunding, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the Treasury refunding, if bank credit appears to be deviating significantly from current projections.
>
> Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Mitchell, Robertson, and Scanlon. Votes against this action: None.
>
> Absent and not voting: Mr. Sherrill.

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MEETING HELD ON MAY 27, 1969

1. Authority to effect transactions in System Account.

According to the information reviewed at this meeting, the pace of expansion in economic activity was moderating slightly further but substantial upward pressures on prices and costs were persisting. New staff projections for the second quarter suggested that the increase in real GNP would be a little less than the 2.8 per cent annual rate now estimated by the Commerce Department for the first quarter. Prices, however, were expected to continue rising rapidly.

Available data for April showed some signs of a less rapid pace of economic advance. Growth in personal income, industrial production, and nonfarm employment slowed, and the unemployment rate edged up by 0.1 per cent for the second successive month, to 3.5 per cent. Housing starts declined for the third successive month. Retail sales increased considerably, but from a March figure that had been revised downward; in April retail sales were only moderately above the level of September 1968, even though prices had risen substantially in that period. On the other hand, new orders for durable goods rebounded in April after declining in March. Much of the April surge of orders may have been in anticipation of the administration's recommendation, made on April 21, for repeal of the 7 per cent investment tax credit as of that date.

Advances in wholesale prices of industrial commodities remained widespread in April, but the average of such prices rose relatively little because of an abrupt reversal of the earlier rapid run-up for lumber and plywood. The consumer price index increased sharply further, with much of the rise accounted for by higher food prices and homeownership costs. Over the past year consumer prices had increased by 5.4 per cent. Unit labor costs in the private nonfarm sector as a whole were reported to have risen markedly in the first quarter.

The staff projections for the second quarter suggested that business inventory accumulation would remain at about the first-quarter rate but that expansion in total final sales would slow. It was anticipated that consumer spending would rise less than in the first quarter, that Federal expenditures on goods and services would increase relatively

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little, and that residential construction outlays would decline. Only a small increase appeared in prospect for business spending on plant and equipment after the sharp expansion of the first quarter. Net exports were still expected to turn up as a result of the ending of the longshoremen's strike, but by considerably less than had been thought likely earlier.

Projections for the second half of 1969 suggested that expansion in real GNP would slow further but that upward pressures on costs and prices would still be strong. The GNP projections assumed that Federal expenditures would remain under substantial restraint and that, as recommended by the administration, the surtax would be continued at 10 per cent through the end of the year and the investment tax credit would be repealed. Although growth in disposable income was expected to be stimulated temporarily in the third quarter by the ending of retroactive tax payments and by the scheduled Federal pay increase, it seemed probable that generally moderate rates of expansion in employment and income in the second half of the year would limit increases in consumer spending. Prospects appeared to be for a continuing downdrift in residential construction outlays and for only small further increases in business capital expenditures.

In April both exports and imports of the United States were above normal as movements of merchandise recovered from the earlier longshoremen's strike. With respect to the over-all international payments of the United States, another large deficit was incurred on the liquidity basis in April while payments on the official settlements basis—which had been in substantial surplus in the first quarter—were about in balance. Extremely large deficits were incurred on both bases in the first half of May, when expectations of a revaluation of the German mark led to a massive flow of capital into Germany.

Beginning in late April, funds moved into marks out of dollars, sterling, French francs, and many other currencies, causing relatively severe reserve losses for a number of countries. Movements out of dollars, from both the United States and the Euro-dollar market, were exceptionally heavy, and earlier flows of Euro-dollars to the United States through foreign branches of U.S. banks were temporarily reversed. Interest rates in the Euro-dollar market, already high in April in consequence of U.S. bank demands and of reduced supplies from banks

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in some European countries, rose sharply further in the first half of May. Subsequently, despite interest costs in the neighborhood of 9½ per cent, U.S. banks again increased their liabilities to foreign branches.

In its May refunding the Treasury offered two new notes—a 15-month, 6⅜ per cent note priced to yield 6.42 per cent and a 7-year, 6½ per cent note priced at par—in exchange for securities maturing in mid-May and mid-June. Of the $5.9 billion of maturing issues held by the public, about $2.1 billion were exchanged for the shorter-term note, and $2.2 billion—considerably more than had been anticipated in the market—for the 7-year note. The rate of attrition, slightly more than one-fourth of public holdings, was high by historical standards but lower than had been generally expected.

System open market operations since the previous meeting of the Committee had been directed at maintaining firm conditions in the money and short-term credit markets. Money market conditions were quite taut during the interval. The effective rate on Federal funds fluctuated mostly in a range of 8 to 9 per cent, compared with rates in the 7¾ to 7⅞ per cent area in the latter part of April. Member bank borrowings rose to an average of about $1.3 billion in the 4 weeks ending May 21 from about $1.0 billion in the previous 4 weeks, and net borrowed reserves increased by a corresponding amount.

The tautness in the money market in part reflected aggressive bidding for funds by large banks as they adjusted to the cumulative effects of monetary restraint, the reduced availability of funds from the Euro-dollar market, and a shift of reserves away from the money centers over the course of the period. Although the System supplied a substantial volume of reserves on balance, it did not fully offset reserve drains stemming from market factors in light of the tendency during much of the interval for short-term Treasury bill rates to move to or below the lower end of recent ranges. For example, the market rate on 3-month Treasury bills, which had been in a range of 6.00 to 6.20 per cent during most of April, declined to a low for the year—5.87 per cent—at the end of that month and subsequently fluctuated mostly in a range below 6.10 per cent. Relatively strong investor demands for bills in the period were augmented by heavy foreign official purchases resulting from the speculative flows into the German mark.

Interest rates on other short-term debt instruments and on long-term

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securities had risen in recent weeks under the influence of taut money market conditions, expectations of a possible increase in the prime lending rate of banks, and dampened hopes for a settlement of the Vietnamese war in the near future. Also contributing to upward pressures was the sizable calendar of corporate bond offerings in May and June. The advance in municipal yields was particularly sharp, reflecting limited bank interest in new issues and efforts by dealers to dispose of bonds for which they had made commitments in April in the expectation of declining yields. Postponements of municipal offerings increased in May, and the calendar for that month—as well as for June—was considerably smaller than the unusually large volume marketed in April.

Business loan demands at banks, which were augmented in April by needs to finance tax payments, apparently continued strong in early May. Bank holdings of municipal securities declined slightly in April but holdings of U.S. Government securities increased a little, in part because of bank participation in the Treasury's late-March bill financing.

Bank credit and the money stock had risen sharply in the first week of April, and although both had declined later in the month, their average levels for April as a whole were considerably above those for March. According to revised estimates, the adjusted bank credit proxy —daily-average member bank deposits, adjusted to include changes in the daily average of U.S. bank liabilities to foreign branches—expanded at an annual rate of 6 per cent from March to April, and the money stock grew at a rate of more than 10 per cent. However, total time and savings deposits of banks declined slightly. Tentative estimates for May indicated that the average level of both the adjusted proxy series and the money stock would be about the same as in April, and that time and savings deposits would again decline slightly. The volume of large-denomination CD's outstanding was being reduced further in May, and other time and savings deposits apparently were recovering sluggishly from the sizable net outflows that marked much of April. The data available for savings flows at nonbank thrift institutions in early May also suggested only modest improvement over the weak April performance.

It appeared likely that the banking system—and financial markets generally—would be under heavy pressure in June. A near-record

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volume of corporate income tax payments due at midmonth was expected to contribute both to substantial demands for business loans and to continuing run-offs of outstanding large-denomination CD's. Staff projections suggested that bank credit would grow relatively little from May to June if prevailing conditions were maintained in money and short-term credit markets. Specifically, the proxy series adjusted for changes in Euro-dollar liabilities was projected to increase at an annual rate in a range from zero to 5 per cent. Some further recovery was anticipated in consumer-type time and savings deposits, at least until the midyear interest-crediting period. U.S. Government deposits were projected to decline on the average in June as a result of net debt repayments by the Treasury in the latter half of the month. Partly for this reason, and partly in consequence of the expected heavy demands for business loans, sharp increases appeared in prospect for private demand deposits and the money stock; the latter was projected to rise at an annual rate of 7 to 10 per cent.

It was noted at the meeting that in recent months banks had begun to draw increasingly on nondeposit sources of funds other than Euro-dollars—such as funds obtained through sales of commercial paper by bank holding companies and sales of loan participations to nonbank customers under agreements to repurchase—and that credit based on funds from these sources was not reflected in the proxy series as currently calculated. While data for firm estimates of the amounts involved were lacking, it was suggested that funds raised from such nondeposit sources might have grown at a rate equivalent to 1 or 2 percentage points in the adjusted proxy series in May and might possibly grow more in June.

In its discussion of policy the Committee took note of the signs of some slowing in the economic expansion and of the indications of stringency in financial markets. In view of the persistence of strong inflationary pressures and expectations, however, the members agreed that a relaxation of the existing degree of monetary restraint would not be appropriate at this time. There was some comment about the possible need for a slight further firming of policy, but it was noted that the strains anticipated in financial markets in connection with corporate tax payments in June militated against such a course. A number of members expressed the view that—while disorderly market con-

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ditions should be avoided—concern among market participants over the possibility of a "credit crunch" would not in itself warrant an easing of monetary policy.

The Committee decided that open market operations should be directed at maintaining the prevailing pressure on money and short-term credit markets, with the proviso that operations should be modified if bank credit appeared to be deviating significantly from current projections. Although not all members were of the same view on the matter, a number suggested that it would be desirable for the change in the adjusted bank credit proxy in June to be kept to the lower end of the projected range, particularly since the measure currently understated the resources actually available to the banking system. And a number of members expressed the hope that growth in the money stock in June could be held below the rate projected.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that expansion in real economic activity is continuing to moderate slightly, but that substantial upward pressures on prices and costs are persisting. Interest rates have risen in recent weeks. Bank credit and the money supply appear to be changing little on average in May after bulging in April. The outstanding volume of large-denomination CD's has continued to decline, and the available evidence suggests only modest recovery in other time and savings deposits at banks and in savings balances at nonbank thrift institutions following the outflows of the first half of April. The U.S. balance of payments on the liquidity basis was in sizable deficit in the first 4 months of 1969 but the balance on the official settlements basis remained in surplus as a result of large inflows of Euro-dollars. However, there were substantial outflows of funds from the United States in the first half of May, during the period of intense speculation on a revaluation of the German mark, and the payments balance was in very large deficit on both bases. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, System open market operations until the

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next meeting of the Committee shall be conducted with a view to maintaining the prevailing pressure on money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Mitchell, Robertson, Scanlon, and Sherrill. Votes against this action: None.

2. Amendment to authorization for System foreign currency operations.

The Committee ratified an action taken by members on May 14, 1969, effective on that date, equalizing the System's swap arrangements with the National Bank of Belgium and the Netherlands Bank at $300 million, and making the corresponding amendment to paragraph 2 of the authorization for System foreign currency operations. Previously, the arrangement with the National Bank of Belgium had been in the amount of $225 million and that with the Netherlands Bank in the amount of $400 million. As a result of this action, paragraph 2 of the authorization read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	300
Bank of Canada	1,000
National Bank of Denmark	100

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000
Bank of Italy	1,000
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	300
Bank of Norway	100
Bank of Sweden	250
Swiss National Bank	600
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,000

Votes for ratification of this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Mitchell, Robertson, Scanlon, and Sherrill. Votes against ratification of this action: None.

The System's swap arrangements with the two central banks in question had been of equal size for several years before the gold crisis of March 1968, when the arrangement with the Netherlands Bank had been increased by $175 million. Members of the Committee had voted in mid-May to approve the restoration of equality in the size of the two swap arrangements at $300 million upon recommendation of the Special Manager, who advised that the action was agreeable to the central banks of Belgium and the Netherlands.

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MEETING HELD ON JUNE 24, 1969

Authority to effect transactions in System Account.

The information reviewed at this meeting suggested that expansion in real economic activity was continuing to moderate slightly in the second quarter but that prices and costs were remaining under substantial upward pressure. Staff projections for the second half of the year implied further slowing of the rise in real GNP but only a moderate diminution of the rate of price advance.

Data for May offered a rather mixed picture of economic developments. Retail sales, according to the advance report, were virtually the same as in April; after allowing for price increases, reported sales were no higher in May than a year earlier. Housing starts declined for the fourth consecutive month to a level about one-fifth below the very high January rate. New orders for durable goods, which had surged in April prior to the administration's recommendation for repeal of the 7 per cent investment tax credit, declined in May to nearly the level in March. Nonfarm employment again expanded at a slower pace than in late 1968 and early 1969. Nevertheless, the labor market continued tight and unemployment remained at the April rate of 3.5 per cent. In addition, industrial production rose considerably from an April level that had been revised upward. In both April and May the advance was concentrated in industries producing business equipment and industrial materials.

Average wholesale prices increased sharply from mid-April to mid-May—mainly because of an exceptionally large rise in prices of farm products and foods, particularly livestock. Average prices of industrial commodities advanced only slightly; as in April, marked declines for lumber and plywood nearly offset increases for other commodities.

Staff estimates of GNP in the second quarter continued to suggest a slowing of growth in consumer expenditures, little change in defense outlays, and a decline in residential construction. However, on the basis of the latest Commerce–SEC survey of capital investment plans of businesses, the estimate of growth in outlays on new plant and equipment in the quarter had been revised upward. The survey results suggested that such outlays had expanded rather steadily in the first half of the year, contrary to earlier indications of a sharp increase in the first quarter and

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a slight decline in the second. The survey also implied that growth in capital outlays would decelerate markedly after midyear, and that for the year as a whole the rise from 1968 would be less than previously indicated—about 12.5 per cent rather than nearly 14 per cent.

Growth in GNP was expected to slow further in the second half of 1969 in part because of expectations of a downdrift in residential construction outlays and slackened expansion in business capital spending. In the latter connection, the staff projections assumed that the investment tax credit would be repealed. They also assumed that Federal expenditures would remain under substantial restraint and that the income tax surcharge would be continued at 10 per cent through the end of the year. Except for the third quarter, when the flow of disposable income was expected to be augmented temporarily by the Federal pay raise and the termination of payments on 1968 income tax liabilities, it appeared likely that growth in consumer spending would be held down by smaller employment and income gains. While the rate of price advance was expected to slow somewhat because of reduced demand pressures, it was anticipated that continuing substantial increases in costs would keep prices under considerable upward pressure throughout the year.

Developments in international financial markets had been dominated in recent weeks by extremely large borrowings of Euro-dollars by U.S. banks through their foreign branches. In the 3 weeks ending June 18 such borrowings rose by more than $3 billion. Together with seasonal pressures in foreign financial markets, the strong bidding for funds by U.S. banks led to sharp further increases in Euro-dollar interest rates until June 10, when the 3-month rate briefly reached 13 per cent. Although Euro-dollar rates subsequently declined, they remained above their levels in late May.

The pull of high Euro-dollar rates apparently added to the outflow of funds from Germany that had begun after the German Government announced on May 9 that the existing parity of the mark would be maintained. It also led to some selling pressure on a number of Western European currencies, although the market for sterling remained relatively firm and the Swiss franc was strong. Central bank discount rates were increased in a number of countries, including Belgium in late May and Canada, France, and Germany in June.

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As a result of the Euro-dollar inflows, the U.S. balance of payments on the official settlements basis reverted to substantial surplus after mid-May. Heavy deficits had been recorded in late April and early May when expectations of a revaluation of the German mark had led to a massive flow of capital to Germany, but the subsequent inflows of funds borrowed by U.S. banks appeared large enough to produce a small official settlements surplus for the second quarter as a whole. On the liquidity basis, however, the U.S. balance of payments was in heavy deficit in the first half of June and a substantial deficit seemed to be in prospect for the second quarter. Outflows of private nonbank funds from the United States to the Euro-dollar market apparently had contributed to the large liquidity deficit of recent weeks.

System open market operations since the May 27 meeting of the Committee had been directed at maintaining the prevailing pressure on money and short-term credit markets. Money market conditions were particularly taut in the first half of June as banks aggressively sought funds to meet substantial loan demands, including expected heavy demands from businesses to finance tax payments due at midmonth. Also contributing to the pressures were large shifts of deposits away from money center banks as the Treasury drew down its tax-and-loan account balances. During the period as a whole the effective rate on Federal funds fluctuated mostly in a range of 8½ to 9½ per cent, compared with a range of about 8 to 9 per cent in the previous interval. In the 4 weeks ending June 18 member bank borrowings averaged about $1,350 million, little changed from the preceding 4 weeks, and the average for net borrowed reserves also was close to its earlier level.

With credit demands remaining strong and the banking system continuing under considerable restraint, most market interest rates had risen appreciably further on balance in recent weeks. Particularly sharp rate advances occurred after major banks increased their prime lending rate by 1 percentage point—to a record high of 8½ per cent—on June 9. Upward pressures on Treasury bill rates were augmented by sales from foreign official accounts—most of which were associated with movements of funds from Germany into the Euro-dollar market—and the 3-month bill rate rose from around 6.10 per cent in late May to a new high of 6.81 per cent on June 12. Subsequently, when foreign official sales diminished and demands developed from investors who were re-

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deeming maturing Treasury securities for cash, the 3-month rate declined to a range around 6.50 per cent.

Yields on new corporate and municipal bonds advanced for most of the period since the preceding meeting, but yields on Treasury bonds turned down shortly after the increase in the prime rate and at the time of this meeting were slightly below their levels in late May. The volume of corporate bonds coming to market in June—and in prospect for July —was large, but most of the recent issues had been well received by investors at the higher yields offered. In contrast, the volume of municipal issues had declined substantially—in part because of cancellations and postponements of previously scheduled issues—but distribution of recent issues was proceeding slowly as a result of limited bank demand. Prices of common stocks turned down after mid-May and fell steadily in subsequent weeks.

Average yields on new-home mortgages were unchanged from April to May, but secondary-market yields on federally underwritten mortgages rose sharply to a new high in June, following the increase in the prime rate. Savings inflows at nonbank thrift institutions increased in May from the low April pace but for the 2 months together inflows were at a rate well below that for the first quarter. In May mortgage commitments outstanding at such institutions declined for the first time in 1969. Thrift institutions reportedly were continuing to follow cautious commitment policies in June, in anticipation of possibly heavy savings outflows following midyear interest and dividend crediting.

In May, according to revised estimates, declines at a 2 per cent annual rate were recorded for both the money stock and the adjusted bank credit proxy—daily-average member bank deposits, adjusted to include changes in the daily average of U.S. bank liabilities to foreign branches. Large-denomination CD's continued to run off at a rapid pace, and net inflows of consumer-type time and savings deposits were unusually small. In the face of strong business loan demands and net deposit outflows, banks substantially reduced their holdings of securities, particularly U.S. Government securities. In addition to enlarging their Eurodollar liabilities to foreign branches, banks apparently made increased use of funds from other nondeposit sources, including sales of loan participations to nonbank customers under repurchase agreements and sales of commercial paper by bank holding companies.

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In the first 5 months of 1969 as a whole, growth in the money stock slowed to an annual rate of less than 3 per cent from about 6 per cent in the second half of 1968. The adjusted bank credit proxy declined at about a 1 per cent annual rate after increasing at a 13 per cent pace in the preceding half year. Since the beginning of 1969 business loans of banks had expanded at a 17 per cent annual rate, holdings of U.S. Government securities had declined at a rate of more than 21 per cent, and holdings of other securities had changed little on balance.

Business loan demands remained strong in early June, although borrowings around the midmonth tax date were smaller than many observers had expected. Staff projections suggested that the adjusted bank credit proxy would decline in both June and July—at annual rates in the ranges of 2 to 4 and 3 to 5 per cent, respectively—if prevailing conditions were maintained in money and short-term credit markets. The projections allowed for the large rise in Euro-dollar borrowings through foreign branches that had already occurred in June and for some anticipated further increases in coming weeks. While the projections did not incorporate allowances for funds raised by banks from other nondeposit sources, it was observed at the meeting that the use of such funds might increase on the average in June by an amount about equivalent to the projected decline in the adjusted proxy series.

With respect to various categories of deposits, the staff projections suggested that in both June and July large-denomination CD's would continue to run off at a substantial rate and that there would be net outflows of other time and savings deposits, particularly around the midyear interest-crediting period. On the other hand, expansion in private demand deposits and the money stock was projected to resume in June and to accelerate in July. In the 2 months together, U.S. Government deposits were expected to decline on the average by an amount roughly twice the projected increase in private demand deposits.

In the Committee's discussion it was noted that, while there had been some moderation in the rate of growth of real economic activity, inflationary pressures and expectations remained strong. A few members commented that the continuing inflationary environment might offer grounds for a slight further firming of money market conditions, or at least the resolution of any doubts arising in the conduct of open market operations in that direction. But the consensus of the Committee was

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that open market policy should remain unchanged at present. In this connection, some members noted the extent to which growth of money and bank credit had already been curtailed, the strains evident in financial markets, and the possibility of unusual liquidity pressures in the weeks ahead.

Comments also were made in the discussion about the desirability of System policy actions in areas other than open market operations—including increases in discount rates, increases in Regulation Q ceiling rates on large-denomination CD's, and actions to limit bank access to various nondeposit sources of funds. While there were some differences of view on these matters, the majority of those commenting thought that increases in discount rates or Regulation Q ceiling rates would not be appropriate at this time but that it would be desirable for the Board to consider some actions with respect to nondeposit sources of funds.

With respect to open market policy, the Committee agreed that operations should be directed at maintaining the firm conditions currently prevailing in the money and short-term credit markets. The proviso was added that operations should be modified if bank credit appeared to be deviating significantly from current projections or if unusual liquidity pressures should develop. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that expansion in real economic activity is continuing to moderate slightly, but that substantial upward pressures on prices and costs are persisting. Most market interest rates have risen considerably on balance in recent weeks, as credit demands continued strong against the background of considerable restraint on the banking system. Growth in bank credit and the money supply thus far in 1969 has been limited, and both declined somewhat on average in May. Large-denomination CD's have continued to run off at a rapid pace recently, and net inflows of consumer-type time and savings deposits have remained small. At nonbank thrift institutions, savings inflows slowed somewhat on average in April and May. Very heavy Euro-dollar borrowing by U.S. banks through their foreign branches produced a large surplus in the balance of payments on the official settlements basis after mid-May. On the other hand, high Euro-dollar interest rates apparently also stimulated outflows of funds from the United States that contributed to a large deficit on the liquidity basis thus far in June. In light of the

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foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the firm conditions currently prevailing in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if unusual liquidity pressures should develop.

Votes for this action: Messrs. Martin, Bopp, Brimmer, Clay, Coldwell, Daane, Mitchell, Robertson, Scanlon, Sherrill, and Treiber. Vote against this action: Mr. Maisel.

Absent and not voting: Mr. Hayes. (Mr. Treiber voted as his alternate.)

In dissenting from this action, Mr. Maisel observed that on balance conditions in money and short-term credit markets were now considerably firmer than at the end of April while the monetary aggregates had been declining. He was concerned that further tightening to an undesirable degree might occur under the directive favored by the majority today, since the language of the second paragraph was similar to that of the directives the Committee had issued on April 29 and May 27. In addition, he noted that the staff projections suggested that the bank credit proxy, before adjustment for Euro-dollar borrowings, and total reserves of member banks might fall at an annual rate of 10 to 12 per cent in June and July together even if conditions in money and short-term credit markets were unchanged. In his judgment, moderate positive rates of growth in bank credit were appropriate under current circumstances, and he thought it would be desirable for the Committee to act now to bring about a transition to maintainable financial conditions. Accordingly, he preferred a directive calling for maintenance of the money and short-term credit market conditions that had prevailed on the average in the second quarter rather than the tighter conditions currently prevailing.

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MEETING HELD ON JULY 15, 1969

Authority to effect transactions in System Account.

According to information reviewed at this meeting, real GNP apparently had continued to rise in the second quarter at an annual rate close to that of the first quarter and slightly below the rate of the final quarter of 1968. Average prices, as measured by the GNP deflator, were estimated to have continued upward at the rapid first-quarter pace. There were indications—including further large declines in prices of common stocks—that some attitudes regarding the outlook were beginning to change, but it appeared that inflationary expectations on the whole were still strong.

The latest economic information continued to exhibit the cross-currents that had been evident in preceding months. Retail sales, according to the advance report, declined in June, and revised estimates for May indicated that they had declined in that month also. On the other hand, industrial production was estimated to have risen considerably further in June, and nonfarm employment expanded more rapidly than in the two preceding months. The labor market remained tight, and the unemployment rate edged down to 3.4 per cent from 3.5 per cent in May.

Average wholesale prices rose sharply further from mid-May to mid-June as prices of farm and food products again advanced substantially. However, average prices of industrial commodities were unchanged for the first time since mid-1968, as further increases for a variety of commodities, particularly metals and products, were offset by continued marked declines in prices of lumber and plywood. The consumer price index rose much less in May than in March and April —partly because of a smaller advance in service costs, including mortgage interest charges and property taxes—but it appeared likely that the index for June would show a substantial increase. Average hourly earnings continued to advance rapidly in the first half of 1969, although not so rapidly as in late 1968. In the limited number of wage contracts on which negotiations had recently been completed, there had been provision for large increases in wage rates.

Staff projections for the second half of 1969 suggested that expansion of real GNP would slow further—reaching a relatively low rate

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in the fourth quarter—but that the advance in prices would diminish only moderately from the rapid pace of the first half. Although prospects for congressional action on the administration's tax recommendations were uncertain, the projections assumed that the income tax surcharge would be continued at 10 per cent through the end of 1969 and at 5 per cent in the first half of 1970, and that the investment tax credit would be repealed.

One of the major forces expected to retard economic growth in the second half was a sharp deceleration in the expansion of fixed capital outlays by businesses, as had been suggested by the recent Commerce–SEC survey. In addition, it appeared likely that outlays on residential construction would decline as a result of limited availability of mortgage funds. Growth in consumer spending was expected to be stimulated temporarily in the third quarter by the Federal pay raise and the ending of retroactive payments on 1968 income tax liabilities, but to slow later on in line with smaller increases in employment and income. Apart from the pay raise, Federal expenditures were expected to remain under substantial restraint.

With respect to the U.S. balance of payments, tentative estimates for the second quarter indicated that the deficit on the liquidity basis had increased substantially further from the high first-quarter rate and that there had been another sizable surplus on the official settlements basis. The liquidity deficit was swollen by very large capital outflows. These included movements of funds into Germany during the period of intense speculation on a revaluation of the German mark in late April and early May and flows of funds to the Euro-dollar market—especially in June—in response to record high interest rates there. There was a sharp decline in foreign purchases of U.S. corporate securities, a shift from inflow to outflow in bank-reported claims on foreigners, and apparently some increase in the outflow of direct investment capital. Merchandise exports and imports both increased following the termination of the longshoremen's strike, and in April and May combined there was a very small trade surplus, in contrast to the small deficit of the first quarter.

The second-quarter surplus in the payments balance on the official settlements basis reflected the movements of foreign funds out of other currencies into Euro-dollars that accompanied a huge increase in bor-

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rowings by U.S. banks from their foreign branches. These developments were concentrated mainly in June; in the 4 weeks ending June 25, Euro-dollar borrowings of U.S. banks rose by $3.6 billion to a new high of $13.6 billion. Some further net increase occurred in early July.

In recent weeks interest rates in the Euro-dollar market had fluctuated below the peaks reached on June 10 but had remained high. On June 26 the Board of Governors announced certain proposals designed to moderate the flow of Euro-dollars between U.S. banks and their foreign branches, including a proposal for a 10 per cent reserve requirement on borrowings by U.S. banks from their branches—to the extent that these borrowings exceeded the daily-average amounts outstanding in the 4 weeks ending May 28, 1969.

On July 9 and 11 the Treasury auctioned tax-anticipation bills due in December 1969 and March 1970, respectively. Each issue amounted to $1.75 billion, and payment on each was scheduled for July 18. Commercial banks, which were permitted to pay for the bills in full through credits to Treasury tax and loan accounts, successfully bid for the bulk of the issues. The Treasury was expected to announce at the end of July the terms on which it would refund $3.4 billion of notes maturing in mid-August, of which $3.2 billion were held by the public. Current estimates suggested that the Treasury also would need to raise some additional new cash during August.

With the banking system remaining under considerable restraint, short-term interest rates recently had risen further on balance. Treasury bill rates fluctuated over an unusually wide range as shifting demand and supply pressures impinged on a market in which dealers were attempting to hold inventories to minimal levels. The market rate on 3-month bills, for example, declined from around 6.50 per cent at the time of the previous meeting of the Committee to about 6.10 per cent in late June in response to strong seasonal demands; the rate then advanced to a range around 7 per cent in reaction to the Treasury's offering of tax-anticipation bills and a large prospective volume of Federal agency financing.

In capital markets, yields on municipal bonds had declined in recent weeks as a result of a sharply reduced volume of current and prospective offerings and light dealer inventories. Yields on long-term

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Treasury and corporate bonds—particularly the latter—also declined for a time in the latter part of June but they turned up near the end of the month, partly because of sizable additions to an already large calendar of corporate offerings. Also contributing to the weakening in the market atmosphere were the delays in congressional action on extension of the income tax surcharge and the announcement by the Federal Reserve of two proposed regulatory actions. These were the proposal on June 26 regarding reserve requirements on Euro-dollar borrowings by U.S. banks and a proposal on June 27 to bring certain Federal funds transactions within the coverage of Regulations D and Q. However, the Government bond market rallied sharply on the Friday before this meeting, following the announcement by a major automobile manufacturer that it had cut back on its capital investment program. On balance, Treasury and corporate bond yields at the time of this meeting were little changed from their levels of 3 weeks earlier.

Secondary market yields on federally underwritten new-home mortgages reached a new high in early July, and the available evidence suggested that mortgage lenders were following highly selective lending policies. Net savings inflows to nonbank thrift institutions slackened considerably in June and for the second quarter as a whole were well below earlier quarters. According to preliminary indications, thrift institutions experienced substantial net outflows of savings in early July, following quarterly interest and dividend crediting.

System open market operations since the previous meeting of the Committee had been directed at maintaining the firm conditions prevailing in the money and short-term credit markets. Day-to-day variations in the Federal funds rate were more pronounced than earlier, but the average effective rate—approximately 9 per cent—was about the same as in the preceding interval. Member bank borrowings averaged $1,325 million in the 3 weeks ending July 9, little changed from the previous 4 weeks, and average net borrowed reserves also remained close to their earlier level.

Commercial bank holdings of securities declined slightly in June. Business loans outstanding were unchanged over the month after rising rapidly earlier in the year, and total loans declined slightly. The volume of loans reported as outstanding at the end of June was reduced significantly by sizable sales of loans during the month to bank

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affiliates, but there apparently had also been some diversion of borrowers' demands to the commercial paper market following the increase in the prime lending rate of banks on June 9.

Total bank credit, as measured by the adjusted proxy series—daily-average member bank deposits, adjusted to include changes in the daily average of U.S. bank liabilities to foreign branches—was estimated to have declined at an annual rate of about 3 per cent from May to June. The decline in the adjusted proxy series reflected a large reduction in member bank deposits and a partly compensating expansion in the Euro-dollar liabilities of domestic banks to their foreign branches. Rough estimates suggested that, if a further adjustment were made for assets sold to affiliates and to customers with bank guarantees, the proxy series would be about unchanged in June.

The money stock was estimated to have increased at an annual rate of about 1 per cent from May to June after declining at a 3 per cent rate in the previous month. The resumption of growth in money reflected an expansion in currency; private demand deposits [1] declined slightly. U.S. Government deposits were reduced considerably on the average in June. The run-off of large-denomination CD's continued without abatement; since mid-December the outstanding volume of such CD's at weekly reporting banks had contracted by about $9 billion, or nearly 40 per cent. Other time and savings deposits of banks changed little on the average in June and—as at nonbank thrift institutions—there apparently were substantial net outflows from consumer-type accounts in early July.

Revised staff projections suggested that the adjusted bank credit proxy would decline at an annual rate of 5 to 8 per cent from June to July if prevailing conditions were maintained in money and short-term credit markets. The projections allowed for some further growth in Euro-dollar borrowings of U.S. banks from the high level of early

[1] It was reported at the meeting that, under present accounting procedures for cash items generated by Euro-dollar transactions of U.S. banks, the recent growth in such cash items appeared to be producing some downward bias in measures of private demand deposits—and hence in measures of the money stock and, to a relatively smaller extent, the bank credit proxy. The staff was studying methods for correcting the bias in question. The information on recent and projected changes in these variables presented at the meeting and included in this policy record does not include such corrections.

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July, but they did not include any allowance for possible changes in the extent to which banks were utilizing funds from other nondeposit sources. It was noted, however, that banks were likely to continue to increase their reliance on funds from such sources.

With respect to the various categories of deposits, it was expected that private demand deposits—and the money stock—would expand moderately from June to July and that U.S. Government deposits would decline sharply. Also anticipated were a continuing rapid run-off in large-denomination CD's and a reduction in the average level of consumer-type time and savings deposits.

Projections for August suggested only a slight further decline in the average level of member bank deposits. Credit demands in that month were expected to be influenced by dealer and bank support of Treasury financing operations. In addition, with maturities of CD's in August less than in earlier months, it appeared likely that the run-off would moderate; and prospects seemed to favor some net inflow of consumer-type time and savings deposits.

In the Committee's discussion a number of members commented that the response of the economy to existing monetary and fiscal restraints was as yet inadequate. Considerable concern was expressed about the persistence of inflationary pressures and expectations and about the uncertain prospects for congressional action on extension of the income tax surcharge.

The members agreed that the forthcoming Treasury refunding militated against any appreciable change in open market policy at this time. Some, however, expressed the opinion that a slight shift toward greater restraint might be warranted. A contrary view was also advanced, favoring a shading toward slightly less restraint in light of the projections for slackened growth in real GNP, recent and prospective changes in bank credit, and the risk that maintenance of current tight money market conditions for an extended period might lead to developments that would necessitate an undesirably large adjustment toward ease later on.

Other members took the intermediate position that further firming would not be appropriate in view of the high degree of restraint already in effect but that, at the same time, the inflationary environment and the uncertain status of tax legislation militated against even a

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slight move toward easing. In the latter connection, it was noted that any indications that monetary restraint was being relaxed might reinforce inflationary expectations just at a time when signs were beginning to appear that some attitudes about the outlook were changing.

At the conclusion of the discussion the Committee agreed that open market operations should be directed at maintaining the currently prevailing firm conditions in money and short-term credit markets, with the proviso that operations should be modified, to the extent permitted by the Treasury refunding, if bank credit appeared to be deviating significantly from current projections. The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that expansion in real economic activity, after moderating slightly in the first quarter, has continued at about the same pace since then. Substantial upward pressures on prices and costs are persisting. Market interest rates have fluctuated widely recently, partly because of varying expectations, although credit demands remain relatively strong. Short-term rates on balance have continued under upward pressure, against the background of considerable restraint on the banking system. In June bank credit showed little change, after allowance for assets sold to affiliates and to customers with bank guarantees. Growth in the money supply resumed at a slow pace, and the run-off of large-denomination CD's which began in mid-December continued without abatement. There apparently were substantial net outflows from consumer-type time and savings accounts at banks and nonbank thrift institutions around midyear, following a period of slackened growth. The over-all balance of payments deficit on the liquidity basis rose sharply in the second quarter; there were large outflows into German marks and into Euro-dollar deposits, and there was no significant improvement in net exports. In contrast, there was another large surplus on the official settlements basis as U.S. banks borrowed heavily in the Euro-dollar market. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

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To implement this policy, while taking account of the forthcoming Treasury refunding, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the currently prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the Treasury refunding, if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Robertson, Scanlon, Sherrill, and Treiber. Votes against this action: None.

Absent and not voting: Messrs. Hayes and Mitchell. (Mr. Treiber voted as Mr. Hayes' alternate.)

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MEETING HELD ON AUGUST 12, 1969

Authority to effect transactions in System Account.

According to preliminary Commerce Department estimates, real GNP had expanded in the second quarter at an annual rate of 2.4 per cent, close to the 2.5 per cent rate of the first quarter and somewhat slower than the 3.5 per cent rate of the second half of 1968. However, substantial upward pressures on prices and costs were persisting; average prices, as measured by the GNP deflator, had increased at an annual rate of nearly 5 per cent in both the first and second quarters. Staff projections suggested some further slowing of growth in real GNP in the second half of 1969 but only a moderate reduction in the rate of price advance.

Recent economic developments continued to present a mixed picture. Industrial production was tentatively estimated to have risen sharply further in July. On the other hand, weekly figures suggested that retail sales were about unchanged from June and no higher than they had been in February. Nonfarm employment expanded less than it had on the average in earlier months of the year, and the unemployment rate rose to 3.6 from 3.4 per cent in June.

Average wholesale prices increased only slightly further from mid-June to mid-July. Average prices of farm products and foods, which had accounted for most of the rise in the wholesale price index in recent months, were unchanged. Price advances continued widespread among industrial commodities, but the average for such commodities rose only moderately because of further declines in prices of lumber and plywood. The consumer price index increased sharply in June with foods, particularly meats, accounting for much of the advance.

In the second quarter, according to the preliminary Commerce Department figures, expansion in real GNP had been sustained by a rise in inventory investment. Declines were recorded in residential construction expenditures and Federal outlays on goods and services, and the rate of increase was slower than in the first quarter for consumer spending and business capital outlays.

One uncertainty in the outlook for the second half of 1969 had been removed by the enactment in early August of legislation to ex-

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tend the income tax surcharge at 10 per cent through the end of the year. The mid-1969 Government pay raise was expected to lead to an increase in Federal outlays in the third quarter and to provide some temporary stimulus to growth in disposable income and consumer spending, but it seemed likely that the decline in Federal outlays would resume in the fourth quarter and that growth in consumer income and spending would again be moderating. Prospects were that residential construction activity would continue to decline in the third and fourth quarters. Further slowing in the expansion of business capital outlays was anticipated in both quarters, as suggested by the June Commerce–SEC survey of business plans and also by a special Federal Reserve survey of capital spending authorizations of about 200 large corporations conducted in late July.

With respect to the balance of payments, it appeared that outflows of U.S. capital remained sizable in July and that the very large deficits that had been recorded on the liquidity basis earlier in the year were continuing. The official settlements balance was still in surplus in the first half of July, a period in which the outstanding Euro-dollar borrowings of U.S. banks increased considerably further. After mid-July, however, there was relatively little net change in such borrowings and the official settlements balance shifted toward deficit. Interest rates in the Euro-dollar market declined from early July to early August but remained at relatively high levels.

On the Friday before this meeting the French Government announced an 11.1 per cent devaluation of the franc. This action was taken against the background of recent substantial losses of international reserves by France and in the interests of avoiding a deflationary policy "that would impose unbearable sacrifices and massive unemployment on the country." Although certain Western European currencies had come under some selling pressure following the announcement, the initial reaction in foreign exchange markets appeared on the whole to be orderly. Earlier—around mid-July—the Bank of Canada had increased its discount rate and the German Federal Bank had announced an increase in reserve requirements against deposit liabilities of domestic banks; and around the end of the month discount rates had been increased by the central banks of Belgium and the Netherlands.

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In its August refunding the Treasury offered a new 18-month, 7¾ per cent note priced to yield about 7.82 per cent in exchange for $3.4 billion of securities maturing on August 15. The new issue was well received and was quoted at a premium in the market. Of the $3.2 billion of maturing issues held by the public, about 14 per cent were redeemed for cash. The Treasury was expected to raise about $1.5 billion to $2 billion of new cash later in the month through an offering of short-term securities.

The atmosphere in securities markets had improved recently—partly because of the enactment of legislation extending the income tax surcharge, of further indications that the rate of real economic expansion was gradually slowing, and of signs that credit demands from some sectors might be moderating. Yields on new long-term corporate bonds and municipal securities, which had been rising in the latter part of July, declined somewhat in early August. Municipal bond markets had been under particularly severe pressures partly as a result of congressional discussion of possible changes in the tax treatment of earnings on such bonds, and these pressures moderated after the House Ways and Means Committee modified certain earlier proposals in this area. Various short-term interest rates also had declined recently. For example, the market rate on 3-month Treasury bills, at about 7 per cent on the day before this meeting, was down from a peak of 7.13 per cent in late July, although it was little changed from its level 4 weeks earlier.

Commercial bank holdings of U.S. Government securities rose during July as a result of bank underwriting of the tax-anticipation bills sold by the Treasury at midmonth, but holdings of other securities decreased considerably. Business loans outstanding were about unchanged for the second successive month after expanding rapidly earlier in the year. To some extent the lack of growth in business loans since May reflected outright sales of loans to bank affiliates. Even with the inclusion of such loans, however, the increase in the last 2 months would have been at a rate only about one-third of that earlier in the year.

Total bank credit, as measured by the adjusted proxy series, was estimated to have declined at an annual rate of about 12 per cent from June to July, as a large reduction in daily-average member

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bank deposits was only partly offset by a rise in the average level of Euro-dollar liabilities of U.S. banks to their foreign branches. Banks increased their reliance on funds from other nondeposit sources, including funds obtained by selling assets to affiliates and to customers with bank guarantees. Rough estimates suggested that with a further adjustment for such funds the proxy series would have declined at an annual rate of 7 to 8 per cent from June to July.

Private demand deposits[1] and the money stock rose on the average in July—the latter at an annual rate of 6 per cent—partly as a consequence of a large further contraction of U.S. Government deposits. The run-off of large-denomination CD's continued without abatement; since mid-December the outstanding volume of such CD's at weekly reporting banks had been reduced by more than $10.5 billion, or about 45 per cent. There also were sizable outflows of other time and savings deposits following midyear interest crediting. Nonbank thrift institutions similarly experienced heavy outflows early in July.

In general, System open market operations since the previous meeting of the Committee had been directed at maintaining firm conditions in the money and short-term credit markets. Money market pressures had tended to ease for a time after mid-July as a result of a shift of reserves toward the money center banks. This tendency was not fully offset through System operations because bank credit appeared to be significantly below earlier projections. However, the extent to which operations were influenced by bank credit developments was affected by "even keel" considerations related to the

[1] Estimates of private demand deposits—and hence of the money stock and the bank credit proxy—had recently been corrected for a downward bias produced, under previously employed accounting procedures, by the recent growth in cash items generated by Euro-dollar transactions of U.S. banks. For the money stock the correction raised the estimated annual rate of increase for July by about 2½ percentage points—from 3.7 to 6.1 per cent; and for the first 6 months of the year by about 1½ percentage points—from 2.2 to 3.6 per cent. The effects of the correction on the adjusted proxy series were smaller. For July, the estimated annual rate of decline was reduced by about 1½ points, from 13.5 to 11.8 per cent; and for the first half of the year an estimated decline at an annual rate of about 1 per cent was revised to an estimate of no change.

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Treasury refunding. Subsequently, a redistribution of reserves away from major banks had contributed to tighter money market conditions despite sizable reserve-supplying operations by the System. In the two statement weeks following the July 15 meeting, the effective rate on Federal funds had averaged about 8¼ per cent—compared with a rate centering around 9 per cent in earlier weeks—and since then had risen to a range around 9¾ per cent. In the 4 weeks ending August 6, member bank borrowings had averaged $1,250 million, down somewhat from the previous period. A corresponding decline in excess reserves had left net borrowed reserves about unchanged on the average.

Prospective changes in the bank credit proxy and related variables were affected by the expected consequences of certain regulatory actions taken by the Board of Governors on July 24, 1969. These were (1) an amendment to Regulation D, effective July 31, requiring member banks to include in deposits used to compute reserve requirements all so-called "London checks" and "bills payable checks" used in settling transactions involving foreign branches; and (2) amendments to Regulations D and Q defining deposit liabilities subject to those regulations to include, beginning August 28, every bank liability on a repurchase agreement (RP) entered into on or after July 25 with a person other than a bank and involving any assets other than direct and fully guaranteed obligations of the United States or its agencies.

The first of these actions was expected to increase required reserves of member banks by about $450 million in the statement week ending August 20. The second action was not expected to have much effect on required reserves, since it appeared unlikely that a significant volume of newly written RP's of the types affected would be outstanding after late August. It was noted, however, that outstanding RP's were expected to decline as current agreements matured and that this decline would tend to reduce bank credit by an equivalent amount, other things equal. Moreover, it was considered likely that bank attitudes toward alternative sources of funds and toward their own lending and investing policies were already being affected by this action, and by the expectation that the Board would soon implement two other regulatory actions it had proposed

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near the end of June. The latter were proposals to amend Regulations D and M, among other things to place a 10 per cent reserve requirement on borrowings by U.S. banks from their foreign branches, to the extent that these borrowings exceeded the daily-average amounts outstanding in the 4 weeks ending May 28, 1969; and a proposal to amend Regulations D and Q to bring a member bank's liability on certain Federal funds transactions within the coverage of those regulations.

The staff projections suggested that the adjusted bank credit proxy would decline at an annual rate of 9 to 12 per cent from July to August if prevailing conditions were maintained in money and short-term credit markets. The projections allowed for only a small further rise in the average level of Euro-dollar borrowings of U.S. banks. While no specific allowance was made in the projections for possible changes in the extent to which banks were utilizing funds from other nondeposit sources, it was noted that the outstanding volume of funds obtained from such sources probably would grow less rapidly than in July.

Among deposit categories, private demand deposits—and the money stock—were projected to decline moderately from July to August, and a further reduction in the average level of U.S. Government deposits was anticipated. Given prevailing levels of market interest rates, it was expected that large-denomination CD's would continue to run off, although less rapidly than earlier because the volume of maturing CD's was smaller. And it appeared unlikely that consumer-type time and savings deposits would show a marked expansion after the large net outflows of July.

In the Committee's discussion account was taken of the indications that the rate of expansion of over-all economic activity was moderating somewhat, of the recent legislation extending the 10 per cent income tax surcharge through the end of the year, and of the substantial degree of monetary restraint already in effect. The Committee agreed that no further increase in monetary restraint would be warranted at present. In particular, it agreed that any tendencies toward firmer money market conditions that might result from recent regulatory actions by the Board of Governors or from other causes should be resisted through open market operations.

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At the same time, a majority of the members thought that action to ease money market conditions would not be warranted now, in view of the persistence of inflationary pressures and the risk that such action would encourage a new surge of inflationary expectations. Some members of the majority expressed the view that System operations should not necessarily be undertaken to offset fully any easing tendencies that might be produced by market forces. On the other hand, it was suggested that the implementation of policy should not be unduly influenced by temporary swings in market psychology.

The Committee concluded that open market operations should be directed at maintaining the prevailing firm conditions in money and short-term credit markets. The proviso was added that operations should be modified if bank credit appeared to be deviating significantly from current projections. It was also agreed that operations should be modified if pressures arose in the aftermath of the devaluation of the French franc or in connection with the regulatory actions taken by the Board of Governors.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting indicates that expansion in real economic activity slowed somewhat in the first half of 1969 and some further moderation is projected. Substantial upward pressures on prices and costs are persisting. Most market interest rates recently have receded slightly from their earlier highs. In July the money supply expanded as U.S. Government deposits decreased further; bank credit declined on average, after adjusting for an increase in assets sold to affiliates and to customers with bank guarantees. The run-off of large-denomination CD's which began in mid-December continued without abatement in July, and there apparently were net outflows from consumer-type time and savings accounts at banks and nonbank thrift institutions combined. The over-all balance of payments deficit on the liquidity basis remained very large in July; the balance on the official settlements basis was still in surplus in the first half of the month but subsequently shifted toward deficit as U.S. banks' borrowings of Euro-dollars leveled off. Foreign exchange markets appear initially to be adjusting in an orderly fashion to the announced devaluation of the French franc. In light of the foregoing developments, it is the policy of the Federal

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Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if pressures arise in connection with foreign exchange developments or with bank regulatory changes.

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Coldwell, Daane, Robertson, Scanlon, Sherrill, and Swan. Votes against this action: Messrs. Maisel and Mitchell.

Absent and not voting: Mr. Clay. (Mr. Swan voted as his alternate.)

In dissenting from this action Messrs. Maisel and Mitchell indicated that they did not advocate lessening monetary and credit restraint. However, they did not want monetary policy to become more and more restrictive. It appeared to them that trends in monetary aggregates and the availability of credit were indicative of increased tightening that would be heightened if money market conditions were maintained at the levels called for in the directive favored by the majority. In order to guard against an undesired further tightening, they favored a directive calling for operations to moderate such contractive tendencies, if prospective declines in monetary aggregates should in fact occur, while maintaining the position of over-all monetary and credit restraint.

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MEETING HELD ON SEPTEMBER 9, 1969

1. Authority to effect transactions in System Account.

Revised estimates by the Commerce Department indicated that real GNP had expanded at an annual rate of 2.0 per cent in the second quarter, after rising at rates of 2.5 per cent in the first quarter and 3.5 per cent in the second half of 1968. Average prices, as measured by the GNP deflator, advanced at an annual rate of 5.1 per cent in the second quarter, a little faster than in the first. Staff projections continued to suggest that growth in real GNP would slow further during the second half of 1969, particularly in the fourth quarter, but that upward pressures on prices would diminish only moderately.

Recent economic information offered additional evidence that the expansion in final demands was slowing somewhat. Contrary to earlier indications, both retail sales and nonfarm employment were now estimated to have declined in July, and it was expected that the preliminary estimate of the industrial production index for that month—which had shown a sharp increase—would be revised downward. In August, according to weekly figures, retail sales rose but, after adjustment for price increases, remained below the level of a year earlier. Nonfarm employment advanced at a considerably slower pace in August than earlier in the year, and tentative indications were that the industrial production index would at most rise only slightly. On the other hand, the unemployment rate edged down to 3.5 from 3.6 per cent in July.

Increases in prices of industrial commodities continued widespread from mid-July to mid-August, and the average rose appreciably. However, the total wholesale price index declined slightly as a result of a reduction in prices of farm and food products. The consumer price index again rose sharply in July, largely because of increases in prices of foods and services.

The staff projection suggested that real GNP would expand in the third quarter at about the second-quarter rate but would rise less in the final 3 months of the year. Growth in private final sales was expected to slow further in the second half, but it appeared likely that the expansion in GNP would be sustained in the third quarter by some increase in business inventory accumulation and by a rise in Federal

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expenditures resulting from the July pay increase. The projections for the fourth quarter suggested little further change in inventory investment and a renewal of earlier declines in Federal outlays on goods and services.

With respect to other categories of private expenditures, consumer spending was now projected to rise at a slower rate in both the third and fourth quarters than it had in the second, despite an anticipated increase in the growth rate of disposable income in the third quarter. Declines in residential construction outlays were expected to continue. The latest Commerce–SEC survey of business plans, taken in August, suggested that spending on new plant and equipment would rise more in the third quarter than the May survey had indicated but that such spending would remain about unchanged in the fourth quarter. For 1969 as a whole, the survey implied a level of capital outlays 10.6 per cent above that of 1968, compared with the increases of 12.6 and 14 per cent, respectively, that had been indicated by the surveys taken in May and February.

The deficit in the U.S. balance of payments on the liquidity basis remained very large in both July and August. The official settlements balance was in surplus for July as a whole, mainly because of a large increase in outstanding Euro-dollar borrowings of U.S. banks in the first half of the month. In August, however, when there was a much smaller increase in such borrowings, the payments balance shifted into deficit on the official settlements basis also. Both exports and imports declined in July, but imports fell more and a slight surplus was recorded in merchandise trade that month.

Following the announcement of the devaluation of the French franc on August 8, interest rates in the Euro-dollar market reversed the decline that had been under way since early July, and conditions in foreign exchange markets became unsettled; sterling, the lira, and the Belgian franc were under selling pressure, and the guilder and mark were in strong demand. Although activity in the exchange markets was greatly reduced after mid-August, uncertainties persisted—partly because of possibilities of a revaluation of the mark following the German elections scheduled for September 28. In mid-August the Bank of Italy increased its basic discount rate from 3½ to 4 per cent.

On August 20 the Treasury auctioned a $2.1 billion strip of bills

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consisting of additions to outstanding issues maturing from mid-September to late October. Commercial banks, which were allowed to make payment for the new bills through credits to Treasury tax and loan accounts, bid successfully for the bulk of the offering. The Treasury was expected to announce around mid-September the terms on which it would refund notes and bonds maturing on October 1, of which the public held about $5.6 billion.

In the early part of September the Treasury's cash balances at both commercial banks and Federal Reserve Banks had been drawn down to quite low levels. The Treasury temporarily financed part of its cash needs by selling $322 million of special short-term certificates of indebtedness to the Federal Reserve on September 5. It appeared likely that the Treasury would experience further cash drains prior to the mid-September tax date and would need to borrow a substantial amount of additional funds directly from the System in the period through mid-month.

After declining somewhat in earlier weeks, long-term interest rates turned up around mid-August and subsequently reached new highs in an atmosphere of renewed concern over the persistence of inflationary pressures and expectations of continuing monetary restraint. The advances in yields also reflected a sizable volume of new issues by various Federal agencies, a growing calendar of new corporate bonds, and the possible offering of an intermediate-term issue in the Treasury's forthcoming refunding. The volume of State and local government securities coming to market had remained relatively light, as many potential issuers had been unable to offer bonds because market interest rates exceeded statutory ceilings. However, uncertainties arising out of legislative proposals affecting the tax-exempt status of municipal obligations and further reductions in bank holdings had contributed to sizable increases in yields on such obligations.

Most short-term interest rates, while fluctuating over a fairly wide range, had changed little on balance since the previous meeting of the Committee. The market rate on 3-month Treasury bills, which ranged from about 6.75 to 7.15 per cent over the interval, was at 7.09 per cent on the day before this meeting—up slightly from its level 4 weeks earlier.

System open market operations since the previous meeting had been

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directed at maintaining firm conditions in the money and short-term credit markets. Operations were complicated over much of the period by the alternating tendencies towards tautness and ease in the money market and in early September by the sizable declines in the Treasury's cash balances at Reserve Banks. The Federal funds rate fluctuated widely, but the average effective rate—about 9 per cent—was approximately the same as in the previous interval. Member bank borrowings averaged $1,250 million in the 4 weeks ending September 3, unchanged from the preceding 4 weeks, and average net borrowed reserves also were little changed from their earlier level.

Preliminary estimates suggested that commercial banks had increased their holdings of U.S. Government securities in August in connection with bank underwriting of the tax-anticipation bills sold by the Treasury late in the month. However, bank holdings of municipal and Federal agency securities decreased substantially for the second consecutive month. Business loans outstanding, which had changed little in June and July, rose considerably during August but other loans declined by a nearly equal amount.

Total bank credit, as measured by the adjusted proxy series—daily-average member bank deposits, adjusted to include changes in the daily average of liabilities of U.S. banks to foreign branches—declined at an annual rate of about 10 per cent from July to August. It was estimated that with a further adjustment for funds raised from nondeposit sources other than Euro-dollars, the proxy series would have declined at an annual rate of about 8 per cent. The volume of funds raised through sales of commercial paper by bank affiliates increased somewhat further on the average in August, but outstanding loans sold to nonbank customers under repurchase agreements declined. As a result of an action taken by the Board of Governors in late July, any such repurchase agreements entered into on or after July 25 became subject to Regulations D and Q on August 28.

Private demand deposits and the money stock were estimated to have decreased from July to August—the latter at an annual rate of about 5½ per cent—as U.S. Government deposits rose somewhat on the average following 2 months of substantial decline. There was a further sizable reduction in the outstanding volume of large-denomination CD's, notably at banks outside of New York and Chicago. Net

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outflows of other time and savings deposits continued, although they were considerably smaller than those in July, following midyear interest crediting. At nonbank thrift institutions, which also had experienced sizable net outflows of savings funds in early July, flows appeared to have remained relatively weak in the first half of August.

Staff projections suggested that the average level of member bank deposits would increase at an annual rate of 2 to 5 per cent from August to September if prevailing conditions were maintained in money and short-term credit markets. It was thought likely that there would be little net change in the combined total outstanding of Euro-dollar liabilities of banks, funds raised by sales of loans under RP's, and funds raised through sales of commercial paper by bank affiliates. Expectations with regard to Euro-dollar borrowings by U.S. banks were affected by the fact that on August 13 the Board of Governors had established a 10 per cent marginal reserve requirement on such borrowings by member banks. The reserve requirement was to be met beginning with the week of October 16, based on an initial 4-week computation period beginning September 4.

All of the increase in the average level of member bank deposits anticipated in September reflected an expected sharp rise in U.S. Government deposits; both private demand deposits—as well as the money stock—and time and savings deposits were projected to contract further. It appeared likely, however, that the rate of reduction in time and savings deposits would moderate from that experienced earlier in the summer, because a smaller volume of large-denomination CD's would be maturing and because prospects were for somewhat less weakness in other time and savings deposits.

The Committee decided that no change in monetary policy should be made at this time, both on general economic grounds and in light of the forthcoming Treasury refunding. Note was taken of the indications that the rate of real economic growth was slowing, but it was agreed that the persistence of strong inflationary pressures and expectations militated against a relaxation of monetary restraint at present. At the same time, a number of members emphasized the desirability of avoiding any firming in the stance of policy.

The Committee concluded that open market operations should be directed at maintaining the prevailing firm conditions in money and

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short-term credit markets, subject to the proviso that operations should be modified, to the extent permitted by the Treasury refunding, if bank credit appeared to be deviating significantly from current projections. It was also agreed to renew the additional provisos that had been included in the previous directive; these called for modification of operations if pressures arose in connection with foreign exchange developments or in connection with regulatory actions taken by the Board of Governors.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting indicates that expansion in real economic activity slowed somewhat in the first half of 1969 and some further moderation during the second half is projected. Substantial upward pressures on prices and costs are persisting. Long-term interest rates recently have risen to new peaks, while short-term rates have changed little on balance. In August the money supply decreased while U.S. Government deposits rose somewhat; bank credit declined further on average; the run-off of large-denomination CD's continued without abatement; and there were further net outflows from consumer-type time and savings accounts at banks. The U.S. foreign trade surplus was very small in July. The over-all balance of payments deficit on the liquidity basis remained very large in both July and August, while the balance on the official settlements basis shifted into deficit in August as U.S. banks' borrowings of Euro-dollars leveled off. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, while taking account of the forthcoming Treasury refunding, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the Treasury refunding, if bank credit appears to be deviating significantly from current projections or if pressures arise in connection with foreign exchange developments or with bank regulatory changes.

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Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Scanlon, and Sherrill. Votes against this action: Messrs. Maisel and Mitchell.

Absent and not voting: Messrs. Daane and Robertson.

Messrs. Maisel and Mitchell dissented from this action for reasons similar to those underlying their dissent from the directive adopted at the previous meeting. They believed that in measuring the degree of monetary firmness or restraint the Committee should give more weight to movements in key monetary aggregates—such as the money stock, private demand deposits, total and nonborrowed reserves, and bank credit—and in longer-term interest rates. In their judgment, the fact that the monetary aggregates had been declining and longer-term interest rates had been rising in recent weeks indicated that restraint had been steadily increasing, even though money market conditions had been relatively stable. They favored maintaining the over-all posture of restraint measured in terms of such aggregates and interest rates, and permitting more flexibility in money market conditions in order to do so.

2. Amendment to continuing authority directive.

The Committee amended paragraph 2 of the continuing authority directive to the Federal Reserve Bank of New York regarding domestic open market operations, to increase the dollar limit on Federal Reserve Bank holdings of short-term certificates of indebtedness purchased directly from the Treasury from $1 billion to $2 billion. With this change, paragraph 2 read as follows:

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate ¼ of 1 per cent below the discount rate of the Federal Reserve Bank of

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New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $2 billion.

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Maisel, Mitchell, Scanlon, and Sherrill. Votes against this action: None.

Absent and not voting: Messrs. Daane and Robertson.

This action was taken on recommendation of the System Account Manager, who advised that the Treasury's needs for temporary accommodation might well exceed the existing $1 billion limit in the period before the mid-September tax-payment date. It was agreed that the limit in question would revert to $1 billion at the close of business on October 7, 1969, the day on which the next meeting of the Committee was scheduled, unless otherwise decided by the Committee on or before that date.

3. Ratification of amendment to authorization for System foreign currency operations.

The Committee ratified an action taken by members on August 27, 1969, effective September 2, 1969, to increase the System's swap arrangement with the National Bank of Belgium from $300 million to $500 million equivalent, and to make the corresponding amendment to paragraph 2 of the authorization for System foreign currency operations. As a result of this action, paragraph 2 of the authorization read as follows:

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	500
Bank of Canada	1,000
National Bank of Denmark	100
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000
Bank of Italy	1,000
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	300
Bank of Norway	100
Bank of Sweden	250
Swiss National Bank	600
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,000

Votes for ratification of this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Maisel, Mitchell, Scanlon, and Sherrill. Votes against ratification of this action: None.

Absent and not voting: Messrs. Daane and Robertson.

The action in question had been taken by members on recommendation of the Special Manager of the System Open Market Account. The latter had advised that the increase in the swap line would be helpful in permitting the National Bank of Belgium to cope with short-run speculative pressures on the Belgian franc arising out of the recent devaluation of the French franc and would thus contribute to stability in foreign exchange markets.

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MEETING HELD ON OCTOBER 7, 1969

1. Authority to effect transactions in System Account.

According to staff estimates, expansion in real GNP continued in the third quarter at about the 2 per cent annual rate of the second quarter, as an increase in inventory investment approximately offset further slackening in growth of private final sales. Average prices, as measured by the GNP deflator, were estimated to have advanced substantially. Staff projections suggested that real GNP would grow more slowly in the fourth quarter and that it might change little in the first half of 1970. With pressures on resources expected to ease over that period, some moderation in the rate of price advance was projected.

A number of monthly measures of economic activity had weakened recently. Nonfarm employment was about unchanged in September and the unemployment rate rose sharply to 4.0 from 3.5 per cent in August. Industrial production edged down in August, and tentative estimates suggested that it changed little or declined slightly in September. It appeared from weekly data for most of September that retail sales in that month were about the same as in August and that, after adjustment for price increases, such sales remained below the level of a year earlier. New orders at manufacturers of durable goods declined appreciably in August, and housing starts fell for the seventh consecutive month.

Prices of a large number of industrial commodities increased from mid-August to mid-September and the average advanced substantially further. The over-all wholesale price index rose only slightly, however, as a result of another decline in prices of farm products and foods. In August the consumer price index again increased considerably.

The staff projections of GNP for the current and the next two quarters were based on the assumptions that the income tax surcharge would be continued at 5 per cent through the first half of 1970, that the investment tax credit would be repealed, and that social security benefits would be increased by 10 per cent on April 1. The projections suggested that expansion in aggregate final demands would continue to moderate through the second quarter of 1970 and that the rate of inventory accumulation would be declining after the turn of the year.

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U.S. merchandise exports rose more than imports in August, so the trade surplus increased a little. With respect to the over-all balance of payments, available data indicated that in August and September the deficit on the liquidity basis had been very large, although not so large as in preceding months, and that the balance on the official settlements basis had shifted into deficit. The official settlements balance had been in surplus for more than a year prior to August mainly as a result of increases in outstanding Euro-dollar borrowings of U.S. banks through their foreign branches, but there apparently had been little net change in those borrowings after July. Speculative flows of funds into Germany during September contributed to the shift in the official settlements balance.

Recent developments in foreign exchange markets had been dominated by events connected with the German mark. Demands for marks increased in early September in anticipation of a possible revaluation of that currency after the German elections scheduled for September 28, and by Wednesday, September 24, the German Federal Bank had acquired a substantial volume of dollars in active but orderly trading. The German authorities closed their exchange markets the next 2 days and, after a brief resumption of trading, again on Monday, September 29. The Government then announced that the mark would be allowed to float temporarily, and the exchange rate immediately broke through its previous upper limit. Subsequently the mark strengthened further, reaching a premium above par of about 6½ per cent at the time of this meeting. During the period, the German Federal Bank frequently sold dollars to moderate fluctuations in the rate. The rise in the exchange rate and the expectation that the mark would be revalued once a new German Government was formed led to some reduction in the earlier tensions in foreign exchange markets, although the French franc and the Italian lira remained under selling pressure.

Earlier in September discount rates had been increased by the central banks of Germany, Belgium, Switzerland, Austria, and Norway. Despite the tightening of conditions in domestic European money markets, interest rates in the Euro-dollar market—which had risen steadily during August—declined moderately after early September, partly because of the easing in demands by U.S. banks for Euro-dollars.

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On September 17 the Treasury announced that in exchange for securities maturing on October 1 and December 15, 1969, it would offer three new notes having, respectively, maturities of about 20 months, 3 years and 8 months, and 6 years and 10 months, and yields of 8, 7.75, and 7.59 per cent. The new issues were initially well received and rose to a premium in the market. Of the $7.6 billion of maturing securities held by the public, about $5.8 billion were exchanged for the new issues, including somewhat more than $1 billion for each of the two longer-term notes. Following this financing, the Treasury announced that on October 8 it would auction $2 billion of tax-anticipation bills due in April 1970. The Treasury was expected to raise additional funds during the fourth quarter to meet further cash needs.

Treasury cash balances at both commercial banks and Federal Reserve Banks had been reduced to very low levels prior to the mid-September tax date, and in the period September 5–16 the Treasury had temporarily financed some of its cash needs through sales of special short-term certificates of indebtedness to the Federal Reserve. The volume of such certificates reached a 16-year high of $1.1 billion on September 10,[1] but the Treasury was able to redeem all outstanding certificates by September 17 and subsequently to rebuild its cash balances to a substantial level.

System open market operations since the previous meeting of the Committee had been directed at maintaining firm conditions in the money and short-term credit markets. Sizable operations were required to offset the impact on bank reserves and money market conditions of substantial changes in Treasury cash balances and large shifts of funds among banks stemming from the Treasury refunding and from foreign central bank transactions. Federal funds traded mainly in a range of 8½ to 9½ per cent; the average effective rate of about 9⅛ per cent was slightly higher than in the preceding interval. Member bank borrowings averaged $1,075 million in the 4 weeks

[1] The volume of special certificates held by the Federal Reserve totaled $322 million on September 5 through 7, $653 million on September 8, $830 million on September 9, $1,102 million on September 10, $862 million on September 11, $759 million on September 12 through 14, $513 million on September 15, and $972 million on September 16.

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ending October 1, down from an average of $1,250 million in the previous 4 weeks. Excess reserves were little changed on the average, and so net borrowed reserves also declined.

Against the background of continuing credit restraint and limited availability of funds, most market interest rates had risen to new highs in the period since the previous meeting of the Committee. Yield increases were relatively pronounced in the capital markets which absorbed large amounts of new corporate, Federal agency, and intermediate-term Treasury issues. Most recently, however, yields on Treasury and new corporate bonds had stabilized following the good reception accorded a sizable new Federal agency offering, some purchases of Treasury notes and bonds by official accounts, and the publication of the 4 per cent unemployment figure for September. Yields on State and local government bonds had moved counter to the general trend in September; they had declined somewhat as a result of a continuing light volume of new issues and of developments in the Congress relating to proposed legislation affecting the tax-exempt status of such obligations.

Most short-term interest rates also had risen since the previous meeting. Rates on Treasury bills were an exception; they were relatively stable for most of the period—mainly because of reinvestment demands generated by the Treasury refunding and by foreign central bank purchases—and had declined in recent days. The market rate on 3-month Treasury bills, at 6.94 per cent on the day before this meeting, was 15 basis points below its level 4 weeks earlier.

Conditions in markets for residential mortgages continued to tighten in September. It appeared that savings flows at nonbank thrift institutions had remained weak during that month, and limited data available for the first few days of October suggested that net outflows following quarterly interest crediting would be larger than usual.

At commercial banks, business loans outstanding increased moderately in September but holdings of U.S. Government securities declined sharply as banks sold Treasury bills acquired in the late-August bill-strip financing. The bank credit proxy—daily-average member bank deposits—increased at an annual rate of 2.5 per cent from August to September. On balance, there was a small reduction in the average outstanding volume of funds obtained by banks from "nondeposit" sources—including Euro-dollar borrowings, funds obtained

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by sales of loans to nonbank customers under repurchase agreements, and funds obtained through sales of commercial paper by bank affiliates. After adjustment for this development, the proxy series was estimated to have risen at an annual rate of about 2 per cent on the average in September. In the third quarter as a whole the proxy series so adjusted was estimated to have declined at an annual rate of 4.2 per cent.

The increase in the average level of member bank deposits in September was attributable almost entirely to a sharp rise in U.S. Government deposits after the midmonth tax date. Private demand deposits and the money stock [2] changed little. Total time and savings deposits declined at a much slower rate than earlier in the year, partly because of a marked reduction in net outflows of consumer-type deposits. In addition, there was a substantial increase in late September in foreign official time deposits. Further run-offs of large-denomination CD's occurred during the month, particularly at banks outside of New York.

Staff projections suggested that the average level of member bank deposits would decline from September to October at an annual rate of 5 to 8 per cent if prevailing conditions were maintained in money and short-term credit markets. It appeared likely that the combined total outstanding of funds obtained from nondeposit sources would increase a little on the average—perhaps by an amount equivalent to 1 percentage point or less in the credit proxy. Among deposit categories, reductions were anticipated in the average level of both Government and private demand deposits, and the money stock was projected to decline at an annual rate of 2 to 5 per cent. Continued reductions were expected in both large-denomination CD's and other time and savings deposits. The run-off of CD's appeared likely to moderate appreciably, however, partly because the volume of foreign official deposits was expected to increase further.

The Committee decided that a relaxation of monetary restraint

[2] The regular annual benchmark corrections and revisions of seasonal adjustment factors for the money stock series had been made since the previous meeting of the Committee. The effect of the adjustment on the statistics for 1969 was to raise the estimated annual rate of growth during the first quarter from 2.9 to 4.1 per cent, and to lower the estimated second-quarter growth rate from 4.7 to 4.5 per cent. During the third quarter the annual rate of increase in the money stock series (on the new basis) was estimated at a fraction of 1 per cent.

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would not be appropriate at this time in light of the persistence of inflationary pressures and expectations. It was also noted in this connection that fiscal policy was likely to become less restrictive in early 1970 even if, as recommended by the administration, the income tax surcharge was continued at 5 per cent through the first half of the year. At the same time, the Committee agreed that an intensification of monetary restraint would not be desirable at present in view of the considerable degree of restraint already in effect and of the indications that the rate of economic expansion was moderating.

The Committee concluded that open market operations should be directed at maintaining the prevailing firm conditions in money and short-term credit markets, subject to the proviso that operations should be modified if bank credit appeared to be deviating significantly from current projections.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that the pace of expansion in real economic activity was sustained in the third quarter by an acceleration of inventory investment, which about offset a further slackening in growth of private final sales. Some monthly economic measures have weakened recently, and slower over-all growth is projected for the fourth quarter. Substantial upward pressures on prices and costs are persisting. Most market interest rates recently have risen to new highs as demands for funds have pressed against limited supplies. In September, on average, the money supply changed little as U.S. Government deposits rose considerably further, and bank credit increased slightly after 2 months of substantial decline. The outstanding volume of large-denomination CD's decreased further in September, and flows of consumer-type time and savings funds at banks and nonbank thrift institutions appear to have remained relatively weak. The U.S. foreign trade surplus increased a little in August. In August and September the deficit in the over-all balance of payments on the liquidity basis was very large, although not as large as in preceding months; and the official settlements balance, which had been in surplus for more than a year, shifted into deficit, reflecting slackened Euro-dollar borrowing by U.S. banks and new speculative flows into Germany. Exchange market tensions were reduced somewhat when the German Government decided to cease

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temporarily official sales of marks, after which the exchange rate for that currency rose above the official parity. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Mitchell, Robertson, Scanlon, and Sherrill. Vote against this action: Mr. Maisel.

In dissenting from this action Mr. Maisel noted that interest rates on all types of market securities had risen substantially on balance in the period since late April, and that during this period the Committee's directives—like that favored by the majority today—had called for maintenance of prevailing firm conditions in money and short-term credit markets. He also noted that the behavior of key monetary aggregates, including member bank reserves, the money stock, and bank credit, had been considerably weaker in the third quarter—either declining more rapidly or rising more slowly—than in the first half of the year; and that sharp declines in the aggregates were projected for October if prevailing money market conditions were maintained. As at the two previous meetings, Mr. Maisel expressed the view that such evidence indicated a steady increase in monetary restrictiveness. He favored permitting more flexibility in money market conditions in order to maintain but not intensify the present degree of monetary restraint measured in terms of key aggregates and interest rates.

2. Amendments to continuing authority directive.

On recommendation of the Manager of the System Open Market Account, the Committee made two amendments to the continuing author-

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ity directive issued to the Federal Reserve Bank of New York regarding domestic open market operations. In addition, the dollar limit specified in paragraph 2 of the directive on Federal Reserve Bank holdings of special short-term certificates of indebtedness purchased directly from the Treasury, which had been temporarily increased from $1 billion to $2 billion at the previous meeting, reverted to $1 billion under the terms of the action the Committee had taken then.

One of the amendments made today also affected paragraph 2; it involved the addition of language authorizing Reserve Banks other than the New York Bank to purchase special short-term certificates from the Treasury for their own account at times when the New York Reserve Bank was closed. With this amendment, paragraph 2 read as follows:

> 2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York, or, if the New York Reserve Bank is closed, any other Reserve Bank for its own account (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate ¼ of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

The second amendment to the directive consisted of the addition of a new paragraph 3, authorizing the Reserve Banks to engage under certain conditions in lending of U.S. Government securities held in the System Open Market Account. The new paragraph read as follows:

> 3. In order to insure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

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Votes for these actions: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Mitchell, Robertson, Scanlon, and Sherrill. Votes against these actions: None.

The amendment to paragraph 2 was made in view of the possibility that the Treasury might need temporary accommodation at times, such as the forthcoming Columbus Day holiday, when the New York Reserve Bank was closed and some other Reserve Banks remained open.

The action to add the new paragraph 3 was taken after the Manager had advised that the problem of delivery failures in the Government securities market had worsened significantly over the past year, partly because private facilities for lending such securities had become inadequate; that delivery failures were markedly impairing the performance of the market; and that the functioning of the market would be improved if securities held in the System Open Market Account could be lent, for the express purpose of avoiding delivery failures, to Government securities dealers doing business with the Federal Reserve Bank of New York and to banks participating in securities clearing arrangements conducted through a Reserve Bank. The Committee concurred in the Manager's judgment that under existing circumstances such lending of securities from the System Open Market Account was reasonably necessary to the effective conduct of open market operations and to the effectuation of open market policies. It was agreed that the authorization would be reviewed periodically to determine whether the contemplated lending activity remained necessary.

The initial instructions specified by the Committee in conjunction with this authorization included a $75 million limit on the par value of securities involved in outstanding loans to any individual dealer at any time and a limit of three business days on the duration of loans to dealers, with those loans eligible for renewal under certain circumstances. The instructions also specified that both the dealers and the banks that borrowed securities were to deposit and pledge collateral consisting of U.S. Government securities of greater current market value than the securities borrowed. In addition, the lending fee to be charged on such securities loans was set at a rate higher than the pre-

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vailing fee charged by private lenders, in order to encourage continued maximum use of available private facilities for lending of Government securities.

3. Amendment to authorization for System foreign currency operations.

The Committee approved increases from $100 million to $200 million equivalent in the System swap arrangements with the Austrian National Bank, the National Bank of Denmark, and the Bank of Norway, and the corresponding amendments to paragraph 2 of the authorization for System foreign currency operations, effective immediately. As a result of this action, paragraph 2 read as follows:

> 2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	200
National Bank of Belgium	500
Bank of Canada	1,000
National Bank of Denmark	200
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000
Bank of Italy	1,000
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	300
Bank of Norway	200
Bank of Sweden	250
Swiss National Bank	600

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,000

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Mitchell, Robertson, Scanlon, and Sherrill. Votes against this action: None.

While Austria, Denmark, and Norway each had a strong current account in its international payments balance, all three countries had experienced reserve losses recently, for the most part as a result of the pull of high Euro-dollar interest rates and of speculation on a revaluation of the German mark. The indicated action was taken on recommendation of the Special Manager, who advised that it should prove helpful in providing against the contingency of destabilizing short-run speculative pressures on the currencies of the countries involved.

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MEETING HELD ON OCTOBER 28, 1969

Authority to effect transactions in System Account.

Preliminary estimates of the Commerce Department indicated that expansion in private final sales had slackened further in the third quarter, but that growth in real GNP was sustained at a 2 per cent annual rate by an acceleration of inventory investment. Prices and costs continued to rise rapidly.

Some crosscurrents were evident in the recent behavior of monthly economic measures. On the one hand, industrial production declined in September for the second successive month; nonfarm employment did not increase, and the unemployment rate rose to 4.0 from 3.5 per cent in August; and growth in personal income slowed considerably. Retail sales advanced moderately, but after adjustment for price increases, sales remained below the year-earlier level.

On the other hand, new orders at manufacturers of durable goods rose sharply in September. The advance was widespread among industries, but was exceptionally large for the machinery and equipment industries. In addition, housing starts increased markedly from an August level that had been revised upward.

Average prices of industrial commodities and the over-all index of wholesale prices rose slightly more from mid-August to mid-September than earlier estimates had indicated. During the third quarter as a whole prices of industrial commodities increased more rapidly than in the preceding quarter. However, the rise in the over-all wholesale price index slowed substantially, as prices of farm products and foods declined somewhat following their sharp advance in the second quarter. The consumer price index increased considerably further in September.

Staff projections continued to suggest that real GNP would grow more slowly in the fourth quarter than in the third, and that there might be no growth in the first half of 1970. As before, the projections assumed that the income tax surcharge would be reduced to 5 per cent on January 1, 1970, and would remain at that rate through the first half of the year; that the investment tax credit would be repealed; and that social security benefits would be increased by 10 per cent on April 1. It was expected that Federal purchases of goods and services would decline over the interval, mainly because of reduced defense outlays, and that expansion

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of aggregate demands in the private sector would moderate further. It was also expected that the rate of inventory accumulation would slow in the first half of 1970. Prospects were for continued increases in costs, but with demand pressures expected to ease, some moderation in the rate of price advance appeared likely.

The U.S. foreign trade surplus increased further in September as exports remained near the high August level and imports declined. The trade balance showed a small surplus in the third quarter as a whole, following the small deficit recorded in the first half of 1969. With respect to the over-all balance of payments, in September the deficit was large on the liquidity basis and even larger on the official settlements basis. On both bases the balance was in deficit for the third quarter as a whole.

On October 24 the German Government announced that, effective October 27, the official parity of the mark would be revalued upward by 9.3 per cent—somewhat more than had been generally expected. Before this announcement the exchange rate for the mark, which had been permitted to float since late September, had risen to a premium of about 8 per cent. The appreciation of the mark and its subsequent revaluation led to a partial reversal of the earlier speculative flow of funds into Germany. Also, interest rates in the Euro-dollar market declined considerably further despite some increase in early October in outstanding Euro-dollar borrowings by U.S. banks.

During October the Treasury auctioned $5 billion of tax-anticipation bills; on October 8 it auctioned a $2 billion issue due in April 1970, and on October 23 a $3 billion issue due in June 1970. It was expected that the Treasury would raise an additional $2 billion to $2.5 billion of new cash later in the fourth quarter to meet further needs for funds.

Since early October interest rates on long-term securities had declined considerably despite a continued heavy calendar of public offerings of new corporate bonds and a marked increase in bond offerings by State and local governments. To a large extent the declines reflected changing expectations among market participants: The publication of certain economic statistics—including the 4 per cent unemployment figure for September—and renewed hopes for peace in Vietnam had led to a growing belief that the pace of the economic expansion would slow in the months ahead and that the pressures in financial markets would moderate. These attitudes subsequently were tempered by new developments, and in

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recent days bond yields had retraced part of their earlier declines.

Most short-term interest rates also had declined on balance since early October, and Treasury bill rates had been relatively stable despite the Treasury's two large bill offerings. The market rate on 3-month Treasury bills was 6.99 per cent on the day before this meeting of the Committee, compared with 6.94 per cent 3 weeks earlier.

System open market operations in the first part of the period since the preceding meeting had been directed at moderating tendencies toward undue tightness in the money market while maintaining the firm conditions that had prevailed earlier. The tendencies toward easing that emerged subsequently were not fully offset, because estimates for October of the bank credit proxy—daily-average member bank deposits—that were prepared shortly after the middle of the month indicated a significantly larger decline than had been projected at the time of the previous meeting. However, the objectives of operations were modified only marginally, and near the close of the period—when new estimates indicated that the proxy series was not so weak as it had appeared for a time—operations were again directed at maintaining firm conditions. Over the period as a whole the effective rate on Federal funds, while fluctuating in a fairly wide range, averaged slightly more than 9 per cent —little changed from the previous period. Member bank borrowings averaged about $1.1 billion in the 3 weeks ending October 22, about the same as in the preceding 4 weeks, but net borrowed reserves increased somewhat as excess reserves declined.

The latest staff estimates suggested that the bank credit proxy was declining on the average in October at an annual rate of 7 to 9 per cent. It appeared that the total outstanding of funds obtained by banks from "nondeposit" sources was increasing; Euro-dollar borrowings of U.S. banks and funds obtained through sales of commercial paper by bank affiliates, taken together, evidently were rising by more than enough to offset further reductions in funds obtained by sales of loans to nonbank customers under repurchase agreements. After adjustment for these developments the proxy series was estimated to be declining on the average in October at an annual rate of 5.5 to 7.5 per cent. In the third quarter as a whole the proxy series so adjusted had declined at an annual rate of 4.3 per cent.

The money stock, which had changed little on balance in the third

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quarter, was now estimated to be rising on the average in October at an annual rate of 1 to 4 per cent. Both U.S. Government deposits and total time and savings deposits were estimated to be declining—the latter slightly faster than in September but much more slowly than in preceding months. Net outflows of large-denomination CD's had diminished markedly in recent weeks, apparently in large part because of an increase in foreign official deposits. There were rather sizable net outflows of consumer-type time and savings funds at banks—and at nonbank thrift institutions as well—following quarterly interest crediting.

Staff projections suggested that, if prevailing conditions in money and short-term credit markets were maintained, the average level of member bank deposits would rise from October to November at an annual rate of 5 to 8 per cent but would change little in December. All of the growth anticipated for November reflected an expected rise in U.S. Government deposits, in large part as a result of bank underwriting of the Treasury's bill financing in late October; private demand deposits and the money stock were projected to remain about unchanged on the average in November, and further declines in time and savings deposits appeared to be in prospect. It seemed likely that there would be some further net increase in November in funds obtained from nondeposit sources, primarily through sales of commercial paper by bank affiliates. After adjustment for such an increase, the proxy series was projected to rise at a rate of 6 to 10 per cent from October to November.

The Committee agreed that no change in monetary policy would be appropriate at this time. It was noted in the discussion that prices were still rising rapidly and, despite the indications of further slowing in the economic expansion, expectations of continued inflation remained widespread. It was also noted that fiscal policy was likely to become less restrictive in 1970, and some members expressed concern about the possibility that the shift in the stance of fiscal policy might be marked.

The Committee concluded that open market operations should be directed at maintaining the prevailing firm conditions in money and short-term credit markets, subject to the proviso that operations should be modified if bank credit appeared to be deviating significantly from current projections. A number of members expressed the view that operations should not be undertaken to resist tendencies toward lower interest rates that might be produced by market forces.

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The following current economic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting indicates that the pace of expansion in real economic activity was sustained in the third quarter by an acceleration of inventory investment, which about offset a further slackening in growth of private final sales. Slower over-all growth is projected for the fourth quarter, although some cross-currents have been evident in the recent behavior of monthly economic measures. Prices and costs are continuing to rise at a rapid pace. Most market interest rates have declined considerably on balance from their recent highs, in large part because of changing expectations. In the third quarter, average monthly bank credit declined and the money supply changed little; in October it appears that bank credit is decreasing further on average but that the money supply is growing somewhat. In recent weeks the net contraction of outstanding large-denomination CD's slowed markedly, apparently reflecting mainly an increase in foreign official time deposits, but flows of consumer-type time and savings funds at banks and nonbank thrift institutions appear to have remained relatively weak. The U.S. foreign trade surplus increased further in September, but the deficit in the over-all balance of payments was still large on the liquidity basis and even larger on the official settlements basis. The appreciation of the German mark since the end of September, culminating in the revaluation of the official parity, has led to a partial reversal of speculative flows, and conditions in the Euro-dollar market have eased. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Maisel, Mitchell, Robertson, Scanlon, and Sherrill. Votes against this action: None.

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MEETING HELD ON NOVEMBER 25, 1969

1. Authority to effect transactions in System Account.

According to reports at this meeting, growth in real GNP apparently was slowing further in the fourth quarter from the 2 per cent annual rate of the second and third quarters. Prices and costs were continuing to rise at a rapid pace. Staff projections suggested that there might be no growth in real GNP in the first half of 1970, and that the rate of price advance might moderate somewhat as a result of reduced demand pressures.

Data for October were generally consistent with the view that the economic expansion was weakening. Industrial production edged down for the third successive month. Although total nonfarm employment increased, the unemployment rate, at 3.9 per cent, was little changed from the 4.0 per cent level to which it had risen in September. In manufacturing, both the number employed and the average length of the work-week declined. As in September, personal income increased much less than it had earlier in the year. In addition, two important series that had risen sharply in September—new orders for durable goods and housing starts—declined in October.

Average prices of industrial commodities increased considerably further from mid-September to mid-October, and the over-all wholesale price index advanced substantially even though prices of farm products and foods changed little. The consumer price index continued upward at a rapid pace despite a seasonal decline in food prices.

In contrast to most broad categories of final demand, both recent and prospective business outlays on plant and equipment now appeared to be stronger than they had earlier. In revising the GNP figures for the third quarter, the Commerce Department had raised its estimates of the increase in business capital spending while reducing its estimates of growth in spending by consumers and State and local governments. Similarly, in staff projections for the fourth quarter and for the first half of 1970, growth rates for business capital outlays had been revised upward somewhat, partly on the basis of the results of a recent private survey of business spending plans. But despite these revisions, it was expected that growth in capital outlays would slow progressively

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through mid-1970—particularly if, as assumed, the investment tax credit were repealed.

In other respects, the broad outlines of the staff projections were essentially unchanged. It was still anticipated that Federal purchases of goods and services would decline through mid-1970, mainly because of reductions in defense outlays, and that inventory accumulation would slow in the first half of the new year. The expansion of final demands in the private sector was expected to remain moderate even if, as assumed, the income tax surcharge were reduced to 5 per cent at the end of 1969 and social security benefits were increased by 10 per cent on April 1.

A small surplus re-emerged in the U.S. foreign trade balance in the third quarter, following three quarters of deficit. With respect to the over-all balance of payments, the deficit on the liquidity basis was again very large, although smaller than in the second quarter. The official settlements balance, after having been in surplus for more than a year, shifted into deficit in the third quarter as a result of a marked slackening of the rise in Euro-dollar borrowings of U.S. banks. Tentative estimates suggested that there had been considerable improvement in the liquidity balance in October and early November—apparently in large part because of a reversal of earlier speculative flows into German marks.

Since the revaluation of the German mark on October 27, that currency had been under fairly persistent selling pressure in foreign exchange markets. Demand had been strong for sterling and had firmed for the lira and the French franc. In the Euro-dollar market interest rates had declined until late October, but they then advanced sharply and steadily—in part as a result of renewed bidding for Euro-dollars by U.S. banks. The price of gold in the London market had declined sharply in recent weeks—from about $40 to a little more than $35, the lowest level since the "two-tier" arrangement had been put into effect in March 1968.

On November 21 the Treasury auctioned $2.5 billion of tax-anticipation bills, of which $1 billion were due in April 1970 and $1.5 billion in June. This financing, together with the addition of $100 million to each of the weekly bill auctions, was expected to cover the Treasury's cash requirements through early 1970.

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System open market operations since the October 28 meeting of the Committee had been directed at maintaining prevailing firm conditions in money and short-term credit markets. Operations were complicated by heavy reserve drains, stemming in part from repayments by foreign central banks of swap drawings on the Federal Reserve. To offset the resulting tendencies toward tighter money market conditions, the System supplied an unusually large volume of reserves, making net purchases of about $2.6 billion of U.S. Government securities. During the period the effective rate on Federal funds averaged slightly more than 9 per cent, little changed from the preceding interval. Member bank borrowings averaged about $1.2 billion in the 4 weeks ending November 19, compared with about $1.1 billion in the preceding 3 weeks.

Interest rates on most short- and long-term securities had declined during much of October, but in the latter part of that month such rates began to rise sharply and by the time of this meeting they had reached levels close to or above earlier peaks. To a large extent the upturn in rates reflected a reversal of earlier expectations that pressures in financial markets would soon abate. Recently, market participants had come increasingly to the view that monetary restraints were not likely to be relaxed soon, as a result of both a growing belief that fiscal policy would be eased significantly and fading hopes for a near-term settlement in Vietnam. In the judgment of many financial observers, that view was supported by the announcement of the Board of Governors on October 29 that it (1) was considering an amendment to Regulation Q under which the rules regarding the payment of interest on deposits would apply to funds received by member banks from the issuance of commercial paper or similar obligations by bank affiliates and (2) had determined that such obligations of subsidiaries of member banks were subject to Regulations D and Q.

Also contributing to the recent advance in interest rates was the continuing heavy demand for funds reflected in the large current and prospective volume of security issues by corporations, State and local governments, and Federal agencies. Upward pressures on Treasury bill rates were augmented by the substantial supply of new bill issues and by large sales of bills by the German Federal Bank following the revaluation of the mark. On the day before this meeting the market rate on 3-month Treasury bills was at a record 7.42 per cent,

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more than 40 basis points above its level of 4 weeks earlier.

Average interest rates on home mortgages rose to new highs in October in both the primary market for conventional loans and the secondary market for FHA-insured loans. New mortgage commitments appeared to have declined somewhat at savings and loan associations during October, and the backlog of outstanding commitments edged lower for the sixth consecutive month. There were unusually large net outflows of savings funds at such associations following quarterly interest crediting at the end of September.

Commercial banks also experienced net outflows of consumer-type time and savings deposits during October. The run-off of large-denomination CD's at banks continued, but at a much slower rate than earlier in the year because increases in foreign official deposits largely offset further reductions in holdings of domestic depositors. Private demand deposits and the money stock changed little from September to October —the former declined slightly, but the latter edged up as a result of an increase in currency outstanding. U.S. Government deposits fell considerably on the average.

Daily-average member bank deposits—the bank credit proxy—declined at an annual rate of about 9 per cent from September to October. Euro-dollar borrowings of U.S. banks changed little on the average, and there were further reductions in funds obtained by sales of loans to nonbank customers under repurchase agreements. However, the outstanding total volume of funds obtained by banks from "nondeposit" sources increased as a result of a substantial rise in funds obtained through sales of commercial paper by bank affiliates. After adjustment for these developments, the proxy series declined at an annual rate of 7.5 per cent.

Staff estimates suggested that the bank credit proxy would probably rise at an annual rate of 9 to 12 per cent from October to November, and that the advance would be even more rapid—perhaps at a 12 to 15 per cent rate—after adjustment for an increase in the outstanding volume of funds obtained from nondeposit sources. Whereas the expansion in the proxy series was attributable in large part to a rise in the average level of U.S. Government deposits, the estimates suggested relatively rapid increases also in private demand deposits and the

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money stock—for the latter, the increase was estimated at a rate in a 4 to 7 per cent range.

Much slower growth in the bank credit proxy appeared to be in prospect for December. Staff projections suggested that if prevailing conditions were maintained in money and short-term credit markets, the proxy series would rise from November to December at an annual rate in the range of 0 to 3 per cent, and in a 1 to 4 per cent range after adjustment for an expected further increase in funds from nondeposit sources. It seemed likely that the money stock would decline slightly on the average in December.

In its discussion of policy the Committee took account of the indications that the economic expansion was slowing further and of the evidences of strain in financial markets. The members agreed, however, that a relaxation of monetary restraint would not be appropriate at this time in view of the continuing strength of inflationary pressures and expectations. The uncertainties with respect to fiscal policy, particularly the possibility of significant easing of fiscal restraint in 1970, were also cited in this connection.

The Committee concluded that open market operations should be directed at maintaining the prevailing firm conditions in money and short-term credit markets, subject to the proviso that operations should be modified if bank credit appeared to be deviating significantly from current projections. It was also agreed that operations should be modified if pressures arose in connection with regulatory action by the Board of Governors in the area of bank-related commercial paper. A number of members expressed the view that operations should not be undertaken to resist tendencies toward lower interest rates should they develop as a result of market forces.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting indicates that real economic activity has expanded only moderately in recent quarters and that a further slowing of growth appears to be in process. Prices and costs, however, are continuing to rise at a rapid pace. Most market interest rates have again been advancing in recent weeks, in many cases reaching new highs as a result of demand pressures, including heavy Treasury and foreign official bill sales, and a reversal of earlier

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market expectations partly stemming from growing concern about the outlook for fiscal policy. In October bank credit declined on average and the money supply changed little, but both appear to be increasing relatively rapidly in November. Recently the net contraction of outstanding large-denomination CD's has slowed markedly, apparently reflecting mainly an increase in foreign official time deposits. However, flows of consumer-type time and savings funds at banks and nonbank thrift institutions have remained weak. In the third quarter a small surplus in U.S. foreign trade re-emerged, but there was another very large deficit in the over-all balance of payments on the liquidity basis and the official settlements balance, which had been in surplus earlier, was also in deficit. More recently, return flows out of the German mark have apparently contributed to some short-run improvement in the U.S. payments position. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if pressures arise in connection with possible bank regulatory changes.

Votes for this action. Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Mitchell, Robertson, Scanlon, and Sherrill. Votes against this action: None.

Absent and not voting: Mr. Maisel.

2. Actions with respect to continuing authority directive.

At this meeting the Committee ratified an action taken by members on November 14, 1969, effective on that date, amending paragraph 1(a) of the continuing authority directive to the Federal Reserve Bank of New York regarding domestic open market operations. The effect of the amendment was to raise from $2 billion to $3 billion the limit on changes in holdings of U.S. Government securities in the System Open

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Market Account between meetings of the Committee. With this amendment, paragraph 1(a) read as follows:

> To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $3.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting.
>
> Votes for ratification of this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Mitchell, Robertson, Scanlon, and Sherrill. Votes against ratification of this action: None.
>
> Absent and not voting: Mr. Maisel.

Later in the course of this meeting the Committee amended paragraph 1(a) of the continuing authority directive to restore the $2 billion limit in effect prior to November 14.

> Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Daane, Mitchell, Robertson, Scanlon, and Sherrill. Votes against this action: None.
>
> Absent and not voting: Mr. Maisel.

The action of November 14 was taken after the Account Manager advised that a temporary increase in the "leeway" was needed to accommodate the large reserve-supplying operations found necessary in implementing the current economic policy directive then in effect. The paragraph was restored to its previously existing form on recommendation of the Manager, who advised that the temporary need for the larger leeway had passed.

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MEETING HELD ON DECEMBER 16, 1969

Authority to effect transactions in System Account.

Reports at this meeting suggested that growth in real GNP, which had been only moderate earlier in the year, was slowing further and perhaps coming to a halt in the fourth quarter. Prices and costs were continuing to rise rapidly. Staff projections suggested that there would be little or no expansion in real GNP in the first half of 1970 and some slowing in the rate of increase in prices.

With few exceptions, data for November supported the view of a weakening in economic expansion. Industrial production declined for the fourth consecutive month. Although the unemployment rate fell sharply—to 3.4 per cent from 3.9 per cent in October—other measures suggested some further easing of labor market conditions; in particular, total nonfarm employment did not increase, employment and overtime hours in manufacturing fell, and claims for unemployment compensation rose further. Retail sales declined in November and, after adjustment for price increases, remained below the level of a year earlier.

The wholesale price index advanced considerably further from mid-October to mid-November, partly because of an exceptionally large rise in average prices of farm products and foods. Average prices of industrial products also increased substantially.

The latest Commerce–SEC survey of business plans, taken in November, suggested that outlays on new plant and equipment would rise sharply in the first half of 1970. As a result, staff projections of fixed investment spending by business in that period had again been revised upward. However, the strengthening of the outlook in this sector did not appear sufficient to change materially the prospect for little or no growth in real GNP in the first half. On the other hand, it was noted that legislation now under consideration in Congress relating to Federal taxes and social security benefits, if enacted, would result in a considerably greater relaxation of fiscal restraint than had been assumed in the projections.

The U.S. balance of payments appeared to be improving in the fourth quarter; in November the deficit on the liquidity basis had diminished further and the official settlements balance had reverted to surplus. However, the improvement seemed to reflect such relatively

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volatile elements as return flows from the German mark and a sharp increase in November in outstanding Euro-dollar borrowings of U.S. banks. In recent weeks interest rates in the Euro-dollar market had remained under upward pressure, in part as a result of actions by the German monetary authorities to encourage German banks to reduce their net foreign assets.

Interest rates on most types of domestic market securities had risen considerably further in recent weeks. Yields on long-term Treasury and municipal bonds currently were at new highs, and yields on new corporate bonds were close to peaks that had been reached in early December. On the day before this meeting the market rate on 3-month Treasury bills was at a record level of 7.92 per cent, 50 basis points above its level of 3 weeks earlier.

These rate advances had occurred against the background of continued heavy demands for funds, and—in the Treasury bill market—large dealer inventories and sustained high financing costs. To an important extent, however, they appeared to reflect expectational factors, including market concern about the possibility that fiscal restraint would be relaxed significantly and the related prospect that the period of severe monetary restraint would be prolonged.

System open market operations since the preceding meeting of the Committee had been directed at maintaining prevailing firm conditions in the money market while taking account of strains in the Treasury bill market as bill rates adjusted sharply upward. The effective rate on Federal funds continued to fluctuate mostly in a range of 8½ to 9½ per cent. Member bank borrowings averaged $1.2 billion in the 3 weeks ending December 10, unchanged from their average in the preceding 4 weeks.

At nonbank thrift institutions there were net outflows of savings funds in October, after quarterly interest crediting, and the inflows in November and early December were at a rate well below that usually expected for the season. Moreover, there was widespread concern about the possibility of very heavy outflows at such institutions around the turn of the year, following year-end interest crediting.

At commercial banks the volume of business loans outstanding changed little over the course of November, and holdings of U.S. Government securities declined somewhat further despite bank underwriting

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of the tax-anticipation bills auctioned by the Treasury late in the month. Holdings of other securities and loans to securities dealers increased sharply, although perhaps only temporarily. From October to November the bank credit proxy—daily-average member bank deposits—expanded on the average at an annual rate of 11 per cent. After adjustment for further growth in the outstanding volume of funds obtained by banks from "nondeposit" sources—including Euro-dollar borrowings and funds acquired through sales of commercial paper by bank affiliates—the proxy series increased at a rate of about 13.5 per cent. So adjusted, the proxy series had declined at annual rates of 7.5 per cent in October and 4.3 per cent in the third quarter.

Private demand deposits and the money stock also expanded on the average in November. The latter grew at an annual rate of about 3.5 per cent, after rising only fractionally in October and remaining unchanged in the third quarter. U.S. Government deposits increased sharply in November, mainly as a result of Treasury financing operations. Outflows of consumer-type time and savings deposits continued, but the net contraction in the volume of large-denomination CD's outstanding remained more moderate than earlier in the year as a result of further sizable increases in foreign official time deposits.

Revised staff projections suggested that if prevailing conditions in the money market were maintained there would be little change in the bank credit proxy from November to December and a slight rise after adjustment for an expected further increase in funds from nondeposit sources. It was anticipated that total time and savings deposits would increase somewhat on the average, but that U.S. Government deposits and private demand deposits—as well as the money stock—would decline somewhat. Projections for January suggested that the proxy series would decline at an annual rate of 1 to 4 per cent—and less after adjustment for another expected increase in nondeposit funds—and that the money stock would remain about unchanged.

The Committee agreed that no relaxation of monetary policy would be appropriate at this time, in view of the persistence of inflationary pressures and expectations and the high degree of uncertainty with respect to the extent to which fiscal policy might be relaxed. The members concluded that open market operations should be directed at maintaining the prevailing firm conditions in the money market. It was also agreed that operations should be modified if unusual liquidity

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pressures should develop. A number of members expressed the view that any tendencies toward lower interest rates that might be produced by market forces should not be resisted.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting indicates that real economic activity has expanded only moderately in recent quarters and that a further slowing of growth appears to be in process. Prices and costs, however, are continuing to rise at a rapid pace. Most market interest rates have advanced further in recent weeks partly as a result of expectational factors, including concern about the outlook for fiscal policy. Bank credit rose rapidly in November after declining on average in October, while the money supply increased moderately over the 2-month period; in the third quarter, bank credit had declined on balance and the money supply was about unchanged. The net contraction of outstanding large-denomination CD's has slowed markedly since late summer, apparently reflecting mainly an increase in foreign official time deposits. However, flows of consumer-type time and savings funds at banks and nonbank thrift institutions have remained weak, and there is considerable market concern about the potential size of net outflows expected around the year-end. In November the balance of payments deficit on the liquidity basis diminished further and the official settlements balance reverted to surplus, mainly as a result of return flows out of the German mark and renewed borrowing by U.S. banks from their foreign branches. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in the money market; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if unusual liquidity pressures should develop.
>
> Votes for this action: Messrs. Martin, Hayes, Bopp, Brimmer, Clay, Coldwell, Maisel, Mitchell, Robertson, Scanlon, and Sherrill. Votes against this action: None.
>
> Absent and not voting: Mr. Daane.

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Operations of the System Open Market Account

The following two reports describe the actions taken during 1969 to carry out the policy directives of the Federal Open Market Committee.

The report on operations in domestic securities was prepared by Alan R. Holmes, Manager of the System Open Market Account, who supervises these operations. It is written from the vantage point of the Trading Desk at the Federal Reserve Bank of New York, where operations in these securities are effected to carry out the policy directives of the Federal Open Market Committee. The report outlines the factors that the Manager takes into account in the day-to-day provision of bank reserves.

The report on foreign currency operations was prepared by Charles A. Coombs, Special Manager of the System Open Market Account, who supervises the Federal Reserve's operations in such currencies. The Federal Reserve has been buying and selling foreign currencies since early 1962 as part of the effort to defend the dollar and strengthen the world payments system. All of these operations for the System Account are carried out, under the authorization of the Federal Open Market Committee, by the Federal Reserve Bank of New York, which also handles foreign currency transactions for the U.S. Treasury.

The report on operations in foreign currencies begins on page 256.

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REVIEW OF OPEN MARKET OPERATIONS IN DOMESTIC SECURITIES

The year 1969 was a period of intensifying monetary restraint. Open market operations were used in combination with other Federal Reserve actions to restrain the expansion of bank credit and to emphasize the System's determination to combat entrenched inflationary pressures and expectations. In the early part of the year operations enforced the shift to intensified monetary restraint that had been signaled by an increase of ¼ percentage point in the discount rate to 5½ per cent in mid-December 1968. Operations underscored firm restraint following a further ½ percentage point increase in the Federal Reserve discount rate announced on April 3, which was accompanied by a similar increase in reserve requirements against member bank demand deposits. Firm pressure on bank reserve positions was maintained over the balance of the year, thereby restraining the growth of the monetary and credit aggregates.

The pressure exerted by sustained monetary restraint was manifest in the indexes of pressure in the money market. Member bank borrowing from the Federal Reserve Banks rose from an average of less than $600 million in the last quarter of 1968 to $900 million in March 1969 and $1.4 billion in May and June. After that it fluctuated around $1.2 billion. The Federal funds rate rose from an average of 6 per cent in December to nearly 7.5 per cent in April and around 9 per cent over the remainder of the year.

The stringency of Federal Reserve policy was also evident in the behavior of the monetary aggregates during 1969. The money supply—private demand deposits plus currency outside banks—rose by only 2.5 per cent, compared with 7.2 per cent in 1968. With market rates of interest above the Regulation Q ceiling rates on time deposits, commercial bank time deposits declined by 5.3 per cent during 1969, compared with an increase of 11.5 per cent in 1968. And total loans and investments at commercial banks grew by 2.3 per cent, or by 3.3 per cent if loans sold to banks' own affiliates are included.

System outright purchases, sales, and redemptions of U.S. Government securities during 1969 totaled $19 billion (not including the purchase and redemption of $2.7 billion of special securities issued directly by the Treasury for brief periods). While this total was prac-

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tically unchanged from the year before, the temporary provision and absorption of bank reserves through repurchase agreements and matched sale–purchase transactions increased by 49 per cent to $100 billion. These techniques, which enabled the System to inject or absorb reserves with minimal impact on the securities markets, were particularly useful when swift reversals of operations were required to maintain steadily firm conditions in the money market.

For the third year in a row, outright transactions in U.S. Government securities for foreign accounts exceeded the volume undertaken for the System Open Market Account by a substantial amount. These operations reflected considerable turbulence in the exchange markets—particularly the speculation in the German mark and the French franc. The System injected, net, $4.2 billion of reserves into the banking system during the year, compared with $3.8 billion in 1968 and $4.8 billion in 1967. The large expansion of the System portfolio in 1969, when money became very tight as compared with 1968, reflected primarily increases in reserve requirements against member banks' demand deposits and the imposition of marginal reserve requirements against liabilities to their foreign branches. System holdings of U.S. Government securities on December 31 totaled $57.2 billion.

JANUARY 1–APRIL 2: OPERATIONS REINFORCE SHIFT TO INTENSIFIED MONETARY RESTRAINT

Economic and financial environment. Federal Reserve policy moved decisively to restraint in mid-December 1968 with an increase of ¼ percentage point in the Federal Reserve discount rate to 5½ per cent and a reinforcing shift in open market operations. The first 3 months of 1969 were a period of intensifying monetary restraint. Open market operations were conducted with a view to increasing the pressure on the banking system, thereby underscoring the determination of the System to combat inflation. Widespread skepticism about the System's resolve at the beginning of the year began to give way during the period. However, there were lingering doubts about the System's perseverance should the results of restrictive policy begin to appear in output and employment.

Few such results made their appearance during the first quarter.

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Rather, the economy continued to exhibit considerable strength. The marked swing of the Federal budget from deficit to surplus, in combination with increased monetary restraint, did not seriously discourage consumer and business spending during the period. Despite payment of the income tax surcharge, consumers maintained a high level of spending by reducing their rate of saving. Moreover, personal income continued to rise rapidly and the unemployment rate remained at or near a 15-year low. The volume of expansionary spending by businesses clearly reflected an inflationary psychology. Consumer and wholesale prices rose at an accelerated rate in the first quarter. A sizable deficit re-emerged in the Nation's balance of international payments on the liquidity basis, although the balance remained in surplus on the official settlements basis—thanks to heavy Euro-dollar borrowings by large U.S. banks.

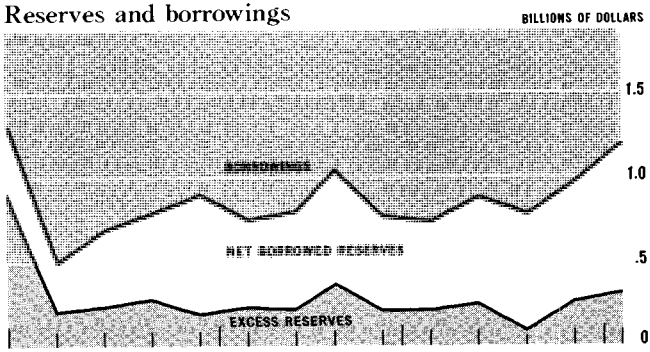
The shift of monetary policy toward restraint was evident both in the change in money market conditions and in the behavior of the monetary and credit aggregates. Member bank borrowing from the Federal Reserve Banks averaged $813 million during the first quarter of 1969, compared with $587 million during the final quarter of 1968. And net borrowed reserves—member bank borrowings from the Reserve Banks less excess reserves—averaged $592 million as compared with $241 million during the previous quarter. Federal funds traded predominantly in a 6.5 to 7 per cent range during March 1969, a full percentage point higher than the range prevailing before the increase in the discount rate in mid-December 1968. (See Chart 1.)

Among the monetary aggregates, the money supply—private demand deposits plus currency outside banks—increased at a seasonally adjusted annual rate of about 4 per cent over the first quarter; during 1968 the money supply had risen at an annual rate of 7 per cent in the final quarter and also for the year as a whole. Time and savings deposits declined at an annual rate of 5 per cent in the first quarter, after growing at a rate of 17 per cent over the last 3 months of 1968. The sharp reversal of time deposit growth reflected largely a decline of $4 billion (not seasonally adjusted) in negotiable certificates of deposit (CD's) over the first quarter as short-term market rates rose above the rates banks were allowed to pay on CD's. Total member bank deposits subject to reserve requirements—the so-called bank credit proxy—fell at a 5 per cent annual rate during the first quarter of 1969. Adjusted

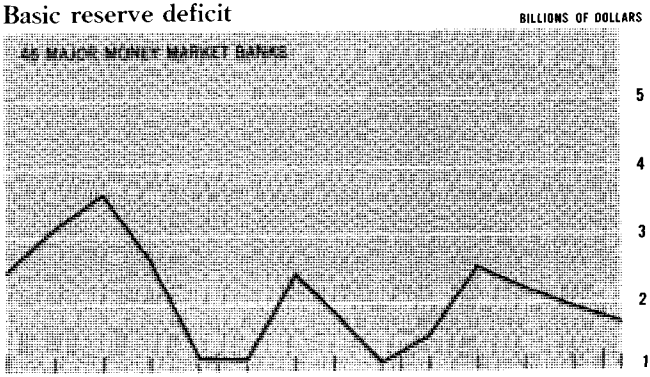
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1. JANUARY 1, 1969 – APRIL 2, 1969

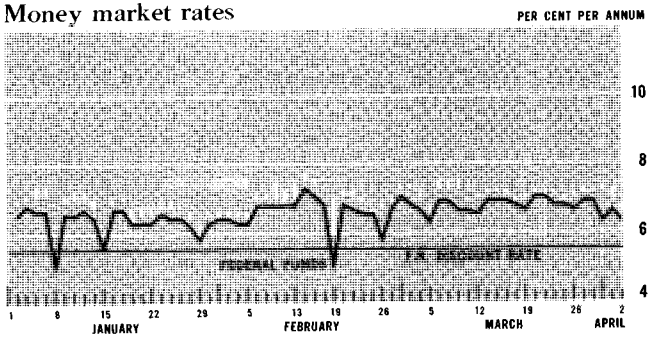
Reserves and borrowings



Basic reserve deficit

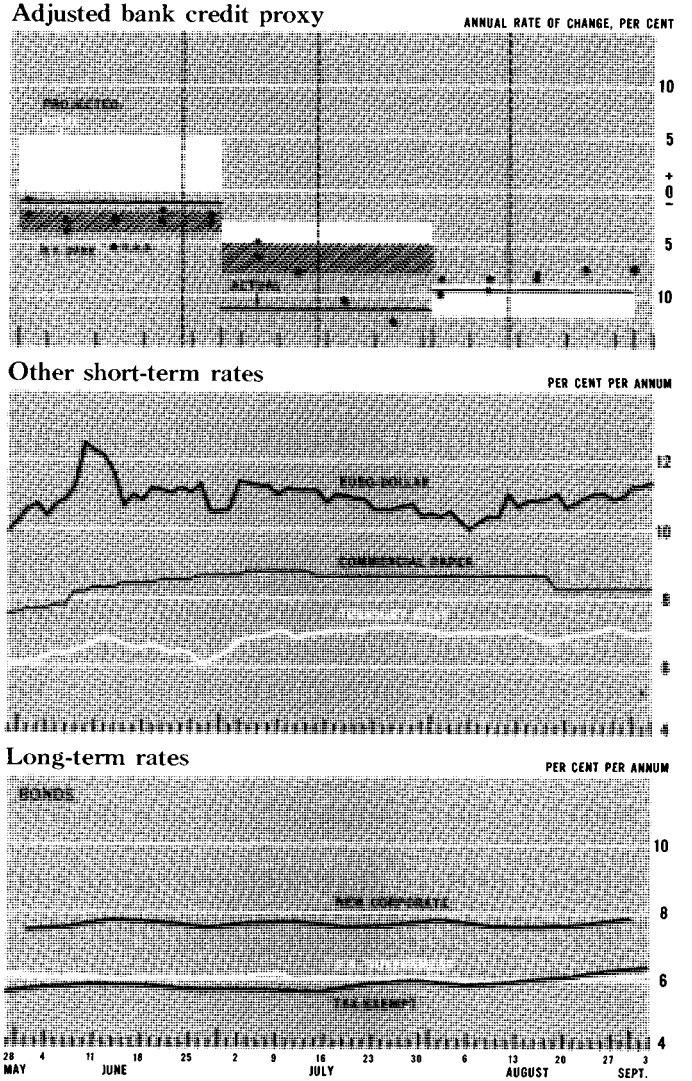


Money market rates



Money market rates: Federal funds, daily effective rates; call loans, daily range on new loans to U.S. Govt. securities dealers posted by New York City banks. *Adjusted bank credit proxy* is total member bank deposits plus liabilities to foreign branches; ranges shown are those projected at FOMC meetings (dates of which are shown by dashed lines)—cross-hatched areas indicate revised ranges for same month as projected at next meeting; slight revisions in ranges not shown; F.R.B. and N.Y. Bank projections

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made on Fridays. *Other short-term rates:* bid rate on 3-month Euro-dollars; daily bid rate on 3-month Treasury bills; and offering rate on 4- to 6-month commercial paper. *Long-term rates:* corporate bonds, weighted averages of new publicly offered bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis; U.S. Govt. bonds, average yield on all bonds due or callable in 10 years or more; tax-exempt bonds, State and local govt. bonds (20 issues, mixed quality), Bond Buyer.

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for the rapid growth of Euro-dollar borrowings, the proxy showed a 2 per cent rate of decline, compared with a 10 per cent growth rate in 1968.

The determined efforts of the monetary authorities to reduce inflationary pressures exerted steady pressure on most short-term interest rates. Yields on 3-month Euro-dollar deposits reached 8½ per cent by early March, a full percentage point above the December high. (See Chart 1.) The commercial bank prime rate was raised by 1 percentage point in 3 steps, to 7½ per cent in mid-March, following the December 1968 increase in the discount rate. Rates on bankers' acceptances and commercial paper also rose.

In contrast to the rise in rates on most other short-term investments, Treasury bill rates, after adjusting upward to the new level of the discount rate, declined somewhat during the first quarter of 1969. As early market skepticism over the Federal Reserve's determination to combat inflation gradually gave way to expectations of a sustained period of monetary restraint, many investors shifted to short-term Treasury bills while awaiting increases in long-term yields. Furthermore, a steady decline in stock prices contributed to demand for bills from investors seeking a temporary haven for their funds; the New York Stock Exchange index during March, for example, averaged about 8 per cent lower than in December. The net increase in the supply of bills, resulting from the Treasury's sale of additional bills during the interval, was readily absorbed by investors. In this atmosphere the market bid rate for the latest 3-month Treasury bill averaged 6.01 per cent in March, 12 basis points below the January average rate.

Capital market yields, however, rose to record levels during the first quarter of 1969. Pressure on bank reserves heightened fears of large-scale bank liquidation of U.S. Government and municipal securities. Although sales did not materialize in large volume, bank demand for such issues was sharply curtailed. As prices deteriorated, other investors also displayed a marked reluctance to commit funds. In such an atmosphere, many corporate and municipal financings that had been scheduled were postponed or reduced in size, but the pressure of new offerings remained heavy. Most new Aa-rated public utility bonds were reoffered to yield slightly over 7 per cent during January, but reoffering yields rose to more than 7.5 per cent during March. The Bond Buyer's index of yields on 20 municipal bonds rose from 4.85 per cent near the

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end of December to 5.30 per cent at the end of March. In the market for U.S. Treasury securities long-term bond yields averaged 6.05 per cent in March as compared with 5.65 per cent in December, while yields on 3- to 5-year maturities rose to 6.33 per cent from 5.99 per cent.

The Treasury's mid-February refunding was conducted against an unsettled background. Holders of the $14.5 billion of 5⅝ per cent notes and 4 per cent bonds maturing in February (including $5.5 billion held by private investors) were offered the option of exchanging their securities for a new 15-month, 6⅜ per cent note due in May 1970 or a new 7-year, 6¼ per cent note due in February 1976. The new 15-month and 7-year notes were priced to yield about 6.42 and 6.29 per cent, respectively. Public response to the offerings was cool despite the fact that the issues carried the highest offering yields on new Treasury securities since the Civil War. Approximately 36 per cent of the maturing securities held outside official accounts were not exchanged. Reflecting prevailing interest rate expectations, only $885 million of the 7-year notes were taken by the public. Government agency financings, which raised $1.1 billion of net new money during the period, were confined to the short-term market.

Open market operations. System open market operations during the first 3 months of the year were directed toward maintaining the firmer conditions in the money and short-term credit markets that had been achieved following the mid-December increase in the Federal Reserve discount rate. Over the period January 1 to April 2, System open market operations in Government securities absorbed nearly $600 million of reserves, net. (See table.) System outright purchases and sales of Treasury securities during the period totaled $1.5 billion and $1.6 billion, respectively, and the System redeemed $0.8 billion of maturing Treasury bills. The System also absorbed $4.1 billion of reserves on a short-term basis through matched sale–purchase transactions, largely in January, and injected $5.5 billion temporarily through repurchase agreements against Treasury and Federal agency securities, mostly in February and March.

The System supplied reserves during the first few days of 1969 in order to relieve year-end pressures and facilitate adjustments in the money and securities markets generated by the December 1968 increase in the Federal Reserve discount rate. Then from January 8 to February

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5 it absorbed reserves steadily to offset the seasonal reflux of reserves. The Account Manager made frequent use of matched sale–purchase transactions when unexpected additions to reserve availability threatened to erode the prevailing firm tone of the money market. This technique, which had been introduced in July 1966, enabled the System to effect much greater short-term reserve absorption than would have been feasible through outright sales, which would have required dealers to assume market risks.

SYSTEM OPERATIONS IN GOVERNMENT SECURITIES DURING 1969

In millions of dollars

Type of operation	Jan. 1–Apr. 2	Apr. 3–May 28	May 29–Sept. 3	Sept. 4–Dec. 31	Total
Outright purchases:					
Treasury bills:					
From market	134	1,235	710	2,401	4,480
From foreign accounts	1,098	498	1,633	3,293	6,522
Coupon issues	253	196	67	192	708
Special certificates of indebtedness	.....	1,130	.....	1,561	2,691
Outright sales:					
Treasury bills:					
To market	605	11	473	663	1,752
To foreign accounts	1,015	400	598	1,880	3,893
Coupon issues	.....	.....	.....	.....	.....
Matched sale—purchase transactions:					
With dealers:					
Sales	3,920	2,329	8,053	8,187	22,489
Purchases	3,920	2,329	8,053	8,187	22,489
With foreign accounts:					
Sales	225	50	.....	.....	275
Purchases	225	50	.....	.....	275
Redemptions:					
Treasury bills	786	206	207	649	1,848
Special certificates of indebtedness	.....	1,130	.....	1,561	2,691
Repurchase agreements:					
Government securities:					
Purchases	5,059	5,745	4,843	8,142	23,789
Sales	4,796	5,900	4,951	8,142	23,789
Federal agency securities:					
Purchases	421	976	847	1,362	3,606
Sales	358	966	920	1,362	3,606
Net change	−595	+1,167	+951	+2,694	+4,217

NOTE.—All figures are as of date of delivery.

The first use of the matched sale–purchase technique in 1969 occurred on January 8, a reserve-settlement day, when year-end pressures in the money market faded and excess reserves accumulated in the banking system. The Account Manager resisted the developing ease by arranging $550 million in matched sale–purchase transactions. Subse-

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quently, a sizable inflow of currency to the banking system and a less-than-anticipated decline in float threatened to lead to a continuation of comfortable conditions in the money market. Over the next several days, therefore, the System sold $395 million of bills in the market and to foreign accounts. Additional reserves were temporarily absorbed on Wednesday, January 15, through $690 million of matched sale–purchase agreements.

The maintenance of steadily firm money market conditions was challenged during the next 3 weeks by a massive shift in reserves toward the money center banks. The basic reserve deficit of the eight major New York City banks swung from an average of $1.4 billion during the 3 weeks ended January 15 to an average of less than $100 million during the next 3 weeks.[1] The larger-than-seasonal improvement reflected both increased borrowings in the Euro-dollar market and higher U.S. Government deposits and a decline in required reserves. The System countered the effect of these developments by aggressively absorbing reserves on all but 4 days of the 3 weeks ended February 5. In addition to six rounds of matched sale–purchase transactions totaling $2.7 billion, the System sold outright a total of $651 million of bills in the market and to foreign accounts and redeemed $225 million of maturing bills.

Despite the contrary influence of market factors during the 3-week period ended February 5, including the periodic emergence of high levels of float, open market operations maintained generally firm conditions in the money market. Federal funds traded predominantly in a 6¼ to 6⅝ per cent range, and the 3-month Treasury bill generally traded in a 6 to 6.20 per cent range. To maintain firm conditions in the money market, member bank borrowing was allowed to rise to an average of $806 million as compared with an average of $593 million during the first 2 weeks of the year. Net borrowed reserves rose to an average of $574 million during the same 3 weeks, almost $200 million higher than during the previous 2 weeks.

A sharp swing in reserve factors and in the distribution of reserves conditioned open market operations during the next two statement weeks, which ended on February 19. Movements in market factors,

[1] The basic reserve position of a group of banks is defined as the group's excess reserves less its net purchases of Federal funds from member banks and less its borrowings from the Reserve Banks.

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particularly increases in currency outside the banking system and in Treasury balances at the Reserve Banks, drained a substantial volume of bank reserves. The major money center banks, especially those in New York City, came under renewed reserve pressure, and they bid more aggressively for funds. Open market operations provided reserves—but not in sufficient volume to offset the upward pressure on the Federal funds rate. Rates on these funds rose to a range of 6¾ to 7¼ per cent in mid-February. The taut conditions contributed to heavy borrowing by member banks. Such borrowing averaged $922 million over the 2 weeks ended February 19, and net borrowed reserves rose to an average of $630 million.

The System supplied reserves daily over these 2 weeks, primarily through repurchase agreements. The heavy use of this technique was dictated by two factors. First, repurchase agreements make it possible for the Account Manager to respond quickly to unexpected pressures in the money market while still keeping the supply of reserves on a short string. Secondly, Treasury bill rates had been moving down, reflecting steady investor demand, and the System did not wish to add to that pressure by making outright purchases of bills in the market. The scarcity of bills was underscored on February 18 when a System go-around elicited only $284 million of offerings of bills by dealers, of which the Account Manager accepted $134 million for the System and an additional amount for foreign accounts. In order to meet further reserve needs, the System purchased $85 million of Treasury coupon issues the next day. The scarcity of bills in the market even tended to make it difficult for the System to provide reserves through repurchase agreements because nonbank dealers did not always have sufficient collateral to match System needs to supply reserves.

Thus, on occasion, the Trading Desk departed from its normal practice of considering only financing needs of nonbank dealers and permitted these dealers to round up additional securities from customers to place under repurchase contract with the System. During the 2 weeks ended February 19 the Account Manager arranged a total of $2 billion of repurchase agreements against Treasury and agency securities. These were supplemented by $329 million of such contracts against bankers' acceptances. With Treasury bills in scarce market supply, repurchase agreements against bankers' acceptances proved a particularly useful means of injecting reserves.

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Open market operations were generally routine over the succeeding 6 weeks—the interval from February 20 to April 2. With Treasury bill rates declining persistently, the System avoided altogether any outright transactions in the bill market. Instead, the Account Manager continued to meet reserve needs primarily through short-term repurchase agreements, which totaled $3 billion against Treasury and agency issues and $402 million against bankers' acceptances during the interval. The System also purchased outright $495 million of Treasury bills directly from foreign accounts and $253 million of coupon issues in market go-arounds. Reserve absorptions were accomplished by sales of $343 million of bills to foreign accounts and redemptions of $556 million of maturing bills.

All of the statement weeks in the interval from February 20 to April 2 followed a similar pattern. In each one, Federal funds traded primarily in a range of 6⅝ to 7 per cent before the weekend. In order to meet indicated reserve needs, the System injected reserves through repurchase agreements before each weekend, and then it geared its subsequent operations to money market conditions. In the 3 weeks ended March 12, the System either absorbed reserves or took no action after the weekend. In the following 3 weeks, which ended on April 2, it injected additional reserves in the latter part of the week. During most of the 6-week period, Federal funds traded predominantly in a 6½ to 6¾ per cent range on the last 3 days of each statement week.

For the 5 weeks ended March 26, member bank borrowing from the Federal Reserve averaged $821 million, and net borrowed reserves averaged $619 million. Amid the churning in the market surrounding the March 31 quarterly-statement publishing date and the April 1 Cook County, Illinois, personal property tax date, however, member bank borrowings at the discount window rose to an average of $1.2 billion in the statement week ended April 2. Net borrowed reserves in that week averaged $886 million—the deepest weekly level since February 1953.

Although day-to-day open market operations encountered no unusual problems during March, the interpretation of the bank credit proxy in the light of the proviso clause of the directive was unusually difficult. (The proviso clause, which has been included in most of the Committee's directives in recent years, typically calls for modification of money market objectives if it appears that bank credit growth is proceeding more quickly or more slowly than expected.) The projec-

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tions of the credit proxy including Euro-dollar borrowings quickly settled near the bottom of the range that had been anticipated by the Committee at its March 4 meeting—a 3 to 6 per cent annual rate of decline in March.

On the surface, the levels projected might have suggested implementation of the proviso clause on the side of slightly less restraint. But several factors argued against such implementation. First there was considerable market belief that the System would not persevere in its policy of restraint, so such a move would have risked being interpreted as a greater relaxation of monetary restraint than intended—particularly in view of the decline in Treasury bill rates after early March. Second, there was growing evidence that banks might be expanding credit in ways not measured by the proxy. And finally, the estimates for April pointed to a probable rise in the proxy, reversing the March decline. In light of all these circumstances, the proviso clause was not implemented.

APRIL 3–MAY 28: OPERATIONS UNDERSCORE FIRM RESTRAINT

Economic and financial environment. Inflationary pressures and expectations showed little sign of abating in the early spring. Economic activity remained disconcertingly strong. Underlining the System's determination to resist inflationary pressures, the Board of Governors announced on April 3 an increase of ½ percentage point in reserve requirements against demand deposits, effective April 17, and concurrently announced approval of a similar increase in the discount rate to 6 per cent (by April 8 the increase was in effect at all Reserve Banks). The Federal Open Market Committee directed the Account Manager to maintain firm conditions in the money and short-term credit markets while taking account of the effects on those markets of the other monetary policy actions.

The second phase of monetary policy in 1969 was not accomplished without complications and stresses. Banks managed reserve positions more cautiously in the restrictive environment, usually amassing reserves each week well in excess of requirements to protect against adverse developments in the uncertain atmosphere. Federal funds rates ratcheted higher over the interval, not only in reflection of these pressures but also in response to the rising cost of Euro-dollar borrowing, which resulted in part from increased speculation on an upward

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revaluation of the German mark. Treasury bill rates, on the other hand, were relatively steady, and the capital markets did not reflect mounting pressures until near the end of the period.

These crosscurrents posed something of a dilemma for the conduct of open market operations. In keeping with the sentiment of the Committee, the Account Manager tended to resolve doubts on the side of restraint. This tendency was reinforced by the strength of the bank credit proxy in April, by the apparent proliferation of bank credit expansion that was not reflected in the bank credit proxy, and by the tenacity of doubts concerning the resolution of the System to hold fast to a policy of stern restraint. The net result of System operations in the April–May interval was to make amply clear that the Federal Reserve was serious about monetary restraint.

Monetary aggregates were a prime concern over the interval. Time and savings deposits continued to decline in the face of competition from money market instruments. Private demand deposits, however, bulged in early April (reflecting in part technical factors related to Euro-dollar flows). Consequently, the money supply spurted at an annual rate of almost 8 per cent for the full month. Meanwhile, the bank credit proxy expanded at an annual rate of 5.5 per cent when adjusted for Euro-dollar borrowings. Open market operations during the month were conditioned by these developments. Over the next month these two aggregates weakened—the money supply rose by only about 1 per cent and the proxy adjusted for Euro-dollar borrowings showed virtually no change.

Total reserves, after being adjusted for the increase in reserve requirements and for seasonal variation, declined at an annual rate of 8 per cent in April but rose at an annual rate of nearly 20 per cent in May. Nonborrowed reserves declined at a 12 per cent rate in April and rose at a rate of 6 per cent in May. The divergent rates for total and for nonborrowed reserves indicate how sparingly the System supplied reserves through open market operations and the resultant greater recourse by member banks to the Federal Reserve discount window. Such borrowing rose from an average of $918 million in March to $996 million in April and $1,402 million in May. The effective rate for Federal funds escalated by about 2 percentage points over the April–May interval to around 8.75 per cent. Net borrowed reserves climbed

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from $701 million in March to $844 million in April and $1,102 million in May. (See Chart 2.)

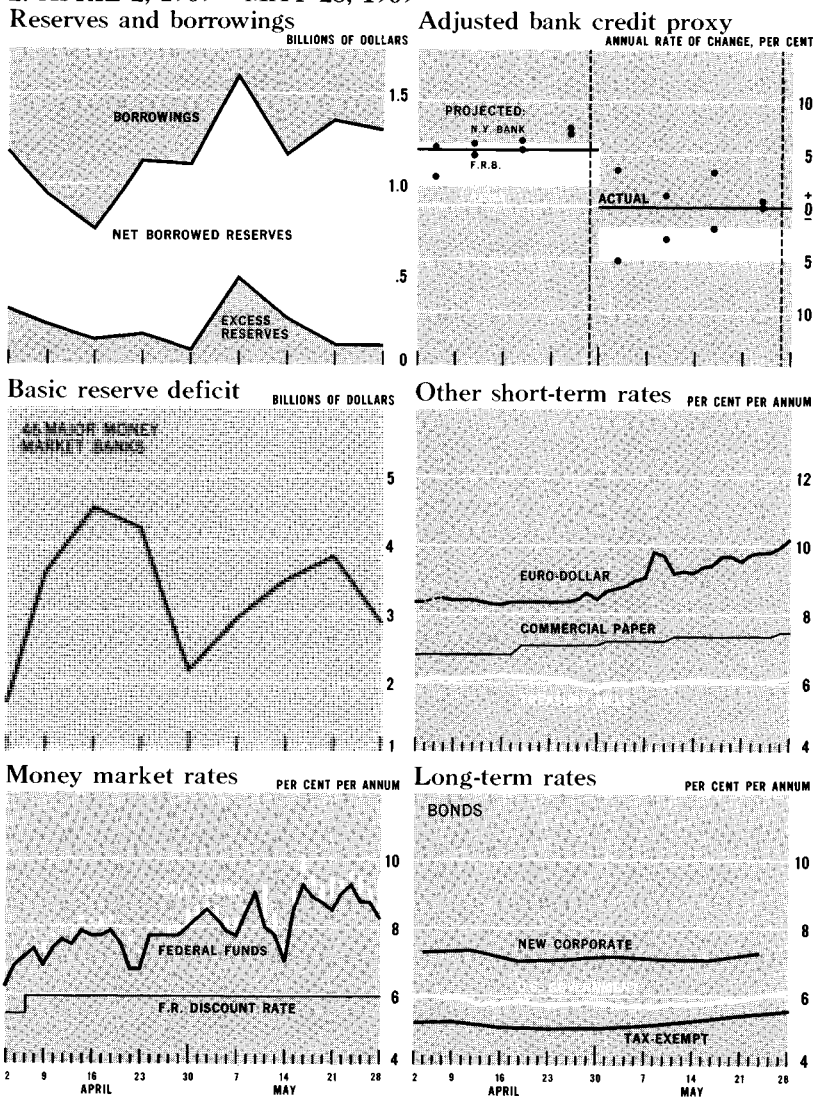
Bank credit, as measured by last-Wednesday-of-the-month figures for loans and investments, spurted over the April–May interval—rising at a seasonally adjusted annual rate of 8 per cent, compared with 2 per cent during the first quarter. Bank loans advanced at a 15 per cent rate over April and May, up from 9 per cent over the first quarter. By April the liquidity position of the banking system had deteriorated considerably. With holdings of Treasury securities at a very low level, bank liquidation proceeded at a somewhat slower pace than in the first quarter. However, banks did reduce further the already meager rate at which they had been acquiring tax-exempt securities. The reduced availability of Euro-dollars during the interval also made it difficult for banks to obtain much in the way of additional funds from this source. Hence, banks relied increasingly on other nondeposit sources of funds, including sales of commercial paper by affiliates and sales of loans either outright or under repurchase agreements—a development that also had an effect on open market operations.

Increases in most short-term market rates were substantial during the April–May interval. The rate on 90-day Euro-dollars rose from 8½ per cent in March to around 10 per cent by the end of May. (See Chart 2.) Rates offered by dealers on 4- to 6-month commercial paper were raised from 6⅞ per cent in late March to 7½ per cent at the end of May. And during the same interval dealers' offering rates on bankers' acceptances were raised from 6⅝ to 7½ per cent.

Treasury bill rates during April–May generally fluctuated within the same 6 to 6.25 per cent range that had prevailed since the turn of the year. Investor demand remained relatively strong, and during the latter half of the interval demand was augmented by the German official placement of dollars acquired as a result of increased speculation in the mark. However, downward pressure on rates stemming from such demand was tempered by the increasing cost of financing dealer inventories as money market rates climbed. In this atmosphere dealers were particularly sensitive to any shifts in supply and demand, and they became restive whenever inventories tended to rise above the very low levels that dealers maintained during most of the period. Although the Treasury did not replace $200 million of the maturing April 30 bill in the regular monthly auction (the portion sold earlier as part of a "strip"),

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2. APRIL 2, 1969 – MAY 28, 1969



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it did replace the outstanding "strip" bills sold in March 1969 by adding $300 million to each weekly auction of bills starting May 8.

Although the Treasury reduced its debt as the budget swung to substantial surplus, financing by federally sponsored credit agencies expanded. Led by the Federal home loan banks and the Federal National Mortgage Association, such agencies raised about $1.4 billion in new money during the April–May interval (while budgeted agencies retired nearly $1 billion of debt). The bulk of this total was used to cushion the impact of monetary policy on housing. The financing was confined to the shorter-term sector of the market—the longest maturity being 39 months. Around mid-April yields on new agency offerings were as low as 6.70 per cent, but as the market grew more congested during May, yields edged higher. One of the last offerings during the interval, $200 million of 39-month debentures, was priced to yield 7.40 per cent.

Capital market yields actually declined somewhat in April but rose again in May. The initially better tone in the markets was related largely to the widespread sentiment that interest rates had reached their peaks, an expectation that stemmed from the feeling that anti-inflation programs being pursued by the Federal Reserve and the administration would prove effective. This confidence was dissipated during May as evidence of sustained inflationary pressures accumulated and as money market rates climbed sharply.

The Treasury's May refunding was conducted in the earlier buoyant atmosphere, however. The terms of the financing were similar to those of the February refunding. The Treasury offered holders of notes and bonds maturing in May and June 1969 the right to exchange their holdings into either a 15-month, 6⅜ per cent note yielding 6.42 per cent or a 7-year, 6½ per cent note priced at par. The yield on the short note was the same as that offered for a comparable note in February, but the longer maturity yielded about 21 basis points more than the 7-year note offered 3 months previously.

In the improved atmosphere, private holders subscribed for $2.2 billion of the longer-term note in contrast to $885 million in February. As market psychology changed, however, prices declined and by May 28 the new 15-month and 7-year notes were bid about $^{8}/_{32}$ and $^{18}/_{32}$, respectively, below their original offering prices. Reflecting this deterioration, average yields on 3- to 5-year Treasury securities, after declining from an average of 6.33 per cent in March to 6.15 per cent during

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April, rose to 6.52 per cent by May 28. Long-term Government bond yields, which had fallen from an average of 6.05 per cent in March to 5.84 per cent in April, rose to 6.15 per cent by the end of May.

Demand for high-yielding corporate issues expanded sharply in April, since many investors believed bond prices had reached bottom. Investor demand prompted many corporations to reschedule sales of issues postponed during the first quarter, and ultimately almost $1.3 billion of publicly offered issues were marketed, the largest monthly total since June 1968. An innovative feature of the period was the sale of 3- to 5-year maturities instead of the typical 20- to 30-year maturities. The expanded supply of new corporate issues soon generated investor resistance, market ebullience faded, and again yields rose toward the end of the period. In early May, for example, new Aa-rated utility issues were marketed to yield 7.25 per cent, 25 basis points less than a similar issue at the beginning of April. At the end of May a similarly rated telephone issue was reoffered to yield 7.65 per cent.

The municipal bond market was faced with two fundamental problems during the interval. The most immediate was the virtual withdrawal of banks—in recent years the major buyers of tax-exempt bonds—from active participation in the market for new issues. Furthermore, the intensifying pressure on bank reserve positions continued to forebode a potential liquidation of bank investments in municipal issues. The outlook grew more clouded as the Congress considered tax-reform measures that would have reduced the attractiveness of municipal securities to investors, especially banks. Nevertheless, municipal yields followed the pattern in other sectors of the capital markets. By the end of April the Bond Buyer's index of yields on municipal bonds had reached 5.09 per cent, a 20-basis-point decline since the end of March. A surge of financing activity accompanied the improved market tone—driving the index above it postdepression high to 5.60 per cent by the end of May.

Open market operations. System open market operations in the April–May interval were directed first at maintaining firm conditions in the money market—confirming the effects of the April increases in reserve requirements and the discount rate. As the period progressed, the System moved toward still firmer conditions in resisting excessive growth of the bank credit proxy in the second half of April, and in the face of mounting evidence that banks were expanding credit increasingly

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with funds obtained in ways not measured by the proxy. Reflecting in part some cushioning of the increase in reserve requirements, as well as accommodation of seasonal needs, System open market operations in Government securities supplied a net of $1.2 billion of reserves from April 3 to May 28.

Outright purchases of Treasury bills totaled $1.7 billion, including $498 million purchased directly from foreign accounts, while purchases of Treasury notes and bonds totaled $196 million. Outright sales of Treasury bills amounted to $411 million, largely to foreign accounts. In addition, $206 million of Treasury bills were redeemed at maturity. Temporary reserve injections and absorptions were accomplished through $6.7 billion of new repurchase agreements and $2.4 billion of matched sale–purchase transactions. In order to tide the Treasury over its mid-April period of cash stringency, the System also purchased a total of $1.1 billion of special certificates of indebtedness, which were redeemed by the Treasury when income tax payments flowed in. The maximum amount of such securities outstanding in this period was $976 million.

In coordinating open market operations with the April 3 announcement of increases in the discount rate and in reserve requirements against demand deposits, the System supplied the bulk of the projected reserve needs for the statement week ended April 9 by repurchase agreements at the start of the period. Thereafter the rate on Federal funds edged progressively higher in the wake of the Board's initiatives. The predominant trading level climbed from 6⅞ per cent on the first day of the period to 7⅛ per cent on Monday, April 7. When the rate rose to 7⅜ per cent on Tuesday, the Desk made a moderate amount of repurchase agreements to mitigate further escalation. Conditions were less taut on the settlement day, however, and the Desk sold a small amount of Treasury bills to a foreign account under a 1-day matched sale–purchase agreement aimed at preserving the money market firmness achieved during the week.

Federal funds rates reached new highs over the Federal tax-payment date despite expanded over-all availability of bank reserves. This is a prime example of the effects that a massive ebb and flow through the Treasury's accounts can have on reserve availability and on the money market when the buffer normally provided by tax and loan accounts disappears. Balances in these accounts were drained prior to the April

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15 tax date, and the Treasury covered deficits by large-scale borrowing from the Federal Reserve Banks. These operations injected about $1 billion of reserves during the statement week ended April 16. In view of the short-term nature of the reserve provisions, the Desk arranged matched sale–purchase transactions—$439 million of 7-day agreements on April 10 and $235 million of 3-day agreements on April 14—to offset the Treasury's operations. The major money center banks bore the brunt of these operations. In the first place, the drawing down of Treasury tax and loan balances was felt mainly by the major depositaries ("C" banks), and in the second place, matched agreements extinguished reserves largely in the money centers. Although net borrowed reserves for the week averaged only $615 million, the lowest level in more than a month, the skewed reserve distribution resulted in a tighter money market, with Federal funds trading at an average of about 7.60 per cent. The Account Manager was prepared to countenance these conditions in light of the strength of the bank credit proxy in April. In addition, the bond markets were buoyant, reflecting expectations that the restrictive monetary policy would rapidly contain inflationary pressures and thus be of short duration.

The System continued to exercise restraint in providing reserves over the second half of April but was swift in absorbing reserves when money market conditions displayed a tendency to ease. The strength of the credit proxy in April remained a major factor guiding this conduct. Rates on Federal funds rose to a 7½ to 7⅞ per cent range, although at times rates were even higher; the effective rate averaged 7.63 per cent. Member bank borrowings from the System averaged more than $1.1 billion over the two statement weeks ended April 30, and net borrowed reserves averaged $1 billion.

The increase of ½ percentage point in reserve requirements against demand deposits impounded about $700 million of reserves during the statement week ended April 23, and additional reserves were drained by the rebuilding of Treasury balances after the tax date. In this environment banks managed reserve positions cautiously by amassing excess reserves early in the statement week. The Desk provided necessary reserves through repurchase agreements and outright purchases of bills at the start of the week but did not attempt to relieve entirely the mounting pressures in the money market. When conditions began to reflect the accumulation of superfluous reserves toward the end of the

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week, matched sale–purchase agreements were used to absorb reserves and underscore the System's commitment to restraint.

Banks generally switched to the opposite strategy of reserve management in the statement week ended April 30—borrowing relatively little at the discount window over the weekend and accumulating reserve deficiencies. The Desk again provided for projected reserve needs early in the week through repurchase agreements and outright purchases of Treasury bills. Reserve availability turned out to be less than projected after the weekend, however, and the money market remained firm. But then pressures intensified at the end of the period as banks scrambled to cover reserve deficiencies. In this event the System provided $697 million in reserves through repurchase agreements over the final 2 days of April. Nevertheless, bank bidding for a diminishing supply of funds forced the Federal funds rate briefly to a new high of 9½ per cent on the settlement day, April 30.

The Federal funds rate eased to 8.25 per cent on May 1 but ratcheted upward over the rest of the month—reaching new high ground prior to each weekend before dipping as the weekly settlement date approached. For May as a whole, the effective rate on Federal funds averaged 8.67 per cent, a full percentage point higher than the average of the last 3 weeks of April. To some extent, this increase reflected a diversion of funds out of the Euro-dollar market into speculation in the German mark, which intensified demands for Federal funds. The cautious management of banks' reserve positions also contributed to the outcome. In the uncertain climate, and in view of the deep basic reserve deficit in the money centers, banks continued to bid aggressively for Federal funds at the start of each statement week.

In this environment, the Account Manager used repurchase agreements on each Thursday and Friday to moderate the strong pre-weekend pressures in the money market. After midmonth, tautness also tended to persist after the weekends and repurchase agreements were used on several other occasions. The generally buoyant state of the Treasury bill market and low dealer inventories precluded more than modest reserve injections through outright purchases of bills in the market during the interval. Outright purchases of Treasury bills from foreign accounts, when possible, were helpful in providing for longer-term reserve needs, and after the Treasury's refunding was completed, the Desk purchased some coupon-bearing Government obligations.

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Because of the low levels of dealer inventories, the Desk also found it necessary on several occasions to request Government securities dealers to use customer collateral to expand the volume of repurchase contracts.

More than $4.6 billion in repurchase agreements against Treasury and Federal agency securities were arranged during the four statement weeks ended May 28. Outright purchases of bills in the market, mainly at midmonth, amounted to $568 million, while purchases of coupon securities totaled $195 million. Purchases of bills from foreign accounts totaled $329 million. Although money market conditions tended to be more comfortable after the weekends, the absorption of redundant reserves was necessary only in the statement week ended May 14, when System foreign currency swap agreements generated an unexpected volume of reserves. During that period the Desk extinguished reserves by selling $349 million of bills to a foreign account on an outright basis and $1.1 billion in the market in 1-day matched sale–purchase transactions. For the month of May as a whole, member bank borrowing from the Federal Reserve and net borrowed reserves averaged $1.4 billion and $1.1 billion, respectively.

MAY 29–SEPTEMBER 3: MONETARY AGGREGATES WEAKEN AS STEADY PRESSURE IS MAINTAINED ON BANK RESERVE POSITIONS

Economic and financial environment. After 5 months of intensifying restraint the System held monetary policy to a generally steady course of firm restraint over the 3 months June through August. During this period the Federal funds rate and marginal reserve measures fluctuated around the levels achieved in May. However, the cumulative effects of firm monetary restraint became manifest in the money and credit markets. Banks grew quite cautious in managing their reserve positions —often accumulating reserves well in excess of their needs. This resulted in an alternating pattern of tautness and ease in the Federal funds market, which in turn prompted a strategy of countervailing open market operations that required frequent reversals of direction. In another manifestation of the cumulative effects of months of pressure on bank reserve positions, most of the monetary aggregates weakened considerably. Indeed, the decline in total member bank deposits (adjusted to

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include Euro-dollar borrowings) induced the Account Manager to relieve pressures slightly in the latter part of July under the proviso clause of the Committee's current policy directive.

Real economic growth slowed further during the period, but inflation continued apace, and the unemployment rate remained quite low. Fiscal restraint was strengthened by an enlarged budget surplus in the second quarter, and some uncertainty over fiscal policy was removed by the early-August extension of the 10 per cent income tax surcharge to the end of the calendar year. The Nation's balance of payments remained in a deep deficit on the liquidity basis. On the official settlements basis the balance continued in substantial surplus through the first half of the period, but turned negative around mid-July when borrowing of Euro-dollars by U.S. banks leveled off.

Open market operations during the June through August interval were conducted with a view to maintaining the prevailing pressure on the money and short-term credit markets. Member bank borrowing from the Federal Reserve Banks averaged $1.3 billion, about the same as during the latter half of May. Excess reserves rose somewhat, reflecting the cautious management by banks of their reserve positions in a period of severe monetary restraint. Net borrowed reserves, therefore, declined to $1 billion on the average over the June through August interval from $1.2 billion during the latter half of May. The effective rate on Federal funds averaged 8.90 per cent, about the same as in the second half of May. (See Chart 3.)

Most other short-term interest rates rose over the period, partly under the influence of the largely unexpected boost in the prime lending rate of commercial banks to 8½ per cent near the start of the period, a full percentage-point increase. Offering rates on bankers' acceptances rose by ⅝ percentage point over the 3-month interval to 8⅛ per cent, while rates on prime dealer-placed commercial paper rose by ¾ percentage point to 8¼ per cent. Rates on 90-day Euro-dollars rose as high as 13 per cent briefly in June and closed in August at 11¼ per cent, up about 1¼ percentage points for the period.

The bank credit proxy, when adjusted for a massive inflow of Euro-dollars, declined at an annual rate of about 1 per cent during June. (See Chart 3.) During July, however, the proxy declined at an annual rate of more than 11 per cent, even after adjustment for Euro-dollar liabilities. The sharp decline reflected largely time deposit losses in the

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absence of any modification of maximum permissible interest rates on such deposits. (Negotiable CD's declined by $4.7 billion, not seasonally adjusted, over the May 29–September 3 interval.) Estimates of funds received from nondeposit sources in July, including sales of loans to affiliates financed by sales of commercial paper, did not significantly mitigate the decline of the credit proxy in July. Consequently, open market operations permitted somewhat more comfortable conditions to develop in the money market during the second half of July in accordance with the Committee's directive to modify operations if bank credit deviated significantly from projections. Despite a further heavy drain of time deposits in August, the decline in the credit proxy eased to an annual rate of 9.5 per cent after adjustment for a slackened rate of growth in banks' Euro-dollar liabilities.

Over the June–August interval as a whole, the credit proxy (adjusted not only for Euro-dollar but also for other nondeposit liabilities [1]) declined at an annual rate of about 4 per cent, as compared with growth at a rate of about 1 per cent over the first 5 months of the year. Commercial bank loans and investments were little changed over the June–August period. The growth in bank loans practically ceased, and net liquidation of tax-exempt securities began. Moderate net investment in U.S. Government securities resumed, however, largely because of bank underwriting of $3.5 billion of tax-anticipation bills sold by the Treasury in July. The money supply rose at a seasonally adjusted annual rate of 1.4 per cent during the interval, down from 4.3 per cent over the first 5 months of the year.

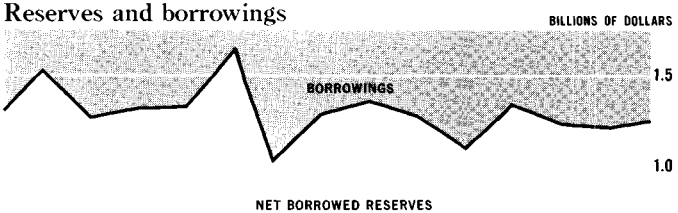
After 5 months of relative stability Treasury bill rates rose sharply, reflecting in part the cumulative effects of monetary restraint. Rates on 3-month bills had averaged between 6.01 and 6.13 per cent on a monthly basis over the January–May period but rose to an average of 6.43 per cent in June and 6.98 per cent during July and August. Upward rate momentum was evident in the bill market even before the June 9 increase in the bank prime rate. The cost of financing dealer positions had become increasingly burdensome, and apprehension among dealers was raised by bill sales by foreign central banks that were related to a movement of funds from Germany into the Euro-dollar

[1] Commercial paper issued by bank affiliates, liabilities to branches in U.S. territories and possessions, and loans sold under repurchase agreements to others than banks or banks' own affiliates. In Chart 3 the proxy is adjusted only for liabilities to foreign branches.

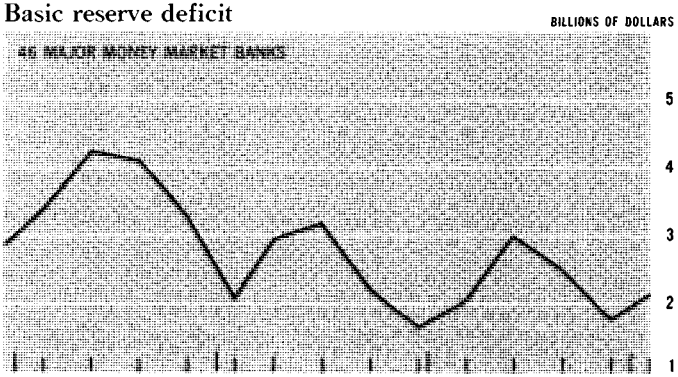
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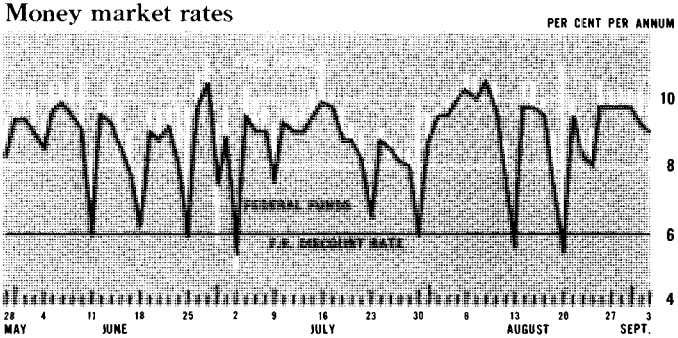
Reserves and borrowings



Basic reserve deficit



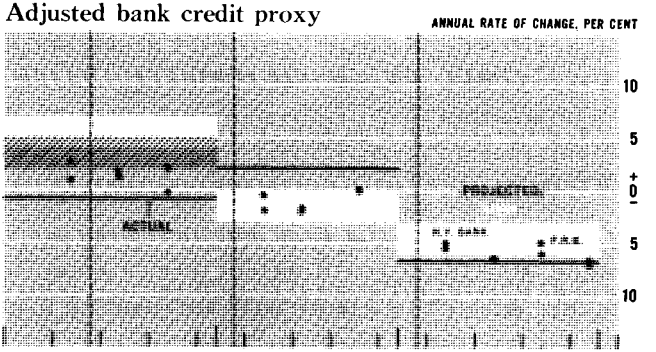
Money market rates



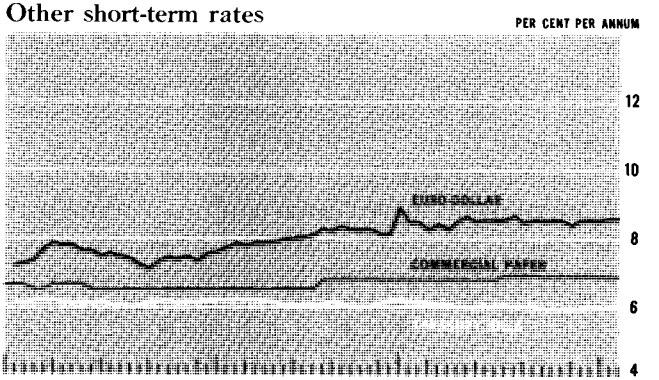
For notes see pp. 212–13.

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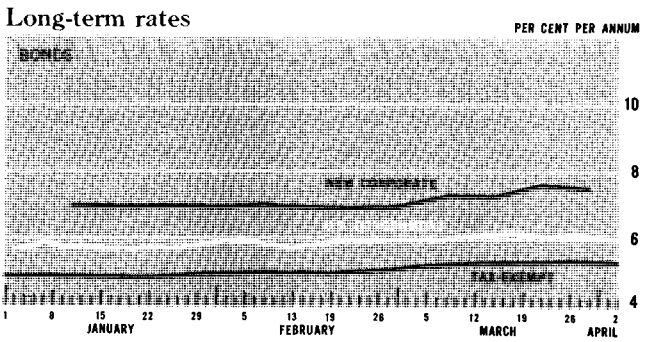
Adjusted bank credit proxy



Other short-term rates



Long-term rates



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market. The increase in the prime rate sparked a sharper rise in bill rates, and rates climbed still higher in the wake of the June 26 announcement of the Board of Governors' proposal to apply a 10 per cent reserve requirement against Euro-dollar borrowings by member banks to the extent that such borrowings exceeded the daily-average amounts outstanding in the 4 weeks that ended May 28, 1969. (The proposal was adopted on August 12, with the new requirement to be met beginning October 16, based on an initial 4-week computation period beginning September 4.)

The Treasury's sale of $3.5 billion of tax-anticipation bills early in July resulted in even higher rate levels. By mid-July, however, sentiment in the market had improved and rates were generally stable over the remainder of the interval, although the added market supply resulting from the Treasury's sale of the $2.1 billion "strip" of bills with an average maturity of 45 days caused some uncertainty during the second half of August.

Yields on intermediate-term Treasury notes and bonds also worked higher over the interval. Average yields on 3- to 5-year Government securities rose from 6.33 per cent in May to 6.64 per cent in June and then stabilized around 7.05 per cent during July and August. Investor demand was light during most of the interval, and activity was dominated by professional trading. In this atmosphere, price movements reflected largely shifts in expectations over the future course of interest rates—with uncertainty over congressional passage of the extension of the income tax surcharge being a matter of concern. Activity expanded somewhat toward the end of the interval as attention focused on the Treasury's August refunding, and the reinvestment of the proceeds of the sale of Alaskan oil-land leases generated some demand for Government securities.

In its quarterly refunding the Treasury offered a single 18-month note in exchange for the $3.4 billion of notes maturing on August 15 (of which $3.2 billion were held by private investors). The new note carried a coupon of 7¾ per cent and was priced to yield 7.82 per cent, 140 basis points more than the yield offered on a 15-month note only 3 months earlier. The terms were enthusiastically received by market participants, who were encouraged by the absence of a longer-term issue and the Treasury's decision not to pre-refund the large October maturity. While the 11.1 per cent devaluation of the French

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franc injected a note of uncertainty into the market, the atmosphere was improved by congressional extension of the 10 per cent tax surcharge to the end of the year. All but 13 per cent of the maturing issue held by the public was exchanged for the new note, a relatively low rate of attrition by recent standards.

Federal agencies raised about $2.4 billion, net, of new money in the short- and intermediate-term markets during the interval, with more than half of this new debt coming to market toward the end of August. The Federal home loan banks and the Federal National Mortgage Association were again the heavy borrowers, accounting for about $1.7 billion. In addition, the Commodity Credit Corporation, which does not usually tap the central money market, sold $700 million of 39-day certificates through competitive bidding in June. Yields offered by the agencies on 6- to 24-month maturities, which were predominant among the new issues, were in a 7.85 to 8 per cent range at the start of the period, but at the end of August a 14-month issue was priced to yield 8.30 per cent. This figure was a new high for yields on agency securities, except for the CCC issue, which sold at an average discount rate of 8.723 per cent. Two sizable 5-year issues marketed in August resulted in downward pressure on prices of similar maturities of Treasury obligations.

The corporate and Treasury bond markets were relatively stable over the interval. The increase in the prime rate at the start of the period generated sharp price declines, but prices fluctuated in a relatively narrow range thereafter. New corporate financing was heavy, but higher yields attracted fairly good investor demand for most new issues that were attractively priced. Most Aa-rated utility bonds marketed during the period were priced to yield between 7.75 and 8.15 per cent as compared with the 7.25 to 7.65 per cent range prevailing during May. In the secondary market average yields on Aaa-rated corporate bonds fluctuated in a 6.90 to 7.10 per cent range on a weekly basis; and in the market for long-term Treasury bonds weekly average yields ranged from 5.98 to 6.11 per cent through the end of August.

The municipal bond market continued to labor under the threat of modification of the tax-exemption privilege. The Bond Buyer's index of yields on 20 tax-exempt issues rose from 5.60 per cent at the end of May to 5.82 per cent after the prime rate increase. (This was the highest point reached by this index since it was first calculated in 1904.)

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New financing activity was light during the summer—reflecting in large part the restrictions of locally imposed interest rate ceilings—and by mid-July the Bond Buyer's index had fallen almost to the level of late May.

However, conditions deteriorated sharply in the wake of the House Ways and Means Committee's tentative approval of a "minimum tax" on previously tax-free income. The heavy tone lifted somewhat when it appeared that new tax-reform proposals would not inhibit future buying of municipal securities by commercial banks. Nevertheless, major uncertainties remained and market participants preferred to stay on the sidelines until the outlook became clearer. Accordingly, prices resumed their downward course, and the Bond Buyer's yield index climbed to a new high of 6.26 per cent by the end of August.

Open market operations. System open market operations during the June through August interval were aimed essentially at maintaining the degree of pressure on the money and short-term credit markets that had been achieved during the first 5 months of the year. A tendency for market pressures to ease during the latter half of July was not fully offset by open market operations, however, in view of the substantial decline in the bank credit proxy. Even so, the Account Manager responded very cautiously to the weakness in bank credit in order to avoid giving the impression of a basic shift in the thrust of monetary policy on the eve of a Treasury refunding.

Throughout the period there was a tendency for banks to manage their reserve positions cautiously—piling up reserves in excess of their requirements in order to avoid being caught short at the last minute. In consequence, money market pressures tended to intensify early in each statement week and to ease toward the end of each statement week. To counter this alternating pattern of stringency and ease in the money market, the System frequently had to reverse direction within a statement week, first injecting and then absorbing reserves.

On a net basis, operations in Government securities supplied $951 million of reserves over the period May 29 to September 3. The System injected reserves through outright purchases of $2.4 billion of Treasury securities and repurchase agreements of $5.7 billion against Treasury and Federal agency securities. In order to absorb reserves, the Account Manager made frequent use of matched sale–purchase transactions—arranging a total of $8.1 billion during the interval—as

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a means of countering easing conditions in the money market with little effect on Treasury bill rates. The System absorbed additional reserves through outright sales of $1.1 billion of Treasury bills and redemptions of $207 million of maturing bills.

Early June was a period of stringency in the money market, as the basic reserve deficit of the major money center banks deteriorated sharply. The large banks acted vigorously to curb credit demands and deposit drains and to acquire funds from other sources: On June 9 several of these banks announced an increase of 1 percentage point in the prime rate to 8½ per cent; borrowings of Euro-dollars rose by $3 billion over the 3 weeks ended June 18—driving 90-day rates for these funds as high as 13 per cent; bidding for Federal funds intensified; and heavy use was made of the discount window, especially by banks outside the major money centers.

In this climate, banks accumulated excess reserves early in each statement week, and money market conditions tended toward alternate tautness and ease. This pattern was not a serious problem during the first statement week of June. The System injected reserves by making $665 million of repurchase agreements against Treasury and agency securities and bankers' acceptances and by purchasing outright $505 million of bills from foreign accounts. Federal funds traded predominantly at 9⅜ per cent through Monday, June 2, and the System took no action to counter a slight easing of the effective rate to 8.50 per cent on the settlement day. Pressures intensified in the statement week ended June 11, however. Federal funds climbed as high as 10 per cent before the weekend, and the System responded by providing $789 million of reserves through repurchase agreements and $71 million through outright purchases of bills from foreign accounts.

The increase in the prime rate on Monday, June 9, threw the Treasury bill market into a state of temporary disruption. Further complicating the System's operations, foreign accounts presented the Desk with more than $700 million of Treasury bills to be sold over the three remaining days of the statement week, an abnormal volume of transactions that reflected primarily movements of funds from Germany into the Euro-dollar market.

Given the state of the bill market, it was doubtful that the market could have absorbed this volume even at sharply higher interest rates. On the other hand, money market conditions were becoming more

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comfortable, and purchases of these bills by the System would have added undesirably to reserve availability. Faced with this predicament, the Account Manager compromised by selling more than $300 million of the bills in the market and purchasing $395 million for the System Account. By the settlement day, June 11, the effective rate on Federal funds fell to 6 per cent and the Desk executed $500 million in overnight matched sale–purchase agreements—partially offsetting the reserve effect of the outright purchases. Even so, net borrowed reserves for the week averaged $812 million, the lowest level since mid-April.

Reflecting in part advance preparations by both banks and corporations, the statement week encompassing the June corporate income tax date was relatively uneventful. However, System operations continued to be complicated by sales of bills for foreign accounts. Although money market conditions tended to be relatively comfortable and some reserve absorption was called for, the System purchased $337 million of bills offered by foreign accounts rather than press them on a nervous bill market. The Desk partially offset this activity, however, by selling in the market $124 million of short-dated bills for which there was a good demand and by arranging a $200 million matched sale–purchase transaction over the weekend. When money market conditions became decidedly easier toward the end of the statement period, the System became more aggressive and sold $1,350 million of bills under matched agreements in the market and $150 million to foreign accounts on an outright basis.

Open market operations continued to supply and absorb reserves alternately in seeking to maintain prevailing pressure in the money and short-term credit markets over the next 4 weeks, which ended on July 16. During this interval the Account Manager arranged $1,220 million of repurchase agreements and $2,170 million of matched sale–purchase transactions. The System also purchased outright $559 million of Treasury securities, including $67 million of coupon issues, and sold $300 million of short-term Treasury bills outright. Member bank borrowing from the Federal Reserve Banks and net borrowed reserves averaged $1.3 billion and $1.1 billion, respectively, about the same average levels as during the prior 4-week interval.

Preparations for the quarterly bank-statement publishing date at the end of June and the Independence Day holiday weekend elicited aggressive bidding for Federal funds, however, and rates reached high

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levels at times. Just before the end of June, for example, the effective rate rose to 10.5 per cent, a rate that was not to be exceeded in 1969. Tautness reemerged on the July 16 settlement date, and although the System combated pressures by repurchase agreements, Federal funds traded briefly at 11 per cent, also a record that was not to be surpassed for the remainder of the year. During the 4-week interval ended July 16, however, the effective rate averaged 8.9 per cent, the same as over the June–August period as a whole.

Indications of weakness in the credit proxy in July brought about a change of emphasis in open market operations after midmonth. Given some uncertainty about the actual course of credit and in view of the forthcoming Treasury financing, the Account Manager cautiously invoked the proviso clause but sought to avoid giving an impression of a basic shift in monetary policy. Interacting with a seasonal decline in money market pressures, open market operations were aimed at allowing a natural abatement of pressures to occur. The slight relaxation of the System's stance was not apparent in marginal measures of reserve availability, but the average effective Federal funds rate for the 2 weeks ended July 30 eased to about 8.25 per cent.

The Account Manager arranged $216 million of overnight repurchase agreements on Thursday, July 17, in order to moderate early firmness in the money market. Soon, however, a swing of reserves to the money center banks generated an easier tone; in fact, the basic reserve positions of the 46 major money center banks improved by $1.5 billion over the last 2 weeks of July. But the Desk did not allow the full effect to remain. On Tuesday and Wednesday, July 22 and 23, the System absorbed $1 billion in reserves through matched sale–purchase agreements and $186 million through outright sales of Treasury bills to foreign accounts.

The Desk took no additional significant action until the final 2 days of the July 30 statement period. At that time a large accumulation of excess reserves prompted the Desk to arrange a total of $1.2 billion of matched sale–purchase agreements. The reserve absorption over the 2 weeks was sizable but not so large as it would have been if the Account Manager had not been acting under the proviso clause to permit some modification of money market conditions.

Firmer money market conditions emerged during the first 2 weeks of August as the major money center banks came under pressure and

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revised estimates of the credit proxy indicated that there was no need to continue the moderation of money market pressures engendered earlier. Open market operations aggressively supplied reserves during the first week of the interval to offset a heavy drain of reserves by market factors and to moderate mounting pressures. The Desk made a total of $1.7 billion of repurchase agreements, arranging them on all but the first day of the statement week ended August 6. Even so, the effective Federal funds rate rose from 8.75 per cent on Thursday to 9.50 per cent over the next 2 days and to a 10.00 to 10.25 per cent range over the final 2 days of the period. One factor restraining the Account Manager from injecting still larger amounts of reserves was the possibility that publication of abnormal weekly reserve data might convey a misleading impression of System action to ease up in order to assist the Treasury financing then in progress.

Taut conditions persisted into the next statement week. Federal funds traded mainly at 10 per cent on Thursday, August 7, and in a 10.50–10.75 per cent range the next day. In this event, the Desk supplied $789 million in reserves through repurchase agreements. Pressures abated after the weekend, however, reflecting heavy member bank borrowing at the Reserve Banks and the extremely cautious accumulation of $4.8 billion in excess reserves over the weekend. The System resisted the easing that this generated after the weekend, but it did not do so aggressively in view of the high rates that had prevailed in the recent past and the desirability of giving banks an incentive to change their overly cautious behavior. On Tuesday the System absorbed $350 million of reserves through overnight matched sale–purchase transactions, and on Wednesday it absorbed $335 million through similar agreements. This token resistance did not prevent the Federal funds rate from declining to as low as 2 per cent before the close on the settlement date.

Open market operations during the three statement weeks ended September 3 consisted of alternately supplying and absorbing reserves in response to widely fluctuating money market conditions. The middle week of the interval provided some noteworthy variation, since banks apparently misjudged reserve availability. As usual, the weekend accumulation of excess reserves in the banking system began to be felt on Monday. Federal funds traded around 8 per cent but the System, aware that reserve availability was not unduly high, showed only token

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resistance to the easing in the funds market by arranging a modest amount of matched transactions. As expected, banks were too aggressive in paring excess reserves and a scramble for the remaining supply occurred on Tuesday. The Desk then injected reserves through repurchase agreements to relieve the stringency.

Over the 3 weeks ended September 3, the Account Manager arranged repurchase agreements totaling $769 million and matched sale–purchase transactions aggregating $973 million. On an outright basis, the System purchased $512 million and sold $222 million of Treasury bills. The effective rate on Federal funds averaged a shade over 9 per cent during the 3-week interval, while member bank borrowing from the Federal Reserve Banks and net borrowed reserves averaged $1.2 billion and $1 billion, respectively.

SEPTEMBER 4–DECEMBER 31: FIRM CONDITIONS MAINTAINED IN THE MONEY MARKET WHILE DOWNWARD PRESSURE ON MONETARY AGGREGATES RELAXES SOMEWHAT

Economic and financial environment. The concluding 4 months of 1969 were an exceptionally trying period for the money and securities markets and for the conduct of open market operations. Despite intervals of market optimism, yields rose to historic highs as the markets reflected discouragement over the tenacity of inflationary pressures and expectations. Contributing to the deepening concern were disappointment over the progress made toward ending the Vietnam conflict and concern about a premature end to fiscal restraint, which might necessitate a prolongation of stern monetary policy.

The market for Treasury bills was subject to especially intense pressure during the last 2 months of the year as foreign accounts liquidated bills in large volume while the Treasury was adding to the supply. In these circumstances the System often faced the task of delicately balancing disparate objectives. The Account Manager sought both to maintain firm conditions in the money market and to avoid exacerbating the weakness in the Treasury bill market. But it was also necessary to avoid giving any false signals that monetary restraint was being relaxed.

Prices and costs continued to rise rapidly during the final months of the year, although real growth in the economy came to a halt. Industrial

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production declined each month after July, and expansion in personal income and in retail sales slowed markedly after August. Growth in employment also slowed. The unemployment rate jumped sharply in September, then fell just as sharply in November. Businessmen, however, tending to believe that the slowdown in the economy would be brief, continued to make plans for large capital outlays in 1970. A sharp improvement in the balance of payments in the fourth quarter reflected in large part a massive—and to some extent temporary—influx of funds from abroad in the latter half of December.

On the average, reserve availability eased slightly during the final 4 months of the year, but short-term interest rates rose. Net borrowed reserves during the September–December period averaged $915 million, about $100 million below the average of the preceding 3 months. And member bank borrowing from the Federal Reserve averaged $1.1 billion, about $150 million less than during the previous 3 months. However, Federal funds traded at an average effective rate of about 9 per cent, slightly above the average of the previous period. (See Chart 4.)

Rates on 90-day Euro-dollars fell from about 11¼ per cent in early September to less than 9 per cent in late October but climbed thereafter to a range of 11¼ to 11½ per cent in the latter half of December. Prime commercial paper rates rose ¾ of a percentage point over the final 4 months of the year to 9 per cent on 4- to 6-month maturities. (See Chart 4.) Posted rates on bankers' acceptances rose by the same margin to record highs of 9⅛ per cent bid and 8⅞ per cent offered.

The monetary aggregates were quite volatile during the last 4 months of 1969, but on the average they showed more strength than had prevailed during the summer. Total member bank deposits were little changed on balance over the last 4 months of the year, following the steep decline of the previous 3-month period. Euro-dollar liabilities of member banks, after more than doubling during the first 8 months of the year to more than $14 billion, also showed little net change during the succeeding 4 months. A number of large banks, however, obtained substantial amounts of funds through sales of commercial paper by holding companies or subsidiaries, and lesser amounts were obtained through branches in U.S. territories and possessions. After adjustment to include these funds, the bank credit proxy grew at an annual rate of about 2 per cent over the last 4 months of the year, compared with a 4 per cent rate

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of decline during the preceding 3 months. The expanded proxy rose slightly in September, but then declined sharply in October—prompting the Account Manager to modify operations temporarily under the proviso clause of the Committee's directive. The expanded proxy rebounded strongly in November but increased only slightly further in December.

The rapid growth of commercial paper issued by affiliates of banks to raise funds for the banks prompted the Board of Governors to consider steps to stop the flow. Bank-related commercial paper outstanding had increased from $1 billion at the end of June to $3.6 billion by October 29. On that date the Board of Governors proposed amendments to Regulation Q that would impose interest rate ceilings on paper issued by bank holding companies. At the same time it ruled that such paper issued by subsidiaries of banks was already subject to Regulations Q and D (reserve requirements). However, the Board of Governors suspended interest rate ceilings and waived reserve-requirement penalties on the latter paper, to the extent that the volume did not exceed amounts outstanding on October 29, and it took no final action on holding company paper before the end of the year. Bank-related commercial paper continued to grow during the final 2 months of the year, but at a slower pace than in immediately preceding months.

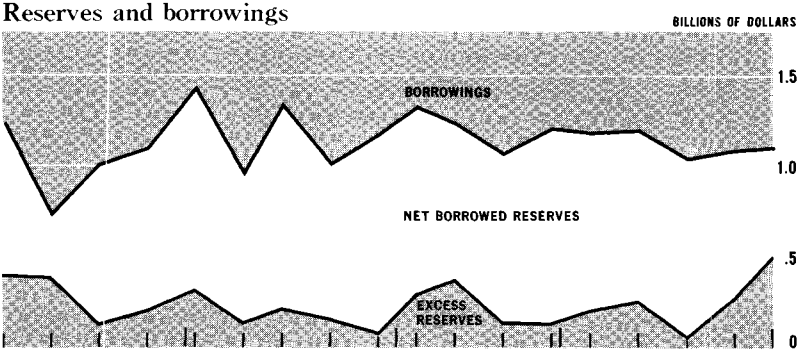
Loan demand remained strong during the interval, and in view of the lack of significant deposit growth, the banks were hard pressed for funds. To obtain funds, they liquidated U.S. Government securities at a rapid rate and continued to reduce holdings of tax-exempt securities during the last 4 months of the year. Over the period the rate of decline in time deposits slowed considerably as some banks, particularly those in New York City, succeeded in placing negotiable CD's with foreign and international official accounts, which are exempt from Regulation Q ceilings on interest rates. Although total CD's in the banking system continued to decline over the final 4 months of the year—bringing the decrease for the year to nearly $12 billion—CD's at the New York City banks rose by about $500 million. The money supply grew at an annual rate of 1 per cent—about the same as over the previous 3 months.

In the securities markets, a spirited rally during October provided the only respite from the bleak atmosphere that engulfed the markets during most of the final 4 months of the year. In September bond yields had risen to new highs as a result of heavy financing demands and mar-

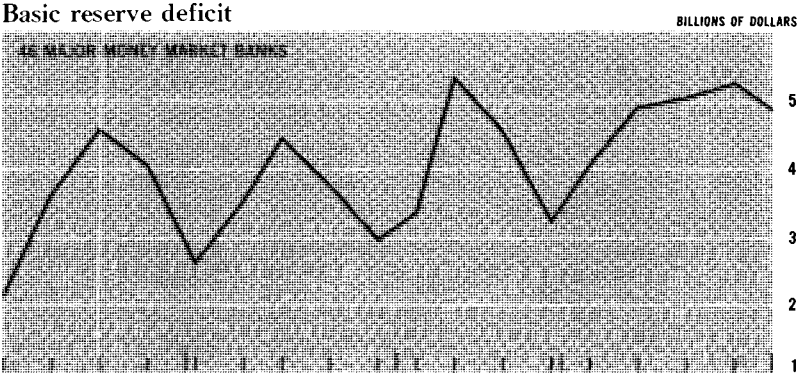
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4. SEPTEMBER 3, 1969 – DECEMBER 31, 1969

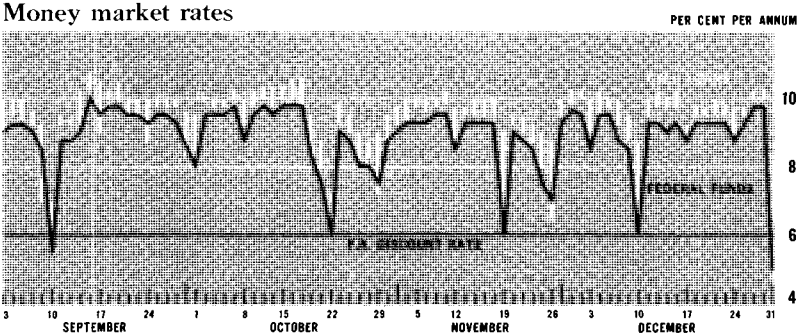
Reserves and borrowings



Basic reserve deficit



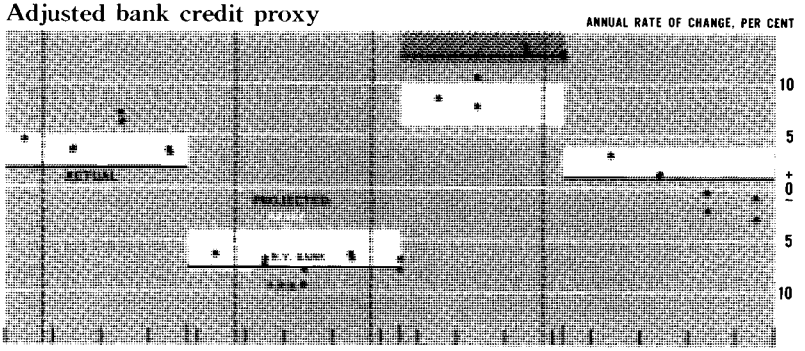
Money market rates



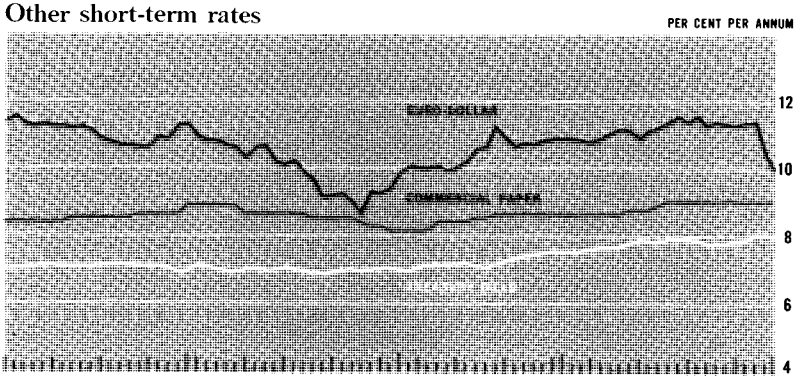
Adjusted bank credit proxy is adjusted, beginning Sept. 3, not only for liabilities to foreign branches but also for commercial paper issued to bank affiliates, liabil-

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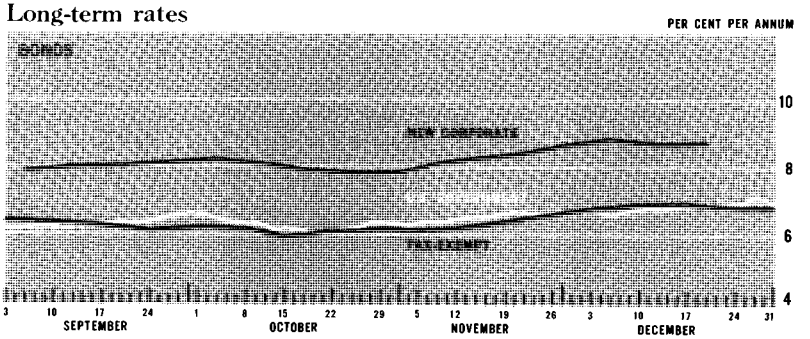
Adjusted bank credit proxy



Other short-term rates



Long-term rates



ities to branches in U.S. territories and possessions, and loans sold under repurchase agreements to others than banks and banks' own affiliates. For other notes see pp. 212–13.

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ket fears. The news in early October that the unemployment rate had leaped to 4 per cent in September sparked a shift in sentiment, but as time passed, hopes for a fundamental change in the market environment faded. The President's policy statement on Vietnam on November 3 disappointed those market participants who had hoped for a more dramatic peace initiative.

Even more discouraging were subsequent statements by the monetary authorities suggesting the need for restraint well into the future. Disillusionment—even disarray—was caused by the possibility that the combined effects of congressional spending and tax reform measures would be inflationary. Heavy sales of Federal agency issues were a major factor in the rise in interest rates during the period. Against this background, the average yield on long-term Treasury bonds climbed from an average of 6.02 per cent in August to a high of 7.13 per cent in late December, while the average yield on 3- to 5-year issues rose from 7.08 per cent to a high of 8.36 per cent.

The Treasury's massive refunding in October was the highlight of activity in the market for Treasury notes and bonds during the interval. Three new notes were offered in exchange for $6.4 billion of notes and bonds maturing on October 1 and almost $2.5 billion of bonds maturing on December 15. The new notes included a 19½-month maturity yielding 8 per cent; a 3-year, 7½-month maturity yielding 7¾ per cent; and a 6-year, 10½-month maturity offered with a 7½ per cent coupon at a discount to yield about 7.59 per cent. The public's response to the offering was better than had been expected in light of the unsettled market conditions, and 76 per cent of the private holdings of the eligible issues were exchanged for the new notes. The exchange attrition was met the next month by the sale of $2 billion of tax-anticipation bills.

Altogether, through sales of tax bills and additions to the regular weekly auctions, the Treasury increased the amount of bills outstanding by a net of $6.5 billion during the last 3 months of 1969. In addition, the supply of bills was augmented by heavy sales by foreign accounts in the wake of the revaluation of the German mark; such sales exerted strong upward pressure on bill rates. The System often facilitated orderly adjustments in rates by purchasing a substantial part of the bills sold by foreign accounts. Over time, of course, these purchases correspondingly reduced System purchases in the market to

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meet seasonal reserve needs. Faced with high financing costs, dealers often sought aggressively in this period to reduce their swollen inventories. Against this background, average issuing rates on both the 3- and 6-month bills rose to records of 8.10 per cent in the weekly auction on December 29. For the 3-month bill, this represented an increase of 108 basis points from early September and 190 basis points from the end of 1968.

During the final 4 months of 1969, the Federal home loan banks and the Federal National Mortgage Association each came to the market about once a month to obtain a large volume of new funds. Federally sponsored credit agencies as a whole raised nearly $3.4 billion of net new money during the last 4 months of the year, with most offerings having maturities of 3 years or less. The highest offering rate occurred in mid-December, when the Federal intermediate credit banks sold a 9-month issue yielding 8.80 per cent; earlier these banks had sold issues with similar maturities at 8.125 per cent (in mid-August) and at 7.95 per cent (in mid-October).

The corporate bond market labored under a heavy schedule of new issues from September through mid-December. Illustrative of the yield movements, a new Aaa-rated issue of a telephone company was sold at a record 9.10 per cent on December 2, compared with 8 per cent on a similar issue 6 weeks earlier. New-issue yields on Aa-rated electric utility bonds rose from 8.10 per cent in late August to a high of 9.20 per cent on December 1; the last such offering of the year yielded 8.95 per cent.

Gloom also pervaded the tax-exempt bond market during most of the interval. To be sure, the Bond Buyer's index of yields on 20 bonds declined to 5.92 per cent in mid-October, reflecting in part news that the tax-exempt status of municipal bonds would not be modified by the pending tax-reform legislation. But as in other market sectors, hopes for a sustained market improvement were soon deflated. The inability of many borrowers to market issues under local rate ceilings remained the dominant characteristic of the market during the interval. Indeed, nearly half of the federally guaranteed bonds of local housing authorities offered in September and November failed to receive bids under the statutory 6 per cent ceiling. Although new-issue activity remained severely hampered by high levels of interest rates, investment demand was also limited by the steady pressure on bank liquidity.

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The Bond Buyer's index of yields on 20 municipal bonds rose to a new high of 6.90 per cent in mid-December and then closed the year at 6.79 per cent.

Open market operations. System open market operations during the final 4 months of 1969 were aimed at maintaining firm conditions in the money and short-term credit markets, while at the same time trying to moderate strains in these markets. Extraneous events made it extremely difficult to achieve these goals. Among the complicating factors were sharp swings in the Treasury's cash balance, unexpected changes in Federal Reserve float, erratic movements in the monetary aggregates, sharply escalating interest rates, and the threat of the emergence of disorderly markets. Speculation in the German mark and large-scale sales of Treasury bills by foreign accounts were added problems. Although weakness in the credit proxy prompted implementation of the proviso clause on the side of less restraint for a brief period in October, the Account Manager did not seek tighter conditions to resist the rebound in deposit growth in November because of sharply rising interest rates. Rather, as the year drew to a close, the Account Manager sought to alleviate undue pressures in financial markets—pursuant to the directives of November 25 and December 16, which called for modification of operations if unusual pressures arose—without forsaking reserve objectives or giving misleading signals of the System's intentions.

The System injected a net of $2.7 billion of reserves through operations in Government securities during the period September 4–December 31, a time of heavy seasonal reserve drains. It purchased $2.4 billion of Treasury bills and $192 million of coupon securities in the market and $3.3 billion of bills directly from foreign accounts, all on an outright basis. The System also purchased directly from the Treasury—and subsequently redeemed—$1.6 billion of special certificates of indebtedness in anticipation of mid-September corporate income tax receipts; the maximum amount of such securities outstanding in this period was $1.1 billion. In addition, the Account Manager arranged a total of $9.5 billion of repurchase agreements against Treasury and Federal agency securities.

The System withdrew reserves during the interval through outright sales of $663 million of Treasury bills in the market and $1.9 billion to foreign accounts and through the redemption of $649 million of

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maturing bills. Short-term reserve absorptions were also accomplished by means of $8.2 billion of matched sale–purchase transactions.

The heavy recourse to direct Treasury borrowing from the System resulted from a substantial underestimation by the Treasury of its cash needs in early September. By September 10 the Treasury had found it necessary to borrow a total of $1.1 billion through issuance of special certificates of indebtedness to the Federal Reserve; this was the highest volume of such certificates outstanding in 16 years. The resultant swing in reserves was pronounced: Treasury operations and other market factors injected $1.9 billion of reserves on the average during the September 10 statement week; however, 2 weeks later $1.3 billion of reserves were absorbed by Treasury operations and other market factors.

In order to maintain prevailing conditions in the money market early in the interval, the System absorbed reserves. Nevertheless, outright sales were hampered by the unwillingness of dealers to increase positions substantially under existing market conditions. Hence, the System sold only $226 million of Treasury bills outright in the market and an additional $247 million to foreign accounts during the statement week ended September 10. The matched sale–purchase technique again proved invaluable for short-term reserve absorptions. But there were still complications.

Normally this technique tends to be used when the money market is comfortable—that is, when banks have built up substantial excess reserve positions. Due to the urgency of the task, however, the System sought to execute matched agreements at a time when bidding for funds by banks was quite strong. For example, on Friday, September 5, after some outright sales of bills for foreign accounts proved the market to be unreceptive, the Desk attempted to generate between $500 million and $800 million of matched transactions. With Federal funds trading at around 9¼ per cent, however, only $360 million of over-the-weekend agreements could be arranged at reasonable rates.

On the following Monday and Tuesday banks were somewhat more responsive to System offers of matched agreements, and by Wednesday excess reserves were sufficiently plentiful that the System was able to conclude $1.2 billion of overnight matched agreements. In all, $2.7 billion of matched agreements were arranged over the four business days

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September 5–10. Nevertheless, the superfluity of reserves was not entirely offset, and net borrowed reserves fell to $349 million, the lowest level since the first week of 1969.

To facilitate the necessary absorption of reserves during the following statement week, which included the tax date, the Desk indicated to dealers during the afternoon of Wednesday, September 10, that the System might seek the next day to arrange matched agreements of as long as 1 week in duration. The unusual advance notice made it possible for dealers to explore potential sources of funds and paved the way for the large operation that followed. Thursday's operation proceeded smoothly, and dealers submitted a broad range of propositions for matched agreements; of these the Desk accepted $1 billion for 7 days and $142 million for shorter periods. The next day it arranged $750 million of matched agreements for 3 days. Float failed to provide the volume of reserves projected, however, and the System reversed gears the day after the September 15 tax date—providing $430 million in repurchase agreements for 1 day to moderate the tautness that was emerging in the money market.

The drain of reserves from the banking system after the tax date was offset with a minimum of direct open market operations. The redelivery of Treasury bills sold earlier under matched agreements provided substantial reserves during the statement week ended September 24, and movements in market factors supplied a satisfactory cushion. The subscription books for the Treasury's final 1969 refunding were open at the end of this period—making it necessary for the System to maintain an even keel in the money market. Since reserve availability was ample, the System sold $182 million of bills to foreign accounts on Monday, September 22, to keep money market conditions from easing and so as to be in a position to relieve upward pressures on rates if they should emerge. When trading in Federal funds did firm late in the period, the Desk arranged $175 million of short-term repurchase agreements and also $218 million of 8-day agreements—the latter against issues eligible for exchange in the Treasury's financing—to mature on the payment date, October 1.

For the three statement weeks ended September 24, the effective rate on Federal funds averaged about 9.10 per cent. Reflecting the superfluity of reserve availability early in the period, however, borrowings and net borrowed reserves over the interval averaged $954 million and

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$712 million, respectively—both about $300 million below the average of the preceding 3 months. Market observers were aware of the unusual circumstances leading to these results, and there was no tendency to read any policy significance into these developments.

During the three statement weeks ended October 15 open market operations aggressively supplied reserves to offset the effects of market factors and to relieve taut money market conditions. The System arranged $3.1 billion of repurchase agreements during the period and supplemented these agreements by outright purchases of $1.1 billion of Treasury bills. In consideration of longer-term reserve needs, it also purchased $129 million of Treasury coupon securities on October 1. Against this background, rates on Federal funds were held in a 9¼ to 9¾ per cent range, with the effective rate averaging about 9.40 per cent. Member bank borrowings and net borrowed reserves averaged about $1.3 billion and $1.0 billion, respectively, approximately the levels that had prevailed, on the average, over the 3 months before the September tax period.

Revised projections on Friday, October 17, indicated that the bank credit proxy was declining in October at an undesirably sharp rate. In line with the proviso clause of the Committee's directive, therefore, the Account Manager permitted somewhat more comfortable money market conditions to develop. On the first 2 days of the statement week ended October 22, the System purchased outright $332 million of Treasury bills and arranged a total of $679 million of repurchase agreements to combat lingering tautness in the money market. Thereafter, market factors began to supply a substantial volume of reserves, and the Federal funds rate eased steadily.

The System did not resist this trend aggressively, but it did absorb a portion of the superfluity of reserves by executing $1.9 billion of matched sale–purchase agreements over the final 3 days of the statement week ended October 22. Reflecting the System's implementation of the proviso clause, net borrowed reserves averaged $859 million, while the effective rate on Federal funds averaged 8.68 per cent, 1 percentage point lower than the previous week's average.

The estimate of the credit proxy was revised upward on October 24, and the Account Manager was less tolerant of comfortable money market conditions during that statement week. The Desk was swift in absorbing superfluous reserves—selling $284 million of bills outright and,

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over 4 days, arranging $1.4 billion in matched agreements. In this event net borrowed reserves rose to $1.1 billion, a level at the higher end of the range prevailing since May, although the average effective Federal funds rate slipped to 8.39 per cent as reserves shifted toward the money center banks.

Money market developments during the three statement weeks ended November 19 were most unusual. Fortunately, the divergent pressures that emerged dovetailed satisfactorily and steady conditions were preserved, although an exceptional volume of open market operations was required. Market factors absorbed more than $2.2 billion of reserves, net, during this interval. The reserves were drained chiefly from the 46 major money center banks, and during the second week of the period these banks had a basic reserve deficit averaging $5.2 billion, the deepest deficit of the year.

The international money flows that followed in the wake of the revaluation of the German mark on October 24 had confronted the Desk with the task of selling a very large volume of Treasury bills for foreign accounts. Since the absorption of reserves by market factors was projected to be of a relatively long duration, the System was in a position to buy most of these bills on an outright basis, thereby leaving the apprehensive bill market largely undisturbed by the foreign liquidation of bills. Purchases from foreign accounts during the period October 29–November 13 totaled $1.6 billion.

In spite of these reserve injections, money market conditions remained unduly firm, and the System injected $1.4 billion of additional reserves through repurchase agreements from October 31 through November 10. The flow of bills from foreign accounts slowed toward the end of the interval, and since reserve injections were still called for, the Desk purchased $526 million of Treasury bills and $64 million of Treasury coupon securities in the market on an outright basis. In all, outright System holdings of Treasury securities rose by more than $2 billion from October 30 through November 19, about matching the absorption of reserves by market factors. Federal funds traded at an average effective rate of slightly more than 9 per cent, and member bank borrowings and net borrowed reserves averaged $1.2 billion and $943 million, respectively, all within the range of recent experience. Treasury bill rates, however, edged somewhat higher, portending the sharper rise that was to follow.

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The Account Manager continued to seek to maintain the prevailing pressures on bank reserves over the next 3 statement weeks, which ended on December 10, but the conduct of open market operations reflected serious concern by the System over the distressed state of the securities markets. Apprehension over the possibility that an expansive fiscal policy would necessitate monetary restraint well into the next year altered market expectations and precipitated a sharp rise in Treasury bill rates. The incidence of three Treasury bill auctions on consecutive business days—that is, on November 21, 24, and 25—accentuated the decline of market confidence, and rates in each auction shattered previous records.

To facilitate orderly rate adjustments, the System purchased a total of $571 million of Treasury bills through market go-arounds on November 21 and 24 and also avoided an increase in market supply by purchasing $69 million of bills from foreign accounts. Further purchases were restrained by bank reserve considerations, however. After about midmonth the distribution of reserves had favored the money center banks and the money market had tended to be relatively comfortable. Therefore, the System sold a small amount of sought-after short-dated bills in the market to offset the earlier reserve injection, and on Wednesday, November 26, it sold $331 million of bills to foreign accounts. The latter operations also provided room for outright purchases—should the extent of unsettlement in the bill market again become critical. In view of the decline in the Federal funds rate, the System also executed $370 million of 2-day matched sale–purchase agreements.

The need to inject reserves to offset market factors over the next 2 weeks—November 28 to December 10—coincided with the secondary objective of preventing disorderly short-term rate adjustments. The System purchased $241 million of bills outright in the market on the first day of the interval and an additional $483 million from foreign accounts on three occasions early in the period. Taut money market conditions also prompted the Account Manager to arrange $1.7 billion of repurchase agreements. On the other hand, projections of bank reserve availability indicated a need to absorb reserves in coming weeks. Accordingly, the System redeemed $246 million of maturing Treasury bills. The Desk also sold $417 million of bills to foreign accounts over the final 3 days of the period, an operation aimed in part

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at maintaining stability in the bill market. The foreign orders were for short-dated bills that were not in great supply in the market, and by selling these bills from its portfolio the System obtained leeway to purchase $349 million of longer-dated bills in the market on the last day of the period for future delivery, thereby removing some of the glut of bills that was putting upward pressure on rates.

Open market operations during the final 3 weeks of 1969 were conducted against a background of seasonal uncertainties. Reserves were more plentiful, but money market conditions tended to be somewhat firmer on the average as desired excess reserves rose seasonally. Member bank borrowings from the System averaged about $1.1 billion during the 3 weeks ended December 31—about $100 million below the level of the preceding 3-week interval. And average net borrowed reserves fell by $200 million, to $800 million. Nevertheless, the average effective Federal funds rate rose to 9 per cent, approximately ⅜ of a percentage point higher than the average of the preceding 3-week period. In part this firmness reflected the mid-December tax date, the uncertainties accompanying reserve flows during the holiday season, and preparations for year-end financial statements.

Pressures during the tax period were not unusual, and Desk activity during the statement week ended December 17 was confined mainly to injecting reserves through repurchase agreements on two occasions after it was learned that reserve availability had fallen short of earlier expectations. Projections were unusually tenuous because of the uncertain effects of bad weather on float, but available data indicated a need to absorb reserves over the period extending into the new year. Therefore, the System chose to redeem at maturity a total of $349 million of Treasury bills.

Sales orders for foreign accounts complicated the task of absorbing reserves during the week ended December 24. Because of the delicate state of the bill market, the System purchased from foreign accounts on Thursday, December 18, $241 million of bills, the bulk of the sales orders that day. To offset the reserve effect of such purchases, the Desk sold almost $225 million of Treasury bills to foreign accounts over the next 2 days and also sold $100 million in the market in response to unsolicited bids. Sales for foreign accounts were again heavy on the 2 days before Christmas. On December 23 the System managed to sell most of these bills in the market—taking only a small

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amount into its own portfolio. But since money market tautness appeared to be emerging on Christmas Eve, the Account Manager injected reserves by buying $119 million of bills from foreign accounts, supplemented by repurchase agreements with nonbank dealers.

Money market conditions and reserve projections were contradictory after Christmas. Consequently, the Desk stood ready either to supply or to absorb reserves, depending on developments. Since the money market remained quite taut before the December 31 settlement day, the Desk arranged a total of $1.3 billion of repurchase agreements over the 3 days, December 29–31. As it later became clear, earlier projections of excessive reserve availability were somewhat off the mark, since float fell sharply below projections. Even so, average net borrowed reserves fell to $596 million during the last week of the year, as member bank holdings of excess reserves rose seasonally. □

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REVIEW OF OPEN MARKET OPERATIONS IN FOREIGN CURRENCIES

The disturbances in foreign exchange markets that had characterized the two preceding years continued in 1969. The root difficulty was the persistence of serious imbalances in international trade and payments, notably the German and Japanese trade surpluses and the French deficit, to which was added an abnormally heavy short-term capital flow from Europe to the United States via the Euro-dollar market. The revaluation of the mark and devaluation of the French franc dealt with the most acute of these problems, however, and by the year-end the foreign exchange markets were pervaded by an unaccustomed calm.

As 1969 opened, the speculative funds that had moved into Germany between late August and the November 1968 Bonn conference were still flowing out at a rapid pace. The Bank of France succeeded in recovering a substantial portion of the reserves it had lost the preceding autumn, while the pound sterling showed a healthier tone and the Bank of England made sizable dollar gains.

In late April, however, reports spread that the German Government might be prepared to consider a revaluation of the mark in the context of a multilateral realignment of parities, and speculation burst out in favor of the mark and against a number of other currencies. In 10 days the flow of funds into the German Federal Bank amounted to $4.1 billion, with $2.5 billion flooding into Germany on Thursday and Friday, May 8 and 9. A substantial share of this flow apparently resulted from hedging and related operations by U.S. corporations, with a consequent inflation of the U.S. payments deficit at that time. Many European countries were even more severely affected: 10 of them suffered reserve losses approximating $1.9 billion during the speculative crisis. On May 9 a German Government communiqué flatly rejecting revaluation broke the speculative wave, and the exchange markets settled back to orderly trading as money flowed out of Germany through midsummer. The reflux of funds from Germany was accelerated by the strong pull of high Euro-dollar rates.

During the spring and early summer of 1969 the Euro-dollar market was subjected to unprecedented credit demands, generated in large part by the effects of increasing monetary restraint in the United States. As U.S. commercial banks borrowed heavily in the Euro-dollar market

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through their overseas branches, Euro-dollar rates moved steadily upward, reaching historic highs by mid-June and strongly attracting funds from foreign financial centers. As Euro-dollar pressures built up, a number of European countries took steps to protect their domestic money markets and international reserves, and in the summer months the Board of Governors issued amendments to its regulations in order to reduce the attractiveness of Euro-dollars to U.S. banks. Euro-dollar rates declined throughout July and early August, as the continuing flow of dollars from the United States was augmented by further dollar outflows from Germany.

Reacting to the payments difficulties that had beset France since the events of May 1968, the French Government devalued the franc by 11.1 per cent on August 8. Although the Belgian franc and, to some extent, sterling and the Italian lira experienced some backwash from the French move, other currencies were relatively unaffected as it became clear that the new franc rate could be readily accommodated within the international structure of currency parities.

Funds began to move into Germany again in early September, with the approach of that country's parliamentary elections in which the future parity of the mark was an issue. With the inflow mounting, the German authorities moved to forestall a repetition of the earlier speculative onslaughts by suspending official foreign exchange dealings during the last two business days before the September 28 elections. Moreover, when the election results pointed to the formation of a new government and a probable mark revaluation, the authorities decided not to attempt to maintain official trading limits for the mark until the new government could take office, some 3 weeks later.

The German mark immediately began to appreciate, reaching a premium of about 7¼ per cent by midmonth. With little divergence of market views regarding the prospective size of a revaluation, and with the German Federal Bank, in effect, putting a floor under each successive advance of the rate, orderly conditions were maintained during the transition period. On October 24 the new government revalued the German mark by 9.3 per cent. The fixing of the new parity—at a higher level than the market had expected—was followed by a sustained capital outflow of massive proportions; for the entire period between September 29, when the mark was allowed to "float," and December 31, German official net losses totaled some $5 billion.

The reflux of funds ended the pressures to which the currencies of a

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TABLE 1: FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Other party to arrangement	Amount of facility (in millions of dollars equivalent)	
	Dec. 31, 1968	Dec. 31, 1969
Austrian National Bank	100	200
National Bank of Belgium	225	500
Bank of Canada	1,000	1,000
National Bank of Denmark	100	200
Bank of England	2,000	2,000
Bank of France	1,000	1,000
German Federal Bank	1,000	1,000
Bank of Italy	1,000	1,000
Bank of Japan	1,000	1,000
Bank of Mexico	130	130
Netherlands Bank	400	300
Bank of Norway	100	200
Bank of Sweden	250	250
Swiss National Bank	600	600
Bank for International Settlements:		
Dollars/Swiss francs	600	600
Dollars/authorized European currencies other than Swiss francs	1,000	1,000
Total	10,505	10,980

number of other countries had been intermittently subjected earlier in the year. The Bank of England and the Bank of France, in particular, benefited from considerable market gains and thus were able to make good progress in reducing their short-term foreign debts. The outflow of funds from Germany also led to a substantial easing in the Euro-dollar market where, initially, interest rates dropped sharply. Starting toward the end of October, however, the expectation of continuing tight credit conditions in the United States, the announcement that the Board of Governors was contemplating steps to discourage excessive recourse by U.S. banks to the domestic commercial paper market, and, later, year-end withdrawals by U.S. corporate depositors and foreign banks pushed interest rates in the Euro-dollar market to exceptionally high levels.

During the year under review, the pressures on central bank reserves

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generated by trade imbalances, capital flows in response to interest rate differentials, and speculative disturbances were relieved to a large extent through financing by the Federal Reserve swap network, associated international short-term credit facilities, and substantial recycling arrangements.

At the beginning of 1969 the U.S. authorities had $432.1 million of outstanding foreign currency commitments under central bank swaps —$112.1 million to the German Federal Bank and $320 million to the Swiss National Bank. The System's obligations to the German Federal Bank were fully liquidated in January, and those to the Swiss National Bank sharply reduced in February. New drawings of $40 million equivalent on the Netherlands Bank and of $100 million equivalent on the Swiss National Bank during the spring were fully repaid by May and July, respectively. By then the other outstanding Swiss franc drawings also had been repaid, so by mid-July the System was out of debt.

Beginning in October, however, the System had to reactivate some of its swap lines, drawing the equivalent of $200 million on the Swiss National Bank, $300 million on the Netherlands Bank, and, later, $55 million on the National Bank of Belgium, as funds flowed into these countries with the unwinding of mark positions and on the expectation that the Netherlands and Belgium might follow Germany in revaluing. In subsequent weeks, however, it was possible for the Federal Reserve to reduce its outstanding commitments to the Netherlands Bank to $130 million and to the Swiss National Bank to $145 million equivalent. Thus, at the year-end over-all System commitments were down to $330 million.

During the year foreign central banks and the Bank for International Settlements (BIS) continued to make substantial use of their swap lines with the System. Their repayments, however, exceeded their drawings by about $1.0 billion, and total borrowings outstanding had been reduced to $650 million by the end of the year. Since the inception of the swap network in March 1962, total drawings on the swap lines by the Federal Reserve and its partner foreign central banks have amounted to $20.5 billion.

The Bank of England's swap borrowings from the Federal Reserve, which had totaled $1,150 million at the end of 1968, were reduced in the early months of 1969, but rose to a peak of $1,415 million during the speculative rush into German marks in early May. Subsequently,

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TABLE 2: FOREIGN CURRENCY TRANSACTIONS OF THE FEDERAL RESERVE, 1969

In millions of dollars or their equivalent

Currency	Operations initiated by the System									Swap operations initiated by others	
	Transactions under swap lines					Other transactions					
	Drawings	Repayments	Disbursements of balances acquired through swaps	Acquisitions of funds for repaying swaps		With U.S. Treasury[1]		With others			
				From U.S. Treasury	From others	Purchases	Sales	Purchases	Sales	Drawings	Repayments
Austrian schilling	.....	.....	.....	.....	.....	.....	0.8	.....	.....	50.0	50.0
Belgian franc	55.0	.....	55.0	.....	.....	.....	.....	.....	2.4	513.0	520.5
Canadian dollar	.....	.....	.....	.....	.....	.....	2.5	.....	(2)	.....	.....
Danish krone	.....	.....	.....	.....	.....	.....	.....	.....	.....	125.0	125.0
Sterling	.....	.....	.....	.....	.....	651.3	704.6	.....	63.3	795.0	1,295.0
French franc	.....	.....	.....	.....	.....	199.5	199.5	.....	4.7	290.0	720.0
German mark	.....	112.1	.....	.....	98.4	.....	165.0	221.6	.....	[3] 142.0	[3] 222.0
Italian lira	.....	.....	.....	.....	.....	124.2	124.2	15.1	10.2	300.0	300.0
Netherlands guilder	340.0	210.0	340.0	.....	209.8	.....	.....	0.5	5.0	191.9	191.9
Swiss franc	300.0	475.0	300.0	144.7	326.5	.....	0.7	2.9	.....	.....	.....
Total	695.0	797.1	695.0	144.7	634.7	975.0	1,197.3	240.1	85.6	2,406.9	3,424.4

[1] Includes forward as well as spot transactions.
[2] Less than $0.05 million.
[3] By the BIS.

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the Bank of England made additional repayments, but it had to draw again in August and September—primarily as a consequence of the French devaluation. In the final quarter of 1969, however, the Bank of England resumed its repayments, and by the year-end outstanding swap drawings had been reduced to $650 million.

The Bank of France, after making repayments earlier in the year on its $430 million swap indebtedness to the Federal Reserve, had to utilize its line again in February and March, bringing commitments outstanding to a high of $461 million at the end of that month; subsequent pressures on the French franc during the rush into marks in early May were financed by drawings on the $200 million credit provided by the U.S. Treasury under the Bonn credit package of November 1968 and on other foreign central banks. Before the end of June the Bank of France had repaid the entire $461 million outstanding under the Federal Reserve swap line.

The National Bank of Denmark reactivated its swap facility with the Federal Reserve in January, drawing $25 million; the full amount was repaid in mid-March. In April, however, the National Bank made a new drawing, of $50 million, and it drew another $50 million during the mark crisis in May. During June, an inflow of funds to Denmark enabled the National Bank to repay the $100 million to the Federal Reserve, restoring the Federal Reserve swap line to a standby basis.

The Austrian National Bank made its first drawing on the swap facility, in the amount of $50 million, to replenish reserves lost in the mark crisis early in May. This drawing was fully repaid in August.

The Netherlands Bank suffered reserve drains late in the second quarter as a result of the strong pull of the Euro-dollar market, and it drew on the Federal Reserve swap line during June and July for a total of $192 million. Defensive measures by the Netherlands Bank subsequently reversed the flow of funds and enabled the Netherlands Bank to reduce its swap debt and, when speculative funds began flowing in, to fully liquidate such debt in October.

The National Bank of Belgium also experienced reserve pressures originating in the Euro-dollar market early in the year and raised its outstanding drawings on the Federal Reserve swap line to $40.5 million by the end of January. After making some net repayment during the rest of the first quarter, the National Bank found it necessary to increase its swap drawings to $175.5 million during the mark crisis in

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May, but it was able to bring down the total of this debt to $114 million as of the end of June. At the end of July Belgium utilized resources immediately available to it at the International Monetary Fund in order to discharge its remaining commitments to the Federal Reserve. The devaluation of the French franc gave rise to rumors that the Belgian franc might also be devalued, and the National Bank made new drawings totaling $244 million. These rumors were quickly dispelled, however, and the National Bank was able to repay its debt completely by the end of October.

The Bank of Italy activated its swap line with the Federal Reserve in late September, drawing $300 million to cover market losses incurred after the French devaluation and prior to the German elections. With funds flowing back from Germany after mid-October, the Bank of Italy fully repaid the drawing in mid-November.

Finally, relatively minor drawings on its swap line were made by the BIS to finance brief imbalances in cash flows. In contrast to earlier years, the BIS did not draw on the swap line to finance intervention in the Euro-dollar market during either the June or the December window-dressing periods, since it was judged that the pressures then impinging on the Euro-dollar market had originated primarily in conditions governed by fundamental economic policy decisions.

No operations in forward markets were undertaken by the Federal Reserve during 1969. Technical forward commitments in lire assumed by the U.S. Treasury in earlier years were fully liquidated by the end of November 1969.

From time to time beginning in May 1969, the Federal Reserve bought foreign currencies on a 3-month swap basis from the Treasury's Exchange Stabilization Fund in order to free some of the Fund's resources for current operations, primarily gold purchases from foreign countries. These swaps reached $975 million by the end of the year. (After rising to a peak of $1 billion early in January 1970, the swaps were fully reversed later that month, when the U.S. Treasury had monetized $1 billion of gold previously held by the Exchange Stabilization Fund.)

GERMAN MARK

During 1968 there were recurrent rumors of imminent revaluation of the mark as Germany continued to show a very large surplus in its balance of payments on current account. Although the current-account

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surplus was offset by an equally substantial outflow of long-term capital, the markets remained apprehensive that the outflow could not be sustained and that German competitive strength eventually would force a mark revaluation. These fears culminated in a huge rush of funds into Germany in November 1968, but speculation receded in the face of the determined refusal by the German Government to revalue the mark, backed up with border-tax measures designed to encourage imports and slow the growth of exports. Reversal of the massive influx took some time, but by early 1969 German monetary reserves were back to their pre-November 1968 level.

In order to encourage the outflow, the German Federal Bank offered in December 1968 to undertake swaps with its banks at more favorable rates and for a wider range of maturities than it had previously provided. The German banks responded to the improved incentives, enabling the authorities to roll over into 1969 the very large December maturities of earlier swaps. Moreover, the German Federal Bank sold very substantial amounts of spot dollars outright, as foreigners withdrew funds from Germany and commercial leads and lags began to unwind.

Heavy demand for dollars, both spot and on a swap basis, continued into January 1969, reinforced by seasonal reflows from the German money market. As the outflows continued, the spot mark eased below par and the Federal Bank raised the cost of its official swaps moderately in several steps. During the period of heavy outflows from Germany beginning in late 1968, the Federal Reserve was able to accumulate substantial amounts of German marks. By late January the System had purchased sufficient marks in the market and from the German Federal Bank to repay in full its outstanding $112.1 million equivalent swap indebtedness to the Federal Bank.

The flow of funds from Germany continued unabated through most of the first quarter of 1969, as the authorities pursued a policy of monetary ease at a time when Euro-dollar rates were rising sharply. In addition to the substantial flow into the short-term Euro-dollar market, long-term capital exports rose to record levels as foreign borrowers flooded the German capital market with loan demands and securities issues in response to the relatively low borrowing costs in Germany. With the mark consequently trading below par, the Federal Reserve and the Treasury purchased marks to add to balances throughout the first quarter.

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Such capital outflows from Germany more than offset the current-account surplus and by mid-March had contributed to a tightening of the German money market and to the appearance of the first signs of indigestion in the capital market. Meanwhile, with domestic credit demand intensifying, German monetary policy shifted toward somewhat less ease. In order to prevent too rapid a tightening of domestic liquidity, however, the Federal Bank had raised its market swap rate, thereby reducing the incentive for banks to make covered placements abroad.

By early April congestion in the capital market was becoming severe and the West German Capital Market Committee acted to space out issuance of securities by foreign borrowers. With capital outflows dropping sharply, the steady decline in German reserves came to an end. Moreover, the gradual shift in official policy toward restraint aroused concern that reliance on monetary means to curb inflationary pressures might result in reflows of funds to Germany and hence to renewed buying pressure on the mark. The 1 percentage point increase to 4 per cent in the Federal Bank's discount rate on April 18 pointed up this potential dilemma inherent in official efforts to avert domestic inflation while avoiding internationally disruptive shifts of funds into Germany.

Against this background, the market grew increasingly apprehensive as the April 27 referendum in France approached—fearing that a defeat for President de Gaulle and his resignation from office might lead to new speculation on changes in currency parities. Demand for marks rose sharply, and on April 22 the Federal Bank began purchasing dollars. The bank immediately resumed swap operations with German banks, in order to push the dollars back into the market. The news of the referendum defeat for President de Gaulle touched off substantially heavier demand for marks on April 28, but the authorities permitted the spot rate to rise steeply and this helped to dissipate the buying pressure. Meanwhile, it soon became clear that the transfer of power in France following President de Gaulle's resignation would be orderly and that a franc devaluation by the interim government was unlikely. Consequently, demand for marks began to taper off, and the Federal Bank succeeded in rechanneling to the international money markets most of the $500 million taken in during this period.

The market atmosphere changed dramatically overnight, however, following reports that German official circles might be willing to con-

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sider a mark revaluation as part of a multilateral realignment of parities. Demand for marks soared as firms with commitments in marks rushed to hedge them, as commercial payments leads and lags began to swing heavily in favor of the mark, and as outright speculation began again on a massive scale. The huge shifts of funds to Germany exerted strong pressure on the Euro-dollar market and dangerously strained the international reserves of some of Germany's trading partners. The speculation did not halt until the German Government announced late on May 9 that it would not revalue the mark and that supporting measures would be announced in a few days. By then the exchange markets had witnessed the heaviest flow in international financial history. The speculative onslaught between the end of April and May 9 increased German monetary reserves by some $4.1 billion—including $2.5 billion on May 8 and 9 alone—to a record level of $12.4 billion.

The exchange markets began returning to normal following the German Government's decision not to revalue, which was backed up by an official communiqué from Basle declaring that agreement had been reached among the central banks on steps to recycle the speculative flows. The unwinding of speculative positions brought a sharp fall in the mark rate and the German Federal Bank began to sell dollars on a large scale.

On May 13 the German authorities announced new measures to be submitted to parliament, including: (1) authority for the German Federal Bank to impose minimum reserve requirements of up to 100 per cent on all foreign-owned mark deposits in German banks, and (2) extension beyond the March 31, 1970, expiration date of the border-tax adjustments introduced in late 1968 to raise export prices and lower import costs.

The outflow of funds from Germany continued through early June, as Euro-dollar rates moved higher and as the Federal Bank resumed market swap operations. A tightening of liquidity conditions in Germany around the mid-June tax date checked the outflow temporarily, but despite a further increase in the Federal Bank's discount rate to 5 per cent, the flow resumed toward the month-end and continued into early July. By then nearly $3 billion had returned to the international markets.

In subsequent weeks the market began to show signs of nervousness once again, with the growing pre-election debate among German politi-

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cal figures keeping the issue of revaluation of the mark in the foreground. Thus, when the German Federal Bank moved to tighten monetary policy further by raising the minimum reserve requirements of commercial banks in mid-July, there was a brief flare-up of demand for marks. This scare passed quickly, however, and the outflow of funds resumed.

The devaluation of the French franc on August 8 introduced new uncertainties and triggered a fresh rush of demand for marks. The Federal Bank once again purchased dollars, but the buying pressures were not sustained as traders became convinced that there would be no change in the mark's parity, at least not until after the September 28 elections, and the authorities were able to swap back to the market a substantial part of the inflow. The mark remained firm into early September in relatively light trading, and there was no further official intervention in the spot market. With funds beginning to come into the reserves as a result of maturing swaps, however, the Federal Bank progressively reduced its swap rate in order to encourage banks to renew these transactions.

Demand for marks soon picked up again as the date of the German elections approached. There was sizable covering of foreign currency positions by Germans as well as mark hedging by foreigners, and the Federal Bank purchased increasing amounts of dollars as September progressed. The bank continued in the meantime to sell dollars on a swap basis, but on September 18, after such sales had reached $0.7 billion over a 10-day period, it raised its swap rate, thus bringing to a virtual halt the covered movements of German bank funds into the Euro-dollar market. Although anxious to encourage a reflow of funds, the authorities felt that the market swaps were again beginning to be used to finance speculative purchases of marks. The spot inflow continued unabated, however, and by September 24, the Wednesday before the election weekend, the Federal Bank had purchased $1.5 billion in active but orderly markets.

After the close of the Frankfurt market on that day, the German authorities announced their decision to suspend official foreign exchange dealings until after the elections, thereby forestalling an influx of funds into Germany that might well have approached the massive proportions of the two preceding crises—in November 1968 and May 1969. The mark continued to be traded that afternoon in New York and on Thursday and Friday in all international exchanges, but activity

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was limited. With no official intervention and with conflicting opinions swaying the market, the rate moved above its ceiling of $0.2518⅞, to as high as $0.2570 on Thursday, September 25.

The election returns, which came in Sunday night, showed that no party had won a parliamentary majority. Negotiations were promptly undertaken, however, by the Social Democratic and Free Democratic parties to form a coalition government, which would presumably favor revaluation. Against this political background, when the Federal Bank reentered the market on Monday morning. September 29, it was immediately flooded with $245 million in the first hour and a half of trading. At that point the German Government accepted a recommendation by the Federal Bank that the mark be permitted to "float" temporarily—by suspension of intervention at the ceiling.

The mark immediately rose above the ceiling and within a week, by early October, it had reached a premium of about 6¾ per cent; it advanced more slowly thereafter to a premium of some 7¼ per cent by midmonth and then fluctuated narrowly around that level. Despite continuing nervousness, the market adapted to the changed circumstances satisfactorily as two factors combined to ensure orderly conditions during the transition period.

First, by October 2 it had become reasonably clear that a Social Democratic-Free Democratic coalition government would take office when the Bundestag reconvened on October 21 and would revalue the mark shortly thereafter. Thus, the main question in the market became the size, rather than the possibility, of a parity change. And even on this score there was little diversity of views in the market, with traders widely expecting the new parity to be set at $0.27027 (DM 3.70).

Second, the German Federal Bank exerted a strongly stabilizing influence by standing ready each day to buy marks at rates slightly below those prevailing in the market, thereby in effect placing a floor just below each successive advance of the rate. Since the mark was technically weak at the time because of the withdrawal of foreign funds that was already under way, there could have been wide fluctuations in the spot rate and repeated departures from the longer-term equilibrium rate had the Federal Bank not stood ready to prevent disorderly fluctuations. The Federal Bank's dollar sales in these operations varied widely from day to day, but amounted to $1 billion by the time the new parity was fixed.

On Friday, October 24, the German Government revalued the mark

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by 9.3 per cent, to $0.2732¼. As had been expected, it also eliminated the special border-tax adjustments that had been introduced in November 1968 to make exports more expensive and imports cheaper, and which had been temporarily suspended on October 11, 1969. The revaluation was larger than had been generally anticipated, thus decisively removing the mark from the realm of speculation while setting into action economic forces that would foster both internal and external equilibrium. The move was well received by the market, which quickly became convinced that a period of much greater calm would ensue.

The German mark traded at its new floor of $0.2710 as soon as the markets opened on Monday, October 27, and apart from a short-lived rally in early December, it remained there through the end of the year as the substantial positions built up in September and during earlier periods were being unwound. Moreover, with interest rates lower in Germany than abroad, foreign firms made large drawings on credit lines established with German banks earlier in the year. Consequently, there were extremely heavy dollar sales by the Federal Bank. By the year-end, such sales totaled more than $6½ billion (including the $1 billion sold during the period when the mark was permitted to float), but they were partly offset by almost $1½ billion in maturing forward contracts. The net outflow of $5 billion created both internal and external problems. Domestically, the authorities were not averse to having some additional pressure exerted on liquidity, since this would only reinforce their policy of monetary restraint, but they were anxious to avoid the development of too severe or abrupt a squeeze. Externally, a considerable reflow of capital was desirable, since it would help rebuild the reserves of other countries, but the size of the reflow was such as to reduce sharply Germany's holdings of liquid dollars.

To provide some relief to the commercial banks, the Federal Bank, effective November 1, reduced minimum reserve requirements by 10 per cent for resident deposits and by 30 per cent for nonresident deposits. The bank also eliminated the special 100 per cent marginal reserve requirement that had been imposed earlier on foreign deposits; reserve requirements against nonresident liabilities were thus again brought in line with those applying to domestic liabilities. Credit conditions continued to tighten, however, as the outflow persisted, and commercial banks were induced to borrow heavily from the Federal

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Bank. When year-end stringencies began to add to the pressure, the Federal Bank lowered reserve requirements by another 10 per cent, but for the month of December only. At the same time, to discourage both domestic credit expansion and capital outflows, the Federal Bank on December 4 raised its "Lombard" rate on secured advances by 1½ percentage points to 9 per cent—thus widening the spread between that rate and the discount rate (which had been raised to 6 per cent on September 11) to 3 percentage points, an unusually large amount. Furthermore, in mid-December the authorities eliminated the prohibition against payment of interest by German banks on foreign-owned deposits, which had been designed to discourage inflows of short-term funds.

On the external side, in financing the outflow, the Federal Bank had used up by mid-November most of its liquid dollar holdings, although total official reserves remained very large. As a consequence, the German authorities encashed in advance of maturity four mark-denominated U.S. Treasury notes totaling DM 800 million and had recourse to their creditor position within the IMF—drawing $540 million on November 26 and, on December 9, an additional $550 million that represented their claims under the General Arrangements to Borrow. There were further heavy outflows in the second half of December, and Germany sold $500 million of gold to the U.S. Treasury on December 29.

STERLING

The unwinding of the speculative excesses of November 1968 had brought an improvement in sterling rates, but as the year 1969 began, the exchange markets continued to take a very cautious view of the future. Progress in reducing the U.K. trade deficit was slow and uneven during the winter months, and sporadic labor difficulties and tensions in the Mideast tended further to delay the return of confidence. In addition, increasing monetary restraint in the United States was quickly transmitted to the Euro-dollar market at the beginning of 1969 through the rapid rise in dollar placements with head offices by the European branches of U.S. banks. The contraseasonal upswing in Euro-dollar rates probably kept sterling from benefiting fully from the normal seasonal reflows of funds from continental centers, augmented on this occasion by the sizable outflows from Germany.

About mid-January Euro-dollar pressures eased temporarily, and

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as the market again expected favorable trade figures, buying of sterling picked up, only to taper off once more later in the month. Although the December trade results failed to measure up to expectations, the release in mid-February of sharply reduced deficit figures for January again gave a boost to the market, which was also encouraged by prospects for a considerable reduction in British Government domestic borrowing during the coming year. On February 27 the discount rate of the Bank of England was raised by 1 percentage point to 8 per cent, to help achieve the desired reduction in bank credit and to help insulate sterling from the pull of continuing high Euro-dollar rates.

The first quarter of the year, moreover, is generally favorable to sterling because of seasonal strength in the export trade of the overseas sterling area (OSA). Since most of the official sterling holdings of those countries are now guaranteed under the terms of the September 1968 arrangements, OSA countries were encouraged to retain rather than convert their sterling balances, thus strengthening the net demand for sterling in the markets. And with the London money market under tight official rein, foreigners tended to buy rather than borrow sterling.

In these circumstances, sterling was firm and the Bank of England was able to make substantial dollar gains. The British authorities used the dollar inflow to meet repayment obligations to the IMF and to begin repaying outstanding shorter-term indebtedness. By the end of March the Bank of England had reduced its drawings from the Federal Reserve by $50 million to $1,100 million. In addition, the bank had liquidated part of the credits drawn under the 1968 sterling balances arrangement.

Sterling remained seasonally strong in early April, and the Bank of England was able to make a further repayment of $150 million to the Federal Reserve. As the month wore on, however, the seasonal strength began to fade, and at midmonth the latest U.K. trade figures showed a smaller improvement than the market had expected, with imports remaining high. In this setting the Government's new budget stirred little market enthusiasm, despite general satisfaction with the further tightening of fiscal policy. To bolster the austerity program, the U.K. authorities provided for substantially increased taxes and an over-all surplus of more than £800 million for the fiscal year 1969-70.

Sterling was also adversely affected in late April by developments abroad. Euro-dollar rates had advanced to relatively high levels in March, and pressures in that market were intensified in April when the

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Federal Reserve Banks raised their discount rates and several continental European central banks followed suit. Moreover, in a number of countries, steps were taken to curtail capital outflows or to induce repatriations of funds. Throughout this period there was no incentive to move covered funds into London, and indeed little net incentive for users of sterling to build their balances above minimum levels.

In these circumstances, sterling was vulnerable to the uncertainties generated by President de Gaulle's decision to stake his presidency on the outcome of the April 27 constitutional referendum. Sterling weakened as the voting date approached, but there was no large-scale selling and official support costs were modest. The rate dropped sharply following the referendum and President de Gaulle's resignation, but demands for sterling for month-end payments absorbed most of the immediate selling pressure.

Just as the market was beginning to regain its equilibrium, a new wave of speculation on possible parity realignments was set off by reports of German official willingness to consider revaluing the mark as part of a broader readjustment of parities. As funds flowed from virtually every major center into Germany, sterling was particularly hard hit, with the familiar build-up of selling pressure in advance of the weekends. Over 10 days of hectic speculation, Bank of England support costs in the spot market were very large, while forward sterling discounts widened sharply. This episode, of course, interrupted the progress that the U.K. authorities had been making in reducing their external indebtedness, and the Bank of England had to draw on the swap line with the Federal Reserve to help cover market losses. At their peak, swap drawings reached $1,415 million.

Sterling had been very heavily oversold, however, and it rebounded sharply following the German Government's May 9 rejection of a revaluation of the mark. During the remainder of May and through June the Bank of England was able to make sizable reserve gains, despite the further upsurge of interest rates in the Euro-dollar market. The reserve gains once again were used to make repayments of debt under various international credit lines. By the end of June the Bank of England had reduced its outstanding drawings from the Federal Reserve to $1,025 million, $75 million below the end-of-March level. In addition, during May and June the United Kingdom made a large scheduled repayment to the IMF and liquidated the bulk of the credit still outstanding under the 1968 sterling balances arrangement.

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On the other hand, the Bank of England obtained new credit from the German Federal Bank under a recycling arrangement designed to neutralize part of the speculative flow from the United Kingdom into Germany, and it drew $500 million from the IMF under a new standby facility. On balance, the British authorities succeeded in making sizable net repayments of debts during the second quarter. In July a generally quieter atmosphere prevailed and the Bank of England further reduced its drawings on the Federal Reserve, to $815 million.

The basic situation was still of concern to the market, however, as the trade figures failed to show the expected gains and as hostilities in the Mideast intensified. Thus sterling was vulnerable to the uncertainties resulting from the devaluation of the French franc on August 8. Both spot and forward sterling rates dropped sharply, and pressures became substantial on August 13 with the release of figures showing an enlarged British trade deficit. Heavy market support was required for a few days, and the Bank of England drew $160 million on its swap line with the Federal Reserve. But once again, more sterling had been sold than the market could deliver, and as speculators paid high prices to cover short sales, the Bank of England recouped a significant part of its losses. Nevertheless, the underlying tone of the market remained pessimistic, and once the cash squeeze had ended, sterling again drifted down close to its floor and required modest support. At the end of August drawings on the swap line stood at $975 million.

This atmosphere persisted into early September, and on September 2 and 3 the Bank of England again drew on its swap line with the System. Thereafter, however, sterling recovered strongly, particularly following the release of data indicating that the United Kingdom's underlying balance of payments had been in substantial surplus during the second quarter. The approach of the German elections brought sterling under modest pressure, but the Bank of England had to make only a small additional drawing on its Federal Reserve swap line, bringing the total outstanding to $1,145 million. When the German mark was allowed to appreciate, sterling moved up smartly and the Bank of England resumed its dollar purchases. The bank then made repayments on the swap line, reducing drawings outstanding to $1,100 million at the end of September. It also liquidated the remainder of its commitments under the 1968 sterling balances arrangement.

The recovery continued throughout October, sustained by oil company purchases of sterling for tax and royalty payments, by the an-

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nouncement of the second consecutive monthly trade surplus, and by the rise in the market value of the German mark (which made further speculation in marks unattractive and induced some profit-taking). The spot sterling rate reached the $2.39 level by mid-October, for the first time since early August; it rose further in the second half of the month and fluctuated just below parity during most of the remaining 2 months of the year. At the same time forward sterling discounts narrowed sharply, the 3-month rate moving down to less than 1 per cent per annum from a range of 6 to 9 per cent in August–September.

The much improved tone of the market reflected a new confidence in the basic soundness of the U.K. balance of payments position, a belief that was bolstered by continued monthly trade surpluses and reserve gains as well as by the announcement that, in the third quarter, the United Kingdom had achieved its second consecutive quarterly surplus on current and long-term capital accounts. The renewed confidence led to a strong reversal of the unfavorable shift in commercial leads and lags that had occurred in late summer, and enabled sterling to remain firm even toward the year-end, when the very high levels to which Euro-dollar interest rates had advanced were exerting a considerable pull.

With this strong undertone in the market, the Bank of England was able to purchase dollars throughout the fourth quarter. Although U.K. reserves were allowed to increase moderately, the bulk of the reserve gains were used to repay debts to the United States, to other countries, and to the IMF. Thus, the Bank of England's swap drawings on the Federal Reserve were reduced by $450 million during the fourth quarter—$200 million were repaid in both October and November, and an additional $50 million in December—bringing outstanding drawings down to $650 million by year-end. Also during this quarter the U.S. Treasury and the Federal Reserve received scheduled repayments of borrowings associated with the June 1966 sterling balances arrangement, of which the System's share was $19.5 million.

FRENCH FRANC

The French franc had come under heavy speculative attack during the rush for German marks in November 1968, and the Bank of France had sustained large reserve losses in support of the franc. In the aftermath of that assault, the French Government had bolstered its defenses with anti-inflationary measures, $2 billion in new international credits,

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and reimposition of exchange controls. Late in 1968 and early in 1969 the exchange controls were tightened to require French commercial and banking interests to surrender substantial amounts of foreign exchange to the Bank of France. The French authorities used these exchange inflows partly to cover the large current deficit in the French balance of payments, but also to reduce their outstanding indebtedness under short-term international credits. Thus, by early March the Bank of France had cut its swap drawings from the Federal Reserve to $306 million from the November 1968 peak of $611 million and had repaid credits drawn from other members of the European Economic Community (EEC) and the BIS.

As these induced reserve inflows tapered off, however, the current-account deficit again began to drain French official reserves. Apart from the weakening reserve position, a number of background factors were cause for continuing concern. Inflationary pressures were still in evidence, and large unresolved wage demands were a potential threat to France's international competitive position. At the same time, recalling the November 1968 Bonn conference, the market remained fearful of a possible currency realignment involving both the German mark and the French franc. These uncertainties kept the franc market off balance, and in spite of tight exchange controls, the franc remained in an exposed position.

New fears of devaluation emerged on March 6 when the French trade union leadership backed up its wage claims by calling a general strike for March 11. The strike call triggered the heaviest burst of selling since November 1968. The devaluation scare receded almost as quickly as it had arisen, however, when the general strike was orderly and, as scheduled, lasted only one day. Although it appeared that the unions were not yet prepared to force the issue on wage claims that far exceeded the official guidelines, uncertainties persisted through the end of March and the official reserves were subjected to further erosion. Accordingly, the Bank of France made new drawings on the Federal Reserve swap line, raising its swap obligations to $461 million by the end of March, and sold $50 million of gold to the U.S. Treasury.

In early April the Bank of France was able to repay $25 million of its swap drawings from the Federal Reserve, but selling of francs soon resumed before the Easter holidays. Near the middle of April a new

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element of doubt suddenly was injected into the situation by President de Gaulle's decision to stake his political future on a constitutional referendum on April 27. At the same time, news of a large trade deficit in March underscored the difficulties involved in restoring the franc to a position of strength. Market tensions increased with the approach of the referendum date. The Bank of France met the pressure in both the Paris and New York markets, at heavy cost to its reserves.

As was to be expected, the news of President de Gaulle's referendum defeat and immediate resignation from office generated still heavier selling pressure on April 28. The selling soon began to fade, however, as it became clear that France's calm response to President de Gaulle's withdrawal from office presaged an orderly transfer of governmental authority. Moreover, the market quickly concluded that no official decision on the franc parity was likely before the formation of a new government in June.

Just as the uncertainties in the franc market were receding, new speculation on a possible revaluation of the German mark and adjustments in other currency parities burst upon the markets. The franc again came under heavy pressure and forward franc rates declined precipitously. The speculative fever abated after the German Government announced on May 9 that it would not revalue the mark, and thereafter the spot franc moved from its floor and the Bank of France began to recoup some of its losses.

Although the latter part of May was a quieter period for the franc, the impending presidential elections, scheduled for June 1 and June 15, aroused renewed uneasiness. Mr. Georges Pompidou's impressive victory was seen by the market as assuring the continuity of stable government in France, but there remained an overriding concern for the viability of the parity. Sharply rising Euro-dollar rates also aggravated the strain on the franc. On June 13 the Bank of France reinforced the authorities' anti-inflationary program by raising its basic discount rate a full percentage point to 7 per cent. Even so, during June the franc required further sizable official support.

In view of the heavy strain on official reserves, the Bank of France made substantial drawings during the second quarter on the international assistance available under the November 1968 package, including the full $200 million provided by the U.S. Treasury. France

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also sold $275 million of gold to the U.S. Treasury in the second quarter. In order to avoid an undue prolongation of credits outstanding under the Federal Reserve swaps, the Bank of France used part of the proceeds of these gold sales, and some of the new drawings on the November 1968 credits, to liquidate its obligation to the System. During the second quarter the Bank of France repaid the $461 million outstanding on the swap line—restoring the $1 billion facility to a fully available standby basis.

The underlying situation remained unchanged as the summer progressed. Although the exchange market received favorably the new cabinet appointments of President Pompidou and the vacation period contributed to quieter markets, the franc remained weak. Faced with a continuing attrition of official reserves, the French Government announced on August 8 that it had decided to devalue the franc, rather than impose too severe a deflation on the French economy. The 11.1 per cent devaluation, to a new parity of $0.180044, had been discussed at the Group of Ten meeting of Finance Ministers in November 1968 at Bonn and was judged to be within the limits that could be accommodated by the existing framework of exchange rates.

Explaining the reasons for the devaluation, the French Minister of Finance and Economic Affairs, Mr. Giscard d'Estaing, noted that French reserve losses had averaged $500 million a month in the second half of 1968 and $300 million a month in the first half of 1969. Thus, France was faced with the prospect of seeing its reserves dwindle to practically nothing by the end of the year. Moreover, he said, further defense of the former par value would have left the franc overvalued and France with a weak competitive position in world markets. The Minister made clear that devaluation would be backed up by a further tightening of economic policy and by continuation of exchange controls. For the rest of the month of August the franc held firmly above its new par and the Bank of France began to accumulate dollars as a steady reflow of funds to France developed.

At the end of August the French Government announced that it had $1.6 billion of international credits available and was applying to the IMF for a standby credit of $985 million. In support of the devaluation, the authorities strengthened their austerity program in early September with further curbs on consumer credit, closer limitation of bank lending, measures to encourage savings, and substantial cuts in public spending. A temporary price freeze imposed immediately

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after devaluation was replaced by strict official surveillance of domestic prices. Minister Giscard d'Estaing declared that the new measures were designed to bring the French trade balance into equilibrium by July 1, 1970.

These measures at first met with a rather lukewarm reception in the exchange market, since even more severe action had been expected, and the French franc tended to weaken early in September in both spot and forward markets. It came under increasing pressure later that month as renewed labor militancy and several major strikes added to the uncertainties generated by the approaching German elections. The franc remained under pressure through mid-October, even after the German mark had been allowed to appreciate considerably above its old ceiling, because the market remained disturbed by France's large current-account deficit and by its labor situation. As a consequence, the Bank of France had to provide substantial support to the spot market throughout this period. On September 25 the Bank of France reactivated its swap line with the Federal Reserve—drawing $65 million to help cover recent market losses; this credit was repaid the following day with the initial $500 million takedown on France's standby agreement with the IMF.

A clear improvement began after mid-October. By the end of that month the spot franc was firmer and—although forward discounts remained relatively large—the Bank of France was purchasing dollars almost every day. While reflows of funds from Germany provided the initial strength, it is now clear that the firming of the spot franc reflected the improved underlying situation as well as both tight domestic credit conditions and a change in market sentiment. Several measures underscored the French authorities' resolve to restrain the growth of domestic demand: The Bank of France raised its basic discount rate from 7 per cent to the exceptionally high level of 8 per cent on October 8; the Government approved a very tight budget for 1970; and it was announced that bank credit would not be permitted to expand between December 1969 and June 1970.

This significant stiffening of French economic policy was well received by the market and the atmosphere was also improved by Finance Minister Giscard d'Estaing's reaffirmation of his confidence that France's trade deficit would be eliminated by mid-1970. The release of trade figures that showed considerable progress in October and November reinforced that forecast.

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Benefiting from the shift in sentiment, as well as from the very taut credit conditions in France, the spot franc remained firm in November and the first half of December while forward rates strengthened markedly. The franc rose sharply toward the close of the year, bolstered by corporate purchases for year-end needs. In November and December the Bank of France more than recouped its losses of the two previous months and used the major portion of these gains to repay short-term international debts and maturing foreign exchange deposits of French commercial banks.

BELGIAN FRANC

At the beginning of 1969 outflows of funds to the Euro-dollar market put the Belgian franc under some pressure, and the National Bank of Belgium provided support for the franc rate. To cover the consequent reserve losses, it made use of its swap line with the Federal Reserve, drawing a net of $33 million during January and raising its swap debt to the System to $40.5 million. A temporary easing of market pressures in February enabled the Belgian authorities to repay $27.5 million of these drawings, but by late March they again had to support the franc as the outflow of funds accelerated. On March 31 drawings of the National Bank of Belgium on the Federal Reserve stood at $23 million.

With little prospect that the demand for funds in the Euro-dollar market would soon abate, and with domestic credit expanding at an excessive rate, the National Bank of Belgium raised its discount rate in two steps in March and April to 5½ per cent. In addition, to relieve pressures on the franc rate, the authorities instructed the Belgian banks to reduce substantially their net foreign asset positions in several stages by the end of June. These measures were followed by an immediate firming of the franc, and by late April the rate had advanced to par.

But the strength was short-lived, as the worldwide rush for marks in early May generated heavy sales of francs along with other currencies. The spot rate declined sharply, and the National Bank of Belgium sold large amounts of dollars to support the spot franc at its floor. The National Bank covered the heavy losses by further drawings on the Federal Reserve swap line. Although pressures eased after the German Government rejected a mark revaluation, there was no important immediate reflux of funds, and at mid-May the National

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Bank's outstanding obligations under the swap line stood at $175.5 million. During the month the swap facility was increased by $75 million to $300 million.

Subsequently, as the exchanges calmed further, the Belgian franc began to strengthen. Although there were occasional moderate outflows to the Euro-dollar market through shifts of nonbank funds, the franc was reasonably well insulated from the heavy pressures in that market in May and June by the directive regarding the commercial banks' foreign asset positions. In late April, moreover, the National Bank of Belgium placed ceilings on the credit expansion and rediscount privileges of commercial banks and, on May 29, raised its discount rate by a further ½ percentage point, to 6 per cent. The National Bank was able to purchase sufficient exchange to reduce its outstanding swap obligation to the Federal Reserve by a net of $61.5 million to $114 million by the end of June.

The franc generally stayed firm in July as Euro-dollar rates eased and there was also a modest commercial demand for francs, but market conditions did not permit significant reserve gains by the National Bank. At the end of the month the authorities moved further to reinforce both the curbs on domestic monetary expansion and the efforts to reduce capital outflows. The National Bank raised its discount rate by a full percentage point to 7 per cent and abolished its preferential discount rates for export credits extended by Belgian banks to countries outside the EEC. These preferential rates had tended to shift financing of other countries' trade to Belgian financial markets rather than to stimulate Belgian exports and consequently had added to the strain on the franc.

By this time the National Bank had been making use of the Federal Reserve swap facility to some extent for a period of 10 consecutive months. In keeping with the principle that whenever possible the use of central bank credit should not be unduly prolonged, the Belgian authorities decided to utilize some of the resources previously accumulated by them with the IMF to repay the swap drawings. Consequently, the Belgians drew $116.5 million from the IMF, representing the credit available to Belgium as a result of IMF use of Belgian francs under the General Arrangements to Borrow plus part of the Belgian gold tranche. The National Bank used nearly all the proceeds to liquidate completely its $114 million swap obligation outstanding to the

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Federal Reserve. The $300 million facility then reverted to a standby basis.

Devaluation of the French franc on August 8 raised widespread market rumors that the Belgian franc might also be devalued. Under renewed pressure, the spot rate dropped to its floor, and in the first week following the French move the National Bank of Belgium suffered substantial reserve losses. To cover the drain, the National Bank reactivated its swap line with the System, drawing a total of $244 million out of the $300 million then available. A calmer atmosphere soon emerged, however, as the market came to appreciate the strength of Belgium's underlying balance of payments position. The franc strengthened markedly and the authorities began to recoup some of the reserve loss. In late August Belgium repaid $20 million of the outstanding drawings, reducing the total to $224 million. Meanwhile, negotiations had been completed for an increase in the reciprocal credit facility with the Federal Reserve by $200 million to $500 million and this was put into effect on September 2. The National Bank of Belgium simultaneously obtained a new $100 million equivalent credit facility from the German Federal Bank.

The Belgian franc began rising sharply in September, despite growing speculation in German marks. The improved tone of the franc was especially pronounced after midmonth when the Belgian authorities announced a number of anti-inflationary measures: The introduction of the value-added tax, scheduled for January 1, 1970, was postponed for another year so as to avoid further increases in domestic prices, while the National Bank raised its discount rate another ½ percentage point to 7½ per cent, effective September 18, and tightened quantitative credit restrictions. Supported by these domestic measures and the increased availability of foreign official credit, the franc firmed toward the end of September. As the rate strengthened, the National Bank purchased dollars in the market, enabling it to repay $20 million of outstanding drawings on its swap line with the Federal Reserve System by the end of the month.

As soon as the German mark was allowed to rise above its ceiling, the exchange markets again demonstrated their capacity for abrupt changes; the Belgian franc suddenly was seen as a candidate for revaluation along with the mark only 2 months after it had been subjected to heavy speculative selling. The spot rate moved to parity

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early in October and rose to its ceiling later that month, while the National Bank made increasingly large market gains. The speculation reached its climax on Monday, October 27, the first business day after the German revaluation. The next day the Belgian Government stated firmly that the franc would not be revalued, and the speculation died down. By that time the National Bank had acquired an amount of dollars more than sufficient to repay in full during the course of October its remaining $204 million swap indebtedness to the Federal Reserve.

Even after the speculative outburst had ended, however, the demand for francs remained very strong. Commercial leads and lags, which had moved sharply against Belgium in August and September, were being reversed in subsequent months. Credit conditions, moreover, remained very tight, causing short-term funds to flow in. With the spot rate not far from its ceiling, the National Bank took in dollars from time to time throughout the rest of 1969. In order to provide cover for some of these dollars, the Federal Reserve reactivated its swap line with the National Bank, drawing a total of $55 million equivalent in November and December.

DUTCH GUILDER

Early in 1969 there was a net inflow on current-account transactions into the Netherlands, but the spot guilder rate fell below par as short-term funds flowed to the relatively high-yielding Euro-dollar market. At the beginning of March the Dutch money market tightened, and on March 6 the flare-up of currency fears strengthened the guilder along with the mark, and the Netherlands Bank purchased dollars to slow the advance in the spot rate. On March 12 the Federal Reserve drew $40 million equivalent of guilders from the Netherlands Bank and used the guilders to purchase an equivalent amount of dollars from that bank. This was the first Federal Reserve use of the swap line since April 1968.

The flurry of demand for guilders soon ended and the market calmed; with Euro-dollar investments becoming increasingly attractive, the spot guilder eased once again. Outflows of funds from the Netherlands were small, however, since the domestic money market was still tight. In early April, liquidity conditions in Amsterdam eased and short-term capital outflows increased. The Netherlands Bank sold dol-

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lars in support of the spot guilder rate, and then it replenished its dollar balances by selling $20 million equivalent of guilders to the Federal Reserve. The System used the guilders to reduce its outstanding swap drawings from the Netherlands Bank to $20 million equivalent.

Although the pressure on the guilder reflected mainly the high interest rates in the Euro-dollar market, inflationary price increases in the Netherlands also began to threaten the guilder's underlying position. Accordingly, on April 8 the Dutch Government imposed a price freeze, and the Netherlands Bank announced a ½ percentage point increase in its discount rate to 5½ per cent, both to reinforce domestic anti-inflationary policies and to reduce the incentive to move Dutch funds abroad. Following these measures, the guilder market generally remained in equilibrium in the latter part of April, and the Netherlands Bank discouraged covered outflows through modest swap purchases of dollars against forward sales, thus widening the forward premium on the guilder.

Near the end of April and in early May, however, the new eruption of mark revaluation fears began pulling funds out of the Netherlands. On May 8 the spot rate dropped to its floor, and the Netherlands Bank provided support that day as the rush for marks reached major proportions. Following the German Government's announcement on May 9 that the mark would not be revalued, speculative pressures lifted throughout the exchanges and the spot guilder moved up from its floor.

The support operation had reduced the dollar position of the Netherlands Bank, which then replenished its holdings by selling the System $20 million equivalent of guilders. This enabled the System to liquidate completely its outstanding swap drawing from the Netherlands Bank, and on May 12 the entire facility reverted to a standby basis. Meanwhile, consultations had been taking place among the Federal Reserve, the Netherlands Bank, and the National Bank of Belgium with a view to restoring the previous equality of the Federal Reserve swap lines with those two banks. On May 15 the System's swap facility with the Netherlands Bank was lowered by $100 million to $300 million while the line with the National Bank of Belgium was increased from $225 million to $300 million.

Higher Euro-dollar rates brought renewed selling of guilders starting at the end of May. With Euro-guilder rates at relatively low levels, there was an incentive to borrow in guilders; as funds flowed out of the

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Netherlands through such transactions, the spot rate again declined to its floor during the early part of June. As a result, the Netherlands Bank was obliged to provide a substantial amount of support and by June 12 found it necessary to draw upon its swap facility with the System. Selling pressure on the guilder continued through June, and by the end of the month the bank's outstanding swap drawings on the Federal Reserve had reached a total of $82.2 million.

Accordingly, in early July the Dutch authorities took measures to prevent the pull of interest rates abroad from imposing a prolonged strain on local interest rates, domestic liquidity, and official reserves. The Netherlands Bank requested that during the latter half of 1969 the Dutch commercial banks reduce their net foreign exchange positions by 10 per cent from either the March–April average or the levels reached in May 1969. Nevertheless, the pressures continued, and with the guilder requiring further official support, the Netherlands Bank drew again on the swap facility.

In the latter part of July the pressure on the spot guilder began to ease, as Euro-dollar rates dropped and Euro-guilder rates rose to levels that discouraged further shifts of liquidity into dollars. At the same time Dutch commercial banks began to repatriate funds in compliance with the earlier official request, thus adding to the demand for guilders. The spot rate consequently was firmer and the Netherlands Bank's support operations tapered off. The Netherlands Bank, however, delivered a sizable amount of dollars to the market in connection with maturing forward contracts, and it drew further on the swap facility with the System to replenish its reserves. By the end of July outstanding drawings by the Netherlands Bank on the Federal Reserve swap line had reached a total of $192 million.

On August 1 the Netherlands Bank announced an increase in its discount rate by ½ percentage point (to 6 per cent) and in its other rates by 1 percentage point as an adjustment to the rise of domestic and foreign interest rates. Following these increases, the spot guilder moved up sharply, as the higher interest rates in the Netherlands further discouraged outflows of funds and as commercial bank repatriations under the July directive continued. With seasonal strength in the balance of payments also exerting an influence, the spot guilder soon moved above par, and the Netherlands Bank began adding to its reserves. Later in the month the Netherlands Bank repaid $82.2 million in drawings outstanding on the swap facility, thereby reducing the

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amount outstanding to $109.7 million. During the remainder of August and in early September the market was quiet and the guilder was firm.

In mid-September the Dutch Government, after having lifted the general price freeze earlier in the month, reinforced its anti-inflationary program. In the same month agreement was reached between the Netherlands Bank and the commercial banks to reduce further their net foreign asset positions to the average of the first 9 months of 1968. As September proceeded, market nervousness over the outcome of the German elections built up, giving rise to further demand for guilders.

At the end of the month, as the German Federal Bank suspended its intervention margins for the mark, buying of guilders intensified, and inflows into the Netherlands became increasingly heavy through October. With the mark rate well above its old ceiling, there was no longer an incentive to move funds into Germany and, more importantly, the market widely expected that the guilder, the only currency to be revalued along with the mark in 1961, would again follow suit. The Netherlands Bank at first held the spot rate just below the ceiling, but later allowed the rate to move up to that level. By October 24, the inflow into Dutch reserves during the period of the "floating" mark had reached $785 million. Part of these gains had been used to liquidate by October 8 the $109.7 million commitment outstanding under the Federal Reserve swap line. In order to provide cover for some of the Netherlands Bank's additional dollar intake, the System in turn subsequently reactivated the swap arrangement, drawing the full $300 million equivalent of guilders available under it, and sold guilders from balances to absorb a further $5 million. In addition, on October 29 the U.S. Treasury covered $200 million of the intake through a special 1-week swap with the Netherlands Bank.

On the same weekend that the mark was formally revalued, the Dutch Government made known its decision not to revalue the guilder. The spot rate then quickly moved away from its ceiling as speculative positions were unwound. By November 5 the Netherlands Bank had sold slightly more than one-third of the dollars it had purchased in October. Consequently, the U.S. Treasury had no difficulty in repaying its swap, and the System repaid $70 million equivalent of its commitments on November 6—reducing its outstanding swap commitments in guilders to $230 million.

More normal trading activity prevailed throughout November, with the spot rate remaining fairly strong as local interest rates tended to

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rise. The domestic money markets were further tightened by the rise in the amount of penalty deposits to be held at the central bank by those commercial banks that had exceeded the designated expansion of credit in earlier months. In addition, several new issues on the Dutch capital market strained liquidity positions and attracted funds from abroad. During November the measures to reduce the commercial banks' net external position were put on a standby basis and banks were again permitted, within certain limits, to increase their net foreign assets. With trading in guilders generally balanced, the Federal Reserve was able to repay a further $30 million equivalent on its swap debt, using guilders purchased from the Netherlands Bank after that bank had converted into dollars guilders that Germany had obtained as part of an IMF drawing at the end of the month.

Early in December domestic liquidity positions became somewhat easier, especially after the penalty deposits to be made in mid-December were sharply reduced. As a consequence, funds moved to the Euro-dollar market where interest rates were rising rapidly, and the spot guilder began to weaken. At times the Netherlands Bank provided support to ease the decline in the rate. The dollar losses of the Netherlands Bank enabled the System to repay a further $70 million equivalent of its swap debt, reducing its outstanding commitments in guilders to $130 million equivalent by the year-end.

SWISS FRANC

In early 1969 the seasonal reflux of funds from Switzerland was reinforced by the pull of high interest rates in the Euro-dollar market. The Swiss franc rate declined and the Swiss National Bank sold a large amount of dollars, providing the Federal Reserve with the opportunity to purchase $190 million equivalent of francs from the National Bank. The System used the francs to repay part of its outstanding swap indebtedness to that bank of $320 million equivalent. Additional repayments were made with $75 million equivalent of francs obtained through U.S. Treasury issues of Swiss franc securities to the Swiss National Bank and the BIS and with $15 million of francs from balances. (At the same time the Swiss National Bank purchased $25 million of gold from the Treasury.) Thus, by the end of February, the System had reduced its Swiss franc swap drawings to only $40 million equivalent.

The flow of excess liquidity from Switzerland tapered off by early

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March, however, and the Swiss franc strengthened steadily. The rate did not reach its official ceiling until late in the month, when the Swiss commercial banks began to repatriate funds to cover their usual quarter-end needs, but at that point the Swiss National Bank took in $244 million. Despite the strong pull of Euro-dollar rates, there was little reflow of funds after the quarter-end. In these circumstances a special transaction was required to liquidate the residual $40 million obligation outstanding under the swap line. On April 29 the U.S. Treasury issued to the Swiss National Bank a 15-month, Swiss franc-denominated note equivalent to $39.5 million. The Treasury sold the francs to the System, which used them, together with a small amount of francs from balances, to liquidate the swap. On April 30, however, in view of the eruption of new uncertainties regarding currency parities, the Swiss National Bank requested the System to reactivate the swap line to provide cover for $100 million of the funds that had come into its reserves at the end of the first quarter.

In early May the rush for German marks began pulling funds from Switzerland, and as the franc rate declined, the Swiss National Bank sold a small amount of dollars. These pressures subsided when the German Government rejected a revaluation of the mark, but the pull of the Euro-dollar market on Swiss franc funds grew stronger during the remainder of May. As the Swiss franc weakened, the Federal Reserve was able to accumulate a small amount of francs in market transactions, and it reduced its outstanding swap obligation by $5 million equivalent to $95 million on May 28.

Swiss banks added substantially to their Euro-dollar assets during June, offsetting the large Swiss balance of payments surplus on current account. At midyear, in particular, the heavy pull from the Euro-dollar market had a strong effect on Swiss banks' portfolio decisions, as the banks preferred to reduce their seasonal repatriation of funds rather than forego the high yields on Euro-dollar placements. Moreover, the Swiss National Bank, while again offering market swap facilities to bridge the quarter-end, limited such facilities to no more than $250 million. For the balance of their liquidity needs the Swiss banks rediscounted an unusually large volume of eligible paper with the central bank. Following past practice, the Swiss National Bank rechanneled to the Euro-dollar market the dollar proceeds of its market swap purchases of dollars, so that over-all there was no drain on the Euro-dollar market from the midyear positioning of the Swiss banks.

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Throughout July the Swiss franc market was quiet, and during the month the Federal Reserve liquidated completely its outstanding $95 million swap drawing on the Swiss National Bank. Against the background of generally calm exchange markets and some Swiss Government need for dollars, the System purchased a total of $60 million equivalent of francs directly from the Swiss National Bank and obtained $30 million of francs from the U.S. Treasury, which had issued to the Swiss National Bank a Swiss franc-denominated certificate of indebtedness for the same amount. Most of the remaining $5 million Swiss francs needed to repay the swap drawing were acquired in the market. On July 17 the entire $600 million facility with the Swiss National Bank reverted to a standby basis.

Trading in Swiss francs remained quiet in August, with only a minimal reaction to the devaluation of the French franc. The spot rate continued very strong but held below the ceiling, and there was no need for official intervention. Late in the month—in view of increasing pressures on the labor supply, industrial capacity, and prices—the Swiss authorities began to move toward a more restrictive policy stance. An understanding was worked out with the commercial banks to limit domestic credit expansion to 9 per cent over the coming year, and the Swiss cantons and municipalities were requested to hold back on their expenditures. In mid-September, in response to rising interest rates at home and abroad, the Swiss National Bank raised its discount rate by ¾ of a percentage point to 3¾ per cent and its "Lombard" rate on secured advances by a full percentage point to 4¾ per cent. The Swiss National Bank also advised the commercial banks that it would undertake no September-quarter-end swaps and that discount facilities would be limited. Accordingly, it requested the banks to repatriate funds from abroad to meet their liquidity needs.

With domestic credit conditions beginning to tighten and the Swiss banks meeting their quarterly requirements in large part through the repatriation of funds, the franc rate was pushed to its ceiling and the Swiss National Bank took in a substantial amount of dollars. The Federal Reserve consequently reactivated its swap facility with the National Bank on October 10, drawing $200 million equivalent of francs to absorb most of that bank's dollar holdings. After the quarter-end, however, the pull of high Euro-dollar interest rates began to draw funds out of Switzerland and the franc soon began to weaken, reaching an 18-month low on November 6. During this period the Federal Reserve

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acquired small amounts of Swiss francs in the New York market and from a correspondent and on November 10 repaid $25 million equivalent of its swap debt to the Swiss National Bank.

Although there had been considerable press and market discussion of the possibility of a Swiss franc revaluation linked to a large revaluation of the German mark, there was no speculative rush into francs when the mark parity was changed. In mid-November a flurry did occur, however, and the spot rate advanced sharply, but the rumors were quickly dispelled by a reaffirmation of the Swiss Government's decision not to revalue the franc.

The franc began to firm again in the second half of November, reflecting largely the usual year-end demand. As in previous years, to help the commercial banks cover their year-end liquidity requirements, the Swiss National Bank offered market swaps of Swiss francs against dollars. These swaps, the first of which were contracted in early December, totaled $793 million by the end of the month—a record amount—and helped keep the spot rate below its ceiling. As in the past, the Swiss National Bank returned the dollars thus acquired to the Euro-dollar market so as to neutralize the effects of the year-end withdrawals on that market. On December 30 the System repaid a further $30 million equivalent of swap debt, using mainly francs purchased in the market in the latter part of November and early in December. The Federal Reserve's outstanding Swiss franc swap commitment was thereby reduced to $145 million equivalent.

ITALIAN LIRA

During the early months of 1969 the upward surge of interest rates in the Euro-dollar and Euro-bond markets resulted in heavy capital exports by Italy. Moreover, domestic political uncertainties spurred additional outflows of funds, particularly through the export of Italian bank notes. Italian lire consequently were heavily offered in the foreign exchange markets, and the Bank of Italy provided substantial support for the lira while allowing the rate to drop sharply below par.

In view of the continued outflow from Italy during the early spring, the Italian authorities took several steps to protect the official reserves and to alleviate the growing strain on domestic capital markets. Italian banks were asked to repatriate by midyear an amount of foreign exchange equivalent to their net foreign assets (then about $800 million).

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Steps were taken to discourage long-term investment abroad, and the authorities moved to reduce excess domestic liquidity and to align Italian interest rates more closely with those prevailing elsewhere.

The cumulative impact of these measures and the beginning of the tourist season brought the lira rate above par by late April, and the Bank of Italy purchased some dollars. The recovery ended in early May, however, with the renewed speculation on the mark. Italian residents joined the rush into marks and also sold lire in order to cover the commitments in German marks, and to some extent in Swiss francs, that they had undertaken because of relatively low interest rates in Germany and Switzerland. The spot rate dropped to its official floor and the Bank of Italy provided substantial support through May 9.

Once the speculation in marks subsided, the lira market improved, and during late spring and early summer there was some reflow from Germany. This reflow, combined with repatriations of funds by Italian banks acting under the official request to eliminate their net foreign asset positions, more than offset the further capital outflows via export of Italian currency. Effective July 1, the Bank of Italy reinforced its defensive measures by imposing a penalty rate 1½ points above its discount rate of 3½ per cent for banks making excessive use of central bank borrowing.

New uncertainties unsettled the lira market with the fall of the Italian Government in early July. Despite the subsequent formation of a new government, a strong undercurrent of apprehension persisted. When the French franc was devalued, the lira dropped to its floor, and during the next few days of exchange market uncertainties lire were offered in heavy volume, with the Bank of Italy extending sizable support. On August 14 that bank raised its discount rate to 4 per cent, and as the speculative pressures subsided, the lira firmed. It held well above the floor through the end of August, and the Bank of Italy was able to take in dollars. The Italian authorities also replenished their dollar balances that month by encashing prior to maturity a $100.2 million equivalent lira note issued by the U.S. Treasury to the Italian Exchange Office in late 1968 in conjunction with the understanding with Italy on the neutralization of U.S. military expenditures.

At the beginning of September, however, the lira came under renewed pressure as sporadic strikes presaged difficult wage negotiations and possibly inflationary settlements late in the year, when large

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labor contracts were due to expire. Moreover, with the German elections approaching, Italian residents who had commitments outstanding in German marks and Swiss francs moved quickly to cover themselves by buying these currencies. The lira dropped to its floor, and the Italian authorities had to provide substantial support to the market. To cover market losses, the Bank of Italy activated its swap line with the Federal Reserve on September 23, drawing $300 million. Under these circumstances, the U.S. and Italian authorities agreed that it was appropriate to terminate the U.S. Treasury's remaining technical forward lira commitments that had arisen in connection with dollar-lira swaps extended by the Italian Exchange Office to its commercial banks. Consequently, these commitments were reduced progressively during the autumn, and by the end of November they had been fully liquidated.

Although the lira remained at the floor in early October, pressures eased considerably as soon as the German mark was permitted to appreciate. By midmonth a firmer tone had set in as the unwinding of mark positions got under way. With repatriations from Germany continuing, the lira moved close to its parity by the middle of November. During this period the Bank of Italy was a frequent purchaser of dollars, and on November 14 it repaid its outstanding $300 million commitment to the Federal Reserve. Thus, at the year-end the swap line was again fully available.

CANADIAN DOLLAR

Canada's trade position remained relatively strong in 1969—though the surplus was less than in 1968—and Canadian residents continued to borrow heavily in the U.S. capital market. Throughout much of the year, however, the Canadian dollar, like other major currencies, was increasingly affected by short-term capital outflows in response to the high and rising level of interest rates in the United States and in the Euro-dollar market. By mid-February the Canadian dollar had moved down from its effective ceiling and the Bank of Canada had provided a small amount of assistance. As of March 3 the Bank of Canada raised its discount rate by ½ percentage point to 7 per cent in order to reduce the incentive to move funds abroad and to combat the strong demand for bank credit in Canada.

One major channel for these outflows was through the so-called "swapped deposits" with Canadian banks. In these transactions, de-

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posits in Canadian funds are converted into U.S. dollars on a covered basis. Using the dollars thus obtained, Canadian banks acquired a substantial amount of short-term assets directly from U.S. banks in forms not subject to Regulation Q. Some of the U.S. dollar proceeds also were invested in the Euro-dollar market, although placements were limited by Canadian official directives issued in 1968 (in conjunction with Canada's exemption from all U.S. balance of payments programs) to prevent Canadian financial institutions from acting as a "pass-through" channel for U.S. resident funds.

The pull of abnormally high yields on U.S. dollar instruments not subject to Regulation Q contributed to a sharp rise in outstanding swapped deposits during the spring and summer months. The large short-term outflows from Canada resulting from these transactions and other Canadian investments abroad were largely offset by a surplus on current and long-term capital accounts combined and by short-term capital inflows from the United States. American investors, seeking outlets not subject to Regulation Q and discouraged by the U.S. balance of payments program from taking advantage of the high rates available in the Euro-dollar market, moved short-term funds to Canada.

Such investments were attractive because the covered outflows from Canada generated equally heavy demand for Canadian dollars in the forward market, and as a result the forward rate moved out to a substantial premium. This premium increased the attraction of covered investments in Canada, where interest rates were rising not only in line with the increase in rates abroad, but also as a result of the tightening of Canada's anti-inflation program. This tightening included an increase of ½ percentage point in the Bank of Canada's discount rate to 7½ per cent on June 11.

By early July, however, the spot Canadian dollar had dropped below par as a result of the overriding effect of short-term capital outflows. To restrain such short-term outflows, the Bank of Canada asked the Canadian banks to regard the existing level of their swapped deposits as a temporary ceiling and, effective July 16, announced a further ½ percentage point increase in its discount rate to 8 per cent. These measures sharply curtailed the outflow of short-term bank capital, and the spot rate quickly moved up above par.

The Canadian dollar remained above its parity throughout the rest of the year in orderly and uneventful trading. The rolling-over of a

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large amount of maturing swapped deposits temporarily depressed the spot rate in September and early October. However, the rate was soon pushed up sharply again by strong commercial demand. Furthermore, because the Canadian chartered banks had previously built up positions in U.S. dollars, they were able to accommodate the usual year-end demand for U.S. dollars without having much recourse to the spot market. This, along with tight monetary conditions in Canada, helped push the Canadian dollar to its effective ceiling ($0.9324) by the year-end. During this period of strength, the Bank of Canada did not intervene very actively in the market, making only modest purchases of dollars. For the year as a whole Canada's reserves, including the IMF creditor position, rose by $60 million, to $2,908 million.

OPERATIONS IN OTHER CURRENCIES

In January the National Bank of Denmark drew $25 million on the swap facility with the Federal Reserve; this drawing was repaid in March. Subsequently, the Danish krone was brought under pressure by sharply higher interest rates abroad, as Danish commercial firms shifted part of their borrowings from international to domestic markets. The National Bank suffered a sizable reserve drain in supporting the krone rate and in the latter part of April drew $50 million under the $100 million Federal Reserve swap arrangement.

Even greater outflows from Denmark occurred as speculation on the German mark developed in late April and early May. To bolster its reserves, the National Bank drew the remaining $50 million under the Federal Reserve swap facility and drew $45 million under the Danish gold tranche with the IMF. With the regular swap line with the Federal Reserve fully utilized, the U.S. Treasury provided a supplementary standby facility for $50 million. The Danish authorities also took several measures to stem the outflow, including a 2 percentage point increase in the discount rate to 9 per cent. Thus reinforced, the krone firmed after the end of the May crisis, and in June the National Bank of Denmark was able to repay the full $100 million of swap drawings on the Federal Reserve. In early October the swap arrangement was increased by $100 million to $200 million and the Treasury line was allowed to lapse. Substantial repatriations of funds followed the German mark revaluation, and as tight domestic credit

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conditions contributed to a resumption of commercial borrowing abroad, the krone firmed further. It traded around par through the end of the year, and the National Bank of Denmark made considerable reserve gains.

The Austrian National Bank also lost reserves during the international rush into marks and in late May drew $50 million under the Federal Reserve swap facility—its first drawing since the arrangement was established in 1962. During the summer tourist season the National Bank began to accumulate reserves, and in August it fully liquidated its $50 million swap drawing. In early October the Federal Reserve's swap arrangement with the Austrian National Bank was raised to $200 million from $100 million. Later in the month the revaluation of the German mark raised market expectations of an upward adjustment in the schilling parity. The Austrian National Bank took in some funds, but the inflow was soon reversed after the Austrian authorities indicated that the schilling would not be revalued.

At the same time that the swap facilities with Austria and Denmark were raised from $100 million to $200 million, a similar increase was made in the swap line with the Bank of Norway.

EURO-DOLLAR MARKET

As 1969 began, interest rates in the Euro-dollar market rose, despite the unwinding of year-end positioning, as major U.S. banks looked to that market to relieve liquidity drains imposed by large run-offs of CD's. The advance in rates gained new momentum following the ¼ percentage point rise in U.S. banks' prime loan rates to 7 per cent per annum on January 7. U.S. banks bid aggressively for Euro-dollars through their European branches, raising their takings to a new peak of $8.5 billion by the end of January. Meanwhile, market supplies were being augmented by further flows of funds from Germany and reflows from Switzerland, and there was some reversal of the heavy U.S. corporate repatriations just prior to the end of 1968. With demand for funds heaviest in the short-term maturities, interest rates for 1-month deposits advanced sharply, to nearly 8 per cent per annum in early January compared with 7 per cent per annum at the year-end.

In late January, however, the heavy flow of funds to the Euro-dollar market from Germany lessened temporarily, while French commercial banks soon began to withdraw funds from the market. Conse-

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quently, even though U.S. banks increased their borrowings through their foreign branches only a little in February, Euro-dollar rates moved sharply higher. Then early in March, in anticipation of higher demands for loans in connection with the March 15 corporate tax date, U.S. banks began to bid more aggressively for Euro-dollars and by mid-month their aggregate dollar borrowings through foreign branches had reached $9.7 billion. Euro-dollar rates, however, were not substantially affected; with the 3-month rate around 8½ per cent, funds were attracted from a great many money markets. Indeed, several European central banks increased their discount rates late in February and in March, as pressures on their reserves mounted and domestic short-term rates rose.

Meanwhile, the growing stringency in U.S. financial markets caused commercial banks in this country to raise their prime rates, on March 17, to 7½ per cent from 7 per cent. Moreover, in early April Federal Reserve discount rates were increased by ½ percentage point to 6 per cent and reserve requirements against demand deposits were raised. The impact of these measures was quickly transmitted to European money market centers, and three central banks followed the Federal Reserve move by raising their discount rates in April. Furthermore, in March the Italian authorities, and in early April the Belgian authorities, imposed restrictions on their commercial banks' net foreign asset positions—in effect requiring the banks to repatriate funds from the Euro-dollar market.

The fresh outbreak of speculative activity in the foreign exchange markets in late April and early May—especially the expectations of a revaluation of the German mark—put very strong pressures on the Euro-dollar market. As huge amounts of funds moved into marks and U.S. banks attempted to maintain the level of their Euro-dollar borrowings, Euro-dollar rates jumped sharply, with the call rate bid up to 10 per cent per annum by May 8. Following the German Government's rejection of a mark revaluation, rates declined briefly.

In June there was a heavy surge of borrowings by U.S. banks in the Euro-dollar market. During the first 3 weeks of the month, when the runoff of CD's was particularly severe, the liabilities of banks to their foreign branches rose more than $3 billion, to $13.1 billion, and generated extreme pressures on Euro-dollar rates. On June 10—the day after U.S. banks had raised their prime loan rates by a full percentage

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point to 8½ per cent—the Euro-dollar call rate rose to 11½ per cent and the 3-month rate was bid up to 13 per cent. The market withstood the high rates without serious dislocation, and rates eased somewhat once preparations for the mid-June U.S. corporate tax date had been completed.

Throughout this period there was evidence that a number of foreign central banks were making substantial placements in the Euro-dollar market, to which U.S. funds were also being drawn. Yet toward the end of the month, there were indications that U.S. corporations pulled substantial amounts of dollar balances and other foreign currency deposits out of Europe, only to redeposit these funds early in July following the month-end reporting date under regulations issued by the Commerce Department's Office of Foreign Direct Investments. At the same time, midyear window dressing by continental European commercial banks was on a much smaller scale than in past years.

In July U.S. banks' demand for Euro-dollars continued at a high level, though the increase in the banks' liabilities to their branches, which reached $14.4 billion on July 30, proceeded at a much slower pace than in June. Euro-dollar rates declined substantially throughout July, and by the end of the month call money was bid at 9 per cent and 3-month deposits at $10\frac{7}{16}$ per cent. The market continued to attract substantial amounts from several European financial centers, and additional central banks took steps to protect their domestic money markets and monetary reserves from the pull of high Euro-dollar rates.

The devaluation of the French franc on August 8 triggered new pressures in the Euro-dollar market. The 3-month Euro-dollar rate jumped to 11 per cent by August 12 and moved irregularly around that level through the rest of the month. The level of U.S. bank borrowings changed little, however, and at the end of August the liabilities of U.S. banks to their foreign branches stood at $14.7 billion.

In the light of the heavy reliance of some U.S. banks on Euro-dollar borrowings and the repercussions on foreign monetary reserves and financial markets, the Board of Governors took a series of measures in order to moderate the flow of Euro-dollars to U.S. banks. First, the Board amended Regulation D (which governs reserves of member banks) so as to eliminate a technical loophole that had led banks to increase their use of overnight borrowings of Euro-dollars. Subsequently, it amended Regulation M (which governs the foreign activi-

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ties of member banks) by placing a reserve requirement of 10 per cent on member bank liabilities to foreign branches in excess of the levels outstanding in a base period, and on U.S. assets acquired by foreign branches from their home offices. Also, Regulation D was further amended to establish reserve requirements against borrowings from nonaffiliated foreign banks.

These measures reduced the incentive for U.S. banks to seek Euro-dollar funds and encouraged them to look for other sources of funds. One alternative that many banks found attractive was the commercial paper market, and as Euro-dollar liabilities stabilized, commercial paper borrowings rose sharply during the summer months. In September U.S. banks' liabilities to their own foreign branches declined slightly, thus helping to bring about some easing of Euro-dollar rates for the shorter maturities: the 3-month rate declined to less than 11 per cent by September 17. After a sharp but brief recovery around the time of the German elections, the rates resumed their decline, and under the pressure of the heavy reflux of funds from Germany in October, they dropped below 9 per cent.

As the use of the commercial paper market by banks through the intermediary of bank-affiliated holding companies or subsidiaries grew, the Board of Governors became concerned that such borrowing might reduce the impact of monetary restraint. Consequently, the Board announced, on October 29, that it was considering an amendment to Regulation Q that would subject all such bank-related commercial paper to the interest rate ceilings that apply to large CD's. Moreover, in a separate but related action, the Board ruled that commercial paper issued by subsidiaries of member banks already is covered by existing provisions of Regulations Q and D.

The prospect of closer regulation of member banks' use of the commercial paper market was swiftly reflected in the Euro-dollar market, and this—in combination with the expectation of continuing tight credit conditions in the United States—contributed to a surge in interest rates from late October to mid-November. In December short-term rates moved even higher as banks attempted to maintain their Euro-dollar borrowings in the face of year-end repatriations of funds by U.S. corporations and foreign banks. By December 18 call money was at 11 per cent, the rate for 1-month deposits had reached 12¾ per cent, and that for 3-month funds 11$^{9}/_{16}$ per cent. After allowance

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for the 10 per cent marginal reserve requirement, the effective cost of 1-month Euro-dollars for U.S. banks that were above the ceiling of their base period at times reached 14 per cent, exceeding the record levels attained in June. However, during the last 2 weeks of December, as repatriations of funds by U.S. corporations preparing to meet their balance of payments guidelines reached yet a new year-end high, U.S. banks lost some $1.6 billion of Euro-dollar funds, bringing the level of their liabilities to their foreign branches to $13.0 billion. □

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Legislation Enacted

Interest on deposits; deposit insurance coverage; commercial paper as deposits; reserves against Euro-dollar borrowings; selective credit controls. By Joint Resolution approved September 22, 1969 (Public Law 91–71), Congress extended until December 22, 1969, the flexible authority of the Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board in regulating the maximum rates of interest or dividends payable by insured banks and savings and loan associations on deposit or share accounts. By Act of December 23, 1969 (Public Law 91–151), Congress further extended such authority until March 22, 1971.

The Act of December 23 also increased from $15,000 to $20,000 the insurance coverage of deposits insured by the Federal Deposit Insurance Corporation and of accounts insured by the Federal Savings and Loan Insurance Corporation.

Included among other provisions of the Act are explicit authorizations for the Board (1) to apply rate limitations and reserve requirements to commercial paper issued "directly by a member bank or indirectly by an affiliate of a member bank or by other means" and (2) to require member banks to maintain reserves against borrowings from foreign banks in a ratio up to 22 per cent.

By repealing certain provisions of the Defense Production Act of 1950, the Act of December 23 restored to the President authority to encourage representatives of all major sectors of the private economy to enter into voluntary agreements and programs furthering the objectives of the Defense Production Act, and it exempted participants from prosecution under the antitrust laws because of their activities in such programs. In addition, the Act empowers the President to authorize the Board to institute selective credit controls when necessary to curb inflation.

State taxation of national banks. An Act of Congress approved December 24, 1969 (Public Law 91–156), expands the authority of States to tax national banks. Certain limited expansion was effective immediately, and effective January 1, 1972, a national bank will, for the purposes of any State tax law, be treated as a bank organized under the law of the State within which its principal office is located. The Board is required to study the probable consequences of the latter provision

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and to report the results of its study to the Congress by December 31, 1970.

Salaries of members of the Board. Section 10 of the Federal Reserve Act was in effect amended by the Executive, Legislative, and Judicial Salary Recommendations included in the President's Budget Message to Congress on January 15, 1969. Those recommendations, in accordance with the Act of December 16, 1967 (Public Law 90–206), raised—effective March 1, 1969—the salary of the Chairman of the Board from $30,000 to $42,500, and the salary of each other member from $29,500 to $40,000. □

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Legislative Recommendations

Lending authority of Reserve Banks; "par clearance"; reserve requirements; purchase by Reserve Banks of obligations of foreign governments; loans to bank examiners. For several years the Board has urged enactment of legislation:

(1) to permit a member bank, subject only to regulations of the Board, to borrow on any security satisfactory to its Reserve Bank without the necessity of paying a higher rate of interest simply because the security does not meet statutory "eligibility" requirements for the basic rate;

(2) to require all federally insured banks to pay at par all checks drawn on them (without deducting "exchange charges");

(3) to establish required reserve-percentage ranges on a graduated basis according to the amount of a bank's deposits, regardless of its location, and to make such requirements applicable to all federally insured banks (rather than to member banks only);[1]

(4) to permit Reserve Banks to invest in obligations of foreign governments or monetary authorities that mature within 12 months and are payable in a convertible currency; and

(5) to permit federally insured banks to make home mortgage loans to bank examiners under appropriate statutory safeguards.

For the reasons stated in earlier ANNUAL REPORTS and reiterated in its ANNUAL REPORT for 1968, the Board again urges enactment of legislation to accomplish the recommendations outlined above.

Bank holding companies. Following its 1968 study of the problems presented by the trend toward the formation of one-bank holding companies, the Board on February 20, 1969, issued the following statement of principles with respect to amendments to the Bank Holding Company Act:[2]

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[1] In its ANNUAL REPORT for 1968 the Board submitted an alternative recommendation under which the Congress would establish only for member banks a system of graduated reserve requirements on the basis of the amount of a bank's demand deposits.

[2] Vice Chairman Robertson did not join in the statement. He issued a separate statement expressing his views as follows: "(1) [O]ne-bank holding companies should be brought within the coverage of the Bank Holding Company Act with-

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Statement of Principles

For several months the Board of Governors has been engaged in an intensive study of the problems presented by the recent trend in the formation of one-bank holding companies. The Board's deliberations have led it to adopt the following statement of principles with respect to possible amendments to the Bank Holding Company Act of 1956:

1. The Board believes that it is essential that one-bank holding companies be included within the purview of the Act.

2. The Board considers that under present circumstances the law should not permit a bank to become a part of a conglomerate organization. The unique characteristics of banks led the Congress in 1933 to separate banking from nonbanking businesses, and in 1956 to reinforce that policy by limiting the activities of multi-bank holding companies to the management and control of banks and closely related activities. The Board believes that this separation should be maintained.

It also believes, however, that, consistent with continued growth and development of a dynamic and increasingly complex economy, banks should be granted greater freedom to innovate new services and procedures, either directly, or through wholly owned subsidiaries, or through affiliates in a holding company system, subject to administrative approval of entry and acquisitions to prevent activities inconsistent with the purpose of the Act.

3. Certain kinds of activities in holding company systems are in the public interest if accompanied by proper safeguards against perverse consequences. In determining whether a particular activity by bank holding company organizations is consistent with the

out a 'grandfather clause' (although small one-bank holding companies might be given special consideration); and (2) some expansion of the powers of banks through subsidiary corporations or through collateral affiliates in a holding company system is justified; but (3) the most important consideration is that the administration of the Holding Company Act should be vested in one Federal agency to assure uniformity in its application, which is essential from the standpoints of the banking community, the Government, and the public." Governor Brimmer agreed with all elements of the Board's statement except item 7, regarding dispersal of authority among the three Federal bank regulatory agencies. He issued a separate statement indicating that "as a matter of principle . . . the administrative authority under the Bank Holding Company Act should be vested in a single agency."

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public interest, consideration must be given to whether the benefits of such affiliation outweigh the potential dangers at which the separation of banking from nonbanking businesses has been directed. Such benefits would include greater convenience to the public, increased competition, and gains in efficiency for the economy generally as well as for the holding company organization. The potential dangers which might result from bank affiliation with nonbanking businesses are undue concentration of resources, decreased competition, conflicts of interest leading to less equality in the availability of credit, and dangers to the soundness of the Nation's banking business.

4. The Board considers that one-bank holding companies and multibank holding companies should be afforded equal treatment under the law with respect to bank and nonbank acquisitions or approvals of *de novo* entry.

5. Bank holding companies should be allowed to enter certain nonbanking areas of activity, specified in statute or agency regulation, which would facilitate broader services for the public. Determinations by the appropriate banking agency would involve an evaluation of the benefits and dangers of such entry. Unless otherwise provided by law, entry by acquisition, purchase of assets, merger, consolidation, or otherwise should be on the basis of considerations similar to the competitive and banking factors contained in the present Act.[1]

6. The Board believes that it would be most effective for one agency (preferably the Board) to continue to administer the Bank

[1] Because of the risk of undue concentration of resources, an applicant proposing an acquisition involving a relatively large amount of nonbank assets would ordinarily bear a greater burden of proving that the acquisition was not contrary to the public interest.

Any expansion of bank holding company activities is predicated on the assumption that the economy generally will also benefit from the ability of such institutions to operate more efficiently in performing certain functions. However, it should be recognized that entry into new activities, particularly those that are financially related—whether *de novo* or by acquisition—raises the question of the effect on competition between bank and nonbank institutions. Preserving the viability of such competition may be of overriding importance. The probability of anticompetitive consequences appears greater in acquisitions of existing concerns than in *de novo* entry.

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Holding Company Act with respect to the holding companies themselves and with respect to the approval of acquisitions by the holding companies. Just as it believes the present system of a single agency determining the approval of new acquisitions by holding companies is proper, the Board believes that the approval for acquisition of subsidiaries by individual banks should be dispersed among the three bank regulatory agencies.

7. Alternatively, and less desirably, if the Bank Holding Company Act were to be amended so that administrative authority over bank holding companies would be dispersed among the three agencies which now share in the regulation of banks, dispersion might occur in the following manner:

(a) Vest authority over multibank holding company acquisitions of banks and of nonbanking activities in the Board.

(b) Disperse authority over one-bank holding companies in the three agencies with a requirement that regulations be jointly promulgated as to permitted nonbank lines of activity and containing guidelines as to acquisitions and mergers, which because of size, or market, or related activities would be presumed to be opposed to the public interest. These regulations would also be applicable to nonbank acquisitions by multibank holding companies.

8. Although one-bank holding companies should generally be subject to the Act to the same extent as multibank holding companies, one-bank holding companies in existence before the recent trend to their formation should be given special consideration. This would mean a qualified exemption for those companies with respect to which the Congress or the agency determines that the combination of bank and nonbank assets does not give rise to any significant extent to the evils at which the Act is directed.[2]

[2] There are various possible forms such an exemption might take: (1) exempting one-bank holding companies with relatively small bank and nonbank assets; (2) exempting one-bank holding companies in existence before the recent trend began (generally accepted as July 1, 1968) as long as they conduct no activities other than those conducted on the cut-off date and do not acquire (by purchase of assets, merger, consolidation, or otherwise) any interest in any other enterprise; (3) exempting such companies irrespective of their activities as long as they make no acquisitions; and (4)

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On April 18, 1969, before the House Banking and Currency Committee, Chairman Martin expressed the views of the Board on holding company legislation (H.R. 6778 and H.R. 9385), and Vice Chairman Robertson expressed his personal views. In response to the committee's request, the Board submitted the following proposed revision of Section 4(c)(8) of the Holding Company Act, including the following list of activities in which the Board considers a registered holding company should be permitted to engage through subsidiary corporations, with the safeguards specified:

(8) shares retained or acquired with the approval of the Board in any company that engages solely in one or more of the following activities:

(A) lending funds on its own account or for the account of others,

(B) acting as investment adviser,

(C) operating a diversified open-end investment company registered under section 8 of the Investment Company Act of 1940, if the shares of such company are sold at a public offering price that does not include a sales load and if any redemption fee or similar charge imposed with respect to such shares does not exceed 1 per cent of the value of the shares redeemed,

(D) leasing equipment, where the initial lease provides for payment of rentals that will reimburse the lessor for the full purchase price of the equipment,

(E) acting as insurance agent or broker where more than half of the premium income is derived from sales to customers who are also customers of a noninsurance subsidiary of the holding company,

(F) acting as insurer principally in connection with extensions of credit by one or more subsidiaries of the holding company,

(G) providing accounting or data processing services functionally related to banking,

(H) acting as fiduciary,

(I) originating, servicing and selling mortgage loans,

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exempting such companies irrespective of their activities or acquisitions but require agency approval of any acquisition.

NOTE.—This statement of principles is directed to the major issues involved in bringing one-bank holding companies within the coverage of the Bank Holding Company Act. Other amendments to the Act also merit favorable action by Congress. Among these are amendments (1) to bring partnerships within the coverage of the Act; (2) to broaden the Board's authority to determine that a company owns or controls a bank; (3) to give the Board jurisdiction over mergers where the resulting bank is a subsidiary of a multibank holding company; (4) to prohibit a bank from voting bank stock held in trust unless it has voting instructions from the beneficiary; and (5) to prohibit tie-in arrangements.

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(J) acting as travel agent or issuing travelers checks,

(K) making equity investments in community rehabilitation and development corporations engaged in providing better housing and employment opportunities for the low-income and moderate-income population, or

(L) performing any other activity that the Board has determined, after notice and opportunity for hearing, is functionally related to banking in such a way that its performance by an affiliate of a bank holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased competition, conflicts of interest, or unsound banking practices.

The Board shall not approve any retention or acquisition under this paragraph (8) except in accordance with regulations prescribed by it, which shall include guidelines taking into account any potential anticompetitive effects, and any other risks of undue concentration of economic resources in any market. Limitations on permissible activities may be established on the basis of any relevant factors, including the size of the bank holding company or its subsidiary banks, the size of the company to be acquired or retained, and the size of the communities in which such activities are to be performed. The Board shall not approve any retention or acquisition under this paragraph which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize any part of trade or commerce in any part of the United States, or whose effect in any line of commerce in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade. In every case, the Board shall take into consideration the financial and managerial resources and future prospects of the companies and banks concerned, and the convenience and needs of the community to be served.

On November 5, 1969, the House passed legislation (H.R. 6778) that in some respects is inconsistent with the Board's statement of principles and its proposed list of permissible activities for holding companies. Specifically, H.R. 6778 would add a new paragraph (f) to Section 4 of the Bank Holding Company Act that would prohibit holding companies and their subsidiaries from engaging in certain of the foregoing activities and limit their activities in certain other areas to a greater extent than would be the case under the Board's recommendations. However, the Board continues to favor legislation in this area.

Credit cards. On several occasions during 1969, the Board was asked for its views on legislative proposals relating to credit cards

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issued by banks and other lenders. In responding, the Board indicated that it does not favor legislation prohibiting unsolicited mailings of credit cards because it believes that such mailings are essential to enable new competitors to enter the field. However, the Board stated that it favors Federal legislation that would, by statute, limit a cardholder's liability for unauthorized use of a credit card and impose some restrictions on unsolicited mailings, designed to protect consumers. Specifically, the Board favored legislation requiring issuers who mail unsolicited credit cards to use unmarked envelopes enclosing (1) an unmarked return envelope containing the card and (2) a statement notifying the addressee of the contents of the return envelope and that the card may be refused merely by mailing the unopened return envelope. □

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Litigation

Investment Company Institute, et al.* v. *Camp. On appeals by the Comptroller of the Currency and the First National City Bank of New York, a ruling by the U.S. District Court for the District of Columbia in favor of the plaintiffs (see ANNUAL REPORT for 1967, page 333) was overturned by the U.S. Court of Appeals. The appellate court held that a commingled managing agency account is a bona fide fiduciary activity authorized for national banks under 12 U.S.C. 92a; it upheld the validity of the provisions of the Comptroller's Regulation 9 (12 CFR 9) that permit national banks to operate that type of account; and it concluded that the Comptroller was authorized to empower First National City Bank to create, organize, and manage the account in question. The appellate court rejected the view of the lower court that the Federal banking laws (12 U.S.C. 24, 78, 377, and 378) make it illegal for a national bank to establish, operate, or be affiliated with such a fund, but agreed with the District Court that the Investment Company Institute had standing to bring the law suit. A petition for certiorari, seeking review by the U.S. Supreme Court, is pending.

United States* v. *First at Orlando Corporation, et al. The U.S. Department of Justice filed suit in December 1969 in the U.S. District Court for the Middle District of Florida, attacking a proposal of First at Orlando Corporation, a registered bank holding company, for the acquisition of 80 per cent or more of the voting shares of each of three banks in Volusia County, Florida, namely, Commercial Bank at Daytona Beach, Peninsula State Bank at Daytona Beach Shores, and Exchange Bank at Holly Hill. Acting pursuant to its authority under the Bank Holding Company Act, the Board had granted approval of the proposed acquisitions (Federal Reserve *Bulletin,* December 1969, page 945). The suit alleges that the effect of the proposed acquisitions will be substantially to lessen competition, or to tend to create a monopoly in violation of Section 7 of the Clayton Act (15 U.S.C. 18). □

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Bank Supervision and Regulation by the Federal Reserve System

Examination of member banks. Each State member bank is subject to examinations made by direction of the Board of Governors or the Federal Reserve Bank of the district in which it is located by examiners selected or approved by the Board. The established policy is for the Federal Reserve Bank to conduct at least one regular examination of each State member bank, including its trust department, during each calendar year, with additional examinations if considered desirable. In most States concurrent examinations are made in cooperation with the State banking authorities, while in others alternate independent examinations are made. All but 59 of the 1,202 State member banks were examined during 1969.

National banks, all of which are members of the Federal Reserve System, are subject to examination by direction of the Board of Governors or the Federal Reserve Banks. However, as a matter of practice they are not examined by either, because the law charges the Comptroller of the Currency directly with that responsibility. The Comptroller provides reports of examination of national banks to the Board upon request, and each Federal Reserve Bank purchases from the Comptroller copies of reports of examination of national banks in its district.

The Board of Governors makes its reports of examination of State member banks available to the Federal Deposit Insurance Corporation, and the Corporation in turn makes its reports of insured nonmember State banks available to the Board upon request. Also, upon request, reports of examination of State member banks are made available to the Comptroller of the Currency.

In its supervision of State member banks, the Board receives, reviews, and analyzes reports of examination of State member banks and coordinates and evaluates the examination and supervisory functions of the System. It passes on applications for admission of State banks to membership in the System; administers the disclosure requirements of the Securities Exchange Act of 1934 with respect to equity securities of State member banks within its jurisdiction under the 1934 Act; and under provisions of the Federal Reserve Act and other statutes, passes on applications for permission, among other things, to (1) merge banks,

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(2) form or expand bank holding companies, (3) establish domestic and foreign branches, (4) exercise expanded powers to create bank acceptances, (5) establish foreign banking and financing corporations, and (6) invest in bank premises an amount in excess of 100 per cent of a bank's capital stock.

By Act of Congress approved September 12, 1964 (Public Law 88–593), insured banks are required to inform the appropriate Federal banking agency of any changes in control of management of such banks and of any loans by them secured by 25 per cent or more of the voting stock of any insured bank. Arrangements continue among the three Federal supervisory agencies for appropriate exchanges of reports received by them pursuant to the Act. The Reserve Banks send copies of all reports they receive to the appropriate district office of the Federal Deposit Insurance Corporation, the Regional Administrator of National Banks (Comptroller of the Currency), and the State bank supervisor.

Upon receipt of reports involving changes in control of State member banks, the Reserve Banks are under instructions to forward such reports promptly to the Board, together with a statement (1) that the new owner and management are known and acceptable to the Reserve Bank or (2) that they are not known and that an investigation is being made.

LOANS TO EXECUTIVE OFFICERS

Period covered (condition report dates)	Total loans to executive officers		Range of interest rate charged (per cent)[1]
	Number	Amount (dollars)	
Oct. 21, 1968—Dec. 31, 1968	6,468	14,715,895	1¼—18
Jan. 1, 1969—Apr. 4, 1969	9,758	20,678,788	2—15
Apr. 5, 1969—June 30, 1969	6,365	14,799,980	2½—18
July 1, 1969—Oct. 21, 1969	18,256	20,864,076	0—18
Oct. 22, 1969—Dec. 31, 1969	(2)	(2)	(2)

[1] The rate of 18 per cent reflects the inclusion of rates of 1½ per cent per month charged on credit-card and check-credit plans.
[2] Compilation of data for condition report of Dec. 31, 1969, has not been completed.

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The findings of any investigation and the Reserve Bank's conclusions based on such findings are forwarded to the Board.

By Act of Congress approved July 3, 1967 (Public Law 90–44), each member bank of the Federal Reserve System is required to include with (but not as part of) each report of condition and copy thereof a report of all loans to its executive officers since the date of submission of its previous report of condition. Since the Board's 1968 ANNUAL REPORT was released, member banks have submitted, as required by law, the data that appear in the table on the preceding page.

Federal Reserve membership. As of December 31, 1969, member banks accounted for 43 per cent of the number of all commercial banks in the United States and for 62 per cent of all commercial banking offices, and they held approximately 81 per cent of the total deposits in such banks. State member banks accounted for 13 per cent of the number of all State commercial banks and 37 per cent of the banking offices, and they held 54 per cent of total deposits in State commercial banks.

Of the 5,871 banks that were members of the Federal Reserve System at the end of 1969, there were 4,669 national banks and 1,202 State banks. During the year there were net declines of 47 national and 60 State member banks. The decline in the number of national banks reflected 42 conversions to branches incident to mergers and absorptions and 28 conversions to nonmember banks. The decline was offset in part by the organization of 16 new national banks and the conversion of 9 nonmember banks to national banks. The decrease in State member banks reflected mainly 42 withdrawals from membership and 17 conversions to branches incident to mergers and absorptions.

At the end of 1969 member banks were operating 15,204 branches, 663 more than at the close of 1968; this included 753 *de novo* establishments.

Detailed figures on changes in the banking structure during 1969 are shown in Table 18, pages 351 and 352.

Bank mergers. Under Section 18(c) of the Federal Deposit Insurance Act (12 U.S.C. 1828(c)), the prior written consent of the Board of Governors of the Federal Reserve System must be obtained before a bank may merge, consolidate, or acquire the assets and assume the liabilities of another bank if the acquiring, assuming, or resulting bank is to be a State member bank.

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In deciding whether to approve an application, the Board is required by Section 18(c) to consider the impact of the proposed transaction on competition, the financial and managerial resources and prospects of the existing and proposed institution, and the convenience and needs of the community to be served. The Board is precluded from approving "any proposed merger transaction which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States." A proposed transaction "whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade," may be approved only if the Board of Governors is able to find that the anticompetitive effects of the transaction would be clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

Before acting on each application the Board must request reports from the Attorney General, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on the competitive factors involved in each transaction. The Board in turn responds to requests by the Comptroller or the Corporation for reports on competitive factors involved when the acquiring, assuming, or resulting bank is to be a national bank or an insured nonmember State bank.

During 1969 the Board disapproved three and approved 20 of these applications, and it submitted 135 reports on competitive factors to the Comptroller of the Currency and 77 to the Federal Deposit Insurance Corporation. As required by Section 18(c) of the Federal Deposit Insurance Act, a description of each of the 20 applications approved by the Board, together with other pertinent information, is shown in Table 21 on pages 355–81.

Statements and orders of the Board with respect to all bank merger applications, whether approved or disapproved, are released immediately to the press and the public and are published in the Federal Reserve *Bulletin*. These statements and orders set forth the factors considered, the conclusions reached, and the vote of each Board member present.

Bank holding companies. During 1969, pursuant to Section 3(a)(1) of the Bank Holding Company Act of 1956, the Board ap-

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proved 21 applications for prior approval to become a bank holding company. Pursuant to the provisions of Section 3(a)(3) of the Act, the Board approved 66 applications by bank holding companies, and denied three applications. To provide necessary current information, annual reports for 1968 were obtained from all registered bank holding companies pursuant to the provisions of Section 5(c) of the Act.

Statements and orders of the Board with respect to applications to form or expand bank holding companies, whether approved or disapproved, are released immediately to the press and the public and are published in the Federal Reserve *Bulletin*. These statements and orders set forth the factors considered, the conclusions reached, and the vote of each Board member present.

Foreign branches of member banks. At the end of 1969, 53 member banks had in active operation a total of 460 branches in 59 foreign countries and overseas areas of the United States; 36 national banks were operating 428 of these branches, and 17 State member banks were operating 32 such branches. The number and location of these foreign branches were as shown in the tabulation on the opposite page.

Under the provisions of the Federal Reserve Act (Section 25 as to national banks and Sections 9 and 25 as to State member banks), the Board of Governors during the year 1969 approved 96 applications made by member banks for permission to establish branches in foreign countries and overseas areas of the United States. During the year, member banks opened 85 branches overseas.

Acceptance powers of member banks. During the year the Board approved the applications of five member banks, pursuant to the provisions of Section 13 of the Federal Reserve Act, for increased acceptance powers. Of these five approvals, three granted banks permission to accept drafts or bills of exchange drawn for the purpose of furnishing dollar exchange as required by the usages of trade in such countries, dependencies, or insular possessions of the United States as may have been designated by the Board of Governors. Two of the approvals granted banks permission to accept commercial drafts or bills up to 100 per cent of paid-up and unimpaired capital stock and surplus.

Foreign banking and financing corporations. At the end of 1969 there were five corporations operating under agreements with the Board pursuant to Section 25 of the Federal Reserve Act relating to investment by member banks in the stock of corporations engaged principally

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[Tabulation referred to on opposite page.]

Latin America	*235*
Argentina	38
Bahamas	32
Barbados	3
Bolivia	4
Brazil	15
Chile	18
Colombia	23
Dominican Republic	11
Ecuador	9
El Salvador	1
Guatemala	3
Guyana	1
Honduras	3
Jamaica	3
Leeward Islands	4
Mexico	5
Netherlands Antilles	2
Nicaragua	3
Panama	26
Paraguay	6
Peru	8
Trinidad and Tobago	6
Uruguay	4
Venezuela	4
Virgin Islands (British)	3
Europe	*103*
Austria	1
Belgium	10
Germany	17
France	11
Greece	8
Ireland	2
Italy	3
Luxembourg	1
Europe—Cont.	
Netherlands	7
Switzerland	6
United Kingdom	37
Africa	*1*
Liberia	1
Near East	*6*
Dubai	1
Lebanon	3
Saudi Arabia	2
Far East	*77*
Hong Kong	13
India	11
Indonesia	6
Japan	13
Korea	3
Malaysia	5
Okinawa	2
Pakistan	4
Philippines	5
Singapore	9
Taiwan	2
Thailand	2
Vietnam	2
U.S. overseas areas and trust territories	*38*
Canal Zone	2
Guam	3
Puerto Rico	18
Marshall Islands	1
Truk Islands	1
Virgin Islands	13
Total	**460**

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in international or foreign banking. Three of these "agreement" corporations have head offices in New York, and one has its head office in Miami, Florida. The four corporations were examined during the year by examiners for the Board of Governors. The fifth "agreement" corporation is a national bank in the Virgin Islands and is owned by a State member bank in Philadelphia.

During 1969, under the provisions of Section 25(a) of the Federal Reserve Act, the Board issued final permits to eight corporations to engage in international or foreign banking or other international or foreign financial operations, and seven corporations commenced operations. At the end of the year there were 63 corporations in active operation under Section 25(a); 32 have home offices in New York City; five in Philadelphia; three each in Boston, Chicago, Detroit, and San Francisco; two each in Dallas, Los Angeles, and Seattle; and one each in Cleveland, Pittsburgh, Norfolk, Winston-Salem, Atlanta, Miami, St. Louis, and Portland. One of the corporations with headquarters in Seattle has five branches in Hong Kong; one of the corporations in Philadelphia and one in New York operate branches in London, and one New York corporation operates a branch in Nassau. Examiners for the Board of Governors examined 57 of these corporations during 1969.

Actions under delegation of authority. Pursuant to the provisions of Section 11(k) of the Federal Reserve Act, the Board of Governors has delegated to the Reserve Banks (1) authority to approve, on behalf of the Board, certain applications of State member banks to establish domestic branches, to invest in bank premises, to declare certain dividends, and to grant a waiver of 6 months' notice by a bank of its intention to withdraw from membership in the Federal Reserve System, and (2) certain other less frequently used authorities. Under such authority the Reserve Banks approved 116 branch applications, 39 investments in bank premises, 43 waivers of notice of intention to withdraw from membership in the Federal Reserve System, and 41 applications of various other kinds.

The Board has delegated to the Director or Acting Director of the Division of Supervision and Regulation authority to approve certain applications to establish domestic branches and various other authorities. Under this authority 77 branches and 88 applications of other kinds were approved.

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The Board has also delegated to any member of the Board, designated by the Chairman, the authority to approve certain applications involving the establishment of a foreign branch or agency by a member bank or corporation organized under Section 25(a) (an "Edge" corporation) or operating under an agreement with the Board pursuant to Section 25 (an "agreement" corporation) and also to grant specific consent to stock acquisitions by an Edge or agreement corporation and to permit Edge or agreement corporations to exceed limitations prescribed by statute. Under this authority a member of the Board has approved 12 branches and 90 investments by Edge or agreement corporations.

Bank Examination Schools. In 1969 the Bank Examination School conducted four sessions of the School for Examiners, four sessions of the School for Assistant Examiners, and two sessions of the School for Trust Examiners. The Bank Examination School was established in 1952 by the three Federal bank supervisory agencies, and since 1962 it has been conducted jointly by the Federal Reserve System and the Federal Deposit Insurance Corporation.

Since the establishment of this program, 4,149 persons have attended the various sessions. This number includes representatives of the Federal bank supervisory agencies; the State Banking Departments of Arkansas, Arizona, California, Connecticut, Florida, Idaho, Indiana, Kentucky, Louisiana, Maine, Michigan, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, and Wyoming; the Treasury Department of the Commonwealth of Puerto Rico; and 19 foreign countries.

Truth in Lending. A report entitled *Annual Report to Congress on Truth in Lending for the Year 1969* was submitted separately, pursuant to the Truth in Lending Act (Title I of the Consumer Protection Act (Public Law 90–321)). □

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Federal Reserve Banks

Examination of Federal Reserve Banks. The Board's Division of Federal Reserve Bank Operations examined the 12 Federal Reserve Banks and their 24 branches during the year, as required by Section 21 of the Federal Reserve Act. In conjunction with the examination of the Federal Reserve Bank of New York, the Board's examiners also audited the accounts and holdings related to the System Open Market Account and foreign currency operations conducted by that Bank in accordance with policies formulated by the Federal Open Market Committee, and rendered reports thereon to the Committee. The procedures followed by the Board's examiners were surveyed and appraised by a private firm of certified public accountants, pursuant to the policy of having such reviews made on an annual basis.

Earnings and expenses. The accompanying table summarizes the earnings, expenses, and distribution of net earnings of the Federal Reserve Banks for 1969 and 1968.

EARNINGS, EXPENSES, AND DISTRIBUTION OF NET EARNINGS OF FEDERAL RESERVE BANKS, 1969 AND 1968

In thousands of dollars

Item	1969	1968
Current earnings	3,373,360	2,764,446
Current expenses	274,973	242,350
Current net earnings	3,098,387	2,522,096
Net addition to or deduction from (−) current net earnings	−557	8,520
Net earnings before payments to U.S. Treasury	3,097,830	2,530,616
Dividends paid	39,237	36,960
Payments to U.S. Treasury (interest on F.R. notes)	3,019,161	2,463,629
Transferred to surplus	39,432	30,027

Current earnings of $3,373 million in 1969 were 22 per cent higher than in 1968, reflecting increases of $527 million on U.S. Government

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securities, $45 million on foreign currencies, and $36 million on discounts and advances.

Current expenses were $33 million more than in 1968, or 13 per cent. Statutory dividends to member banks amounted to $39 million, an increase of $2 million from 1968. The rise in dividends reflected an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Federal Reserve Banks.

Payments to the Treasury as interest on Federal Reserve notes totaled $3,019 million for the year, compared with $2,464 million in 1968. This amount consists of all net earnings after dividends and the amount necessary to bring surplus to the level of paid-in capital.

The cost to the Federal Reserve Banks for separating silver coin from clad coin during the year amounted to $83,921. This operation was performed during the period May 1968 through July 1969, at the request of the Bureau of the Mint, and yielded approximately $101 million in silver dimes and quarters, which were then made available to the Mint for melting. Expenses of the Reserve Banks for the project in both years totaled $391,141, after recovery of $12,000 from the sale of separating equipment.

Expenses of the Federal Reserve Banks also included costs of $210.32 for two regional meetings incident to the Treasury Department savings bond program.

A detailed statement of earnings and expenses of each Federal Reserve Bank during 1969 is shown in Table 7 on pages 336 and 337, and a condensed historical statement in Table 8 on pages 338 and 339.

Holdings of loans and securities. The accompanying table shows holdings, earnings, and average interest rates on loans and securities of the Federal Reserve Banks during the past 3 years.

Average daily holdings of loans and securities during 1969 amounted to $55,198 million—an increase of $3,263 million over 1968. Holdings of acceptances decreased $6 million, whereas there were increases of $2,736 million in U.S. Government securities and $533 million in discounts and advances.

The average rates of interest on holdings were up from 5.22 per cent to 5.93 per cent on discounts and advances, from 5.75 per cent to 7.01 per cent on acceptances, and from 5.17 per cent to 5.89 per cent on U.S. Government securities.

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RESERVE BANK EARNINGS ON LOANS AND SECURITIES, 1967–69

Item and year	Total	Discounts and advances	Acceptances	U.S. Govt. securities[1]
	In millions of dollars			
Average daily holdings:[2]				
1967	46,417	178	104	46,135
1968	51,935	569	73	51,293
1969	55,198	1,102	67	54,029
Earnings:				
1967	2,164.6	7.7	4.8	2,152.1
1968	2,687.4	29.7	4.2	2,653.5
1969	3,250.8	65.3	4.7	3,180.8
	In per cent			
Average rate of interest:				
1967	4.66	4.33	4.62	4.66
1968	5.17	5.22	5.75	5.17
1969	5.89	5.93	7.01	5.89

[1] Includes Federal agency obligations.
[2] Based on holdings at opening of business.

Volume of operations. Table 9 on page 340 shows the volume of operations in the principal departments of the Federal Reserve Banks for 1966–69.

Discounts and advances were the highest in number since 1959, and the dollar volume reached a new peak as the number of banks borrowing rose to 1,714 against 1,310 in 1968.

The number of coins received and counted also rose sharply during the year, a reflection of the continuing increase in coins in circulation. Volume was again higher in most of the other operations, particularly in checks handled, food stamps redeemed, and transactions in U.S. Government securities.

Loan guarantees for defense production. Under the Defense Production Act of 1950, the Departments of the Army, Navy, and Air Force, the Defense Supply Agency of the Department of Defense, the Departments of Commerce, Interior, and Agriculture, the General Services Administration, the National Aeronautics and Space Administration, and the Atomic Energy Commission are authorized to guarantee

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loans for defense production made by commercial banks and other private financing institutions. The Federal Reserve Banks act as fiscal agents of the guaranteeing agencies under the Board's Regulation V.

During 1969 the guaranteeing agencies did not authorize the issuance of any new guarantee agreements. Loan authorizations outstanding on December 31, 1969, totaled $72 million, of which $71 million represented outstanding loans and $1 million additional credit available to borrowers. Of total loans outstanding, 29 per cent on the average was guaranteed. During the year approximately $66 million was disbursed on guaranteed loans; of this total, $49 million was disbursed on a loan authorized in 1968 as part of the financing for expansion of domestic copper production.

Authority for the V-loan program, unless extended, will terminate on June 30, 1970.

Table 11 (page 341) shows guarantee fees and maximum interest rates applicable to Regulation V loans.

Foreign and international accounts. Assets held for foreign account at the Federal Reserve Banks declined $2,609 million in 1969. At the end of the year they amounted to $19,217 million: $10,506 million of earmarked gold; $7,030 million of U.S. Government securities (including securities payable in foreign currencies); $134 million in dollar deposits; $146 million of bankers' acceptances purchased through Federal Reserve Banks; and $1,401 million of miscellaneous assets. The latter item consists mainly of dollar bonds issued by foreign countries and international organizations. Assets held for international organizations, including IMF gold deposits, declined $964 million to $7,157 million.

In 1969 new accounts were opened in the names of the People's Bank of the Union of Burma, Central Bank of Kuwait, Southern Yemen Currency Authority, and National Bank of Somalia.

The System did not make any gold collateral loans during 1969.

The Federal Reserve Bank of New York continued to act as depositary and fiscal agent for international organizations. As fiscal agent of the United States, the Bank continued to operate the Exchange Stabilization Fund pursuant to authorization and instructions of the Secretary of the Treasury. Also on behalf of the Treasury Department, it administered foreign assets control regulations pertaining to assets in the United States of North Vietnam, Cuba, Communist China, and

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North Korea, and their nationals, and to transactions with those countries and their nationals.

Bank premises. During 1969 the Board authorized construction of new buildings for the Minneapolis Bank and the Cincinnati and Memphis Branches.

With the approval of the Board, a site was obtained for the new building authorized for the Minneapolis Bank, and property adjacent to the Los Angeles Branch was acquired for future expansion.

Table 6 on page 335 shows the cost and book value of bank premises owned and occupied by the Federal Reserve Banks and of real estate acquired for banking-house purposes. □

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Board of Governors

Building annex. In April 1969 the Board of Governors announced it had postponed indefinitely the construction of an annex to its present building in order to minimize competition for scarce goods and services during a period of strong inflationary pressures. Construction had been scheduled to begin in 1969 with completion in 1971.

Income and expenses. The accounts of the Board for the year 1969 were audited by the public accounting firm of Lybrand, Ross Bros. & Montgomery.

ACCOUNTANTS' OPINION

Board of Governors of the
Federal Reserve System:

We have examined the balance sheet of the Board of Governors of the Federal Reserve System as of December 31, 1969, and the related statement of assessments and expenses for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the balance sheet and related statement of assessments and expenses present fairly the financial position of the Board of Governors of the Federal Reserve System at December 31, 1969 and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Lybrand, Ross Bros. & Montgomery

Washington, D.C.
February 2, 1970

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEET
DECEMBER 31, 1969

ASSETS

OPERATING FUND:		
Cash		$ 1,241,526
Miscellaneous receivables and advances		56,380
Stockroom and cafeteria inventories at first-in, first-out cost		33,318
Total operating fund		1,331,224
PROPERTY FUND:		
Land and improvements		792,852
Building		4,330,488
Furniture and equipment		1,215,113
Construction in progress		1,744,297
Total property fund		8,082,750
		$ 9,413,974

LIABILITIES AND FUND BALANCES

OPERATING FUND:		
Current liabilities:		
Accounts payable and accrued expenses	$1,247,215	
Income taxes withheld	158,752	
Accrued payroll	143,542	
		$ 1,549,509
Fund balance:		
Balance, January 1, 1969	902,719	
Excess of expenses over assessments for the year ended December 31, 1969	1,121,004	
		(218,285)
Total operating fund		1,331,224
PROPERTY FUND:		
Fund balance:		
Balance, January 1, 1969	6,841,299	
Additions	1,265,217	
Property adjustments and disposals	(23,766)	
Total property fund		8,082,750
		$ 9,413,974

The accompanying notes are an integral part of the financial statements.
[See page 324 for notes.]

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Board of Governors of the Federal Reserve System

Statement of Assessments and Expenses for the Year Ended December 31, 1969

Assessments Levied on Federal Reserve Banks:		
For Board expenses and additions to property		$15,067,500
For expenditures made on behalf of the Federal Reserve Banks		21,234,263
Total assessments		36,301,763
Expenses:		
Expenditures for printing, issue and redemption of Federal Reserve Notes, paid on behalf of the Federal Reserve Banks		21,234,263
For the Board:		
Salaries	$9,425,813	
Retirement and insurance contributions	1,861,627	
Travel expenses	503,338	
Legal, consultant and audit fees	356,802	
Contractual services	389,038	
Printing and binding—net	479,736	
Equipment and other rentals	1,036,928	
Telephone and telegraph	194,247	
Postage and expressage	200,402	
Stationery, office and other supplies	117,561	
Heat, light and power	63,901	
Operation of cafeteria—net	77,843	
Repairs, maintenance and alterations	85,845	
Books and subscriptions	37,779	
System membership, Center for Latin American Monetary Studies	27,000	
Miscellaneous—net	89,193	
		14,947,053
For property additions		1,241,451
Total expenses		37,422,767
Excess of Expenses Over Assessments		$ 1,121,004

The accompanying notes are an integral part of the financial statements.

[See page 324 for notes.]

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Board of Governors of the Federal Reserve System

Notes to Financial Statements

Accounting Methods

The Board has consistently followed the practice of not providing for depreciation on fixed assets. Acquisitions are charged to expense and proceeds from sales of fixed assets are recorded as income. The property accounts are increased or reduced at full cost, with corresponding increases or decreases in the property fund balance when property is acquired or sold.

Assessments and expenditures made on behalf of the Federal Reserve Banks for the printing, issuance and redemption of Federal Reserve Notes are recorded on the cash basis and produce results which are not materially different from those which would have been produced on the accrual basis of accounting.

Long-term Leases

The Board leases outside office space at an annual rental of $339,638 under leases expiring in 1972. These leases may be terminated with six months notice.

Construction

Except for those items previously committed amounting to approximately $1,500,000, construction of the planned Federal Reserve North Building and North Garage has been postponed indefinitely. The architect has estimated the total cost as approximately $30,000,000.

Retirement Plan

There are two contributory retirement programs for employees of the Board. About 75% of the employees are covered by the Federal Reserve Board Plan. All new members of the staff who do not come directly from a position in the Government are covered by this plan. The second, the Civil Service Retirement Plan, covers all new employees who come directly from government service. Employee contributions and benefits are the same under both plans and are based upon the Civil Service Plan.

Under the Civil Service Plan, Board contributions match employee payroll deductions while under the Federal Reserve Plan, Board contributions are actuarially determined annually.

Total Board contributions to these plans in 1969 totaled $1,797,467 including $446,000 required to fund cost of living allowances to annuitants under the Federal Reserve Plan. There are no unfunded prior service costs under either plan.

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