Prefatory Note

The attached document represents the most complete and accurate version available based on original copies culled from the files of the FOMC Secretariat at the Board of Governors of the Federal Reserve System. This electronic document was created through a comprehensive digitization process which included identifying the best-preserved paper copies, scanning those copies,[1] and then making the scanned versions text-searchable.[2] Though a stringent quality assurance process was employed, some imperfections may remain.

Please note that some material may have been redacted from this document if that material was received on a confidential basis. Redacted material is indicated by occasional gaps in the text or by gray boxes around non-text content. All redacted passages are exempt from disclosure under applicable provisions of the Freedom of Information Act.

[1] In some cases, original copies needed to be photocopied before being scanned into electronic format. All scanned images were deskewed (to remove the effects of printer- and scanner-introduced tilting) and lightly cleaned (to remove dark spots caused by staple holes, hole punches, and other blemishes caused after initial printing).

[2] A two-step process was used. An advanced optical character recognition computer program (OCR) first created electronic text from the document image. Where the OCR results were inconclusive, staff checked and corrected the text as necessary. Please note that the numbers and text in charts and tables were not reliably recognized by the OCR process and were not checked or corrected by staff.

Content last modified 6/05/2009.

CONFIDENTIAL (FR)

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

November 22, 1968

The Domestic Financial Situation

Policy loan advances made by life insurance companies declined seasonally during October, but volume nevertheless remained large. During the third quarter, similarly, the share of total invested funds accounted for by policy loans decreased from the previous period, but remained quite high. The total volume of funds invested during the third quarter continued relatively modest. The volume of new commitments for corporate direct placements made by life insurance companies during October recovered from the reduced September rate, though the average yield remained unchanged.

Flow of funds figures for the third quarter of 1968 show a large total credit flow--$122 billion at a seasonally adjusted annual rate--of which bank credit at a $65 billion rate represented an extraordinarily high 54 per cent. These figures are much above the $88 billion total--22 per cent of which came from banks--in the first half of 1968, but both the low first half and the high third quarter are distorted by current Treasury practice in managing its cash balances and borrowing. Had the Treasury maintained its cash at normal seasonal levels throughout the year and linked its borrowing more directly to financing requirements, total credit flows would have been at about $100 billion rate in both the first half of the year and the third quarter, and bank credit would have risen from 30 per cent of the first half total to 40 per cent the third quarter.

Apart from the Treasury's cash operations, there was a marked shift in the third quarter away from Government demands for funds and toward private borrowing. Government financing needs were $20 billion lower than in the first half of the year, reflecting mainly extra revenues from the surcharge but also a sizable reduction in outlays through loan programs, both mortgages and other. Private borrowing, on the other hand, was $19 billion higher than during the first half, with the increase fairly evenly distributed among households, business, and state and local governments. This rise in private credit was much larger than would be suggested by the extent of credit easing or by changes in capital expenditures or state and local government activities. The resulting private total of $86 billion was much the largest flow of private credit on record, exceeding the earlier high (the second quarter of 1966) by 16 per cent.

The shift in form of credit flow is put into context in the table below. On an NIA basis, the Government's deficit was improved by about $6 billion from the first half to the third quarter, after allowing for accruals of the corporate part of the surcharge from the beginning of the year. When corporate taxes are stated on a payments basis, as on the second line, the shift toward surplus was almost $13 billion, which together with the drop in lending programs produced the $20 billion decrease in Government credit need mentioned above. Federal borrowing was actually larger than in the first half, however, producing a rise in cash balances--in seasonally adjusted terms--of very large proportions.

The over $13 billion shift in Federal accounts toward a smaller deficit was balanced by an $8 billion decrease in household and business saving and a $5 billion increase in net capital outlays of these sectors.

The rise in private borrowing associated with expanded capital outlays, and reduced saving, was mainly short-term, with consumer credit, commercial paper, and loans from finance companies particularly strong. Only about $3 billion of the increase was supplied directly by banks, but another $6 billion came indirectly through bank credit to finance companies, resulting in a sizable part of the total $14 billion increase that originated in the banking system.

As suppliers of funds to financial markets, the private sectors shifted away from direct purchases of securities, which had been very large in the first half, and increased dramatically their flows into time deposits, particularly CD's. It was the combination of time deposits from private investors and the very large buildup in Federal cash balances at banks that made commercial banks the major direct supplier of funds in the third quarter. Time deposit inflows and Treasury deposit growth together amounted to 48 per cent of total borrowing, to which money-supply liabilities, Euro-dollar borrowing, and other sources added on balance only 6 percentage points to make up the 54 per cent total supply from banks.

Bank credit to private borrowers, either directly or through lending to finance companies, was only about 40 per cent of total bank credit growth during the third quarter, while the other 60 per cent took the form of Government security purchases, security credit, and buying of municipals. In the Government securities market banks financed, directly and through loans to dealers, about two-thirds of the large total volume of Federal borrowing during the quarter, leaving relatively minor amounts to be picked up by other investors. Through direct purchases of municipals and credit to security dealers, banks were, at the same time, the source of about half of total funds supplied to municipal and corporate security markets.

Table 1

FLOW OF FUNDS
(Seasonally adjusted, annual rates)

	First half, 1968	Third quarter, 1968	Change
	(Billions of dollars)		
Federal Government			
Net surplus, NIA basis	- 9.4	-3.4	6.0
Tax receipts less accruals	- 5.1	1.7	6.8
Surplus, tax payment basis	-14.5	-1.7	12.8
Lending programs, etc.	15.7	8.1	-7.6
Net borrowing	17.6	33.1	15.5
Cash balances	-12.6	23.3	35.9
Households and businesses			
Net saving, NIA basis a/	84.8	82.6	-2.2
Tax accruals less payments	4.8	-1.3	-6.1
Net saving, tax payments basis	89.6	81.3	-8.3
Net capital outlays a/	65.9	71.3	5.4
Net borrowing	58.6	72.3	13.7
Outlays less borrowing	7.3	-1.0	-8.3
Financial asset acquisitions, net	82.3	82.3	nil

a/ Net of depreciation allowances. Capital outlays include consumer durables.

Table 2

FLOW OF FUNDS
(Seasonally adjusted, annual rates, in billions of dollars)

	1966	1967	1st half, 1968	3rd quarter, 1968	Change from H1/68
Total borrowing by nonfinancial sectors	69.9	83.1	88.3	121.7	33.4
By sector borrowing					
U.S. Government	6.3	12.7	17.6	33.1	15.5
Foreign	1.5	4.0	3.4	2.3	-1.1
State and local governments	6.8	10.5	8.7	14.0	5.3
Business	33.6	37.2	31.2	37.0	5.8
Households	21.7	18.7	27.4	35.2	7.8

Table 3

FLOW OF FUNDS
(Seasonally adjusted, annual rates, in billions of dollars)

	1966	1967	1st half, 1968	3rd quarter, 1968	Change from H1/68
Direct lending in credit markets	69.9	83.1	88.3	121.7	33.4
Federal Reserve	3.5	4.8	5.5	7.3	1.8
Commercial banks	17.3	36.2	19.0	65.9	46.9
Nonbank finance	22.5	32.4	27.1	31.2	4.1
U.S. Government	7.9	4.5	11.1	5.7	-5.4
Foreign	-1.4	3.2	-.5	-.1	.4
Private domestic nonfinancial sectors	20.1	2.0	26.1	11.8	-14.3

Table 4

FLOW OF FUNDS
(Seasonally adjusted, annual rates, in billions of dollars)

	1966	1967	1st half, 1968	3rd quarter, 1968	Change from H1/68
Sources of credit	69.9	83.1	88.3	121.7	33.4
Private domestic nonfinancial sectors	42.8	53.0	60.6	67.3	6.7
Money supply	2.9	12.0	9.3	10.3	1.0
Time deposits at commercial banks	12.5	22.4	12.5	30.9	18.4
Savings institution deposits	7.3	16.6	12.6	14.2	1.6
Credit market instruments	20.1	2.0	26.1	11.8	-14.3
U.S. Government cash	-.4	1.2	-12.6	23.3	35.9
U.S. Government loans	7.9	4.5	11.1	5.7	-5.4
Foreign funds	-.9	5.4	-.6	-.6	--
Insurance and pension reserves	12.8	13.2	14.0	14.2	.2
Sources n.e.c.	7.7	5.8	15.8	12.0	-3.8

KEY INTEREST RATES

	1968			
	Low	High	Oct. 28	Nov. 21
Short-Term Rates				
Federal funds (weekly average)	4.56 (1/3)	6.38 (5/15)	5.84(10/23)	5.45(11/20)
3-months				
Treasury bills (bid)	4.82 (1/29)	5.92 (5/21)	5.46	5.42
Bankers' acceptances	5.25 (3/7)	6.13 (5/24)	5.88	6.00
Euro-dollars	5.43 (2/2)	7.19 (6/4)	6.44(10/24)	6.91
Federal agencies	5.00 (2/9)	6.11 (5/17)	5.63(10/24)	5.77
Finance paper	5.13 (3/7)	6.13 (6/25)	5.75	5.75
CD's (prime NYC)				
Highest quoted new issue	5.25 (2/8)	6.00 (11/21)	5.85(10/24)	6.00
Secondary market	5.20 (1/31)	6.20 (5/31)	6.05(10/24)	6.05
6-months				
Treasury bills (bid)	4.98 (1/29)	6.08 (5/21)	5.47	5.60
Bankers' acceptances	5.38 (3/7)	6.25 (5/24)	6.00	6.12
Commercial paper	5.50 (3/7)	6.25 (7/25)	5.88	5.88
Federal agencies	5.25 (2/9)	6.25 (5/24)	5.68(10/24)	5.91
CD's (prime NYC)				
Highest quoted new issue	5.50 (3/7)	6.25 (7/11)	5.62(10/24)	5.75
Secondary market	5.45 (1/31)	6.40 (5/31)	6.00(10/24)	6.20
1-year				
Treasury bills (bid)	5.05 (8/1)	6.03 (5/21)	5.43	5.53
Prime municipals	2.75 (8/8)	3.90 (5/31)	3.10(10/24)	3.20
Intermediate and Long-Term				
Treasury coupon issues				
5-years	5.42 (1/12)	6.21 (5/21)	5.58	5.62
20-years	5.16 (8/1)	5.77 (3/14)	5.45	5.60
Corporate				
Seasoned Aaa	5.95 (9/5)	6.29 (6/6)	6.03	6.16
Baa	6.77 (10/3)	7.10 (6/3)	6.77	7.02
New Issue Aaa				
With call protection	6.13 (8/29)	6.83 (5/24)	6.50(10/24)	6.64
Without call protection	6.29 (2/2)	6.99 (6/3)	6.64(10/24)	6.77
Municipal				
Bond Buyer Index	4.07 (8/8)	4.71 (5/24)	4.52(10/24)	4.62
Moody's Aaa	3.80 (8/8)	4.42 (5/31)	4.21(10/24)	n.a.
Mortgage--Implicit Yield				
In FNMA Weekly Auction 1/	7.12 (5/6)	7.72 (6/10)	7.23	7.35(11/18)

1/ Yield on 6-month forward commitment after allowance for commitment fee and required FNMA stock purchase. Assumes discount on 30-year loan amortized over 15 years.

<u>Corrections</u>

Page III - 20, <u>other short-term rates</u>. Second sentence should have read: "Rates on finance company paper and bankers' acceptances are now around 1/8 of a percentage point above the levels prevailing at the time of the last Committee meeting." Since November 18, however, finance company paper rates have slipped back to where they were in late October.

Page III - 23. In table on <u>Projection of Treasury Cash Outlook</u>, the level of the cash balance at end of January should be $4.6 billion, not $4.4 billion.

CONFIDENTIAL (FR)

SECOND SUPPLEMENT

INTERNATIONAL DEVELOPMENTS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

November 25, 1968

SUPPLEMENTAL NOTES

International Developments

Exchange markets reacted today in a relatively quiet way to last week's and the weekend's developments. There was some unwinding of speculative positions taken last week, including a substantial return flow of spot funds out of German marks, but demand for forward marks was still strong.

Last week's most striking developments were the decision of the German Government on Tuesday not to revalue the mark but rather to make a modification in the border taxes on trade, and the acquiescence of other governments in this decision. The communique issued at the conclusion of a 3-day meeting (Wednesday to Friday, November 20-22) of the Group of Ten Finance Ministers and Central Bank Governors stated that "after thorough discussion of the German measures" (including other measures mentioned below) they "agreed that these measures would make a significant contribution to the stability of the monetary system and the adjustment process." The measures include (1) a modification of the border taxes associated with the value-added tax, to put a 4 per cent tax burden on exports and to reduce the tax on most imports by 4 percentage points from 11 per cent to 7 per cent; (2) a reserve requirement of 100 per cent against net additions to banks' gross liabilities to foreigners; and (3) action "to restrict certain short-term transactions of German banks with non-residents."

The first of these measures has received Cabinet approval and now requires legislation, which is expected to be passed this week. The effects on merchandise trade should be approximately equivalent to those of a 4 per cent upward revaluation of the mark. However, intra-Common Market trade in agricultural products subject to the Common Agricultural Policy will apparently not be affected; a revaluation would have lowered both import costs and the prices received by German farmers. The new measure has no direct effect on tourist and other service transactions, nor on capital transactions. Speculators do not get the windfall gains they had hoped for from a revaluation of the mark.

The 100 per cent reserve requirement against additions to banks' foreign liabilities was adopted by the Bundesbank on Thursday. The legal authority to set special requirements on additions to deposits was first used in 1960, but at that time the marginal requirement applied to domestic as well as foreign liabilities and the maximum rate was 30 per cent. Authority to set different requirements on foreign than on domestic liabilities was used in 1961-62 and in 1964-67, at which times there was a 30 per cent rate on all foreign liabilities.

The reference in the communique to restriction of short-term transactions of German banks with non-residents refers to a plan for licensing nonresident lenders and depositors.

President de Gaulle, contrary to widespread expectations, stated on Saturday that the <u>French franc</u> will not be devalued. On Sunday he gave some indications of the policy measures that will be adopted, but details await the Premier's appearance before the Chamber of Deputies Tuesday evening. The $2 billion central bank credit package for France announced by the G-10 communique was not contingent on a franc devaluation and therefore remains available. President Johnson has expressed to President de Gaulle the U.S. "hope that your course of action will be successful" and has offered U.S. cooperation.

The measures foreshadowed in President de Gaulle's brief speech include: (1) relieving exporters of certain taxes; (2) "rigorously" implementing controls on exchange transactions, and also (3) on payments of existing taxes; (4) cutting the 1969 budget deficit from $2.3 billion (as it stood before the $0.4 billion expenditure cut announced last Tuesday by Premier Couve de Murville) to $1.3 billion, mainly by cuts in many kinds of expenditures; (5) refusing to allow further wage increases of a sort that "would prevent the economy from becoming vigorous and competitive again," and (6) preventing further price increases. In addition, it is expected that a ceiling will be set on bank credit expansion beyond the year-end.

Effects of the German and French actions may be appraised as follows: (1) The German border tax action will tend to make the German export surplus somewhat smaller than it now is, but will still leave a large current account surplus to be covered by long-term capital outflows. By reducing import costs and by holding back aggregate demand, the action will help to relieve upward price pressures in Germany; thus it may facilitate continuance of Germany's relatively easy monetary policy, which in turn would help to maintain long-term capital outflows. (2) The French actions, especially if they prove successful in reducing the pace of price inflation, should tend to halt the recent trend of deterioration in the current account of the French balance of payments.

(3) It is too early to judge whether the German and French actions, in combination, will bring an end to speculation on changes in the value of either of these currencies. (4) Net effects on the U.S. balance of payments should be slightly favorable for the current account and should help to maintain inflows of long-term capital to the United States. (If and when confidence in the French franc is restored we might see a repatriation of French banking funds that have been on deposit in the Euro-dollar market, which in turn might lead to a return flow of funds from U.S. banks to their branches abroad; but this is for the present only a potentiality.) (5) Net effects on the U.K. current balance should also be slightly favorable.

The news of the past week aroused new uncertainties in the minds of exchange market participants regarding the future of the pound sterling. To check the spread of such attitudes, the British authorities on Friday announced three further sets of actions to restrain domestic demand and improve the balance of payments. (1) The "regulator" surcharge has been activated, at 10 per cent of the amount of existing purchase taxes and existing excise taxes on tobacco, drink, and gasoline. (2) Importers of most manufactures will be required to make a deposit equal to 50 per cent of the value of the goods when passing them through customs. The deposit will not bear interest and will be repaid by the government after six months. (3) Bank loans to the private sector, other than for exports and shipbuilding, are to be subjected to tighter ceiling control, expected to bring a 2 or 3 per cent reduction in outstandings by next March.

The second of these measures, in conjunction with the third, will put a severe strain on the liquidity of British businesses that deal in or use import manufactures. The import deposit requirement could have a strong impact in the next few months, partly in reducing imports, and partly in putting pressure on foreign suppliers to lengthen their credit terms for British imports.