FEDERAL RESERVE BANK OF NEW YORK

ANNUAL REPORT 1966

FEDERAL RESERVE BANK OF NEW YORK

March 6, 1967

To the Member Banks in the
Second Federal Reserve District:

It gives me great pleasure to present our fifty-second Annual Report, reviewing the major economic and financial developments of 1966.

The United States economy was under great strain in 1966, as mounting defense needs were superimposed upon a civilian economy already operating at full capacity. Output advanced at a rapid pace, but this expansion was accompanied by a sharp rise in prices and costs and by a marked worsening of the foreign trade surplus. As the year drew to a close, the pressures in the economy abated somewhat. It was clear, however, that the noninflationary environment that had characterized the earlier years of the current expansion had not yet been regained. On the international side, our payments deficit and our international position generally continued to be matters of deep concern.

Monetary policy became increasingly restrictive during the first part of the year in an effort to restrain inflationary forces in the economy. This restraint, in conjunction with rapidly growing demands for borrowed funds, produced serious strains in the credit markets by midsummer. Thereafter, the slower rate of expansion in the economy, additional measures of fiscal restraint, and an easing of monetary policy contributed to a lessening of the pressures in the credit markets.

The outlook for 1967 is clouded by crosscurrents in the economy and the continuing uncertainty of the Vietnam war. The tasks of returning to a balanced, noninflationary growth and of reaching external equilibrium pose difficult problems for policy makers.

Alfred Hayes

ALFRED HAYES
President

Federal Reserve Bank
of New York

FIFTY-SECOND ANNUAL REPORT

For the Year
Ended
December 31, 1966

Second Federal Reserve District

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The Strains and Stresses of an Overheated Economy

The United States economy was under great strain in 1966. The escalation of the Vietnam conflict beginning in mid-1965 had superimposed an enlarged defense effort upon a civilian economy rapidly approaching full utilization of resources. Despite an increasingly restrictive monetary policy as well as a number of fiscal policy steps, the expansion of aggregate demand outran the growth of productive capacity in the first part of 1966. Prices and costs broke out of the pattern of remarkable stability of the preceding years, and the foreign trade surplus deteriorated sharply. As monetary policy bore the brunt of the effort to protect the internal and the external value of the dollar, interest rates soared to levels not seen in more than a generation. The upward ratcheting of rates and heavy prospective credit demands led by late summer to fears that financial markets would break under the strain. Developments in September, including a Federal Reserve statement on business loans and discount administration and the introduction of new fiscal restraints, dissipated the crisis atmosphere. A slowing of the rise in the private economy contributed to a shift in expectations, and by the year-end monetary policy had moved to less restraint.

Abroad, economic and financial conditions were almost as turbulent. The pound sterling experienced another major crisis, and only a sweeping program of deflationary measures, without peacetime precedent in a democratic country, helped restore confidence in the British currency. Interest rates in most industrial countries rose rapidly, as monetary policies were tightened to contain inflationary pressures and as the effects of credit tightness in individual countries spread beyond national borders. While developed countries grappled with inflation, payments imbalances, and the issues of international liquidity, less developed nations faced not only the age-old problem of poverty and capital shortage but also a widening gap between precarious food supplies and surging population growth.

In the United States, the economy moved into 1966 at an excessively rapid pace, spurred by mounting defense expenditures and booming business capital outlays. The expansion slowed down in the second quarter, mainly because consumers cut back their spending on automobiles and other durable goods under the impact of accelerated personal income tax payments and of a widespread discussion of automobile safety. After midyear, the overall advance speeded up again though not back to the inordinate rate of the first months of the year. Defense outlays accelerated further, but private spending began to slow as residential construction slumped and the growth of plant and equipment outlays showed signs of tapering off. At the same time, the rise in prices started to moderate, reflecting a reversal of the earlier sharp runup, first, of crude industrial materials prices and, then, of food prices. Labor costs, in contrast, went on increasing and, with the slowdown in productivity gains, labor costs per unit of output turned sharply upward.

The year ended with the total output of goods and services growing quite rapidly but with somewhat diminishing pressures on capacity. The outlook was clouded, however, by divergent trends in different parts of the economy. Inventory accumulation was proceeding at an unsustainable rate, the capital spending boom was waning, and consumers were hesitant. On the other hand, defense expenditures still seemed headed strongly upward, state and local government outlays remained on an uptrend, and the housing slump gave signs of bottoming out.

For 1966 as a whole, aggregate spending rose more rapidly than in 1965. But with the economy at full capacity more of the advance was dissipated in higher prices, and total output in real terms rose somewhat less than in 1965. Inflationary pressures dealt a damaging blow to the Administration's wage-price guideposts, as wage increases well above national productivity gains were negotiated. Labor unions, moreover, sought to protect their members from rising consumer prices through cost-of-living escalator clauses. An inflationary climate inevitably increases union interest in such clauses, even though they are often self-defeating and clearly adverse to the national interest. In the first years of the expansion before excess demands developed, the wage-price guideposts on balance played a useful stabilizing role, notwithstanding some problems in their application. The working-out of some kind of national consensus on the behavior of wages, other costs, and profits in relation to prices would make an important contribution to stable growth in the future.

Another major unresolved problem is the involuntary idleness of too many workers among the minority groups, the unskilled, and teen-agers. The reduction of overall unemployment to below 4 per cent of the labor force in 1966 was a very satisfactory achievement. There does seem to be general agreement, however, that in order to achieve significant further reductions in unemployment greater emphasis needs now to be placed on special manpower programs and related measures designed to draw into employment those who have not been able to find jobs. Such programs are required both to assure fuller utilization of the country's economic potential and to help provide greater equality of opportunity for all individuals.

The upsurge of demands and the absence of greater fiscal restraint made 1966 a year of difficult problems and decisions for the Federal Reserve, as it endeavored to carry out its responsibility for encouraging noninflationary growth and assuring the proper functioning of the financial system. Monetary restraint was gradually increased during the first eight months of the year, but close attention was paid to the effects of the resulting reduction in liquidity throughout the economy. The plant and equipment spending boom, heavy inventory accumulation, in part stimulated by surging defense outlays, and a marked speedup in tax payments substantially enlarged the gap between business needs for funds and internally generated cash flows. Credit demands on the banking system and the capital markets soared, and, given the restrictive stance of credit policy, interest rates reached the highest levels in several decades. Commercial banks found themselves under tremendous pressure, with seemingly unlimited demand for loans confronting an eroded liquidity position and heightened competition for loanable funds. In an effort to honor loan requests, under established—and often long unused—lines of credit, from customers who were only slightly deterred by stiffening terms, commercial banks liquidated securities and vigorously bid for time deposits. Those with foreign branches avidly sought dollar deposits abroad. Through midsummer, the upswing in business loans continued at a record-breaking rate and the advance in total bank credit slowed only a little.

Mortgage lending, however, fell off sharply, largely because the inflow of savings into thrift institutions dropped abruptly with the increased attractiveness both of market instruments and of commercial bank time deposits. At the midyear interest payment period, the savings institutions—in particular savings and loan associations—were threatened by substantial withdrawals of funds. In earlier years many of these institutions had acquired a substantial volume of funds through aggressive bidding, and such funds were highly sensitive to changes in interest rates. Later in the summer, with market interest rates continuing to mount, commercial banks began losing time deposits as Regulation Q ceilings on interest rates payable on time deposits limited their attractiveness vis-à-vis market instruments. At the same time, the banks continued to face heavy credit demands, including anticipatory borrowing, and thus found themselves forced to sell Government and municipal securities in an unreceptive market. Heavy Federal agency financing and the sale of financial assets by the United States Government had added to the market pressures before midyear, and the lack of evidence that fiscal restraints would be brought into play increased developing uncertainties. With no apparent end to the demand for funds and the upsurge in interest rates, conditions in the financial markets seriously deteriorated in August and some observers even saw the threat of a financial panic.

At the very end of August, hints reached the market that some fiscal measures were in the wind and that agency financing would be curtailed. On September 1, the Federal Reserve System issued a statement designed to help calm the financial markets and to express the System's concern over the unsustainably rapid growth of bank credit. The following week, the President proposed fiscal restraint measures, specifically the suspension of certain tax benefits applicable to business capital spending, and the Treasury announced the curtailment of Government agency financing and the suspension of sales of participation certificates. The atmosphere in the financial markets, as a result, improved considerably.

Early in the fall, the financial setting began to change. The upswing in interest rates topped off, net flows of funds into nonbank financial institutions started to improve, and the growth of bank credit waned as commercial banks continued to lose time deposits. With the moderation of private demands in the economy and a downturn in total bank credit, the Federal Reserve moved overtly through open market operations gradually to lessen monetary restraint. And, just before the year-end, the System announced that the special factors referred to in the September 1 statement on business loans and discount administration were no longer applicable. The year closed with interest rates generally declining and bank credit again increasing.

As the year ended, it was clear that System policy had helped to prevent the breakout of inflationary psychology which threatened in the early part of 1966 and to moderate the excessively rapid advance of the economy. It was also obvious that the imbalance between monetary and fiscal policy had led to disturbingly rapid increases in interest rates and to profoundly uneven impacts on different sectors of the private economy. Credit policy, moreover, had to resort to certain specific measures, such as the use of Regulation Q to limit maximum interest rates on time deposits, that like other selective and direct regulations have definite limitations. In the light of the 1966 experience, financial institutions appeared to be reappraising their policies with a view to avoiding the recurrence of some of their recent difficulties. Certain groups among the savings institutions faced the problem of finding ways to strengthen their liquidity and to establish a better balance of their assets and liabilities with respect to maturity. The commercial banks, for their part, seemed to be reevaluating in particular the proper function of credit lines and the degree of ease or caution with which they should be extended in the future, as well as their practices with respect to liquidity and their recently increased dependence on borrowed funds. More generally, public attention was drawn to the disruptive side effects of a situation in which excessive reliance had to be placed on monetary policy to avoid an inflationary surge. All in all, there were good prospects that the financial stresses and strains of 1966 could result in public and private actions which would lead to a more soundly based and more readily adaptive credit and financial system.

The policy of monetary restraint proved of great help in the continuing endeavor to eliminate the United States balance-of-payments deficit and, more immediately, in protecting our official reserves. It was a major factor in maintaining confidence in the dollar when foreign opinion was skeptical about United States determination to prevent unsustainably rapid growth; it contributed importantly to improving this country's capital account when the balance on other international transactions worsened. Overall, the liquidity deficit for 1966, at $1.4 billion, was little changed from the $1.3 billion to which it had fallen in 1965. The financing of the deficit, however, altered greatly: the large borrowings of United States banks abroad led to a reduction in official foreign holdings of dollars and thus helped turn the balance on official transactions, as contrasted with the liquidity balance, from a deficit to a surplus. On the other hand, this shift of funds, and to some extent other improvements in capital flows attributable to the tight monetary conditions in the United States, also made the country's external position more vulnerable over the near term.

In view of the continuing balance-of-payments problem, there was no choice but to extend into 1967, and to strengthen modestly, the voluntary restraint programs instituted in 1965—the Federal Reserve-administered program covering the banks and other financial institutions and the Commerce Department program applying to nonfinancial corporations. However undesirable such artificial restraints on international capital flows may be as longer run measures, their extension for another year must be viewed as an alternative to the greater evil of a weakening of confidence in the United States dollar.

Given the key role of the dollar in the world's financial system, assuring that its status as a reserve currency is not jeopardized must also remain a principal goal in the continuing search for ways to improve that system. In the summer of 1966, the system came under heavy pressure as a result of massive speculative sales of sterling. The pressures were successfully countered with the aid of central bank credit arrangements anchored in the Federal Reserve reciprocal currency network. The market then turned in sterling's favor again with the British government's sweeping program of corrective measures. On the positive side, the stability of the international monetary system was substantially strengthened through the increase in the Federal Reserve swap network from $2.8 billion to $4.5 billion in September. In the first part of the year, the facilities available under the International Monetary Fund were also greatly enlarged.

As 1967 opened, both achievements and problems loomed large. On the international economic front, the world's monetary arrangements appeared to be stronger than a year earlier and international liquidity negotiations were making progress in a broader forum. The international adjustment mechanism, however, still appeared less than satisfactory, as many countries struggled with the problem of reaching and maintaining a mix of policies appropriate both for domestic and external objectives. Some Continental countries had made progress in 1966 in reducing their payments surpluses. But a serious overall imbalance persisted in the international payments of the United States on the one hand and of many Continental countries on the other. Development policies increasingly focused on the population problem, as food shortages became a widespread concern. In the meantime, development aid from the industrial nations was kept down by balance-of-payments and budgetary difficulties and numerous other factors involving both givers and takers.

In the United States, the full employment of resources had been achieved and an excessively rapid upswing of total demands had been moderated. But the economy had developed distortions, and costs were under heavy pressure. Returning to a balanced, noninflationary growth and reaching external equilibrium thus posed difficult problems for policy makers. Monetary policy recognized the easing tendencies that had developed in the economy before the end of 1966. After the turn of the year, President Johnson's proposal for surcharges on personal and corporate income taxes pointed up the probable need for fiscal restraint in 1967. Especially in the continuing uncertainty of the Vietnam war, it would seem essential that fiscal, as well as monetary, policy be able to move promptly to meet changing conditions.

THE UNITED STATES ECONOMY IN 1966

Business Conditions: A Year of Strong Demand and Inflationary Pressures

The economy showed clear indications of overheating as 1966 opened. Throughout the year the nation was beset by serious inflationary problems, stemming largely from rapidly growing military demands. Gross national product (GNP) —the total output of goods and services—in 1966 amounted to $740 billion, a gain of $58 billion over 1965. A disturbingly large part of this advance, however, reflected higher prices rather than real growth. In the overly exuberant first quarter of the year, a sharp increase in demand induced an unsustainably rapid expansion in real output as well as an accelerating rise in prices. Real growth through the remainder of the year was slower, reflecting in part the effect of policy measures, but the rate of price increase continued to be excessive. A moderation in the tempo of expansion in the private economy during the latter months of 1966 was accompanied by sluggishness in some important business indicators—such as retail sales and industrial production—and by the emergence of uncomfortably large inventory positions in certain industries.

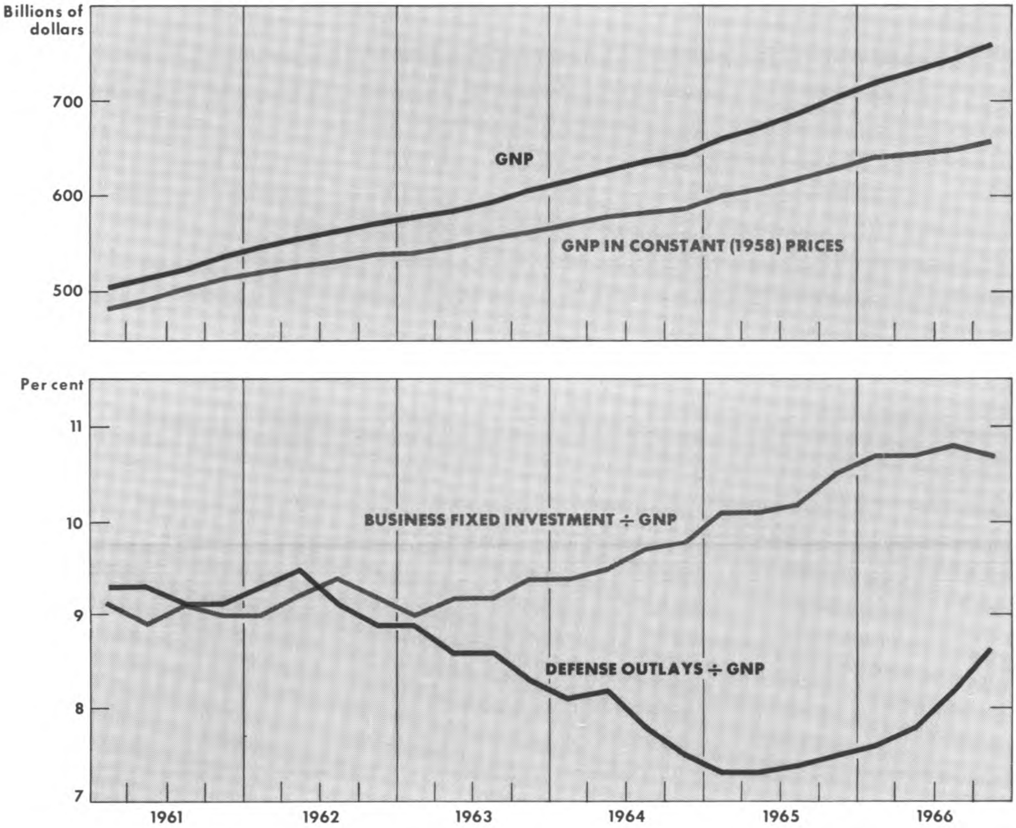
Inflationary pressures were pervasive in 1966, with prices and costs rising throughout the economy. Price advances in the agricultural sector played a smaller part in the overall increase than had been the case in 1965. On the other hand, wholesale prices of nonagricultural goods, as well as consumer prices for services and nonfood commodities, recorded the sharpest advances in many years. While agricultural prices tend to fall as well as rise over time, experience suggests that higher costs and prices outside the agricultural area are largely permanent. In this respect, the course of events in 1966 was of particular concern in view of the difficulties higher industrial prices put in the way of achieving an improvement in the nation's balance of payments. Moreover, the sharp advance in consumer prices is bound to be a factor in the numerous labor negotiations scheduled for 1967, raising the probability of wage settlements that will put further upward pressure on production costs.

THE STIMULUS OF MILITARY DEMAND. The rapid growth of defense requirements was the largest single factor shaping the course of economic activity in 1966. This marked a major shift in the character of the business expansion. For several years the share of defense spending in overall GNP had been declining, and in fact such expenditures had actually edged downward during the years 1962-64. When the commitment of United States forces to Vietnam was expanded in mid-1965, however, there began a sharp, accelerating rise in spending on goods and services for military purposes. Though the share of GNP directly attributable to defense requirements was still only a relatively modest 8½ per cent in the fourth quarter of 1966, in contrast to more than 13 per cent during much of the Korean war period, burgeoning military demands had a dominant influence on the economy's expansion during the year (see Chart 1). The significance of these demands is suggested by the fact that enlarged defense outlays for goods and services accounted for nearly 25 per cent of the increase in GNP during the year, a striking shift from the earlier years of the current expansion when such spending contributed little or nothing to the overall growth of demand.

The military buildup and the demand pressures associated with it affected virtually every sector of economic activity. The armed forces, in adding more than 500,000 men during the year, took a substantial share of the total increase in the nation's available manpower, contributing appreciably to the tightening of civilian labor markets. The surge of military demands was obviously a sharp spur to activity in a number of industries—among them aircraft, ordnance, electronics, and apparel—leading in turn to intensified pressures on productive capacity. The result was further stimulus to the already high level of capital spending. Moreover, the rapid rate of business inventory accumulation during much of the year was in good part related, directly or indirectly, to the expansion of defense demands.

Business fixed capital spending recorded a further strong increase in 1966, generating intense pressures on the capital goods industries as well as very heavy demands for credit. The expansion was particularly rapid early in the year, when corporate profits were continuing to grow in line with the substantial 1965 advance and profit expectations were buoyant. In an effort to moderate excessive demand pressures and restrain some of the exuberance in the civilian economy, President Johnson in April asked businessmen to review their spending plans with a view to finding projects that could be eliminated or stretched out. The growth of capital spending was subject to dampening by other influences as well

Chart 1. GROSS NATIONAL PRODUCT: The expansion of GNP was especially strong in the first quarter of 1966, followed by a more moderate rate of growth. A large part of the year's increase in GNP was attributable to rising prices, and the growth of output measured in constant prices slowed. The share of business fixed investment in total output rose through most of the year, while the share of defense spending moved sharply higher.



GNP is expressed at seasonally adjusted annual rates.

—including the rising cost and reduced availability of credit, shortages of labor and materials, delivery delays, and rising prices. Nevertheless, capital spending continued to expand strongly throughout the first half. In early September, the President asked Congress to suspend temporarily the 7 per cent tax credit on capital investment and the use of accelerated depreciation in business tax calculations. The enactment of these suspensions, effective in early October, may have played some part in the slower rate of capital spending growth in the fourth quarter. The rise in such spending had in fact already slowed in the third quarter, reflecting the influence of the various constraints already cited. A major factor coming to bear toward the end of the year was a slowing in the growth of final demand, while capacity continued to expand. Not only did pressures on capacity ease somewhat, but there also developed some undesired inventory accumulation, which tended to put an additional damper on the investment boom.

RESIDENTIAL CONSTRUCTION AND CONSUMER DEMAND. While the size and great productive potential of the United States economy generally facilitated a continued growth in the output of "butter" despite the sharp rise in the production of "guns", the year was nevertheless marked by some significant readjustments of output and resources. Thus, the shift of national output toward sectors oriented to defense and capital investment was accompanied by a dampening of demand in some civilian-oriented sectors. There was a slowing in the growth of output of consumer goods, particularly durables, but the most severe impact was on residential construction, where activity dropped sharply.

The shift away from residential construction was, in large measure, induced by a reduction in the flow of housing credit. The impact of the reduced availability and sharply rising cost of credit, both for construction loans and for long-term mortgages, was felt in most other types of building activity as well. Construction of stores and offices declined appreciably, and public construction flattened out.

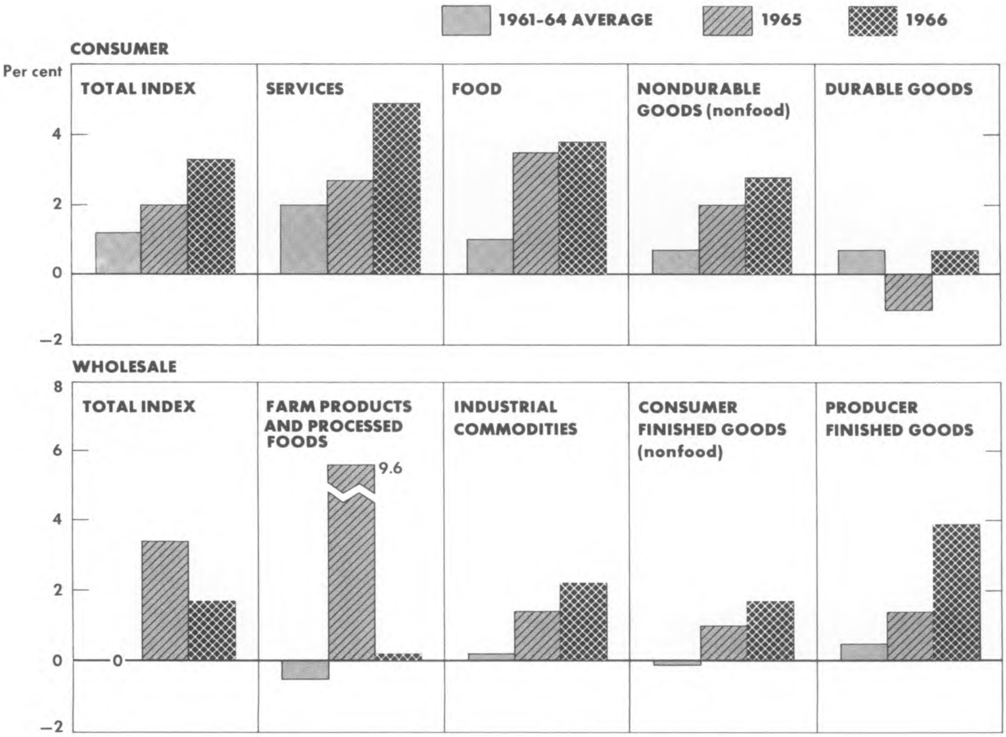
During the first half of the year, exceptionally heavy business demands for credit were augmented by a very large volume of sales of United States Government agency securities and participations in Federal loans. With the overall supply of savings narrowing at the same time, interest rates rose sharply. In the competition for funds, the major traditional sources of home mortgage credit—savings and loan associations and mutual savings banks—experienced particularly severe pressure on their ability to attract funds and hence on their ability to lend. Moreover, the existence of interest rate ceilings under usury laws created additional problems for mortgage lenders in some states. Spending on residential construction fell by 25 per cent between the first and fourth quarters of the year, despite a steady rise in building costs, while over the same period the number of new private nonfarm housing units started dropped by more than one third. The shortage and high cost of mortgage credit also slowed the turnover of existing homes. A sizable volume of backed-up demand for housing apparently developed during the year, as vacancy rates in both sale and rental units moved appreciably lower. By the year-end, there had been some improvement in the housing credit situation, partly as a result of measures taken during the summer and fall (described on pages 27-28 below) to improve the relative position of home mortgage lenders in the competition among institutions seeking loanable funds. At the same time, there were indications in the final months of the year that the decline in housing activity had bottomed out.

The slump in housing activity had ramifications in other parts of the economy. There was some redistribution of productive resources from housing to other areas in the construction sector, as well as some actual release of resources: employment declined in construction while rising strongly elsewhere, and an easing of demand for construction materials reduced pressures in supplying industries. Moreover, there was a slowing in the demand for home furnishings, particularly household appliances. This had a bearing on the sluggishness, during the second half particularly, of aggregate retail sales volume and of consumer goods output. Toward the year-end, some appliance manufacturers apparently found their inventories to be rather heavy and some production cutbacks were instituted.

The growth of consumption expenditures during the year was influenced by a number of other factors in addition to the problems of the housing industry. The vigorous rise of employment and of wage rates led to a brisk advance in money incomes. Yet there was evidence that some uneasiness developed among consumers as the year progressed, arising from various concerns: the Vietnam conflict, the highly publicized issue of auto safety, the stock market decline, rising prices and the possibility of an income tax rise, and apprehension in the latter part of the year that a recession might lie ahead. The rash of buyer strikes during the summer and fall, in protest over food prices particularly, was vivid evidence of consumer restiveness.

Indeed, while personal income was growing strongly, real purchasing power expanded less because of widespread price increases as well as a variety of tax increases. The consumer price index advanced at a rapid pace, as price increases were recorded for a broad range of consumer goods and services (see Chart 2). The 3.3 per cent rise in this index during the year was the largest since 1951. Aside from higher prices, a rise in social security tax rates also cut into the growth of income available for spending. Moreover, higher taxes were imposed by states and localities, including in this Federal Reserve District an income tax in New York City and a sales tax in New Jersey. The quick reimposition of some Federal excise taxes that had been cut in January was specifically intended to restrain demand, as was the shift to graduated Federal income tax withholding (the latter affecting only the timing of tax payments, not actual liabilities). After

Chart 2. CONSUMER AND WHOLESALE PRICE INCREASES: The rise in consumer prices accelerated in 1966, with substantial advances for a broad range of nonfood commodities as well as for foods and services. At the wholesale level, the overall advance was slowed by a decline of agricultural prices in the fourth quarter, but industrial prices rose more rapidly than in 1965 despite a drop in raw materials prices in the latter part of the year.



Data are percentage changes on a December-to-December basis.

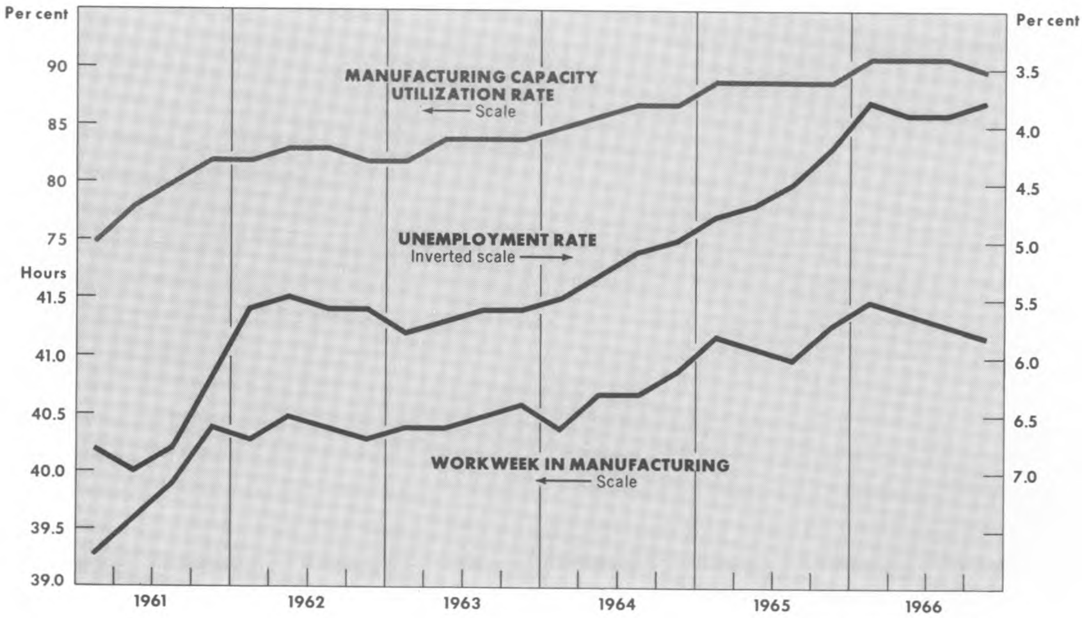
making allowance for the rise in the consumer price index, the take-home pay after taxes of the average worker showed virtually no improvement during 1966.

Consumer demand for durable goods was sluggish through most of the year. In addition to the effect of the housing decline on durables sales, new car demand was decidedly less buoyant in 1966 than in the two preceding years. Auto sales in the fall, after the introduction of the new models, did not come up to industry expectations, and consequently production schedules were revised downward. Total consumer spending on durable goods fell off in the second quarter, when auto sales dipped very sharply, then recovered and held through the second half at about the level reached in the first quarter. Excluding the effects of higher prices, expenditures on durable goods declined somewhat during the course of the year. Outlays for nondurables and services moved ahead throughout 1966, but a substantial share of the higher sales volume reflected higher prices, and in both categories the real growth of consumption during 1966 was smaller than in 1965.

COST AND PRICE PRESSURES ACCELERATE. The pace of economic activity in 1966 put heavy pressure not only on plant capacity but also on the labor supply (see Chart 3). The unemployment rate held below 4 per cent in most months and on several occasions dipped to 3.7 per cent—the lowest rate in thirteen years. Labor shortages, especially of skilled workers, were a factor in the amount of overtime worked and the high level of the factory workweek. The pressures in the labor markets, and the skilled-worker shortage particularly, were to some degree a reflection of the fact that 400,000 adult men (aged 20 and over) were added to the armed forces during the year, along with about 125,000 teen-agers. Under the pressure of heavy nonagricultural and military demands, the long-term downtrend of farm employment accelerated further—releasing more than 300,000 workers. Close to 3 million persons, two thirds of them adults, nevertheless remained unemployed at the year-end. Though many of these workers were unemployed because of normal job turnover, the fact that many others were simply unable to find employment reaffirmed the desirability and value of manpower training and similar programs designed to give these workers the skills required for the jobs the economy has to offer.

In the tight labor market conditions prevailing in 1966, wages rose more rapidly than in any other year of the current expansion. Employers competed to

Chart 3. **RESOURCE UTILIZATION: At the end of 1965, utilization rates both of manpower and of manufacturing capacity were already at high levels. Under the pressure of strong demands, rates of resource utilization rose even further in the first part of 1966 and remained high throughout the year.**



All data are seasonally adjusted.

attract and keep personnel, particularly those with scarce skills, and workers generally found the situation favorable to obtaining sizable pay gains. The high level of corporate profits, following their rapid advance over the several preceding years, was frequently a significant factor both in the formulation of workers' demands and in the terms of the settlements reached. In the latter half of the year, an identifiable pattern of annual increases approximating 5 per cent was emerging from well-publicized negotiations, raising serious concern over the course of labor costs in 1967 when a number of major contracts come up for negotiation. Another worrisome development was the renewed interest in cost-of-living escalator clauses, which in the past have contributed significantly to feeding inflationary pressures. The substantial gains in compensation being recorded in a broad range of industries were outpacing the growth of overall labor productivity—which was slowing while wage rises were accelerating—and unit labor costs began to rise after several years of virtual stability. Increases of this sort were a particularly important factor in the rapid advance of consumer service prices, but their impact was felt, on both profits and prices, over a wide range of the economy. In the manufacturing sector, unit labor costs rose by close to 3 per cent during the year, with the rate of increase accelerating in the second half.

The strength of aggregate demand not only played a role in the rise of unit labor costs but also clearly permitted—indeed even encouraged—producers of goods and services to raise their prices on a broad front. The most striking feature of the price advance during the year was its pervasiveness throughout the nonagricultural sectors. Though sharp increases for foods and other farm products were a significant force pushing up the overall level of both wholesale and consumer prices during much of 1966, the latter months of the year saw a substantial reversal of this thrust as agricultural supply conditions improved. Nonagricultural prices, in contrast, generally rose at a pace substantially faster than in recent years. In consumer markets, this was true of prices both for services and for nonfood commodities. At the wholesale level, the index of industrial prices rose during the first half at an annual rate in excess of 3 per cent, more than twice the 1965 advance. After midyear the industrial index showed only a very modest further rise, largely as a result of price declines for certain raw materials—such as lumber and other building materials and leather—which had previously soared to very high levels. Prices of semifinished and finished commodities continued to rise at a substantial pace. Increases during the year were especially sharp for machinery and for producers' equipment generally.

Monetary Policy and Credit Markets: Restraint Takes Hold

At the beginning of 1966, it was evident that the major task of monetary policy would be to restrain demand pressures in an economy that was clearly overheated. While there had been a moderate shift toward monetary restraint in 1965, in the latter months of that year it had become clear that the threat of serious inflationary pressures was increasing. The need not only to preserve balance in the domestic economy but also to improve our international payments position called for further measures to moderate the rise in aggregate demand. Since fiscal policy in 1966 continued to be stimulative on balance, a heavy burden was placed on monetary policy in the task of exerting the needed restraint.

The period roughly comprising the first two thirds of the year was characterized by a gradual increase in monetary restraint. In the face of very strong credit demands both at banks and in securities markets, there was a sharp rise in interest rates and increasing strain in financial markets. In contrast, the latter months of the year were marked by an easing of demands in the private economy and a slowing in the pace of credit expansion coupled with an appreciable calming and subsequent easing of the atmosphere in financial markets. With the moderation of private demand, the Federal Reserve moved in the late fall toward a less restrictive policy stance.

The gradual move toward restraint by the Federal Reserve during 1965 had culminated in an increase in the discount rate in early December and a simultaneous increase in time deposit interest rate limits under Regulation Q. In December and January, the System sought to facilitate a smooth transition to higher interest rate levels by easing the pressure on bank reserves, and net borrowed reserves fell to levels of less than $50 million from an average of about $150 million in the preceding months. Thereafter, increasing pressure was put on bank reserve positions. Member banks stepped up their borrowings from the Federal Reserve, and net borrowed reserves averaged between $300 million and $400 million in May and June.

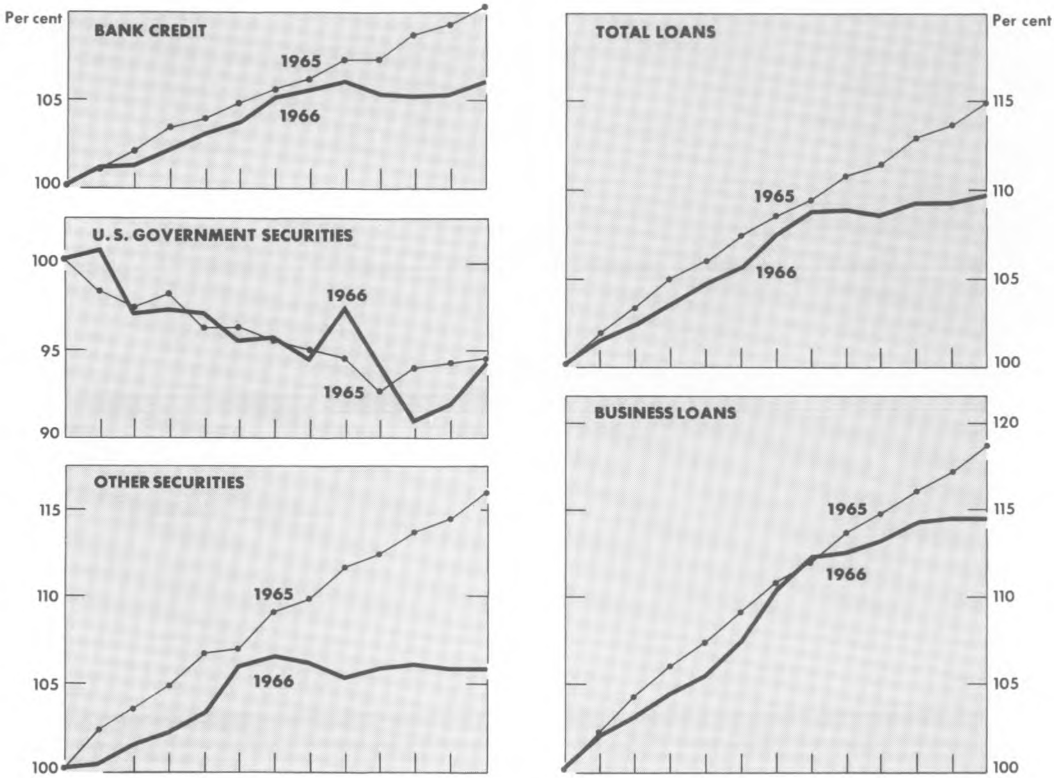
Between July 14 and September 2, the boards of directors of seven of the Federal Reserve Banks voted discount rate increases of either ½ or 1 percentage point, subject to review and determination by the Board of Governors of the Federal Reserve System. In no instance did the Board of Governors approve the proposed discount rate increases. This Bank's directors voted to increase the discount rate ½ of a percentage point, to 5 per cent, on July 14.

The directors felt that such action was appropriate in view of the inflationary pressures in the economy, the continuing balance-of-payments deficit, and the absence of greater fiscal restraint. Moreover, the wide spread between the existing discount rate and most market rates was contributing to the uncertainties in the credit markets and might lead to difficulties in discount window administration. In disapproving this discount rate increase, the Board of Governors noted that it might weaken the effect of the previously announced rise in the British bank rate, designed to strengthen the position of the pound sterling. The Board questioned whether a discount rate increase of ½ of a percentage point would be sufficient to quiet domestic credit market uncertainties; it suggested that the announcement effect of such a change could be exaggerated, and might result in further undesirable interest rate escalation. The Board also noted that it was not evident that the unusual spread between the discount rate and market rates was causing unmanageable problems in discount window administration.

During the summer months, the Board of Governors of the Federal Reserve System moved to limit member bank reserve availability by increasing, in July and September, reserve requirements on time deposits in excess of $5 million. In addition, the Board constrained banks' ability to attract funds, and thus their lending ability, by reducing maximum rates payable on smaller denomination time certificates of deposit (C/D's) in July and September and by not raising the maximum rate on large-denomination C/D's. Banks sought to maintain their lending ability by reducing their Government securities holdings and bidding aggressively for loanable funds. As a result, they were able to maintain a very rapid expansion of lending, particularly to business, into the third quarter of the year (see Chart 4).

Though policy restraint clearly worked to moderate aggregate demand growth during the year, the heavy reliance on monetary measures was accompanied by mounting strains in the financial markets. Through the late spring and into the summer, sharply rising interest rates and growing congestion in the securities markets reinforced expectations of still tighter credit conditions. These developments came to a climax in August, when many interest rates reached the highest levels in more than a generation and disorderly conditions appeared to threaten in some market sectors. In a statement to member banks dated September 1, the Federal Reserve made clear its desire to see a slowing in the growth of bank loans to business, as a means both of reducing the rate of total bank credit expansion and of easing the pressure that banks were putting on the securities markets. At the same time, the System sought to assure financial markets of its intent to provide adequate reserves to support reasonable credit growth, and to prevent any unduly severe market stringency. Furthermore, the Administration early

Chart 4. BANK CREDIT: Following an exceptionally strong advance in 1965, total bank credit continued to grow at a fast rate through the first eight months of 1966. Business loans showed a particularly rapid expansion, due in part to special pressures associated with a shift in tax payment schedules. Holdings of United States Government securities declined through most of the year, while the aggregate portfolio of other investments ceased growing after mid-year. Business loan growth slowed in the latter months of 1966, and the expansion of total bank credit was interrupted; at the close of the year, however, bank credit was again expanding.



Data shown are for all commercial banks, as of the end of the month, seasonally adjusted. Monthly figures for each year are expressed in terms of an index with the value for December of the preceding year set equal to 100.

in September introduced measures of additional fiscal restraint and announced a curtailment through the end of the year of demands to be placed on the credit markets by the sale of Federal agency securities and participations in Federal loans.

In the latter months of the year, market expectations improved significantly, as financial pressures moderated and interest rates declined appreciably from their late-summer peaks. The easing of excessive demand pressures led the Federal Reserve to relax the degree of restraint on bank reserve positions. While net borrowed reserves gradually declined, the lending ability of banks nevertheless remained heavily constrained. This tightness, as well as some apparent slackening in loan demand, was reflected in a very marked slowing of bank loan expansion and an actual interruption, for a short period during the fall, in the growth of overall bank credit. The expansion of total bank credit was resumed in December. Late in the year, it was announced that, in view of substantial moderation in bank credit growth and in financial market strains, the Federal Reserve System's September 1 statement was no longer applicable.

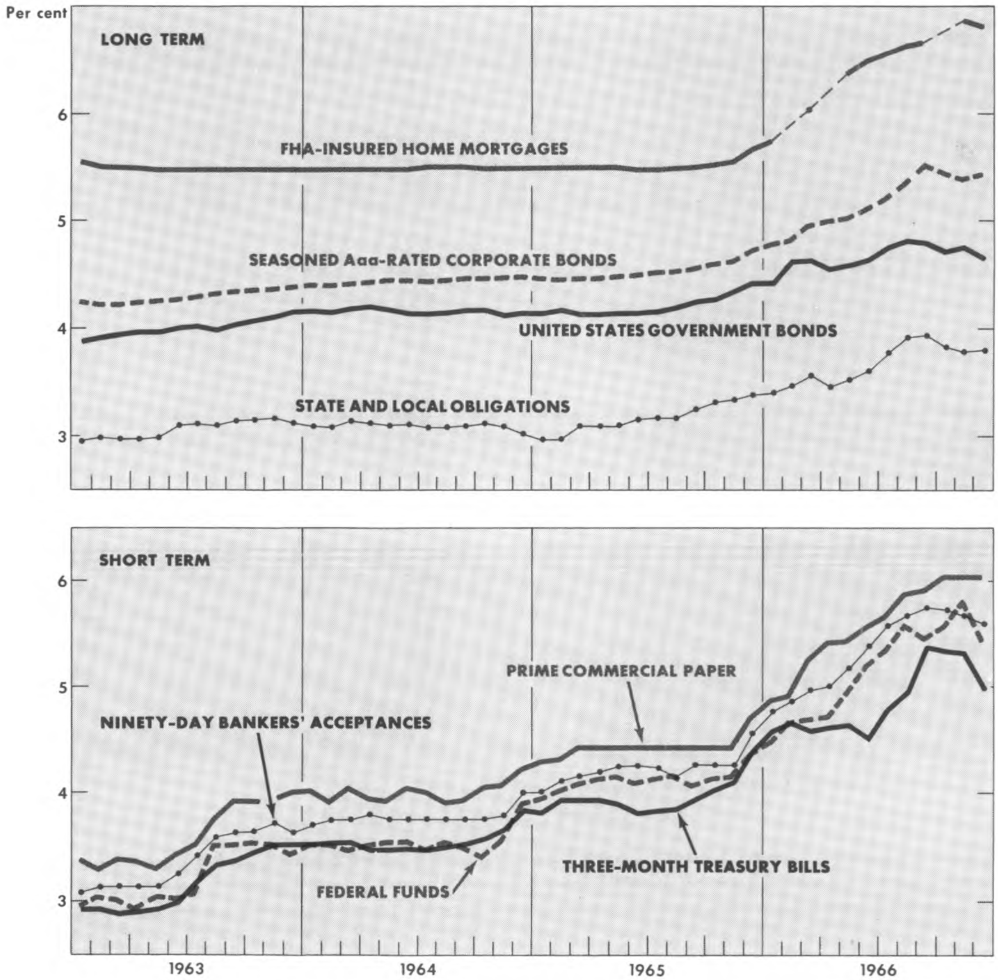
INTENSE COMPETITION IN THE CREDIT MARKETS. The aggregate expansion of credit through most of 1966 was clearly too rapid relative to the economy's capacity for real growth without causing inflationary imbalances. Business demand for borrowed funds was extremely heavy, stimulated by the widening gap between cash flow and outlays for investment in capital facilities and inventories. Internal cash flow was very heavily limited in the first half of the year by changes in the schedules for paying Federal corporate income taxes and taxes withheld from employees, and these special but nonrecurring factors provided an unusual extra stimulus to business borrowing in that period. Cash flow was also affected by the fact that corporate profits, after reaching a record high in the first quarter, failed to expand further in the second quarter and declined slightly during the second half of the year. The credit needs associated with the vigorous growth of economic activity were augmented in the spring and summer by anticipatory borrowing stemming from expectations of continuing interest rate rises and shrinking credit availability. Moreover, large sales of Federal Government agency and participation issues, concentrated in the second quarter, added heavily to pressures on the credit markets and on interest rates.

A striking characteristic of the very rapid growth of total credit during the year was the substantial shift of credit flows toward business borrowers. Businesses borrowed very heavily in the securities markets, while at the same time banks were most reluctant to turn down their business customers. Given the restrictive policy of the Federal Reserve, banks could maintain this rapid loan growth only by seeking aggressively to attract loanable funds and by reducing their holdings of securities. Early in the year, rates paid on C/D's of most maturities moved swiftly toward the 5½ per cent ceiling set under Regulation Q, but the inflow of time deposit funds nevertheless slowed as competing money market instruments became more attractive (see Chart 5). Facing a slowdown in sales of large-denomination C/D's to business, banks moved aggressively to tap consumer savings by offering small-denomination C/D's. A good part of the growth in these deposits was at the expense of the banks' own passbook savings accounts. There was also a shift of savings flows away from thrift institutions, such as savings and loan associations and mutual savings banks, and toward both the credit markets and commercial banks.

Aggressive bidding for Federal funds, at progressively higher interest rates, also reflected the heavy pressure on bank liquidity. In still another measure to attract loanable funds, large banks with international operations borrowed substantial amounts of foreign-owned dollar balances through their branches abroad. As banks found it increasingly difficult and costly to attract funds and bank liquidity declined, lending terms grew progressively stiffer. Rates on consumer loans generally advanced, and the prime rate, charged to the best business customers, was upped three times during the year to reach 6 per cent in August. In such conditions, the chief means open to banks of obtaining funds for lending was the running-down of investment portfolios. The decline in United States Government securities holdings was sharp, while the acquisition of state and local government securities—for which banks had provided important buying support in recent years—slowed substantially. These actions contributed significantly to the upward pressure on market interest rates.

Responding to the high market rates available, the savings flows of the nonfinancial public shifted markedly toward the direct acquisition of capital market instruments in preference to claims on banks and other depository institutions. The rise in direct lending meant that the public was increasingly acquiring less liquid capital market instruments, with the result that its liquidity position gradually became less ample. While depository institutions as a group experienced a reduction both in fund inflows and in their importance as credit suppliers, the commercial banks fared better than the savings and loan associations and mutual savings banks. Savings institutions are heavily invested in long-term

Chart 5. INTEREST RATES: Intense competition for funds was reflected in a sharp rise through much of 1966 in both short- and long-term interest rates. By late summer, rates in many market sectors had reached the highest levels in decades, but rates moved lower again in the latter part of the year as financial pressures eased.



Mortgage interest rate data are average yields in secondary markets for Federal Housing Administration-insured mortgages on new homes, with thirty-year maturity. For short periods following changes in the maximum contractual rate, secondary market yield data are not available; such periods are indicated by broken lines.

mortgages carrying fixed interest rates, while the bulk of their liabilities is short term. Thus these institutions had much less flexibility than the commercial banks in raising the rate of return on their portfolios. This in turn limited their ability to raise interest rates on deposits and compete for loanable funds.

The increasing interest rate competition among financial intermediaries during the spring and summer was of concern to the Federal Reserve System and to other regulatory agencies. Mutual savings banks and savings and loan associations were encountering especially serious difficulties, as their overall net intake of funds dwindled and many suffered sizable deposit losses. In this situation, special arrangements were made by the Federal Reserve to provide emergency credit assistance to nonmember depository-type financial institutions that might experience large deposit drains. These arrangements were designed for use in the unlikely event that exceptional drains of funds from such institutions could not be accommodated through normal adjustment procedures. In fact, the special arrangements were not used.

On the other hand, the strong competitive position of banks in the deposit markets enabled them to maintain a high rate of lending, especially to businesses. To exert a tempering influence on bank issuance of C/D's, the Federal Reserve Board in July and September increased the reserve requirements on time deposits in excess of $5 million. In July, the Board also reduced from 5½ per cent to 5 per cent the maximum rate that banks could pay on new multiple-maturity time deposits, the form in which small-denomination C/D's were most commonly sold.

As a result of the combined effects of heavy credit demands and restrictive policy, it appeared to market participants that current and prospective credit demands were running well ahead of available supplies, with the result that market expectations deteriorated as the summer progressed. Interest rates were by August at the highest levels in decades, and there was growing congestion in the securities markets as the prospect of a further heavy volume of Federal agency securities and participation certificates was superimposed on the strong and growing credit demands of businesses and state and local governments. At the same time, banks continued to liquidate sizable amounts of some types of securities, while sharply curtailing the acquisition of others. Insurance companies, too, were hard pressed to meet loan commitments as a sharp rise in policy loans and a fall in loan repayments cut into their cash flow. The rise in interest rates and an expectation that credit conditions would become still tighter in turn stimulated additional anticipatory demand for credit. Against this background of sharply rising interest rates, falling bond prices, and a heavy calendar of forthcoming issues, there developed something of an atmosphere of impending crisis. Sellers in the securities markets found dealers very reluctant to bid, and new issues moved very slowly even at sharply higher offering yields. Market participants were increasingly concerned over the chance that even more severe pressures might develop—especially if banks began to experience, at the September tax date, a sizable loss of C/D funds.

CREDIT MARKET TENSION EASES. The fears that characterized the credit markets proved unfounded. The System sought, during the late summer and the fall, to reemphasize that it had both the instruments and will to do whatever might be needed to avoid a financial crisis. Perhaps more importantly, the Administration moved to moderate Federal credit demands. It was announced in September that sales of participations in Federal loans would be temporarily suspended and that Federal agencies likewise would cease temporarily to raise new funds through the markets. Moreover, the Administration's request for suspension of tax incentives to investment was a specific measure to impose some degree of fiscal restraint on aggregate demand, thus tending to moderate some of the pressures generated by the heavy reliance on monetary policy. In late September, Congress granted to the Federal Reserve, and to other agencies responsible for supervising financial institutions, broader and more flexible powers to regulate the rate practices of banks and savings institutions. The System quickly imposed a 5 per cent ceiling on the smaller denomination, fixed maturity C/D's that were competing most directly with deposits at savings institutions. At the same time, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board established various interest rate limits intended to reduce the intensity of competition among institutions seeking to attract savings. These actions served further to reduce the earlier concern regarding the condition of the thrift institutions.

The restoration of a calmer atmosphere in the financial markets during the fall took place along with a perceptible easing of demand pressures in the private areas of the economy. This easing, as well as the abatement of anticipatory credit demands, and the termination—at least temporarily—of special credit needs associated with the acceleration of corporate tax payments, all contributed to a reduction of financial pressures. Interest rates in a number of market sectors declined appreciably from their late-summer peaks. Credit conditions remained tight, however. State and local governments, in particular, continued to encounter difficulty in raising funds at interest rates acceptable to them, and there was scarcely any easing in mortgage interest rates. Toward the year-end, however, there was an appreciable improvement in fund flows to thrift institutions, and this further helped to dispel the highly apprehensive atmosphere that had prevailed in midsummer.

Late in the year, with some abatement of excessive demand pressures in the economy, the Federal Reserve took a less restrictive stance in the supplying of bank reserves. Net borrowed reserves declined and in December averaged about $150 million, contrasted with as much as $400-500 million during the August-October period. The moderation in aggregate demand pressures, as well as the changes that had occurred in the credit markets, was reflected in the announcement late in December that the System's September 1 statement relating to business loans and discount administration had served its purpose and was no longer applicable.

Though there was some apparent easing in the intensity of demand for bank loans, as for credit generally, supply factors were also of great importance in the sharp slowing of business loan expansion during the latter part of the year and the interruption, for a period, of growth in total bank credit. In the period from August through November, banks experienced a runoff of large-denomination C/D's, to the extent of nearly $3 billion, as funds shifted to competing instruments yielding more than the maximum 5½ per cent payable on the C/D's. The loss of C/D funds was partly offset by a rise in the inflow of foreign-owned dollar balances, borrowed by some banks through their branches abroad. Nevertheless, to maintain expansion of their loan portfolios, banks had to make continuing sizable reductions in their investment holdings. Bank liquidity thus declined even further, and this served as an important constraint on lending. As the year drew to a close, the easing of financial market pressures and the decline of interest rates helped to improve the position of banks by stemming the outflow of C/D funds, and the expansion of total bank credit was resumed. The liquidity position of banks remained tight, however, and there was no easing of their lending terms.

Bank credit expanded in 1966 by a bit less than $18 billion, down sharply from the exceptionally large increase of $28 billion recorded in 1965. The pace of overall credit expansion also slowed in 1966, but the reduction was milder than that which occurred in bank credit. The flow of credit to the nonfinancial sectors of the economy, from all sources, amounted to $70 billion in 1966, compared with about $72 billion in 1965. Through most of 1966, as bank credit became costlier and harder to obtain, borrowers increasingly turned to other sources of credit. The year was thus marked by a substantial rise in the share of credit flowing directly from savers to final borrowers, bypassing both commercial banks and other financial intermediaries. In these circumstances, the shrinkage in bank credit growth exaggerated the degree of tightness in overall credit availability. The growth in direct lending was, however, associated with a marked slowing in the growth of the nonfinancial public's holdings of liquid assets—money, time deposits, savings shares, and the like. As a result, there was a sharp decline in the public's liquidity position measured relative to the aggregate volume of economic activity.

In the final months of the year, direct lending by the nonfinancial public dropped off sharply. At the same time, financial intermediaries—thrift institutions and insurance companies, as well as commercial banks—were giving high priority to the rebuilding of their liquidity positions, and they increased their lending only moderately. Thus, the flow of overall credit to the nonfinancial sectors of the economy declined in the latter part of the year.

THE WORLD ECONOMY IN 1966

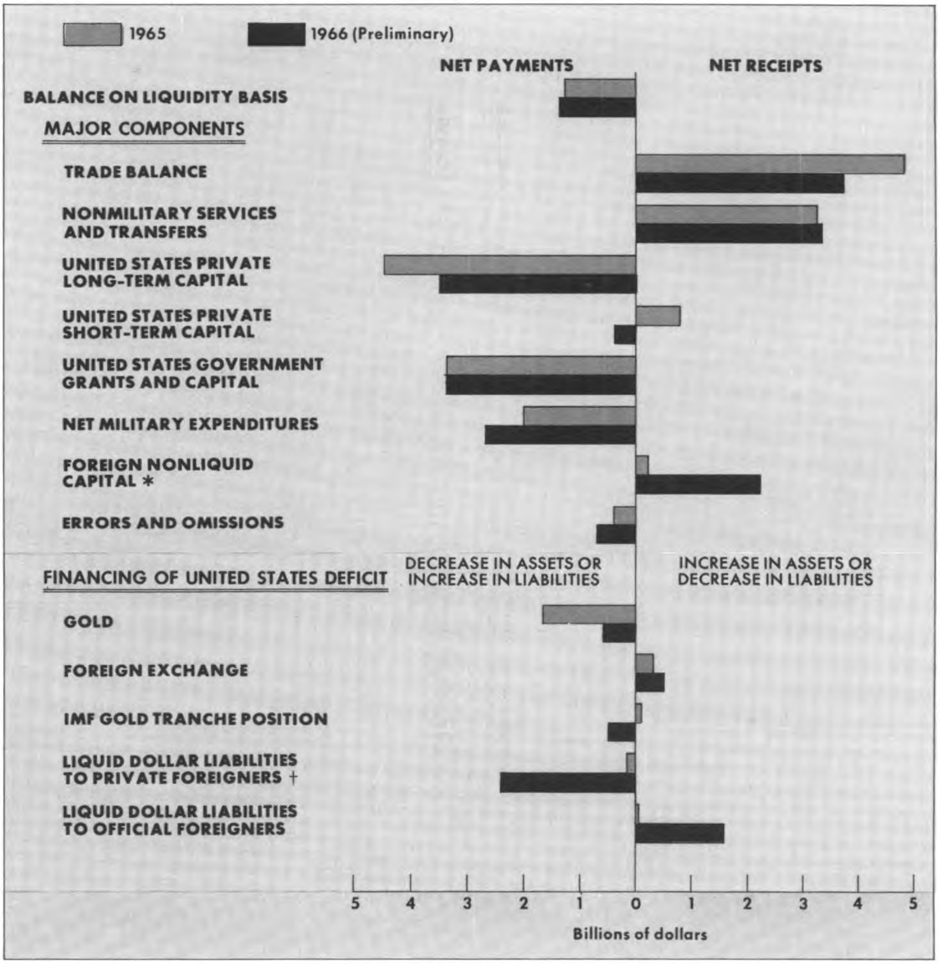
The United States Balance of Payments: The Vietnam War Retards Restoration of Equilibrium

The United States balance-of-payments deficit on the liquidity basis[1] increased slightly to $1.4 billion in 1966 from $1.3 billion in 1965 (see Chart 6). The direct and indirect effects of the expanding United States role in the Vietnam war hindered further progress in reducing the deficit. In addition to mounting United States Government and troop spending abroad, the growing military effort also intensified domestic demand pressures which cut into the United States trade surplus. Had it not been for a very large shift from liquid to nonliquid investments by foreign monetary authorities and international organizations, a sharp worsening in the payments balance would have occurred. At the same time, tighter credit conditions in the United States and the President's voluntary restraint program—particularly that part covering foreign transactions of domestic business concerns—significantly improved the United States balance on private long-term capital flows.

Tight credit conditions and relatively high interest rates in this country also played a major role in the emergence in 1966 of a $0.3 billion payments surplus on the basis of official reserve transactions—a substantial improvement over the $1.3 billion deficit recorded in 1965. The squeeze on the liquidity positions of major United States international banks in 1966 led them to bid aggressively

[1] *The "balance on liquidity basis", as defined by the United States Department of Commerce in its* Survey of Current Business, *is the net sum of transactions in merchandise trade, services and transfers, United States private capital, United States Government grants and capital, foreign nonliquid capital, and unidentified transactions. When summed, these transactions equal the change, if any, in the United States international liquidity position, i.e., in United States monetary reserves and liquid liabilities to* all *foreigners. Another definition of the payments position published in the* Survey *is called the "balance on official reserve transactions basis". This definition differs from the "liquidity" balance in that changes in liquid liabilities to private foreigners and nonmonetary international organizations are put "above the line", and certain nonliquid liabilities to official foreigners are put "below the line". Hence, this balance is measured by changes in United States monetary reserves and changes in liquid and certain nonliquid liabilities to* official *foreigners.*

Chart 6. THE UNITED STATES BALANCE OF PAYMENTS—ITS COMPONENTS AND FINANCING: The United States balance-of-payments deficit (on the liquidity basis) in 1966 was slightly larger than the deficit the previous year. The expansion of the Vietnam conflict led to increased Government spending abroad and intensified demand pressures in the domestic economy, which cut into the trade surplus. Despite a decline in liquid liabilities to official foreigners, total liquid liabilities to all foreigners showed a larger increase in 1966 than in 1965, but gold losses declined to less than half the 1965 rate.



* Foreign private and official long-term investments in this country, prepayments for military shipments, and purchases of nonmarketable nonconvertible United States Treasury securities.

† Including nonmonetary international and regional organizations.

for dollar funds through their branches abroad. As a result, Euro-dollar rates climbed steeply, private investors abroad were encouraged to increase their holdings of dollars, and the flow of dollars to foreign central banks was cut back. Prepayments of governmental obligations to the United States also tended to reduce official dollar holdings in some countries. United States monetary reserves, however, declined.

EXCESSIVE DEMAND CUTS TRADE SURPLUS. With the rise in aggregate spending intensifying the pressure on domestic resources and prices, excess demand spilled over into imports and tended to retard export growth. Thus, the trade surplus declined \$1.1 billion to \$3.7 billion in 1966.

Imports rose by 19 per cent in 1966, compared with 14 per cent in the preceding year and an average 6 per cent increase in the previous ten years. Almost all the rise in 1966 was due to a larger physical volume of imports. Although increased demands for imports were spread across the board, there were especially large advances in imports of consumer goods and capital equipment, particularly machinery. The rise in machinery imports reflected, in part, the lengthening delivery schedules of domestic suppliers. There was also a large increase in automotive imports, mainly caused by the implementation of the free trade agreement on automobiles and parts signed by the United States and Canada in 1965. At the end of 1966, some slowdown in the rate of growth of imports was probably due to the easing of pressures on domestic resources.

The large increase in imports was partially offset by a substantial rise in United States exports. During the year, exports expanded by some 11 per cent, compared with 4 per cent the previous year. The growth of exports was due to a number of special factors as well as to the generally high level of economic activity abroad. Agricultural exports were up very sharply, partly as a result of a step-up in United States Government-financed shipments under Public Law 480. The free trade agreement on automotive products with Canada also led to substantial increases in exports of passenger cars and parts. Aside from these special gains, exports of machinery (particularly electrical machinery) and chemicals showed significant increases. Aircraft exports were, however, delayed by production bottlenecks.

A reduction in the demand pressures in the United States economy could halt the erosion of the trade surplus. But adverse cost-price developments in the United States during 1966 could have a more lasting effect on our international competitive position. In contrast to the more rapid rate of increase of United States prices and costs, price increases in most industrial countries abroad were apparently not much greater, and were often less, in 1966 than in 1965. Thus, in 1966, the United States probably experienced a smaller improvement in its international competitive position than in the earlier years of the current economic expansion.

GOVERNMENT SPENDING ABROAD RISES. The increasing scale of the United States commitment in Vietnam led to a substantial rise in United States Government spending abroad. Net military spending overseas increased by an estimated $0.7 billion. Almost all of this rise was directly associated with the war effort. While the Government's net foreign grants and loans did not increase significantly, there would have been a sizable increase in the outflow except for the receipt of over $0.4 billion of debt prepayments by France, Italy, and Germany.

LONG-TERM CAPITAL OUTFLOWS REDUCED. In contrast with the adverse impact of the Vietnam war, a number of factors—including the restrictive credit policy of the Federal Reserve and the voluntary restraint program—contributed to a significant improvement in the United States balance on long-term capital account. The flow of private foreign capital into nonliquid dollar assets was substantial, while the outflow of private United States long-term capital was apparently reduced by over $0.9 billion in 1966 from approximately $4.4 billion in 1965 and 1964.

While direct investment outflows by United States corporations in 1966 were not substantially below the $3.4 billion outflow in 1965, the net balance-of-payments impact of these outflows was mitigated as a result of the Administration's voluntary restraint program. Under this program, participating corporations were requested to limit the total of direct investment outflows and reinvested earnings in developed countries abroad. However, funds borrowed overseas could be set against investment outflows in meeting targets, and United States corporations financed a larger proportion of their foreign investments through new securities issues in Europe. The total of such issues by financial affiliates incorporated in the United States is estimated to have risen to $0.6 billion in 1966, from about $0.2 billion in 1965. The long-term capital inflow resulting from these new issues abroad partly offset the adverse balance-of-payments impact of direct investment outflows. At the same time, the restraint program encouraged large borrowings in foreign markets by subsidiaries and affiliates incorporated abroad of United States firms, thus reducing their need for direct investment funds from the United States.

The balance of payments drew additional support in 1966 from a moderate reduction in long-term United States bank loans to foreigners. The strong domestic demand for credit and a shortage of loanable funds reduced the incentive to lend abroad, with the result that net bank claims on foreigners declined by some $0.3 billion—the decline in long-term claims more than offsetting a slight increase in short-term claims. Consequently, most banks had no difficulty in staying well within the guidelines suggested by the Federal Reserve under the voluntary credit restraint program and, at the end of the year, banks were about $0.9 billion below the recommended ceiling.

Also contributing to the reduction in the outflow of private United States long-term capital in 1966 was a modest decline in net purchases of foreign securities by United States residents. Although new issues by foreign borrowers totaled about the same in both years, the 1966 total was swollen by some $150 million of Canadian securities that were delayed from 1965 to 1966 under an intergovernmental understanding. Redemptions and transactions in outstanding foreign securities resulted in a larger influx of funds in 1966 than in 1965, but a large part of this improvement reflected special purchases by the Canadian government of Canadian and World Bank securities held by United States residents. In any case, it appears that tighter credit conditions and higher long-term interest rates in the United States tended to deter new offerings by foreign borrowers and to discourage purchases of foreign securities by domestic residents.

An inflow of foreign nonliquid capital in excess of $2.0 billion—compared with a $0.2 billion inflow in 1965—provided major support for the United States payments position. About half of this inflow reflected shifts out of short-term, liquid dollar instruments into long-term investments by international institutions and foreign monetary authorities. In addition, net military prepayments by Germany (under its agreement to offset the foreign exchange cost of stationing United States troops in Germany by military purchases in the United States) contributed to the inflow of official nonliquid capital.

MODERATE SHORT-TERM CAPITAL OUTFLOWS. While long-term capital flows shifted sharply in favor of this country in 1966, there was a moderate outflow of United States short-term funds. This outflow represented a substantial deterioration from the $0.8 billion inflow of funds in 1965. However, the 1965 experience had been largely due to the initial impact of the voluntary restraint program, as United States business firms and financial corporations repatriated funds held abroad in compliance with the 1965 guidelines.

FINANCING THE DEFICIT. In contrast to 1965, when the liquidity deficit was largely financed by gold sales, the $1.4 billion 1966 deficit was financed by an increase of over $0.8 billion in liquid dollar liabilities to foreigners and a $568 million decline in United States monetary reserves. The reserve loss consisted of a $571 million gold outflow and a $537 million decline in the United States International Monetary Fund (IMF) position, only partially offset by a $540 million increase in United States holdings of convertible currencies. While liquid dollar liabilities to foreign monetary authorities declined by nearly $1.6 billion in 1966, liquid liabilities to private foreigners—which include the foreign branches of United States banks—and nonmonetary international institutions increased by $2.4 billion. This massive buildup in foreign private liquid dollar holdings, which helped reverse the preceding year's flow of dollars to foreign central banks, largely reflected tight credit conditions in the United States. Major United States international banks, in their efforts to satisfy domestic demand for credit, borrowed heavily in the Euro-dollar market, including funds with very short maturities, through their foreign branches. As a result, liabilities to these branches abroad increased by approximately $2.5 billion. A substantial portion of the inflow of liquid funds represented by this increase in foreign private holdings of dollars could be reversed should credit conditions in this country ease significantly in comparison with credit conditions abroad. Such a reflux could lead to substantial dollar sales to foreign monetary authorities, which by itself could shift the balance on official reserve transactions into deficit again.

Most of the 1966 decline in the United States gold stock occurred in the first half of the year and was more than accounted for by French gold purchases. However, as the year advanced the French payments position deteriorated, and the Bank of France bought no more gold from the United States after September. During 1966, the United States made a number of drawings on the IMF; however, other countries drew substantial amounts of dollars, reducing the Fund's dollar holdings and thus decreasing the United States repayment obligation. As a result, the increase in net United States indebtedness to the Fund was held to $537 million during 1966. The increase in United States holdings of convertible currencies largely reflected official United States participation in international currency stabilization operations; monetary authorities abroad received dollars to use in these operations, and the United States received foreign currencies in return.

VOLUNTARY RESTRAINT PROGRAM EXTENDED. In view of the continuing need for a reduction in the United States balance-of-payments deficit, the Administration's voluntary restraint program was extended for another year in December 1966. The Department of Commerce guidelines for 1967 were designed to improve the aggregate of selected balance-of-payments transactions of nonfinancial corporations. As part of the overall target, the total of direct investment outflows and retained earnings in selected countries, minus borrowings abroad, is to be limited under a formula designed to hold the net total of such flows close to the 1966 experience.

The Federal Reserve guidelines for banks in 1967 are somewhat more restrictive than in 1966. The 1967 ceiling on bank credit to foreigners was kept at the same level as in 1966, but banks were asked to space out the use of the leeway under the ceiling which, as of September 30, 1966, amounted to approximately $1.2 billion. Not more than 40 per cent of the leeway is to be used before March 31, 1967, and an additional 20 per cent becomes usable in each of the remaining three quarters to the end of 1967. In addition, increases in credits to developed countries (which should give absolute priority to financing United States exports) during the five quarters should take up no more than 10 per cent of the total leeway. In effect, this provision limits the increase through the end of 1967 in lending to developed countries by banks to about $120 million. In connection with such loans, banks were again requested to avoid policies that would place undue burden on the payments position of the United Kingdom, Japan, and Canada. The guidelines for nonbank financial institutions were simplified: these institutions were requested to limit the increase in certain types of loans and investments in selected foreign countries until the end of 1967 to no more than 5 per cent of the level on September 30, 1966.

The International Monetary System: Progress in Cooperation and Reform

In 1966, the Free World made further progress in expanding working arrangements to meet current problems and in developing plans for reform of the institutional framework so that future reserve adequacy and efficient adjustment of international payments imbalances can be assured.

The strong speculative pressure on sterling in the exchange markets in early summer was met by the British authorities through use of credit facilities that were largely in force when the heavy selling of sterling started. These facilities, developed in the last few years, included central bank and other credit lines from the United States, nine other countries, and the Bank for International Settlements (BIS). The short-term credits from European central banks, which had formed a part of the September 1965 arrangements in support of the pound, came up for renewal in June and were placed on a continuing basis, this time including French participation. Drawing upon the various facilities as selling pressures on sterling grew, the British authorities were able to gain the time needed to put into effect the sweeping corrective program announced on July 20 (see page 41 below).

The sterling and other exchange markets, which had been subject to considerable buffeting during July when speculation against the pound reached major proportions, settled down to more balanced and orderly trading in August, but in an atmosphere of continued anxiety. Against this background, the Federal Reserve broadened earlier discussions aimed at enlarging its network of swap arrangements with foreign monetary authorities (eleven central banks and the BIS). In September, nearly all swap lines were increased, including a \$0.6 billion increase (to \$1.35 billion) in the facility with the Bank of England. The total of all arrangements was raised to \$4.5 billion from \$2.8 billion, increasing reciprocal credit facilities to levels well above the size of any routine drawing that might reasonably be expected and thus creating a broad margin of safety against any unforeseeable threats to international currency stability. The Bank of England announced the negotiation of new credit facilities with European central banks at the same time that its swap line with the Federal Reserve was increased; these moves helped to set the stage for the return of market confidence in sterling.

In addition to the expansion of bilateral credit lines between central banks, the general increase in country quotas at the IMF served to strengthen further the international monetary system. Most countries—including the United States—agreed to a 25 per cent increase in their quotas, and some sixteen countries (including Canada, Germany, and Sweden), whose international transactions have become increasingly important in the world economy, accepted even larger percentage increases. The effect was to raise aggregate IMF quotas from $16.0 billion to $20.6 billion during the year. The IMF also made several innovations in its own operations. For example, in connection with a United States drawing in August, the Fund arranged to borrow $250 million equivalent of lire from the Italian monetary authorities; the lire borrowed by the IMF were additional to those to be supplied by Italy under its Fund quota and committed to the Fund under the General Arrangements to Borrow (instituted in 1962). Also, the IMF increased the amounts available under its compensatory financing facility, established three years ago to help counter the effects of temporary declines in export proceeds of primary producing countries.

Official discussions of international monetary problems continued in 1966, delineating new areas of agreement upon which eventual reform—probably in the form of a contingency plan for deliberate creation of international reserve assets—may be based. The deputies of finance ministers and of central bank governors of ten major industrial countries—the Group of Ten—issued a report in August, describing the results of their deliberations on the adequacy of international liquidity and the possible development of new reserve media. This report, and the statements of the various countries at the September IMF meeting in Washington, revealed significant areas of agreement, although major differences remain. It was agreed, for example, that the distribution of any new reserves among countries should follow the pattern of the distribution of quotas in the Fund, or a similar formula, and that new reserves should be created on the basis of long-term needs for liquidity, rather than to finance particular national deficits or short-term fluctuations in world economic activity. Moreover, there was general agreement that the interests of all Fund members in an adequate growth in world reserves must be fully recognized, although it was clear that the major industrial nations, which must provide much of the financial strength behind any new reserves, would have to have an appropriate weight in decisions to create new reserves, especially with respect to timing and amounts. While the consensus among developed countries was that existing reserves are adequate, differences remain on how soon it would be necessary to activate any contingency plan. In addition, important questions concerning the form new reserve assets should take and procedures governing holding and use remain to be resolved.

Any decisions on these matters must, of course, be consistent with the continued role of the dollar as an international currency. At the time of the September IMF meeting, it was decided to hold a series of joint meetings between the executive directors of the Fund and the deputies of the Group of Ten to develop a convergence of views on the elements of a contingency plan. The first of these joint meetings was held at the end of November 1966.

Concurrent with the discussions on liquidity, a study group in the Organization for Economic Cooperation and Development considered the closely related question of improving the balance-of-payments adjustment process. To the extent that the magnitude of payments imbalances can be limited, or adjustment of imbalances speeded up, or more appropriate policy measures taken to correct imbalances, the need for international reserves would be reduced. The study group's report (also released in August) was a review of the types of policies—and the strengths and weaknesses of each—that are appropriate to bring about adjustment in varying circumstances. The responsibilities of surplus as well as deficit countries were discussed. Some attention was given to the possibility of establishing rules under which countries would agree to take certain types of policy measures under specified conditions. The prevailing view, however, was that circumstances vary too much for rigid rules to offer appropriate guidance. However, a set of informal guidelines, which should contribute to improving the adjustment process, was developed. In this connection, the group recommended that fiscal policy be used more actively as a countercyclical weapon, and that more flexible and selective fiscal instruments be adopted in some countries.

Economic Conditions Abroad: Strains on Resources Reduced

Perhaps the most dramatic events of the world economy in 1966 were related to Britain's efforts to reshape its economy so that both a high level of domestic growth and the pound's stability would be assured over the long run. Throughout the 1960's, and before, the British economy has suffered from a variety of ills: recurrent excess demand, inadequate growth of productivity, strong tendencies toward price and wage inflation, and—particularly since 1964—a stubborn payments deficit.

Although Britain had made some progress toward achieving internal and external equilibrium in 1965, the continued rise in demand coming from both the household and public sectors was pushing up prices and spilling into imports at an increasing rate. As a result, the basic balance-of-payments position worsened somewhat in the first half of 1966. In addition, sizable wage settlements suggested that further spiraling of costs and prices would be forthcoming. The May budget was designed to deal with these difficulties, but the major impact of the budget was to come in the autumn, and events in the exchange markets did not allow the time needed for these measures to become effective. The seamen's strike, the Rhodesian crisis, and tight monetary conditions abroad had an unfavorable impact on the pound in the exchange markets. These pressures culminated in the July attack on sterling in the exchange market, and the British government moved quickly to assemble an even more severe series of restraining measures.

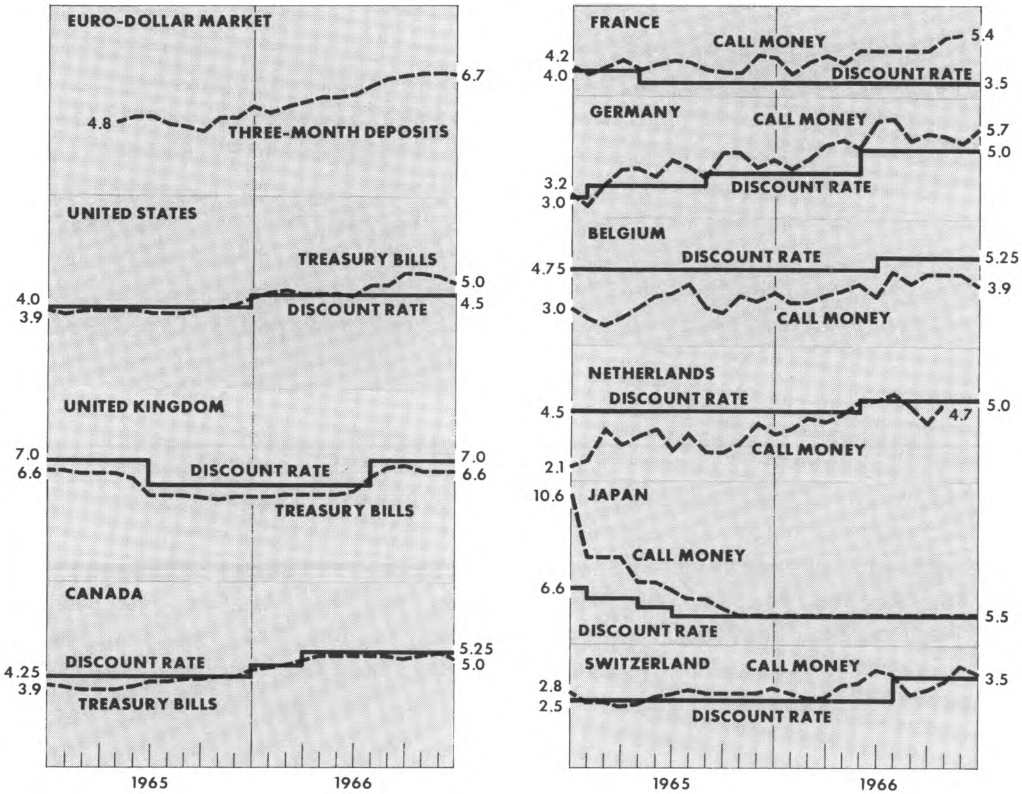
Monetary measures, announced early in July, included an increase in the Bank of England's discount rate to 7 per cent, a tightening of the allowable ceiling on lending by commercial banks, and a doubling of the special deposits required of commercial banks. These measures did not stem the sales of sterling.

On July 20, new and more drastic measures were announced. Taxes were increased, consumer credit controls were tightened, and the government announced cuts in planned domestic and overseas spending. On top of this, prices, wages, and dividends were to be frozen for six months and severe restraint was to be maintained for another six months, with legislative powers to enforce the program.

Evidence of the effectiveness of these measures accumulated over the remainder of the year. Excess demand pressures in the domestic economy were considerably relieved, and imports tended to level off. At the same time, exports resumed their earlier rise. While the long-run problems were still to be solved, sterling had a more resilient tone in the exchange market by the year-end, and the Bank of England had not only repaid part of the official credits received earlier, but had also substantially reduced its commitments in the forward exchange market.

Britain's efforts to achieve external balance had been complicated by the general tightening of credit conditions and widespread increases in interest rates in the other industrial countries in 1966 (see Chart 7 and Chart 8). Worldwide

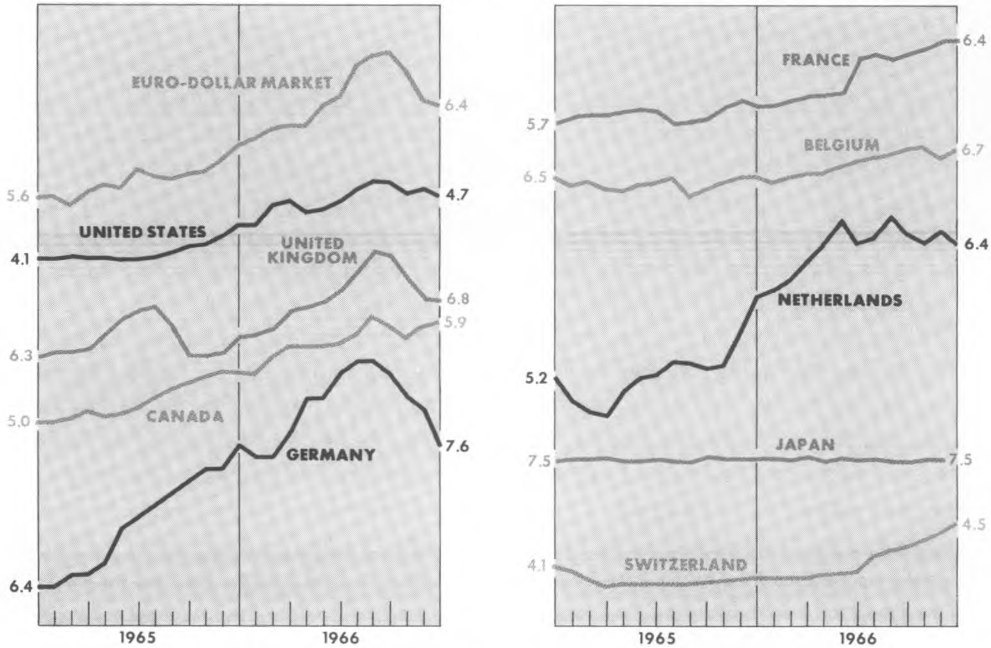
Chart 7. CENTRAL BANK DISCOUNT RATES AND SHORT-TERM INTEREST RATES IN SELECTED COUNTRIES: Monetary restraint and strong credit demands resulted in increases in short-term interest rates in most industrialized countries and in the Euro-dollar market in 1966. Market rates eased toward the year-end in some countries, as inflationary pressures moderated.



demands for credit were very strong, and central banks in a number of major countries moved to restrict credit availability in efforts to restrain inflationary pressures. Between March and July, discount rates in Canada, the Netherlands, Germany, Belgium, Switzerland, and Sweden were all increased. Although the tightening of monetary policy was primarily directed to restraining domestic demand in each of these countries, the general rise in interest rates abroad was often cited as a supplementary factor by the various central banks.

Other restraining measures were also taken in many of these countries. In Canada, new measures largely took the form of fiscal restraint, including both the scaling-down of planned government expenditures and upward adjustments in tax rates. In the Netherlands, budgetary measures were supplemented by the imposition of a ceiling on wage increases in new labor contracts and a continuation of the ceiling on bank lending. In Belgium, price controls were maintained on many basic products throughout the year, and a price freeze was imposed from May to September. By and large, as the year drew to a close, there

Chart 8. LONG-TERM BOND YIELDS IN SELECTED COUNTRIES: Heavy demands for credit in the United States and many European countries led to widespread increases in long-term interest rates in 1966. In the final months of the year, however, long-term interest rates declined markedly in the Euro-dollar market, the United Kingdom, and Germany, and to a lesser extent in a number of other countries, mostly reflecting an easing of demand pressures.



Yields on representative government or public sector bonds, except for Japan where seven-year industrial bonds are used.

was evidence that demand pressures had eased in most of the countries that had been suffering from overheating.

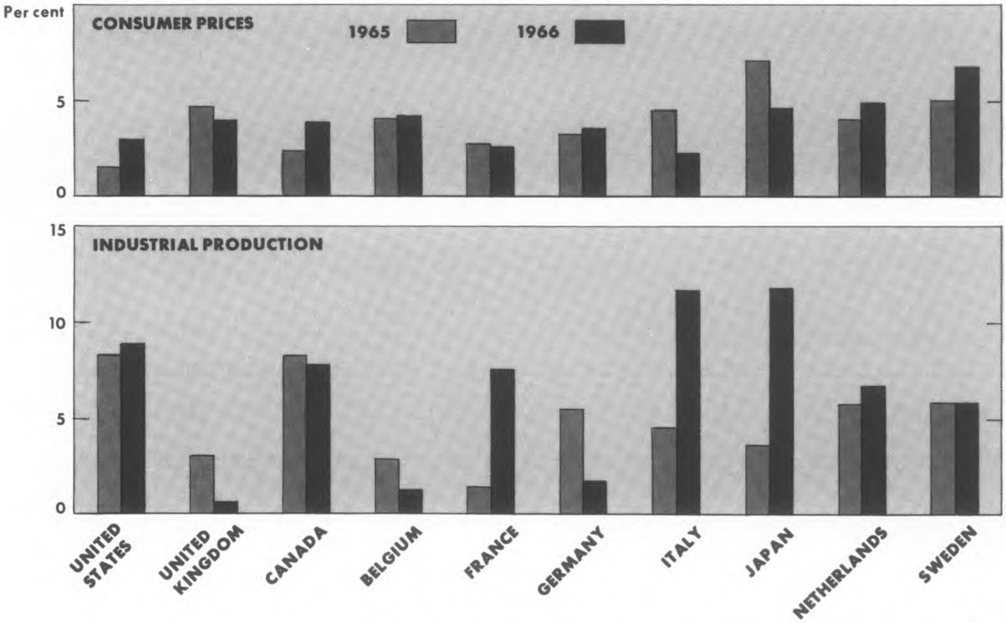
In Germany, moderating domestic demand was partly offset by a continued increase in exports, and unemployment remained relatively low. With the growth of imports slowing, the trade surplus increased sharply and Germany's balance of payments shifted from deficit to surplus in 1966.

In Japan, Italy, and France, the economic situation during 1966 was quite different. Previous retrenchment programs had reduced pressures on resources, and by the beginning of 1966 policies of expansion were again in force. As a result, these countries were able to achieve a substantial increase in economic growth in 1966 and, in the case of Italy and Japan, price pressures were significantly reduced from 1965 (see Chart 9). At the same time, interest rates were relatively stable in Japan and Italy, while rates in France gradually rose. The payments surpluses of Italy and France narrowed substantially in 1966 as their economies expanded. Japan's surplus apparently declined only slightly in 1966 as an increase in its trade surplus partly offset a larger outflow of long-term capital than in 1965.

In the less developed countries, the picture was mixed, especially with respect to their all-important export markets. Several of the Middle Eastern oil-producing states benefited, in terms of increased receipts, from more advantageous tax and royalty agreements worked out in 1965 and early 1966, and their international reserves rose in 1966. Copper supplies were tight early in the year, and Chile and Zambia benefited from the very high levels that copper prices reached toward the middle of the year. On the other hand, a number of other Latin American and African countries were adversely affected by declining sugar and coffee prices during the year.

The capital needs of the less developed countries remained great, but the level of aid from the industrial countries did not increase significantly in 1966. However, to encourage private investment in less developed areas, the World Bank established procedures for settling, on a voluntary basis, investment disputes between states and nationals of other states. Over forty-five countries had signed the convention by late summer 1966. Moreover, international arrangements of a regional nature are playing a more important role in development finance. The Asian Development Bank, with over thirty members and a total capital authorization of $1.1 billion, was inaugurated in December 1966. The African Development Bank enlarged its membership and resources, although it had not yet begun actual lending operations. And, as part of the movement toward integra-

Chart 9. **INDUSTRIAL PRODUCTION AND CONSUMER PRICES IN SELECTED COUNTRIES: In France, Italy, and Japan, industrial production in 1966 increased much more rapidly than in 1965, while in the United Kingdom, Belgium, and Germany, production grew at less than half the rate of 1965. Price pressures in Italy and Japan were significantly reduced in 1966. Although price increases in Canada, the Netherlands, and Sweden were noticeably larger in 1966 than in 1965, there was some easing of inflationary pressures as the year drew to a close.**



Where consumer price or industrial production data were not available for all of 1966, the percentage increase in 1966 over 1965 was computed by comparing the average level of the index in the months for which figures were available in 1966 with the average level of the index for the same months in 1965.

tion in Latin America, a limited clearing agreement (including bilateral credit facilities) began operating among most members of the Latin American Free Trade Association.

In 1966, a number of Eastern European countries continued to modify their economic policies. Overall production targets were still determined by central planning, but more emphasis was placed on the market process and on decentralization of decision making. Furthermore, some progress was made in rationalizing price and wage structures to reflect relative scarcities. The pace of change differed among these countries, with Czechoslovakia and East Germany tending to show greater experimentation along new lines. At the same time, trade between Eastern Europe and the West continued to grow, with some evidence that Western European nations, who accounted for the bulk of this growth, were offering easier credit terms.

THIS BANK'S OPERATIONS

Volume and Trend of the Bank's Operations

DOMESTIC OPERATIONS. The volume of operations in most departments of the Bank rose in 1966, reflecting continued growth in the Bank's activities of transferring funds for the public during a period of rapid economic expansion and as agent of the Treasury.

Both the number and the dollar amount of checks processed by this Bank reached record levels during 1966. The dollar amount of United States Government checks handled increased by 29 per cent, to $29 billion, but the number of such checks increased only 1 per cent over the 1965 level. Some 770 million other checks were handled during the year, an increase of 6 per cent over 1965 as compared with a 3 per cent advance in 1965 over 1964. While the dollar volume of such checks processed during 1966 rose 11 per cent to $589 billion, the rate of increase was smaller than the very large 20 per cent gain recorded in 1965. The relatively slower rate of growth in 1966 reflected an 18 per cent decrease in the dollar amount of checks drawn on this Bank, which was the counterpart of expanded use of this Bank's wire transfer facilities to effect interbank settlements. In contrast, the dollar volume of checks drawn on commercial banks during 1966 increased by 28 per cent, compared with a 17 per cent increase recorded in 1965 over 1964.

Although the dollar amount of checks drawn on this Bank fell in 1966, there was a sharp rise in the use of this Bank's wire transfer facilities—more than offsetting the lower check volume. The dollar volume of wire transfers (excluding Treasury transfers between Federal Reserve Districts) increased by 24 per cent to reach $2,128 billion, an all-time high. This gain was more than double the percentage increases that occurred in each of the previous two years. However, the 11 per cent advance in the number of transfers during 1966 was roughly of the same size as the comparable gains recorded in the past two years.

This Bank continued to make substantial improvements during 1966 in its check collection function which had completed the transition to a fully auto-

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

Number of pieces handled (in thousands)★	**1966**	**1965**
Currency received	1,469,135	1,455,219
Coin received†	1,462,830	678,248
Gold bars and bags of gold coin handled	347	430
Checks handled:		
United States Government checks	63,933	63,259
All other	769,653	727,707‡
Postal money orders handled	29,792	31,533
Collection items handled:		
United States Government coupons paid	3,713	3,581
Credits for direct sendings of collection items	337	339
All other	18,399	18,689
Issues, redemptions, exchanges by fiscal agency departments:		
United States savings bonds	30,831	30,814
All other obligations of the United States	9,895	8,377
Obligations of Federal agencies§	142	53
Obligations of international organizations	76	135
Safekeeping of securities:		
Pieces received and delivered	10,130	8,521
Coupons detached	5,131	5,767
Wire transfers of funds‖	1,123	1,011
Amounts handled (in millions of dollars)		
Discounts and advances¶	31,148	24,327
Currency received	10,187	9,968
Coin received†	167	48
Gold bars and bags of gold coin handled	4,912	5,994
Checks handled:		
United States Government checks	29,482	22,897
All other	589,059	530,182‡
Postal money orders handled	604	613
Collection items handled:		
United States Government coupons paid	3,132	2,834
Credits for direct sendings of collection items	826	820
All other	3,524	3,841
Issues, redemptions, exchanges by fiscal agency departments:		
United States savings bonds	1,768	1,750
All other obligations of the United States	612,503	585,460
Obligations of Federal agencies§	7,564	3,052
Obligations of international organizations	925	939
Safekeeping of securities:		
Par value pieces received and delivered	785,281	724,282
Wire transfers of funds‖	2,127,906	1,715,001

★ Two or more checks, coupons, etc., handled as a single item are counted as one "piece".
† Excludes shipments of new coin from the Mint.
‡ Revised.
§ The 1966 figures include the addition of two agencies.
‖ Excludes Treasury transfers between Federal Reserve Districts.
¶ The number of discounts and advances handled in 1966 was 2,698, compared with 1,555 in 1965.

mated system in 1965. The eight high-speed check processing systems in use at the beginning of 1966 were replaced during the year with seven new systems of greater capacity. This change contributed importantly to increasing the efficiency and lowering the costs of handling the rapidly rising volume of checks. By December, 91 per cent of all checks dispatched by this Bank were processed on the high-speed equipment, compared with 90 per cent in December 1965. About 99 per cent of the checks handled by this Bank were preprinted with the routing-symbol transit numbers of the drawee banks in Magnetic Ink Character Recognition (MICR) symbols.

During 1966 coin receipts (other than shipments of new coin from the Mint) increased substantially, reversing the downward trend that had prevailed since 1962. This Bank received 1,463 million pieces of coin in 1966, more than double the number received in 1965, while the dollar volume of these receipts amounted to $167 million, compared with only $48 million recorded in 1965. The sharp rise in coin receipts reflects the end of the five-year coin shortage. With the infusion of new coins into circulation, as authorized by the Coinage Act of 1965, there was only a limited amount of coin rationing during the first quarter of 1966. Thereafter, rationing was eliminated for all coins except half-dollars, which continued to be distributed on a pro rata basis.

This Bank's fiscal agency operations expanded moderately in 1966. The processing of obligations of the United States Government (other than United States savings bonds), Federal agencies, and international organizations increased by 18 per cent to about 10 million items; the corresponding dollar volume advanced 5 per cent to reach $621 billion. The enlarged volume of operations reflected in part the expansion of this Bank's fiscal agency function, as the Bank became the agent for the Export-Import Bank and the Commodity Credit Corporation.

Aggregate Second District member bank borrowings from this Bank during 1966 reached a postwar high of $31.1 billion as monetary policy tightened. This was 6 per cent higher than the previous postwar high of $29.4 billion recorded in 1957. However, on a daily average basis, the dollar volume of discounts and advances in 1966 was $171 million, 19 per cent below the 1957 high of $212 million. The proportion of Second District member banks which borrowed at least once during the year was up sharply in 1966 to 52 per cent of the banks that were members at any time during the year, compared with 39 per cent during 1965.

The growing public interest in economic affairs was reflected in the activities of this Bank as a source of pertinent information. Throughout the year, over half a million copies of the Bank's publications, other than periodicals, were distributed and 279 speeches were delivered by the staff to various business, banking, and educational groups. In addition, 13,266 visitors were received for tours of the Bank.

Average employment at this Bank declined for the third consecutive year. The reduction in average employment in 1966 came to nearly 4 per cent, considerably above the 1 per cent decreases recorded in both 1965 and 1964. The decline in employment reflects the trend toward increased automation of check processing and other facilities at the Bank's Head Office. Total employment, including the officers and staff of the Buffalo Branch, was 3,913 at the end of 1966.

FOREIGN AND INTERNATIONAL OPERATIONS. This Bank, acting on behalf of the Federal Reserve System and the United States Treasury, once again engaged in sizable foreign exchange operations during 1966, taking advantage of market conditions to reduce official United States foreign exchange commitments whenever possible and relying on credit facilities available to the United States when the dollar came under occasional pressure.

Total holdings of gold, dollar balances, and other assets for foreign and international accounts rose to a record level of just over $29.0 billion in June but closed on December 31 at $28.4 billion, down $509 million for the year. Holdings for international organizations increased by a net $763 million, mainly as a result of increased quota payments in gold to the International Monetary Fund (IMF) by member countries and United States drawings from the Fund. Holdings for foreign accounts, on the other hand, fell $1.3 billion, with much of the reduction having been concentrated in a few accounts. Declines in foreign accounts' combined holdings of United States Government securities and—to a lesser extent—of gold more than offset increases in other assets.

Gold operations declined considerably from 1965 levels, as correspondents purchased less gold from the United States Treasury and repatriated a smaller amount of gold deposited at this Bank. In order to help correspondents relieve seasonal pressures and meet other temporary dollar requirements, this Bank once again extended credits to several central banks against gold under earmark. All such credits had been repaid at the year-end.

A number of countries purchased gold from the United States during 1966 and 1965 in connection with their subscription payments under increased quotas at the IMF. In order to compensate for these losses, the quota-increase arrangement provided that the Fund would deposit gold with the Federal Reserve Bank of New York. These compensating operations began in September 1965, and as of December 31, 1966 the Federal Reserve Bank of New York held (for United States Treasury account) $211.5 million of gold so deposited by the IMF.

Financial Statements

STATEMENT OF CONDITION
(In thousands of dollars)

Assets	**DEC. 31, 1966**	**DEC. 31, 1965**
Gold certificate account	2,048,010	2,478,306
Redemption fund for Federal Reserve notes	443,812	409,153
Federal Reserve notes of other Banks	189,085	151,311
Other cash	31,317	16,507
Total cash	2,712,224	3,055,277
Discounts and advances	32,352	30,627
Acceptances	193,119	186,434
Federal agency obligations	33,800	0
United States Government securities	11,525,500	10,034,131
Total loans and securities	11,784,771	10,251,192
Other assets:		
Cash items in process of collection	1,993,690	1,676,821
Bank premises	9,358	8,667
All other★	526,222	276,390
Total other assets	2,529,270	1,961,878
Total Assets	**17,026,265**	**15,268,347**

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

STATEMENT OF CONDITION
(In thousands of dollars)

Liabilities	DEC. 31, 1966	DEC. 31, 1965
Federal Reserve notes	9,238,183	8,600,326
Deposits:		
Member bank reserve accounts	5,277,742	4,803,963
United States Treasurer — general account	271,154	159,647
Foreign★	55,965	39,581
Other†	396,432	184,729
Total deposits	6,001,293	5,187,920
Other liabilities:		
Deferred availability cash items	1,417,581	1,141,912
All other	72,512	49,263
Total other liabilities	1,490,093	1,191,175
Total Liabilities	**16,729,569**	**14,979,421**
Capital Accounts		
Capital paid in	148,348	144,463
Surplus	148,348	144,463
Total Capital Accounts	**296,696**	**288,926**
Total Liabilities and Capital Accounts	**17,026,265**	**15,268,347**
Contingent liability on acceptances purchased for foreign correspondents‡	49,005	37,546
Ratio of gold certificate reserves to Federal Reserve note liability	27.0%	33.6%

★ After deducting participations of other Federal Reserve Banks amounting to	118,080	110,700
† Includes IMF gold deposit.		
‡ After deducting participations of other Federal Reserve Banks amounting to	141,548	105,977

STATEMENT OF EARNINGS AND EXPENSES FOR THE CALENDAR YEARS 1966 AND 1965 (In thousands of dollars)

	1966	1965
Total current earnings	485,347	391,856
Net expenses	41,395	41,716
Current net earnings	443,952	350,140
Additions to current net earnings	395	264
Deductions from current net earnings:		
Loss on sales of United States Government securities (net)	622	2
All other	7	4
Total deductions	629	6
Net additions or deductions (—)	—234	258
Net earnings available for distribution	**443,718**	**350,398**
Dividends paid	8,770	8,501
Payments to United States Treasury (interest on Federal Reserve notes)	431,063	334,648
Transferred to surplus	3,885	7,249

SURPLUS ACCOUNT

	1966	1965
Surplus — beginning of year	144,463	137,214
Transferred from net earnings for year	3,885	7,249
Surplus—end of year	**148,348**	**144,463**

Changes in Membership

During 1966, the total number of member banks of the Federal Reserve System in this District declined from 409 to 399. The decrease in the number of member banks was the net result of the mergers of eleven member banks and the organization of one new national bank. The 399 banks constitute 83 per cent of all commercial banks and trust companies in this District and hold 97 per cent of the total assets of all such institutions in this District.

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

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

	DECEMBER 31, 1966			DECEMBER 31, 1965		
Type of Bank	Members	Non-members	Per cent members	Members	Non-members	Per cent members
National banks★	281	0	100	288	0	100
State banks and trust companies	118	82	59	121	80	60
Total	**399**	**82**	**83**	**409**	**80**	**84**

★ Includes one national bank located in the Virgin Islands.

CHANGES IN FEDERAL RESERVE MEMBERSHIP IN SECOND DISTRICT DURING 1966

Total membership beginning of year	**409**
Increases:	
New national banks	1
Nonmember converted to national banks	2
Decreases:	
Member banks merged with other members	9
Member banks merged with nonmembers	2
National banks converted to nonmembers	2
Total membership at the year-end	**399**

Changes in Directors and Officers

CHANGES IN DIRECTORS. In November, the Board of Governors of the Federal Reserve System reappointed Everett N. Case a Class C director for the three-year term beginning January 1, 1967 and redesignated him *Chairman* of the Board of Directors and *Federal Reserve Agent* for the year 1967. Mr. Case, President of the Alfred P. Sloan Foundation, New York, N. Y., has been a Class C director since January 1961. He served as *Deputy Chairman* in 1965 and as *Chairman* and *Federal Reserve Agent* in 1966.

Also in November, the Board of Governors reappointed Kenneth H. Hannan *Deputy Chairman* for the year 1967. Mr. Hannan, Executive Vice President of the Union Carbide Corporation, New York, N. Y., served as a Class B director from January 1960 through 1965. In 1966, he was appointed a Class C director for a three-year term and *Deputy Chairman* for 1966.

In December, member banks in Group 3 elected Eugene H. Morrison a Class A director and Maurice R. Forman a Class B director, each for a three-year term beginning January 1, 1967. Mr. Morrison, President of Orange County Trust Company, Middletown, N. Y., succeeded Robert H. Fearon, President of The Oneida Valley National Bank of Oneida, Oneida, N. Y., who served for the three-year term that ended December 31, 1966. Mr. Forman, President of B. Forman Co., Inc., Rochester, N. Y., served as a director of the Buffalo Branch of this Bank from January 1963 through 1966 and as *Chairman* of the Branch Board of Directors in 1965. As a director of this Bank, he succeeded Albert L. Nickerson, Chairman of the Board of Mobil Oil Corporation, New York, N. Y., who served from August 1961 through 1966.

At the Buffalo Branch, the Board of Governors in December appointed Gerald F. Britt a director of the Branch for a three-year term beginning January 1, 1967. Mr. Britt, President of L-Brooke Farms, Inc., Byron, N. Y., succeeded Thomas E. LaMont, who is engaged in farming in Orleans County, N. Y. Mr. LaMont had served as a Branch director since November 1959, and as *Chairman* of the Branch Board in 1963 and 1966. Also in December, the Board of Governors appointed Carl A. Day a director of the Buffalo Branch for the unexpired portion of Mr. Forman's term, ending December 31, 1968. Mr. Day is Executive Vice President of Bausch & Lomb Inc., Rochester, N. Y. In December, the Board of Directors of this Bank appointed E. Perry Spink a director of the Buffalo Branch for a three-year term beginning January 1, 1967. Mr. Spink, Chairman of the Board of the Liberty National Bank and Trust Company, Buffalo, N. Y., previously served for a three-year term as a director of the Buffalo Branch from January 1958 through December 1960. In his present term of office, he succeeded Charles W. Millard, Jr., Chairman of the Board of Manufacturers and Traders Trust Company, Buffalo, N. Y., who served for the three-year term that ended December 31, 1966. In December, the Bank's Board of Directors also designated Robert S. Bennett *Chairman* of the Branch Board for the year 1967. Mr. Bennett, General Manager of the Lackawanna Plant of the Bethlehem Steel Corporation, Buffalo, N. Y., has been a director of the Branch since January 1965.

CHANGES IN OFFICERS. Since January 1966, five officers have retired or resigned:

Martin W. Bergin, Manager, Public Information Department, resigned effective March 31, 1966, to accept a position with the Retirement System of the Federal Reserve Banks in anticipation of his appointment as Secretary of the Retirement System, which became effective August 1, 1966. Mr. Bergin joined the Bank's staff in July 1951 and became an officer in January 1960.

Horace L. Sanford, Vice President, Foreign, retired effective July 1, 1966, after completing forty-eight years of service with the Bank. Mr. Sanford joined the Bank's staff in July 1918 and became an officer in 1936. He served as an officer in the Foreign function from 1942 until his retirement.

Insley B. Smith, Vice President in charge of the Buffalo Branch, retired effective November 1, 1966. Mr. Smith had completed forty-four years of service at the time of his retirement, having joined the Bank's staff at the Head Office in September 1922. He became an officer in January 1938, and in January 1945 he was assigned to the Buffalo Branch as the officer in charge of the Branch.

Francis H. Schott, Adviser, Research and Statistics, resigned effective January 15, 1967, to accept a position with The Equitable Life Assurance Society of the United States. Mr. Schott joined the Bank's staff in July 1951 and became an officer in August 1961.

Thomas J. Roche, Senior Foreign Exchange Officer, retired on special service retirement effective February 1, 1967. Mr. Roche joined the Bank's staff in July 1934 and became an officer in January 1956.

The following additional changes in the official staff, including the appointment of nine new officers, have been made since January 6, 1966:

Richard H. Hoenig, formerly Chief, Public Information Division, Public Information Department, was appointed an officer with the title of Manager effective April 1, 1966 and assigned to the Public Information Department.

Fred H. Klopstock, formerly Senior Economist, was appointed Manager effective July 1, 1966 and assigned to the International Research Department.

Frederick C. Schadrack, Jr., Manager, formerly assigned to the International Research Department, was assigned to the Domestic Research Department effective July 1, 1966.

Thomas O. Waage, Vice President assigned to Public Information, was also assigned to Foreign, effective August 1, 1966, where he assumed certain administrative responsibilities.

Harold A. Bilby, Vice President, formerly assigned to Accounting and Planning, Government Bond and Safekeeping of Securities, and Loans and Credits, was appointed Vice President and Senior Adviser, effective October 1, 1966. In his new position, Mr. Bilby has broad responsibilities for advising the directors, the President and the First Vice President, and other officers with respect to policy matters.

William H. Braun, Jr., formerly Assistant Vice President, Bank Supervision and Relations, was appointed Vice President effective October 1, 1966 and assigned to Accounting and Planning.

Felix T. Davis, formerly Assistant Vice President, Government Bond and Safekeeping of Securities, was appointed Vice President effective October 1, 1966 and assigned to Government Bond and Safekeeping of Securities.

Angus A. MacInnes, Jr., formerly Assistant Vice President, Cash and Collections, was appointed Vice President in charge of the Buffalo Branch effective October 1, 1966.

Thomas M. Timlen, Jr., formerly Assistant Vice President, Accounting and Planning, and Loans and Credits, was appointed Vice President effective October 1, 1966 and assigned to Loans and Credits.

John T. Keane, Cashier, Buffalo Branch, was appointed Assistant Vice President of the Branch effective October 1, 1966, continuing as Cashier.

William E. Marple, formerly Manager, Credit and Discount Department, was appointed Assistant Vice President effective October 1, 1966 and assigned to Loans and Credits.

Paul Meek, formerly Manager, Securities Department, was appointed Assistant Vice President effective October 1, 1966 and assigned to Open Market Operations and Treasury Issues.

Everett B. Post, formerly Manager, Planning Department, was appointed

Assistant Vice President effective October 1, 1966 and assigned to Accounting and Planning, with responsibility for the Accounting and Planning Departments.

George C. Smith, formerly Manager, Check Department, was appointed Assistant Vice President effective October 1, 1966 and assigned to Cash and Collections, with responsibility for the Check Department.

Robert C. Thoman, formerly Manager, Personnel Department, was appointed Assistant Vice President effective October 1, 1966 and assigned to Bank Supervision and Relations.

Leonard I. Bennetts, Manager, formerly assigned to the Bank Relations Department, was assigned to the Cash Custody Department and the Collection Department effective October 1, 1966.

Louis J. Brendel, Manager, formerly assigned to the Computer Services Department, was assigned to the Planning Department effective October 1, 1966.

Howard F. Crumb, formerly Chief, Computer Services Division, Computer Services Department, was appointed an officer with the title of Manager effective October 1, 1966 and assigned to the Computer Services Department.

Adam R. Dick, formerly Special Representative, Bank Relations Division, Bank Relations Department, was appointed an officer with the title of Manager effective October 1, 1966 and assigned to the Bank Relations Department.

Karl L. Ege, Manager, formerly assigned to the Cash Custody Department and the Collection Department, was assigned to the Check Department effective October 1, 1966.

Francis H. Rohrbach, formerly Chief, Personnel Relations Division, Personnel Department, was appointed an officer with the title of Manager effective October 1, 1966 and assigned to the Personnel Department.

Herbert H. Ruess, formerly Chief, Credit Division, Credit and Discount Department, was appointed an officer with the title of Manager effective October 1, 1966 and assigned to the Credit and Discount Department.

Ralph H. Gelder, formerly Chief, Public Information Division, Public Information Department, was appointed an officer with the title of Manager effective January 5, 1967 and assigned to the Personnel Department.

Scott E. Pardee, formerly Chief, Foreign Research Division, International Research Department, was appointed an officer with the title of Manager effective January 5, 1967 and assigned to the Foreign Department.

Edwin R. Powers, formerly Special Assistant, Foreign Department, was appointed an officer with the title of Manager effective January 5, 1967 and assigned to the Foreign Department.

A. Marshall Puckett, formerly Chief, Domestic Research Division, Domestic Research Department, was appointed an officer with the title of Senior Economist effective January 5, 1967.

Leonard Lapidus, Manager, formerly assigned to the Personnel Department, was assigned to the Bank Examinations Department effective January 6, 1967.

MEMBER OF FEDERAL ADVISORY COUNCIL—1967. The Board of Directors of this Bank selected R. E. McNeill, Jr., to serve during 1967 as the member of the Federal Advisory Council representing the Second Federal Reserve District. Mr. McNeill is Chairman of the Board of the Manufacturers Hanover Trust Company, New York, N. Y. He replaced William H. Moore, Chairman of the Board of the Bankers Trust Company, New York, N. Y., who served as a member of the Council for the past three years.

Directors of the Federal Reserve Bank of New York

DIRECTORS	Term expires Dec. 31	Class	Group
GEORGE A. MURPHY Chairman of the Board, Irving Trust Company, New York, N. Y.	1967	A	1
ROBERT G. COWAN Chairman of the Board, National Newark & Essex Bank, Newark, N. J.	1968	A	2
EUGENE H. MORRISON President, Orange County Trust Company, Middletown, N. Y.	1969	A	3
ARTHUR K. WATSON Chairman of the Board, IBM World Trade Corporation, New York, N. Y., and Vice Chairman of the Board, International Business Machines Corporation, Armonk, N. Y.	1967	B	1
MILTON C. MUMFORD Chairman of the Board, Lever Brothers Company, New York, N. Y.	1968	B	2
MAURICE R. FORMAN President, B. Forman Co., Inc., Rochester, N. Y.	1969	B	3
EVERETT N. CASE, *Chairman, and Federal Reserve Agent* President, Alfred P. Sloan Foundation, New York, N. Y.	1969	C	
KENNETH H. HANNAN, *Deputy Chairman* Executive Vice President, Union Carbide Corporation, New York, N. Y.	1968	C	
JAMES M. HESTER President, New York University, New York, N. Y.	1967	C	

DIRECTORS—BUFFALO BRANCH

ROBERT S. BENNETT, *Chairman* General Manager, Lackawanna Plant, Bethlehem Steel Corporation, Buffalo, N. Y.	1967
J. WALLACE ELY President, Security Trust Company of Rochester, Rochester, N. Y.	1967
JOHN D. HAMILTON Chairman of the Board, Marine Midland Chautauqua National Bank, Jamestown, N. Y.	1967
CARL A. DAY Executive Vice President, Bausch & Lomb Inc., Rochester, N. Y.	1968
ARTHUR S. HAMLIN President, The Canandaigua National Bank and Trust Company, Canandaigua, N. Y.	1968
GERALD F. BRITT President, L-Brooke Farms, Inc., Byron, N. Y.	1969
E. PERRY SPINK Chairman of the Board, Liberty National Bank and Trust Company, Buffalo, N. Y.	1969

MEMBER OF FEDERAL ADVISORY COUNCIL—1967

R. E. MCNEILL, JR. Chairman of the Board, Manufacturers Hanover Trust Company, New York, N. Y.	1967

Officers of the Federal Reserve Bank of New York

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

HAROLD A. BILBY, *Vice President and Senior Adviser*
WILLIAM H. BRAUN, JR., *Vice President*
JOHN J. CLARKE, *Vice President and General Counsel*
CHARLES A. COOMBS, *Vice President*
FELIX T. DAVIS, *Vice President*
GEORGE GARVY, *Economic Adviser*
MARCUS A. HARRIS, *Vice President*
ALAN R. HOLMES, *Vice President*
ROBERT G. LINK, *Vice President*
FRED W. PIDERIT, JR., *Vice President*
WALTER H. ROZELL, JR., *Vice President*
THOMAS M. TIMLEN, JR., *Vice President*
THOMAS O. WAAGE, *Vice President*

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

PETER FOUSEK, *Assistant Vice President*
PETER P. LANG, *Adviser*
BRUCE K. MACLAURY, *Assistant Vice President*
WILLIAM E. MARPLE, *Assistant Vice President*
SPENCER S. MARSH, JR., *Assistant Vice President*
PAUL MEEK, *Assistant Vice President*
DONALD C. NILES, *Assistant Vice President*
EVERETT B. POST, *Assistant Vice President*
LAWRENCE E. QUACKENBUSH, *Assistant Vice President*
FRANK W. SCHIFF, *Assistant Vice President*
KENNETH E. SMALL, *Assistant Vice President*
FREDERICK L. SMEDLEY, *Assistant Vice President*
GEORGE C. SMITH, *Assistant Vice President*
ROBERT C. THOMAN, *Assistant Vice President*

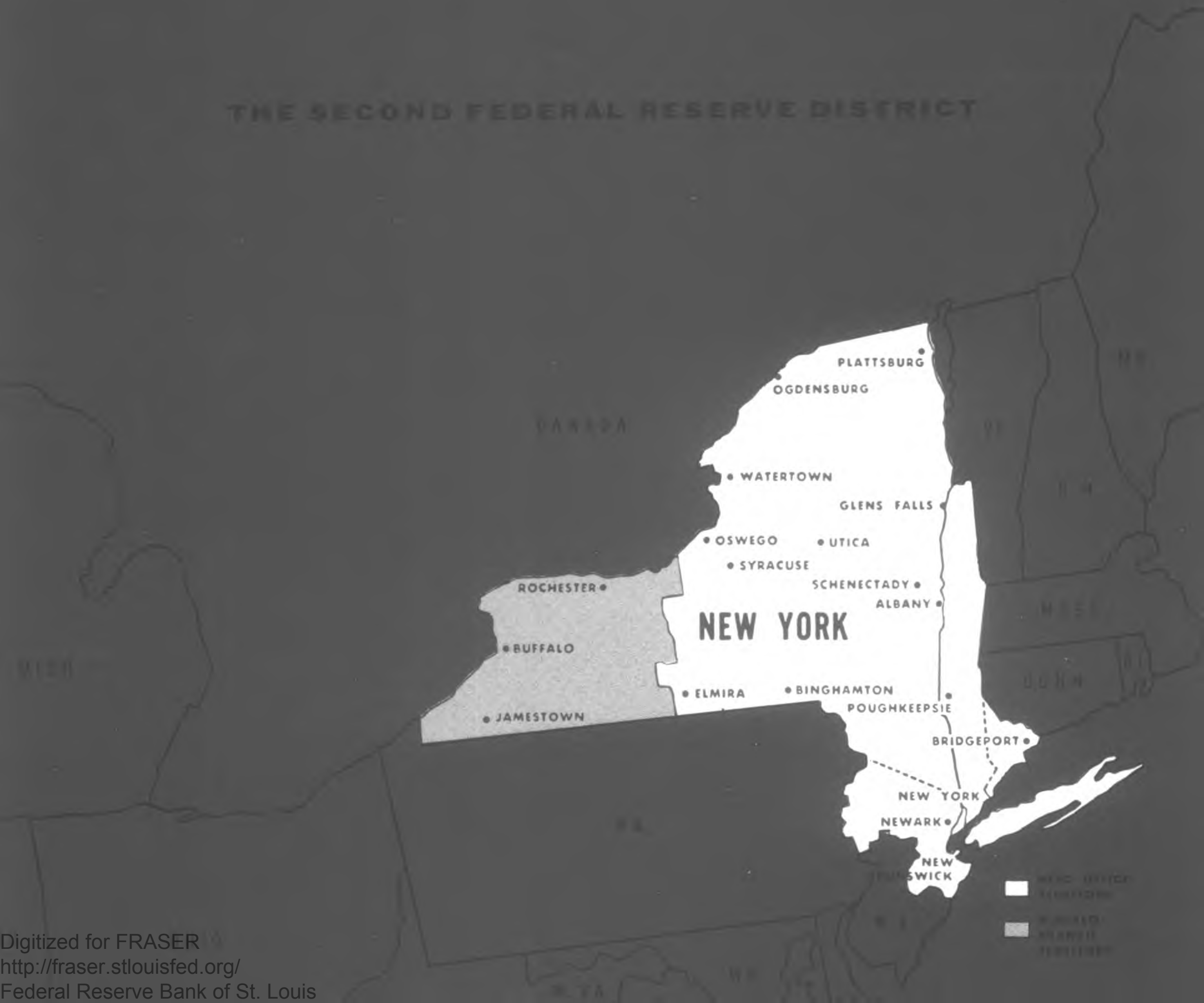
GERALD E. BEACH, *Manager, Government Bond and Safekeeping Department*
LEONARD I. BENNETTS, *Manager, Cash Custody Department, and Manager, Collection Department*
DAVID E. BODNER, *Manager, Foreign Department*
LOUIS J. BRENDEL, *Manager, Planning Department*
A. THOMAS COMBADER, *Manager, Building Operating Department*
ROBERT L. COOPER, *Manager, Acceptance Department*
ROBERT J. CROWLEY, *Manager, Foreign Department*
HOWARD F. CRUMB, *Manager, Computer Services Department*
RICHARD G. DAVIS, *Manager, Domestic Research Department*
RICHARD A. DEBS, *Secretary, and Assistant Counsel*
FREDERICK W. DEMING, *Manager, Securities Department*
ADAM R. DICK, *Manager, Bank Relations Department*
KARL L. EGE, *Manager, Check Department*
MARTIN FRENCH, *Manager, Security Custody Department*
RALPH H. GELDER, *Manager, Personnel Department*
EDWARD J. GENG, *Manager, Securities Department, and Assistant Secretary*
RICHARD H. HOENIG, *Manager, Public Information Department*
FRED H. KLOPSTOCK, *Manager, International Research Department*
LEONARD LAPIDUS, *Manager, Bank Examinations Department*
MADELINE H. MCWHINNEY, *Manager, Statistics Department*
ROBERT MEYER, *Assistant Counsel*
ARTHUR H. NOA, *Manager, Service Department*
JAMES H. OLTMAN, *Manager, Bank Examinations Department*
SCOTT E. PARDEE, *Manager, Foreign Department*
EDWIN R. POWERS, *Manager, Foreign Department*
CHARLES R. PRICHER, *Manager, Cash Department*
A. MARSHALL PUCKETT, *Senior Economist*
FRANCIS H. ROHRBACH, *Manager, Personnel Department*
EDWIN S. ROTHMAN, *Manager, Foreign Department*
HERBERT H. RUESS, *Manager, Credit and Discount Department*
WALTER S. RUSHMORE, *Manager, Savings Bond Department*
FREDERICK C. SCHADRACK, JR., *Manager, Domestic Research Department*
BETTY JEAN SHEA, *Assistant Counsel*
ALOYSIUS J. STANTON, *Manager, Accounting Department*
ROBERT YOUNG, JR., *Assistant Counsel*

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

OFFICERS — BUFFALO BRANCH

ANGUS A. MACINNES, JR., *Vice President*
JOHN T. KEANE, *Assistant Vice President and Cashier*

HARRY A. CURTH, JR., *Assistant Cashier*
RONALD B. GRAY, *Assistant Cashier*
GERALD H. GREENE, *Assistant Cashier*
ARTHUR A. RANDALL, *Assistant Cashier*


THE SECOND FEDERAL RESERVE DISTRICT
CANADA
PLATTSBURG
OGDENSBURG
WATERTOWN
GLENS FALLS
OSWEGO
UTICA
SYRACUSE
SCHENECTADY
ALBANY
ROCHESTER
BUFFALO
NEW YORK
ELMIRA
BINGHAMTON
JAMESTOWN
POUGHKEEPSIE
BRIDGEPORT
NEW YORK
NEWARK
NEW BRUNSWICK