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Contents

Discount Rate and Regulation Q Changes 254

The Federal Reserve's Role in the Economy: An Address by William McChesney Martin, Jr. 256

The Business Situation 260

The Money and Bond Markets in November 263

Federal Reserve Accounts, Money Supply, and Bank Credit 267

1966 Guidelines under the President's Balance of Payments Program—Official Statements 271

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Increases in Discount Rates of the Federal Reserve Bank of New York and the Federal Reserve Bank of Chicago and Increases in Maximum Interest Rates on Time Deposits under Regulation Q

The following statement was released by the Board of Governers of the Federal Reserve System on December 6, 1965:

The Federal Reserve announced today two complementary actions to reinforce efforts to maintain price stability, and thus to foster balance in the economy's continued growth and strength in the dollar's international standing.

The actions, intended not to cut back on the present pace of credit flows but to dampen mounting demands on banks for still further credit extensions that might add to inflationary pressures, were as follows:

1. The Board of Governors in Washington approved actions by the directors of the Federal Reserve Banks of New York and Chicago increasing the discount rates of those banks from 4 to 4½ per cent, effective December 6, 1965. The discount rate is the interest rate charged member banks for borrowing from their District Reserve Banks.

2. Simultaneously, the Board increased the maximum rates that member banks are permitted to pay their depositors to 5½ per cent on all time deposits and certificates of deposit having a maturity of 30 days or more. This change is also effective Monday, December 6. Previously, the maximum rates payable were 4 per cent for time deposits and certificates of 30 to 89 days, and 4½ per cent on those of 90 days or more. No change was made in the rate payable on savings deposits (4 per cent).

The increase in the rates that member banks are permitted to pay their depositors is intended to enable the banks to attract and retain deposits of businesses and individuals and thus to make more effective use of savings funds already available in the economy to finance their loan expansion.

The increase in discount rates is intended to moderate additional bank reliance on short-term borrowings from the Federal Reserve to meet intensifying loan demands.

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The action contemplates, however, the continued provision of additional reserves to the banking system, in amounts sufficient to meet seasonal pressures as well as the credit needs of an expanding economy without promoting inflationary excesses, primarily through the Federal Reserve's day-in and day-out purchases of Government securities in the open market.

The changes in discount rates and the maximum rates that banks may pay depositors were the first in either respect since November 24, 1964.

Since then, total borrowing by consumers, business, and state and local governments has risen sharply, and interest rates at all maturities from the shortest to the longest have been rising under demand pressures. In these circumstances, the Federal Reserve would be forced to increase bank reserves at an accelerated pace if all demands for borrowing money at present rates were to be satisfied.

With slack in manpower and productive capacity now reduced to narrow proportions, with the economy closer to full potential than at any time in nearly a decade, and with military demands on output and manpower increasing, it was felt that excessive additions to money and credit availabilities in an effort to hold present levels of interest rates would spill over into further price increases in goods and services. Such price rises would endanger the sustainable nature of the present business expansion. Moreover, increases in costs and prices would make it more difficult for American goods to compete in markets at home and abroad.

In addition, a pattern of interest rates that is accepted by borrowers and lenders as fully reflecting market forces should add assurance of a smooth flow of funds to all sectors of the economy. Discount rate increases in 1963 and 1964 did not stop business or credit growth, but helped to keep the economy within an expansion that was sustainable.

In sum, the actions taken should have the three-pronged impact of:

1. Backing up the Government's efforts to prevent inflationary excesses from damaging an economy now carrying the added burden of military operations in Vietnam;
2. Bolstering the Government's programs to overcome the persistent deficit in the United States balance of payments; and
3. Demonstrating anew United States determination to maintain the international strength of the dollar.

Governors Robertson, Mitchell, and Maisel dissented from the discount rate action on the ground that it was at least premature in the absence of more compelling evidence of inflationary dangers. Governor Robertson also dissented from the action to increase the maximum rates on time deposits.

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The Federal Reserve's Role in the Economy*

By WILLIAM MCCHESNEY MARTIN, JR.
Chairman, Board of Governors of the Federal Reserve System

In meeting with your Association, I feel very much at home. Life insurance and central banking have many problems and many attitudes in common. We are both deeply concerned with long-term aims, with maintaining the strength of our economy and the strength of our currency.

Millions of Americans are putting their faith in life insurance for the protection of the future of their families, and this faith rests on the expectation that your policies will return to them a full measure of value for the dollars they are paying to you. These millions who entrust funds to you, and who rely on the Federal Reserve to safeguard the value of their money, want most of all safety and security—in your case, safety and security from want for their old age and for their families; in our case, safety and security from the twin dangers of inflation and deflation, the two deadly enemies of rational financial planning.

In trying to fulfill our duties, both your Association and the Federal Reserve System must rely on the best information and the most accurate analysis covering the innumerable factors that influence the development of our economy. It is therefore no coincidence that each of us has sponsored programs of basic economic research, and that the Federal Reserve has time and again benefited from the work of your Association. I may mention in particiular your invaluable studies in the fields of savings, capital markets, and interest rates.

I gladly take this opportunity to thank you for those contributions to our common efforts, and I can only hope that our research program proves as useful to you as yours has proved to us.

Now, if I may, I should like to make some observations on the Federal Reserve's role in our economy. I shall begin with recent developments.

Just a few days ago, the Federal Reserve raised discount rates to 4½ per cent, and the maximum rate payable on time deposits to 5½ per cent. The discount rate thus reached its highest level in more than thirty years, and the time deposit rate its highest level since the promulgation of Regulation Q, also more than thirty years ago.

In view of these developments, I would like to speak on three questions that I believe of interest to you: First, for what reasons and for what purpose did the Federal Reserve act? Second, does the action mean that the Federal Reserve disagrees with the rest of the Government on the basic issues of financial policy? And third, what is the significance of this action for the future?

First, I want to say that the Federal Reserve acted because it believed that the previous level of the discount rate and of time deposit rates was out of line with conditions in the money and credit markets and especially with the need to keep the flow of bank credit large enough to satisfy the needs of our expanding economy but not so large as to threaten to turn that expansion into an inflationary boom.

Second, the Federal Reserve acted not to hamper but to further the goal of the Administration—shared by the Congress and by the American people as a whole—to do the best that can be done to assure the continuance of our economic expansion, maintenance of generally stable prices, and restoration of reasonable equilibrium in our international payments.

And third, the Federal Reserve will continue to shape its policies with complete flexibility, firming whenever our further progress is threatened by inflation and easing whenever that threat has passed.

The Federal Reserve, in all its actions, aims always at the same goal: to help the economy move forward at the fastest sustainable pace. We reach our destination most rapidly as well as most assuredly when we travel at maximum *safe* speed—and this speed cannot be the same under all conditions and at all times.

* An address before the fifty-ninth annual meeting of the Life Insurance Association of America, New York City, December 8, 1965.

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Actually, the recent increase in rates is intended not to reduce the pace of the economy's expansion but to moderate mounting demands for bank credit that might jeopardize that pace by overstimulating the economy.

A brief review of developments over the past twelve months in the three critical sectors of production and employment, the balance of payments, and prices will provide background for our recent action.

The production and employment record of our economy has been excellent. Our industrial output will be at least 7 per cent higher this year than in 1964, a significant gain by any standard. Employment has expanded fast enough to reduce the unemployment rate by a full percentage point since October 1964. For the first time since 1957 it seems likely that we may soon reach our interim goal of pushing unemployment down to, if not below, 4 per cent of our labor force. And despite such progress, average wages of production workers do not seem on balance to have risen faster than productivity so that labor costs per unit of output in manufacturing have remained virtually unchanged. The American worker—with whose progress all of us are concerned—has shown great responsibility in negotiating wage settlements that help to insure a steady rise in the real incomes of all Americans.

Our record on international payments balance is fair enough, but less satisfactory than in the field of production and employment. Over the first three quarters of the year, our deficit on so-called "regular transactions" was at an annual rate of $1¾ billion—far smaller than in any calendar year since 1957 but still far too large for comfort. We need to do much better if we are to reach our goal of reasonable payments equilibrium next year, and especially if we wish to do so without further interference with the freedom of international transactions.

But in the third critical area, maintenance of general price stability, our record has not been so good as in other recent years. Whenever in recent years our economic growth was less rapid and our payments deficit larger than we would have wished, we could be hopeful because our price level had remained stable. For we knew that such stability was a firm basis for further economic expansion as well as for further progress toward payments balance. But over little more than twelve months, the crucial index of industrial wholesale prices has risen about 1¾ per cent, after four years of virtual stability.

It is quite true that prices have not broken out of the pattern of modest and selective advance in recent months. In order to avert such an eventuality, the Government has taken action relating to prices of a number of individual key commodities. But selective intervention to deal with price pressures necessarily has limits. In the longer run, it would be ineffective if not accompanied by measures that affect the source of price pressures rather than the prices themselves.

Unlike price pressures during the period before 1958, recent price developments cannot be explained by cost-push influences. As mentioned before, unit labor costs have remained essentially stable. Such price pressures as are making themselves felt must be primarily attributed to demand-pull.

This fact should not cause surprise. The closer an economy comes to full employment of manpower and capital resources, the greater is the risk that bottlenecks will develop in strategic areas so that large new injections of bank credit and money will serve to raise prices more than production.

Whatever divergent views the experts may take in regard to the ability of a central bank to control price pressures generated by cost-push, nobody has ever denied that it is the function of monetary policy to restrain price pressures that originate from private demand. Hence, the threat to continued maintenance of the noteworthy price stability of the first four years of the present business expansion must be of concern to the Federal Reserve.

I do not want to imply that monetary policy had ignored the problem before last weekend. Since December 1964, the free reserves position of member banks has changed from a moderate plus to a moderate minus—limiting the ability of banks to increase their credit creation. The interplay between that degree of restraint and the accelerating pace of economic expansion led in many —though not all—financial markets to increases in interest rates, well before the recent rise in discount and time deposit rates. But let us not overlook the fact that, despite such restraint, commercial and industrial bank loans have increased this year by about 20 per cent.

As long as unemployment of manpower and plant capacity was greater than could be considered acceptable or normal, we had every reason to lean on the side of monetary stimulus. While this posture did risk some spill-over of funds abroad, the adverse effect on our payments balance was more than offset by the benefit to our domestic economic growth. And we have tried to combat excessive capital outflows by selective fiscal and monetary measures, including the voluntary foreign credit restraint efforts of our financial institutions in which the members of your Association have so magnificently joined.

But despite the exemplary compliance of the financial community, and the dramatic decline in the foreign credits of financial institutions, foreign investments of nonfinancial corporations were large enough to explain the persistence of our international payments deficit. As financial

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institutions reduced drastically the availability of dollar credits abroad, and thus had more funds to devote to domestic uses, their domestic customers were in a position to use part of the newly available funds to finance their ventures abroad. This is an example of the leakage inherent in selective credit controls, an indication of their limited effectiveness, and a demonstration of why they can only serve as stopgaps rather than lasting remedies.

Our closer approach to a satisfactory level of domestic output and employment has diminished the weight of the arguments against the use of general rather than selective measures to help counter price pressures at home as well as to help correct our payments imbalance. Obviously, no one, and least of all those of us responsible for monetary policy, would ever want to do anything that could undercut the sustained progress of the economy. But those who are fearful of the economic consequences of *any* move even toward the mildest restraint—any drop of free reserves below zero, any slight rise in interest rates—would do well to consider the record of the economy's performance over the past twelve months.

Let none of us overlook the fundamental difference between a change in interest rates *imposed* by a central bank *contrary* to the trend of basic economic forces, and a change *permitted* by the central bank *in line with* those forces.

If the Federal Reserve had followed the advice offered by some and had tried to force interest rates up at a time when the demand for investable funds (even at existing relatively low rates) was not sufficient to employ our idle resources and to move our economy rapidly toward fuller employment, such a policy would indeed have harmed our domestic economy, and in consequence the economy of the entire Free World. Conversely, if the Federal Reserve had strained to keep interest rates from rising by providing reserves without limit at a time when funds borrowed from banks were beginning to generate an aggregate demand in excess of output from available resources, the Federal Reserve would again have become, in the words of one of my distinguished predecessors, a veritable engine of inflation.

Recent developments in our economy—mounting danger of price pressures, rapidly climbing bank credit, and continuing deficit in our payments balance—have been warning signals. And they have indicated that prevailing market rates of interest were beginning to distort the flow of funds through the economy. Our recent action has been designed to insure that the demands for credit do not reach inflationary dimensions, and at the same time that the flow of savings remains sufficient to sustain, and be efficiently directed to sustaining, the economy's growth.

I realize that judgments can differ, not only as to the substance of an action, but also as to its timing. To me, the effective time to act against inflationary pressures is when they are in the development stage—before they have become full-blown and the damage has been done. Precautionary measures are more likely to be effective than remedial action: the old proverb that an ounce of prevention is worth a pound of cure applies to monetary policy as well as to anything else. It is simpler, for one thing, to try to prevent prices from rising than to attempt to roll them back. And finally, it is surer and safer: so long as inflation is merely a threat rather than a reality, it is enough to prevent the pace of economic expansion from accelerating dangerously. But once that pace has become unsustainably fast, then it becomes necessary to reduce the speed, and once such a reduction is started, there is no assurance it can be stopped in time to avoid an actual downswing.

This is no mere theoretical reasoning. It has been the practical experience of other industrial countries in recent years. Those countries that permitted inflationary trends to take firm hold have been forced to institute harsh remedial measures to restore stability, and invariably they have had to pay the price of actual reduction in output and real income. We shall succeed in avoiding a "stop-and-go" cycle—as the British call the practice of first permitting inflationary pressures to develop and then taking drastic measures to suppress them—only if we do not delay until inflation is upon us.

One curious concern voiced in the press is that our action might hamper the Administration in its efforts to introduce a "tough" budget next year. Nonsense. I have every confidence that the President will come up with a budget for fiscal 1967 just as "tough" as the necessities of the war in Vietnam permit. It is monetary policy that must adapt itself to the hard facts of the budget—and not the other way 'round.

Now I'd like to add something about our increase in maximum rates on time deposits. This part of the action was designed to permit the banking system as a whole, and the smaller banks in particular, to expand their resources sufficiently to provide the economy with additional credit, especially medium- and long-term accommodation.

In recent weeks, the rates paid by the largest banks on certificates of deposits had been "bumping" against the previous ceiling of 4½ per cent. This situation not only made it difficult for those banks to add to their resources; more important, it made it virtually impossible for the smaller banks to add to theirs, since these banks have to pay some premium in order to attract new depositors in competition with the giants.

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Let me emphasize that the new rate sets a maximum, not a standard. We expect banks, both large and small, to exercise a high degree of prudence and responsibility in their use of this increased rate flexibility. If they do, there now will be room for smaller banks to attract funds by paying slightly higher rates than the big ones. This opportunity for smaller banks to compete more effectively is both economically advisable and socially equitable. It makes for a better regional distribution of the availability of funds throughout the country; and it makes for a larger flow of funds to small business, which is mainly dependent on the smaller banks for their credit accommodation.

The Board of Governors has purposely refrained from raising the maximum rate for savings deposits. It has done so in order to minimize the impact on competitive relationships between commercial banks and savings banks and savings and loan associations, which depend for their resources mainly on funds deposited by individual savers rather than by corporations. I expect a continued ample flow of funds into residential construction.

I hope this discussion will add to understanding of the reasons and the purposes of our action. But what about its relation to the basic financial policies of the United States?

The Administration has—rightly, in my judgment—stated time and again that its goal was the most rapid economic progress compatible with price stability and payments equilibrium. And the Administration—no less than the Board of Governors of the Federal Reserve System—has recognized, by deeds as well as by words, that the dangers of spreading price increases and persisting payments deficits are the primary threats to the achievement of that goal.

In the monetary sphere, no less than in others, the making of decisions—on the direction of operations, on the precise timing of actions, and on the precise choice to be made among the instruments of policy available—is often difficult, but the necessity of making these decisions is inescapable.

And in the monetary sphere, the Federal Reserve Act imposes the responsibility—as well as the authority—for making decisions upon the Board of Governors and the Federal Open Market Committee. In the discharge of our responsibility, and in the exercise of our authority, we must—and we do—give careful consideration to the opinions and judgments of others who also bear grave responsibilities. But the use of the authority assigned to us cannot be delegated, nor can the responsibility we bear be escaped. To promote effectiveness and to avoid inconsistencies, we will always endeavor, to the best of our abilities, to coordinate our moves with those of other agencies in seeking to achieve the common goals of economic policy. But we cannot take monetary measures that are contrary to our best judgment, or refrain from taking measures that we consider necessary.

As I have said many times, the American people, through the legislative process, can change the authority and responsibility of the Federal Reserve System whenever they choose to do so. But unless and until the law is changed, I should consider it a violation of my oath of office to vote for or against a policy measure for any reason other than my best judgment of that measure on its merits.

Now, in conclusion, a few words about the third question, concerning the significance of our recent action for the future.

I cannot repeat often enough that the main requirement of monetary policy is flexibility, the capacity for adaptation to changes in the economy as they develop. This is particularly true for monetary policy in times of prosperity. Whenever the economy approaches full employment, the central bank must be constantly on guard against two opposite dangers that threaten continued expansion: not only against the risk of orderly growth giving way to an unsustainable boom, but just as much, if not more so, against the risk of an upswing leveling-off and giving way to stagnation or downturn. The Federal Reserve is not looking only at those data that seem to be warning of inflationary pressures. It is also scanning the horizon just as carefully for indications of weakness in the economy wherever it may be found—in residential construction, in inventories, in employment, or in any other sector.

Moreover, monetary policy will always need to take into consideration other Government policies and especially fiscal policies. Obviously, it will make a great difference for the development of interest rates, of monetary and credit conditions in general, and thus for the posture of monetary policy, whether the Treasury will need to divert more funds from the private capital and credit market than last year or whether, on the contrary, it will be able to reduce its borrowing. Even if we knew how the private economy would develop next year, we could not know whether any action that might be needed would be taken in the fiscal sector or whether the main burden of policy action would fall on the Federal Reserve.

For these reasons, I hope you will understand that neither I nor anybody else can predict whether, in the future, conditions will be such as to require greater firmness or greater ease, or for that matter a policy of neutrality.

There is only one thing I can predict and promise. The Federal Reserve will do its utmost, within the limits of its powers, to maintain a solid monetary and credit foundation on which to build the economy's continued progress.

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The Business Situation

The economy continues to move to new high ground, and business sentiment appears to have become progressively more confident about future prospects. Private residential construction activity was off again in November, but most other broad measures were up for the month. Moreover, the economy appeared to be gathering further momentum, with the unemployment rate declining once again. Orders already in hand appear to support the outlook for protracted strength in production over the near term. Meanwhile, consumer buying intentions remain high, capital spending plans are buoyant, and Government expenditures will be rising substantially. In view of these facts, several well-known business forecasts have recently projected a level of over-all activity in 1966 that implies a continuation of roughly the same rapid rate of growth that has been experienced over the past year and a half.

If these projections are realized, it seems likely that there will be a further lowering in the already reduced margin of unutilized resources. The labor market is already as tight as it has been at any time in the past eight years, and the unemployment that now exists appears to be more and more concentrated among workers without adequate skills and within a few localized pockets of surplus labor. There will, of course, be another substantial addition to the labor force next year, and the expected high level of capital spending will both increase physical capacity and add to labor productivity. Nevertheless, cost-price movements will continue to bear the closest scrutiny.

The recent cancellation of aluminum and copper price increases has helped dampen some of the fears of an imminent inflationary spiral, and although there has been a renewed flurry of price advances on a few industrial raw materials, such prices remain below their earlier peak in May. The consumer price index, however, moved to a new high in October. The increase for all commodities except food was the largest monthly advance in two years. The year-to-year rise since October 1964 amounts to 1.8 per cent, which is more than the increase that has characterized earlier periods of the expansion. The wholesale price index also climbed in October, making the over-the-year rate of advance 2.3 per cent.

OUTPUT, ORDERS, RETAIL SALES, AND EMPLOYMENT

The Federal Reserve Board's index of industrial production rose by 0.6 percentage point in October to 143.6 per cent of its 1957-59 average. The advance was sufficient to recoup about half of the decline in September when reductions in steel inventories adversely affected total output. Furthermore, the October gain occurred in spite of the fact that steel inventories continued to exert a depressing influence—iron and steel output fell by 8 per cent during the month. In late November, there were signs that the decline in steel ingot production was bottoming out at an annual rate of roughly 105 million tons.

Among other industries in October, coal and crude oil output rose substantially as producers worked to meet impending winter needs and to make up for strike and hurricane losses during the preceding month. Output of business and defense equipment was also up markedly. Consumer goods production advanced at a slightly faster pace than on average earlier in the year, with increases in the production of home appliances, furniture, and nondurable consumer goods following a period of somewhat sluggish growth. The rate of automobile assemblies also moved ahead somewhat in October and, with a further rise in November, total assemblies for the first eleven months of the year amounted to 8½ million units. This means that the first eleven months already surpass the previous full-year record of 7.9 million units set in 1955. If December schedules are met, output for the full year will amount to more than 9.3 million units.

Near-term prospects for further strength in production remain good. New orders received by manufacturers of durable goods rose in October, despite a drop in Government orders placed with defense industries subsequent to a surge in such bookings during the summer. Moreover, the volume of new bookings remained above current shipments, with the result that backlogs of unfilled orders piled up further in most broad industry groups. The total backlog has risen sharply and steadily since late 1963. October marked the twenty-second consecutive month of increase,

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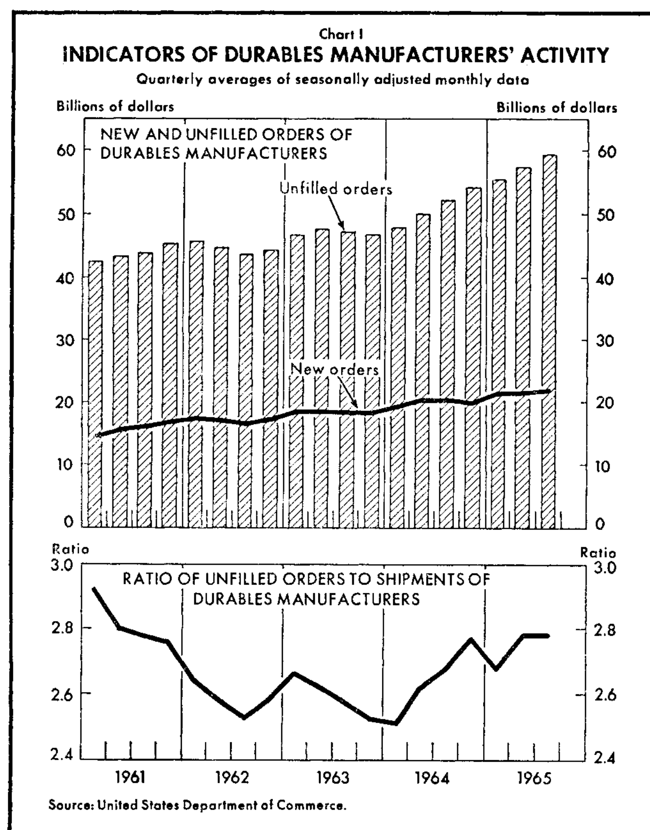
following a period of somewhat more modest growth earlier in the current expansion (see Chart I). Since the rise in backlogs has outpaced gains in shipments, the ratio of unfilled orders to shipments (also shown in the chart) has risen to the highest level since January 1961. The present backlog is equivalent to about three months of shipments at the current rate.

Longer term growth prospects for production are being bolstered by heavy current and prospective consumer demand. Retail sales were at a record high in October and appear to have remained near this level in November. These gains, moreover, occurred without any push from automobile sales, which declined slightly below the September rate. Some of the recent spending undoubtedly reflects a slightly delayed reaction to the bulge in consumer income in September when the Government made large retroactive payments for increased social security benefits. Consumers' buying plans continue to show strength, according to the Census Bureau's latest quarterly survey taken in mid-October. At that time, the proportion of households intending to buy a new car or an additional household appliance was at the highest level of the current expansion.



Total payroll employment also advanced in November, and gains were widespread among industry groups. In manufacturing industries as a group, moreover, average weekly hours climbed to the highest level since June 1965. Overtime of manufacturing production workers remained near the record high established in October. According to the Bureau of the Census, the total labor force grew further during the month and the unemployment rate fell to an eight-year low of 4.2 per cent.

GROWTH AND UTILIZATION OF RESOURCES

Should economic activity continue to advance at roughly the 1965 rate over the year ahead, one crucial question would be whether this further growth can be met by the increase in the economy's resources of labor and capital without more severe supply pressures than now exist. Many economic projections indicate that greater tightness will prevail. For example, the University of Michigan's econometric model points to an over-all unemployment rate averaging 3.9 per cent in 1966, a 0.7 percentage point decline from the estimated 1965 average. Moreover, the large capital spending now planned for next year, the strength of consumer buying plans, and rising defense outlays suggest that capacity utilization ratios may advance beyond currently high levels, despite the continuous additions to plant and equipment.

The growth in the labor force is clearly among the key variables bearing on the question of future noninflationary expansion. Over the past four and one-half years of general business advances, the civilian labor force has been growing by about 1.0 million persons per year (see Chart II). The actual increase in the year ended in November 1965, however, amounted to 1.6 million persons. Despite this larger addition, the number of new jobs created by the growing economy has been sufficient to reduce the unemployment rate by 0.7 percentage point over these twelve months and by 2.7 percentage points since the expansion began in February 1961. Among married men, about 98 of every 100 wanting to work held a job in November, the highest employment rate for this key category since such data began to be collected in late 1954.

According to recent estimates by the Bureau of Labor Statistics, the total labor force is likely to increase by about 7½ million persons between 1965 and 1970, or by an average of some 1½ million persons per year (see Chart II). The projection of a substantially larger annual accretion in the next few years than in the early years of the present expansion reflects the post-World War II "baby boom". Even the enlarged increase in the labor force, however, is well within the bounds of the

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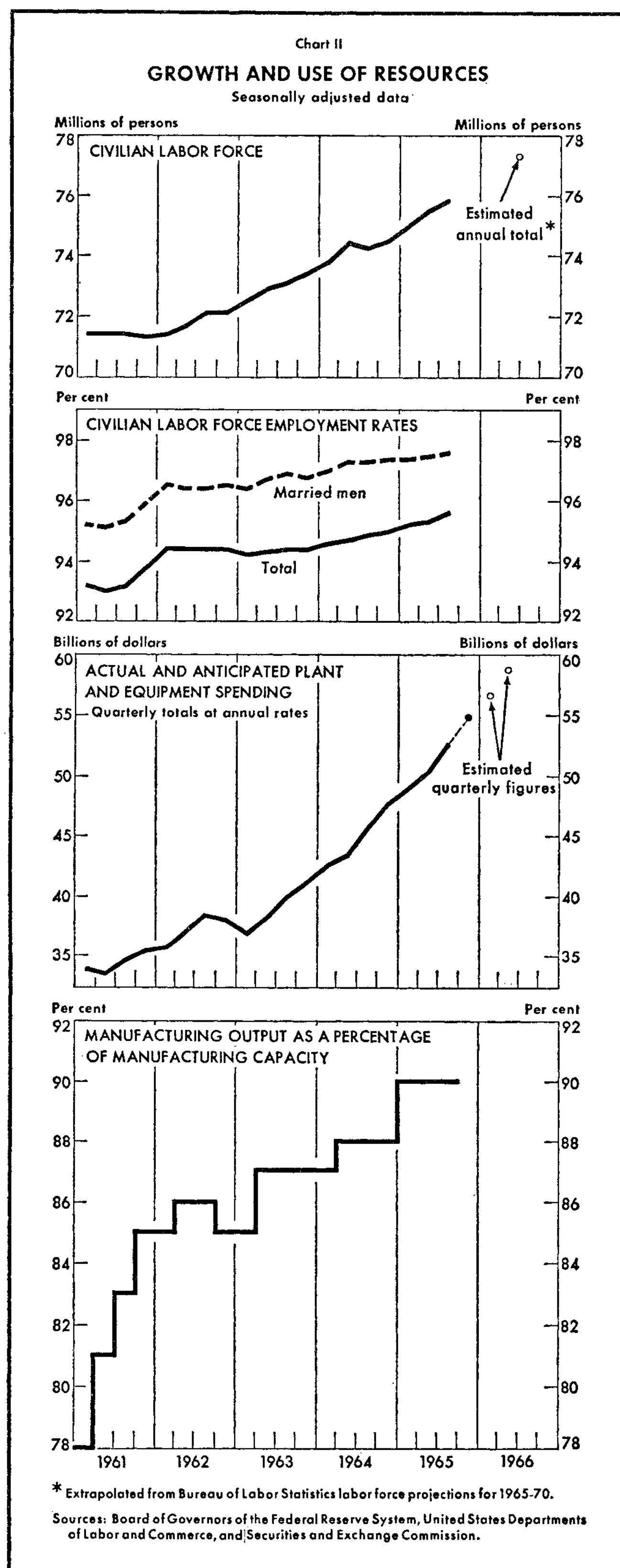

* Extrapolated from Bureau of Labor Statistics labor force projections for 1965-70.
Sources: Board of Governors of the Federal Reserve System, United States Departments of Labor and Commerce, and Securities and Exchange Commission.

gain in over-all employment that the economy has generated in the past year. Moreover, since many of the new labor force entrants will initially be lacking in skills, they will not immediately alleviate the shortages of skilled labor that have become more and more evident.

Over the longer run, one major way of overcoming actual or potential labor shortages is of course to increase workers' productivity, which has already been growing rapidly during this expansion. In fact, real output per employed person has increased by some 3.2 per cent annually over the past five years. Productivity growth has been stimulated by the large and steadily rising volume of capital spending that businessmen have undertaken. Over the past five years, the amount of such spending—both for capacity expansion and modernization—has totaled more than $200 billion, and according to an upward revision in recent Department of Commerce-Securities and Exchange Commission estimates, nearly $52 billion will be spent in 1965 alone (see Chart II). This figure, if realized, would represent capital outlays 60 per cent higher than those in 1961. Moreover, the report indicates that businessmen now plan to increase such expenditures to an annual rate of nearly $57 billion in the first quarter of 1966 and to an annual rate of $58.8 billion in the second quarter of next year—gains of 9.4 and 13.5 per cent over the 1965 level. These estimates follow the fall McGraw-Hill survey, which already pointed to an advance in capital spending in the next year larger than that indicated in similar surveys of previous years.

Despite the increase in capacity that has stemmed from these capital expenditures, manufacturers as a group continue to operate at rates close to their preferred capacity utilization ratios. According to an index developed at the Board of Governors, operations have been running at around 90 per cent of capacity since the first quarter of this year, some 12 points above the level at the beginning of the expansion in early 1961 (see Chart II). Indeed, a number of industries—notably automobiles, nonferrous metals, rubber, textiles, and machinery—have reported shortages of capacity.

Given the persistent need to improve labor productivity and the long-run growth needs of the economy, the high level of capital outlays planned for 1966 is encouraging. But the very fact that capacity and skilled labor are presently in short supply means that further large additions to aggregate demand—as implied by these capital spending plans—will make for more pressure on available resources in the short run. The economy will have to surmount these pressures if further gains in activity are to continue to take place in a generally noninflationary environment.

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The Money and Bond Markets in November

An atmosphere of uncertainty continued to prevail in the Government securities market during November. The long-standing concern on the part of market participants over the interest rate outlook was reinforced by indications that the economy was expanding on a broad front, and that the volume of new corporate and Government agency securities issues was rising. Against this background, the prices of Treasury notes and bonds moved further downward in early November, reaching new lows for the year. Subsequently, the tone of the market improved when several corporate issues were accorded a favorable reception. Furthermore, successful official moves to restrain price pressures in the metals industries were seen as enhancing the prospects for interest rate stability. Near the close of the month, however, an easier undertone reappeared as the market reacted to upward revisions of estimates of the Federal deficit for the current fiscal year and to discussion of the possibility that Federal Reserve Bank discount rates and other interest rates might move higher. The tone of the corporate bond sector improved moderately during the first half of the month, when higher reoffering yields on a heavy volume of new issues attracted investor interest. Investors resisted underwriter efforts to price new issues higher, however, and yields were near their peak as the month closed. In the tax-exempt sector, considerable caution persisted. Prices declined virtually throughout the month, and new issues were offered at progressively higher yields.

Treasury bill rates tended to edge irregularly higher over the month. Yields of the scarce shorter term issues receded moderately at the beginning of the month, while rates on longer term bills edged higher. Subsequently, investment activity contracted somewhat, and rates tended to creep higher at the close of the month as the December dividend and tax dates approached and rate expectations began to shift.

The money market continued firm in November although the distribution of excess reserves shifted markedly within the month. The average level of reserve availability for the banking system was little changed during the month, although temporary reserve dislocations were caused by the power failure in the Northeast on November 9.

THE GOVERNMENT SECURITIES MARKET

Prices of Government notes and bonds receded further at the beginning of November. Uncertainty over the future course of interest rates continued to restrain investor demand and stimulate professional offerings. Market caution was increased by the unexpectedly large allotments awarded subscribers to the Treasury's November cash refunding,[1] by the substantial calendar of scheduled capital market issues, and by continuing evidence of strong business loan demand. Government securities dealers sought to reduce their inventories, while investor offerings expanded both on outright sales and on switches into corporate and Government agency bonds. Prices of many Treasury coupon issues slipped to new lows for the year. (The right-hand panel of the chart on page 264 shows the rise in yields that accompanied this decline in bond prices.)

Around midmonth, the higher yields on intermediate- and long-term Government securities attracted renewed investment interest, particularly in intermediate-term issues, and stimulated dealer short-covering operations. Bond traders also derived encouragement from the favorable receptions accorded several sizable new corporate and tax-exempt offerings marketed during this period. Meanwhile, the cancellation of previously announced increases in aluminum and copper prices also aided confidence in the tenability of existing interest rate levels. Prices of Treasury coupon issues edged irregularly higher from November 10 until near the end of the month in moderately active trading, which included year-end switching for tax purposes. As November ended, the market received the news that the Federal deficit for the 1966 fiscal year would be larger than previously expected, primarily reflecting increased military spending. This news led to renewed price declines as the market weighed the possibility of higher interest rates.

In the Treasury bill sector, rates moved narrowly in

[1] For details see this *Review*, November 1965, page 233.

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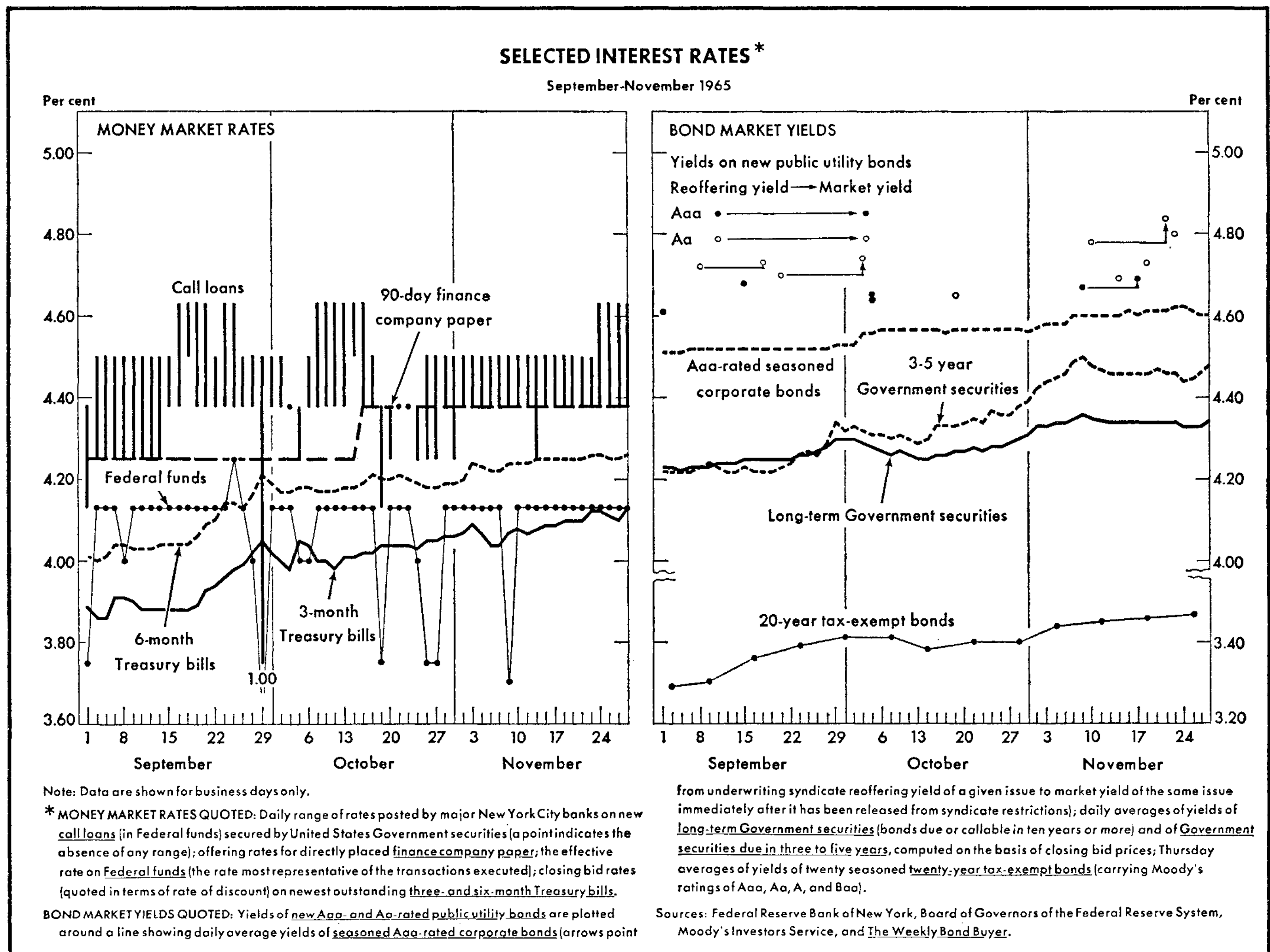

Note: Data are shown for business days only.

* MONEY MARKET RATES QUOTED: Daily range of rates posted by major New York City banks on new call loans (in Federal funds) secured by United States Government securities (a point indicates the absence of any range); offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three- and six-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields of new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields of seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield of a given issue to market yield of the same issue immediately after it has been released from syndicate restrictions); daily averages of yields of long-term Government securities (bonds due or callable in ten years or more) and of Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields of twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and *The Weekly Bond Buyer*.

November but tended higher. In the opening days of the month, a fairly good demand from public funds and other investors for the scarce 1965 maturities as well as for bills maturing early in 1966 pushed rates on these issues lower. At the same time, rates for longer term bills edged higher on moderately large commercial bank offerings (see the left-hand panel of the chart). Investment activity contracted somewhat following the Treasury's November 12 announcement that it would sell an additional $2.5 billion of June 1966 tax anticipation bills for payment on November 24 to meet its remaining cash needs for calendar 1965. At the November 17 auction, the tax bills drew lively interest from commercial banks, which were permitted to make full payment for their purchases by crediting Treasury Tax and Loan Accounts. Banks outside New York City were particularly attracted to the issue, and its average issuing rate was set at 4.075 per cent. This was almost 20 basis points below the market rate prevailing on the June tax bills already outstanding, and reflected the value placed by the banks on acquiring additional Tax and Loan Account deposits. The auction rate, however, was considerably higher than the 3.938 per cent average issuing rate set at the earlier October auction of June tax bills, in part because of the shorter average duration expected this time for the Tax and Loan deposits.

A good interest developed in the June tax bills after the auction, and dealers and investors readily absorbed commercial bank selling. Large Federal Reserve purchases toward the end of the month to supply reserves exerted

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Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, NOVEMBER 1965

In millions of dollars; (+) denotes increase, (−) decrease in excess reserves

Factors	Changes in daily averages—week ended				Net changes
	Nov. 3	Nov. 10	Nov. 17	Nov. 24	
"Market" factors					
Member bank required reserves*	− 87	+ 256	− 87	+ 44	+ 126
Operating transactions (subtotal)	− 448	− 451	+ 48	+ 249	− 602
Federal Reserve float	− 281	+ 290	+ 63	+ 276	+ 348
Treasury operations†	+ 66	− 115	+ 27	+ 148	+ 126
Gold and foreign account	+ 8	− 25	—	− 16	− 33
Currency outside banks*	− 127	− 518	− 51	− 87	− 783
Other Federal Reserve accounts (net)‡	− 113	− 86	+ 11	− 71	− 259
Total "market" factors	− 535	− 195	− 39	+ 293	− 476
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 537	+ 420	− 201	− 260	+ 496
Bankers' acceptances	+ 2	+ 3	− 1	+ 4	+ 8
Repurchase agreements:					
Government securities	—	+ 4	− 4	—	—
Bankers' acceptances	+ 22	− 19	− 21	+ 4	− 14
Member bank borrowings	+ 148	− 152	+ 155	− 128	+ 23
Other loans, discounts, and advances	+ 13	− 12	− 2	—	− 1
Total	+ 721	+ 244	− 74	− 380	+ 511
Excess reserves*	+ 186	+ 49	− 113	− 87	+ 35
	Daily average levels				
Member bank:					
Total reserves, including vault cash*	22,111	21,904	21,878	21,747	21,910§
Required reserves*	21,732	21,476	21,563	21,519	21,573§
Excess reserves*	379	428	315	228	337§
Borrowings	486	334	489	361	417§
Free reserves*	− 107	+ 93	− 174	− 133	− 80§
Nonborrowed reserves*	21,625	21,570	21,389	21,386	21,493§
	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 1,039	− 229	− 5,582	+ 38	− 4,734
More than one year	—	—	+ 5,582	—	+ 5,582
Total	+ 1,039	− 229	—	+ 38	+ 848

Note: Because of rounding, figures do not necessarily add to totals.
* These figures are estimated.
† Includes changes in Treasury currency and cash.
‡ Includes assets denominated in foreign currencies.
§ Average for four weeks ended November 24.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS NOVEMBER 1965

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended				Average of four weeks ended Nov. 24
	Nov. 3	Nov. 10	Nov. 17	Nov. 24	
Eight banks in New York City					
Reserve excess or deficiency(−)*	18	57	12	− 9	20
Less borrowings from Reserve Banks	96	79	59	46	70
Less net interbank Federal funds purchases or sales(−)	−114	296	379	202	191
Gross purchases	*834*	*1,066*	*995*	*927*	*956*
Gross sales	*949*	*770*	*616*	*725*	*765*
Equals net basic reserve surplus or deficit(−)	37	−319	−426	−257	−241
Net loans to Government securities dealers	521	354	550	596	505
Thirty-eight banks outside New York City					
Reserve excess or deficiency(−)*	20	29	13	26	22
Less borrowings from Reserve Banks	72	10	157	78	79
Less net interbank Federal funds purchases or sales(−)	745	802	643	584	694
Gross purchases	*1,399*	*1,494*	*1,327*	*1,235*	*1,364*
Gross sales	*654*	*692*	*685*	*651*	*671*
Equals net basic reserve surplus or deficit(−)	−797	−783	−787	−636	−751
Net loans to Government securities dealers	156	53	147	120	119

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In per cent

Maturities	Weekly auction dates—November 1965				
	Nov. 1	Nov. 8	Nov. 15	Nov. 22	Nov. 29
Three-month	4.082	4.045	4.097	4.104	4.115
Six-month	4.219	4.221	4.259	4.253	4.249

Maturities	Monthly auction dates—September-November 1965		
	Sept. 24	Oct. 26	Nov. 24
One-year	4.236	4.192	4.276

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

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little influence on rates, since dealer portfolios had been built up in anticipation of these seasonal purchases. A more cautious atmosphere, however, began to appear near the close of the month, as rates on bank loans to Government securities dealers edged higher and the market began to talk of the possibility of higher rates in the future.

OTHER SECURITIES MARKETS

Prices of corporate and tax-exempt bonds drifted lower in light trading at the beginning of the month. Market attention focused upon the increasingly heavy calendar of scheduled flotations, particularly of corporate bonds. Over the midmonth period, a better tone emerged in the corporate sector after several new issues—marketed at relatively attractive yield levels—were quickly taken up by investors. Investor resistance developed in the second half of the month, however, and yields on new issues again tended higher. Investor interest reappeared at the higher rates, although a considerable amount of unsold bonds remained on the dealers' shelves at the month end. In the tax-exempt sector, on the other hand—where investment interest from commercial banks and other sources apparently waned—a cautious tone persisted throughout the month. Activity in both sectors centered upon new issues since reoffering yields on corporate and tax-exempt flotations were generally higher than yields on outstanding bonds.

Over the month as a whole, the average yields on Moody's seasoned Aaa-rated corporate bonds rose by 4 basis points to 4.60 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) rose by 7 basis points to 3.47 per cent. (See the right-hand panel of the chart.) These indexes are, however, based on only a limited number of issues and do not necessarily reflect market movements fully.

THE MONEY MARKET AND BANK RESERVES

The money market remained firm in November. The effective rate on Federal funds held generally steady at 4⅛ per cent, while rates quoted by the major New York City banks on their call loans to Government securities dealers were generally within a 4¼ to 4½ per cent range. Nationwide reserve availability, on the other hand, fluctuated widely during the month in the wake of the massive power failure which beset the Northeastern United States on November 9. The unusual bulge in free reserves that occurred following the blackout, combined with a continued generally firm tone in the money market, illustrated anew the limitations of any single measure—e.g., free (or net borrowed) reserves—as a satisfactory barometer of monetary policy.

During the first statement period of the month, preceding the week of the blackout, Federal Reserve open market operations provided over $1 billion of reserves on a Wednesday-to-Wednesday basis to offset the drains stemming from movements in "market" factors. As a result, the average level of net borrowed reserves was little changed from the preceding week. Reserve distribution remained in favor of the major banks in New York City, which continued to have a basic reserve surplus. Nevertheless, total member bank borrowings from the Federal Reserve moved up from the low level of the preceding week to about the $500 million mark in the first week of the new "country" bank settlement period.

At dusk on Tuesday, November 9, an abrupt interruption in electrical transmission over a broad area of Canada and the Northeastern United States plunged most of the First and Second Federal Reserve Districts into darkness. With transportation and communications systems severely disrupted by the power failure, check-clearing operations were considerably hampered and Federal Reserve float consequently soared by over $500 million on Wednesday, November 10. This rise in float and other factors caused average nationwide reserve availability to swell by $170 million over the statement period. The bulk of the rise in excess reserves wound up as idle funds in the major money market banks in New York and Boston, but had little effect on the money market in view of the difficulties these banks had in estimating their reserve positions on Wednesday, November 10. In recognition of the special difficulties caused by the power failure, these banks were permitted by the Federal Reserve authorities to carry the reserve excesses over into the following week.

In that following statement week, once power was fully restored, the machinery of the banking system quickly returned to a normal operating basis. The reserve excesses carried over from the preceding week were quickly absorbed, partly as a result of a large seasonal buildup of reserves at country banks. Over-all reserve availability returned to the levels prevailing before the blackout, and the market remained firm throughout the week, with Federal funds trading mainly at 4⅛ per cent. Subsequently, the money market was steady, as System open market operations withdrew reserves in large volume to offset the country banks' sharp reductions in their holdings of excess reserves in the final week of this reserve averaging period. In the final statement week of the month, firmness in the money market continued as System open market operations largely offset the increase in reserves stemming from a rise in float and other market factors.

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Federal Reserve Accounts, Money Supply, and Bank Credit

Over the past four and one-half years of economic advance, total loans and investments at all commercial banks have grown at a compound annual rate of 8.5 per cent, more than twice as fast as the rate of growth of bank credit in the two preceding general business expansions. Moreover, due to a surge in bank credit demands in the early months of 1965, the 9.4 per cent rate of growth in bank credit over the year ended in September 1965 has been more rapid than earlier in the expansion.

This article focuses on the provision by the Federal Reserve of member bank reserves underlying the bank credit expansion between September 1964 and September 1965. The associated rise in the money supply and in commercial bank time deposits is also discussed. The article thus continues and updates a type of analysis initiated in the December 1964 issue of this *Review*. The discussion is illustrated by the set of charts shown on page 268.[1]

The reader will realize that the financial interrelations that are described are highly complex. All magnitudes shown in the charts are determined mutually and simultaneously through additions to reserves by the Federal Reserve and the demands for, and supplies of, funds generated by the banking system and the nonbank public. Where one breaks into this interrelated system to describe what actually has happened during a particular period is largely a matter of choice. The approach adopted here is to begin with the creation of bank reserves by Federal Reserve operations and then to work "forward" through the banking system to the nonbank public. In retracing this analysis with the aid of the charts, it should be kept in mind that a numerical accounting of what actually happened should not be interpreted as a causal chain of past events or a mechanical prediction of future events under similar circumstances. Eventual reactions to the creation of additional bank reserves by the Federal Reserve depends—most broadly—on the demand for credit and the respective costs of borrowing from banks and from other sources. On the liabilities side, the public's relative preference for currency, demand deposits, and time deposits, as well as a number of technical factors, have a bearing on the final numerical outcome. Nevertheless, *ex post facto* analysis of the type here presented can be illuminating provided its limitations are kept in mind.

SOURCES AND USES OF BANK RESERVES

The Federal Reserve supplied nearly $4.4 billion of additional member bank reserves during the twelve months ended September 1965, as can be seen by adding the figures in the first column of Chart I. The bulk of this amount was made available to banks through net System purchases of United States Government securities and bankers' acceptances. As has been true in previous periods, however, the volume of reserves actually held by member banks went up by only a fraction of the new reserves supplied by the System. Thus, a large portion of the expanded Federal Reserve credit offset the drain on reserves stemming from the $1.6 billion outflow of gold over the twelve-month period, most of which took place in the first half of 1965. A continued surge in the amount of currency held by the nonbank public was a second major drain, absorbing nearly $2 billion of the increase in Federal Reserve credit. Together, these two factors absorbed about four fifths of the total increase in Federal Reserve credit (as shown by comparing the sum of Columns 2 and 3 of Chart I with the sum of Column 1).

Had the Federal Reserve failed to offset the gold outflow and the increase in currency in circulation, a marked contraction in bank credit and deposits would undoubtedly have been forced. As it was, more than $800 million of the total increase in Federal Reserve credit was added to member bank reserves after allowance for the major

[1] The data shown in the charts have been compiled from several releases, containing diverse data that are not necessarily wholly consistent. Thus, some of the underlying data are available on a daily average basis, while other items can be obtained only on a last-Wednesday-of-the-month basis. The numbers presented have been derived from balance sheets as close as possible to the two weeks ended September 30, 1964 and the two weeks ended September 29, 1965.

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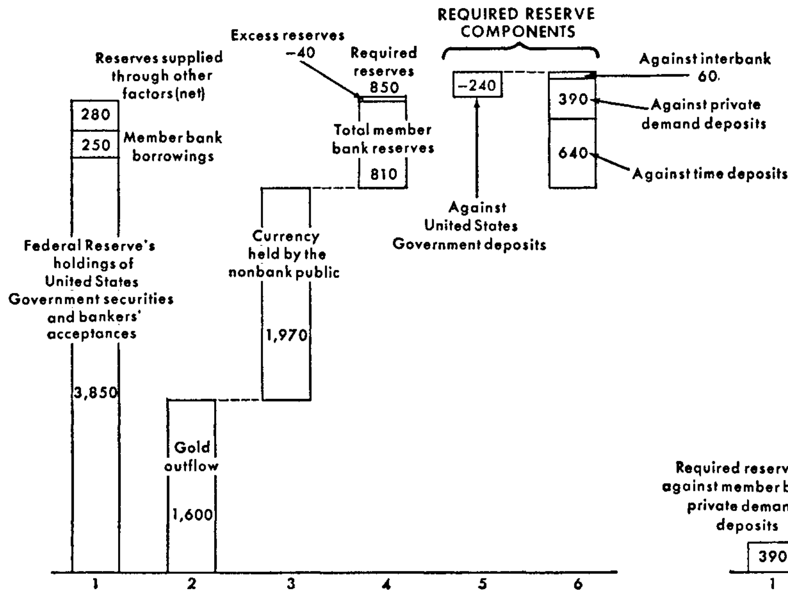

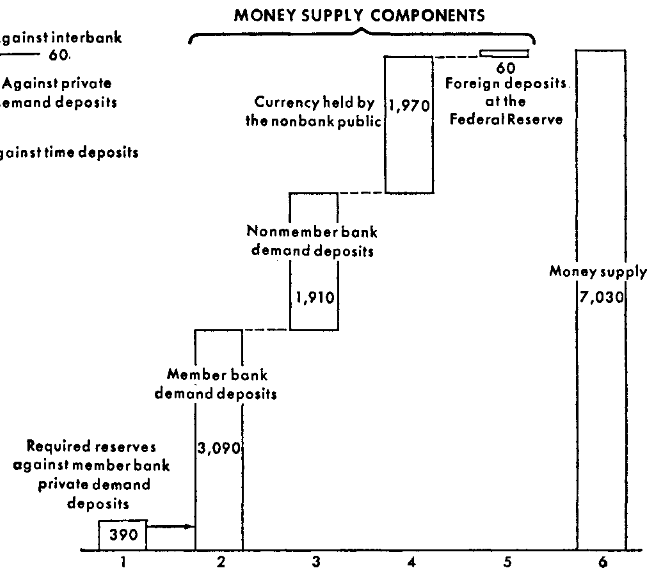

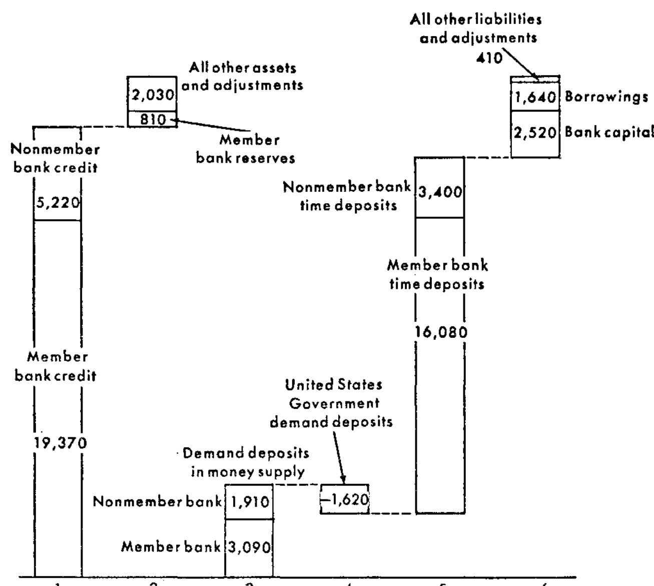

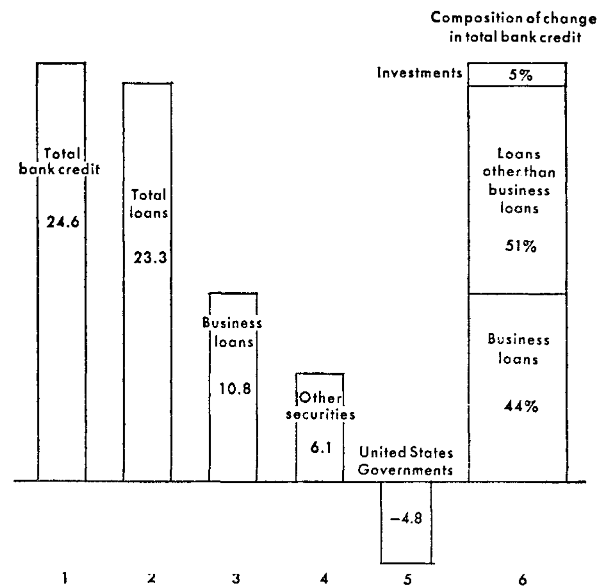

Note: Minor items are not shown separately in order to simplify the presentation.

Sources: Board of Governors of the Federal Reserve System; Federal Reserve Bank of New York.

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drains—an amount that met the bulk of the $850 million increase in required reserves over the year (see Column 4 of Chart I). At the same time, member banks utilized the reserves that they did hold more fully, as indicated by the fact that they reduced their excess reserves by $40 million over the period.

Actually, reserves required against private demand and time deposits as well as against net interbank deposits (shown in Column 6 of Chart I) went up by nearly $1.1 billion over the period. Total required reserves rose by a somewhat smaller amount, however, as a sharp drop in United States Government deposits—the $1,620 million shown in Column 4 of Chart III—released some $240 million of reserves (Column 5, Chart I). It is also noteworthy that, despite substantially lower reserve requirements against time deposits than against demand deposits, the bulk of the additional reserves were required against time deposits.

THE INCREASE IN THE MONEY SUPPLY

The $390 million increase in reserves required against private demand deposits was associated over the period under study with a rise of about $3.1 billion in such deposits at member banks (Chart II). The implied ratio of nearly eight to one between the increases in deposits and reserves over this period reflects, of course, a weighted average of the demand deposit reserve requirement ratios at reserve city and "country" banks. On top of this rise in private demand deposits at member banks, there was some $1.9 billion in such deposits created at nonmember banks over the period.[2] Adding the previously mentioned large increase in currency holdings of the nonbank public to this total deposit increase—and further adding the small increase in foreign demand deposits at the Federal Reserve—one arrives at a gain in the total money supply over the period of some $7 billion (shown in Column 6 of Chart II).[3] This represents a 4.4 per cent increase in the money supply, about the same percentage rise as in the preceding year.

Two points might be made about the composition of this increase in the money supply. First, the addition to coin and folding money accounted for nearly 28 per cent of the over-all gain in the stock of money, considerably more than the 22 per cent share of currency in the money stock outstanding in September 1964. This reflects the fact that currency has in recent years been gaining again in relative importance in the money supply, after nearly two decades of almost continuous relative decline following World War II. Second, with respect to the deposit component of the money supply, a growing share has been accounted for by nonmember banks. In early 1961, at the start of the current business upswing, only about 18 per cent of the demand deposits included in the money supply had been held at nonmember banks. Over the first three and one-half years of expansion, however, nonmember bank deposits accounted for nearly 33 per cent of the gain in total private demand deposits at all commercial banks, and over the past year their share in the increase has amounted to nearly 40 per cent. Nevertheless, nonmembers still accounted for only about 20 per cent of total private bank demand deposits in September 1965.

COMMERCIAL BANK ASSETS AND COUNTERPARTS IN BANK LIABILITIES AND CAPITAL

Fractional reserve requirements permit, as previously noted, a multiple expansion of bank credit and deposits on the basis of given reserve increases. Even though member bank reserves went up only by some $800 million during the period, this rise—combined with a drawing-down of excess reserves—was sufficient to support nearly $19.4 billion in additional member bank credit, as can be seen in the first two columns of Chart III. At the same time, nonmember banks increased their outstanding credit by more than $5.2 billion. Together, these gains in bank loans and investments represented a very substantial 9.4 per cent increase over the twelve-month period. (Chart IV and its discussion will provide a breakdown of the bank credit increase.)

The major counterparts of this growth in bank credit and other assets are shown in the staggered Columns 3 through 6 of Chart III. First, there was the $5 billion increase in private demand deposits that has already been shown in Chart II as a component of the rise in the money supply. Total demand deposits at commercial banks went up by a substantially smaller amount over the period, however, as the previously mentioned decline in United States Government deposits offset some of the gain in

[2] Since nonmember banks do not maintain their reserves at Federal Reserve Banks, the figures for required reserves shown in the charts do not include these reserves. The banks do, however, have to comply with state-imposed reserve requirements; and part of the reserves supplied by the Federal Reserve System in effect served to support expansion of nonmember bank deposits and credit.

[3] The money supply is technically defined as including (a) demand deposits at all commercial banks, other than deposits due to domestic commercial banks and the United States Government, less cash items in the process of collection and Federal Reserve float; (b) foreign (official) balances at Federal Reserve Banks; and (c) currency outside the Treasury, the Federal Reserve System, and the vaults of all commercial banks.

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private accounts.[4]

The bulk of the growth in bank credit and total assets has had its liability counterpart in the form of increased commercial bank time deposits. Time and savings deposits at all commercial banks rose by nearly $19.5 billion over the past year, or by some 16 per cent. (This growth rate actually exceeds the rapid pace of 15 per cent per year set in the preceding three and one-half years of business expansion.) Although time and savings deposit balances accounted for only about 40 per cent of total commercial bank liabilities (plus capital) in September 1964, their share of the increase in this total over the subsequent year came to nearly 64 per cent. The growth of time and savings deposits has been fostered throughout the current expansion by the narrowing differential between interest rates on such deposits at commercial banks and at competing institutions as banks have competed more aggressively for these types of deposit. Furthermore, the development of the market for negotiable certificates of deposit and the repeated upward revision of maximum rates of interest payable on such deposits under Federal Reserve Regulation Q have been major stimulants to time deposit growth at commercial banks.

The growth in bank capital contributed another important counterpart to the increase in bank credit (Column 6, Chart III). This increase—some 9 per cent—is somewhat more rapid than the 7 per cent per year average growth during the preceding three and one-half years. A rise in bank borrowings of some $1.6 billion accounts for the bulk of the remaining rise in the counterparts of the bank credit expansion shown in Chart III. This increase consisted mainly of greater interbank indebtedness, more member bank borrowings from the Federal Reserve, and the issue of short-term promissory notes by banks.

[4] United States Government deposits were unusually volatile over the year ended in September. In early 1965, with Government revenues running substantially higher than expected and well ahead of current expenditures, the Government's balances at commercial banks grew substantially (to a record $9.7 billion in May). This increase has been more than wiped out by a greater than seasonal decline in the past several months so that there was a net decline over the year ended in September.

BANK CREDIT

The major components of the change in bank credit over the year ended in September are presented in Chart IV. During the early years of the current expansion, loan demand was moderate by the standards of preceding expansions, but it has become considerably heavier in the past year. Thus, the growth rate of business loans amounted to 19.3 per cent in the year ended in September 1965, compared with an annual rate of increase of only 8.5 per cent over the previous three and one-half years of economic advance. This single loan category accounted for some 44 per cent of the rise in total bank credit from September 1964 to September 1965 (see Column 6, Chart IV), as against only half as much earlier in the expansion.

Banks were able to satisfy exceptionally large loan demands without liquidating investments. Indeed, holdings of securities other than those issued by the United States Government have been rising throughout the current expansion. In the year ended in September 1965, the rise in bank holdings of municipals and other securities exceeded the decline in Government securities by more than $1 billion. This net increase in investments occurred although the liquidation of Government securities, which previously had been proceeding at only a slow pace, gained momentum as banks cut their holdings by $4.8 billion, or nearly 8 per cent.

BIBLIOGRAPHY ON MONETARY THEORY AND POLICY

The Board of Governors of the Federal Reserve System has just announced publication of a bibliography covering monetary theory and policy. Copies are available, upon request, from the Division of Administrative Services, Board of Governors of the Federal Reserve System, Washington, D. C. 20551, at $1.00 each.

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1966 Guidelines under the President's Balance of Payments Program

Statements of the Board of Governors and the United States Department of Commerce

BANKS AND NONBANK FINANCIAL INSTITUTIONS

The following statement was released by the Board of Governors of the Federal Reserve System on December 6, 1965:

The Board of Governors of the Federal Reserve System today issued new guidelines for financial institutions to follow during 1966 in cooperating with the President's program to improve the nation's balance of payments.

For the year 1966 the guidelines for both banks and nonbank financial institutions have been revised to suggest limitations on expansion of foreign credits which are comparable to the limitations suggested for 1965, but with variations to remove certain inequities inherent in the 1965 program.

The basic feature of the guidelines for 1965 has been a percentage limitation on increases in foreign credits from the base date of December 31, 1964. In general, each bank was requested to restrict its foreign credits outstanding to an amount not in excess of 105 per cent of the amount outstanding at the end of 1964, and each nonbank financial institution was requested to operate within a framework roughly comparable with that suggested for banks.

Although the banking system as a whole has stayed well under the suggested ceiling for 1965, some further expansion has been provided for in the 1966 program for two reasons: (1) it is believed that banks will continue to cooperate with the spirit as well as the letter of the program and will utilize the expansion suggested only to the extent needed to meet priority credit requirements; and (2) it is intended to make certain that export financing is available in adequate amounts, and that the bona fide credit needs of less developed countries will continue to be met.

Under the 1966 program, commercial banks are requested to restrain any expansion in foreign credits to such an extent that the amount outstanding does not exceed 109 per cent of the amount outstanding on December 31, 1964. Further, in order to spread throughout the year any outflow necessary to meet priority credit requirements, it is requested that the expansion be utilized at a rate of not more than 1 per cent per calendar quarter; that is, the target would be 106 per cent of the 1964 base during the first quarter, 107 per cent during the second, 108 per cent during the third, and 109 per cent for the remainder of the year. Special consideration for banks with small bases will add about 1 per cent to the total, bringing the possible expansion for 1966 for the banking system as a whole to about the same amount as that provided for 1965.

The 1966 guidelines for nonbank financial institutions have been made broadly comparable with those of the bank guidelines. But the foreign financial assets of such institutions continue to be classified into three groups—liquid funds, investments and credits maturing in ten years or less and in financial subsidiaries, and long-term investments—each subject in whole or part to a guideline ceiling. In some cases the guidelines for 1966 are based on outstanding amounts at September 30, 1965, where the use of a December 1964 base might be inequitable to individual institutions.

The priorities established by the 1965 guidelines remain in effect; i.e., an absolute priority for bona fide export credits, and highest priority in nonexport loans to credit to less developed countries.

The Board expressed its appreciation for the cooperation of the financial institutions since February 10, 1965, and its confidence in the continued

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cooperation of the banks and other financial institutions—so essential to the success of the President's balance of payments program.

Copies of the new guidelines are being made available through the Federal Reserve Banks. Banks and other financial institutions having questions concerning their application are urged to consult with the Federal Reserve Bank of their District.

BUSINESS CONCERNS

The following statement was released by the United States Department of Commerce on December 6, 1965:

Secretary of Commerce John T. Connor announced today more ambitious targets for President Johnson's voluntary balance of payments program in which some 500 business corporations are now cooperating in the national effort to reduce the dollar outflow.

While calling for a "special effort" to restrain the outflow of funds for direct investments abroad, the Secretary said that "we will also continue in 1966 the basic strategy followed in 1965 under which each chief executive is asked to maximize his company's contribution to the balance of payments through a variety of means—including export expansion, repatriation of income from abroad, repatriation of short-term foreign financial assets, and the maximum use of funds obtained abroad for investment purposes".

The Secretary said he anticipated this effort may raise industry's net contribution to the balance of payments by about $3.4 billion in 1966 compared with 1965.

The Secretary recommended that each company set a separate target on direct investment for 1965-66 combined based on a general formula.

The 1966 program also provides:

Geographic focus of the program will continue to be on developed countries, but the coverage will be broadened to include direct investment in Canada, Abu-Dhabi, Bahrain, Indonesia, Iran, Iraq, Libya, Qatar, Kuwait-Saudi Arabia Neutral Zone, and Saudi Arabia. The new list again will be the same as that prepared for application of the interest equalization tax.

Some 400 additional companies will be asked to join the program in 1966. Between 500 and 600 companies are currently participating.

The reporting system will be improved to provide the government more detailed information on the progress of the program.

The chief executive of each company will be asked to make a personal appraisal each quarter of his company's progress in achieving targets forecast for 1966, together with a commentary on company experience quarter-by-quarter on transactions projected for 1966.

Secretary Connor revealed the new program in a letter written to companies cooperating in the program.

"In making our program more effective, it will remain *voluntary,*" Secretary Connor said. "The President is convinced that the voluntary approach adopted this year was the correct way to proceed, and it will continue during 1966."

In calling for restraints on direct investment outflows, the Secretary said: "The basic aim is *not* to restrain expenditures by United States companies on plant facilities abroad. Rather it is to minimize the impact of the outflow of funds on the United States balance of payments."

Although geographic coverage of the program is being extended, the Secretary said, "we still wish to encourage American private enterprise to help raise standards of living in the developing countries of the Free World".

He estimated that the business community may improve its net contribution to the balance of payments by $1.3 billion in 1965 compared with 1964. In 1966 he hoped that this over-all improvement could be raised to $3.4 billion—"if the business community is successful in restraining direct investment, maximizing export shipments, repatriating income and foreign financial assets—along with other measures".

He recommended the following target to American industry in planning its direct investment for 1966:

Direct investment in the two-year period 1965-66 combined should be limited to 90 per cent of the amount during the three-year period 1962-64. For this purpose, direct investment is defined to include

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the net outflow of funds from the United States plus undistributed profits of subsidiaries abroad.

"For industry as a whole," Secretary Connor said, "this target would permit a rate of direct investment during the two years 1965 and 1966 combined approximately 35 per cent above the annual average during the 1962-64 base period. This rate of increase should result in a level of direct investment outflow of about $2.4 billion in 1966—roughly the same as in 1964, following an expected substantial rise in 1965 compared with the previous year. The expected result can also be expressed as a projected increase of more than $1 billion in the surplus of total direct investment income over direct investment outflow in 1966 compared with the level anticipated in 1965."

Each company head was asked to use the above formula in estimating his own target for direct investment in 1966, using the same base period of 1962-64. Because of the varying impact of the formula on different companies, the Secretary indicated that Commerce officials will be prepared to discuss particular situations with individual companies.

Commenting on his request for moderation of direct investment in Canada in 1966, Secretary Connor asked companies to continue efforts to expand exports to Canada and to repatriate income and short-term financial assets held with Canadian institutions.

Explaining his request for inclusion of Canada in the direct investment program in 1966, Secretary Connor said: "In view of the large prospective increase in direct investment in Canada by American firms next year, we think it is desirable to ask for moderation on the outflow of direct investment funds to that country along with other developed areas. At the same time, we realize that United States companies, partly because we did not ask for restraint in 1965, have under way firm investment commitments in Canada (for example those incurred under the United States-Canadian automotive parts agreement) which they will find it necessary to carry out. But it is our impression that companies will have ample opportunity within the direct investment target to fulfill these commitments, and we are certain they would want to give them the highest priority."

On his recommendation to expand geographic coverage, the Secretary noted that the additional countries "possess large reserves of internationally traded natural resources in which United States direct investment is substantial. We think it reasonable and equitable to include the substantial flows of investment funds to these countries in the base and target for balance of payments improvement during 1966."

In his letter, the Secretary said the revisions in the program for 1966 have been approved by his Balance of Payments Advisory Committee, which consists of: Albert L. Nickerson, Chairman of the Board, Socony Mobil Oil Company, Committee Chairman; Carter L. Burgess, Chairman of the Board, American Machine and Foundry Company; George S. Moore, President, First National City Bank; Elisha Gray, II, Chairman, Whirlpool Corporation; Sidney J. Weinberg, General Partner, Goldman, Sachs and Company; Carl J. Gilbert, Chairman, The Gillette Company; Stuart T. Saunders, Chairman, Pennsylvania Railroad Company; J. Ward Keener, President, B. F. Goodrich Company, and Fred J. Borch, President, General Electric Company.

"I am personally confident," he said, "that the leaders of American business fully understand the seriousness of the foreign situation which we face. Furthermore, the increased military effort in Vietnam will put further pressure on our balance of payments. To help compensate for the added drain, we have found it necessary to strengthen the voluntary program for 1966."

Pending the transmittal of detailed worksheets, the Secretary outlined principal features of revisions in the reporting system. Companies will be asked to report quarterly on a number of international transactions as in 1965—but with the following geographic classification: all areas; all developed countries, with Canada, Western Europe, and other developed countries shown separately; and all less developed countries combined.

Initially, each firm will be requested to review its transactions for 1964 and 1965 and to recast them on a quarterly basis comparable to the categories to be shown in the 1966 worksheet. Companies will be asked to prepare and report as early as possible after receipt of the worksheet (and in any case by next February 15) a forecast for 1966 for a number of transactions listed on the worksheet. The forecast should include data on exports, imports, direct investment income (consisting of dividends, interest, and branch profits); undistributed profits of subsidiaries; royalties; management fees, and other service incomes; and capital outflows from the United States for direct investment. Companies should forecast these principal headings for all geographical areas combined, showing a division only for all de-

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veloped vs. all less developed countries. Firms will be asked to review these forecasts each quarter and to make revisions where appropriate.

The items above would also be reported on a quarterly basis in the greater geographic detail previously indicated. Also, companies will be asked to report long-term capital transactions with foreigners other than their affiliates and changes in short-term financial assets held abroad in the name of the parent company. The transactions listed can be used by the company to develop its own balance of payments ledger quarter-by-quarter and for the year as a whole. In developing this balance of payments statement, companies should show the net balance in two ways—(1) including imports, (2) excluding imports.

Secretary Connor said he would also ask for reports on quarterly changes in the amounts outstanding of long-term capital obtained from foreign residents (including branches and subsidiaries of United States banks). If foreign subsidiaries obtain long-term debt capital in the United States (including bank loans, bonds, notes, or commercial credits), changes during the quarter in the amounts outstanding should be reported in the quarterly worksheet. If the parent company obtains equity capital from foreign residents through the sale of its securities abroad, the amount of proceeds is to be reported in the worksheet.

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Publications of the Federal Reserve Bank of New York

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