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FEDERAL RESERVE BANK OF ST. LOUIS

Review

CONTENTS

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FEDERAL RESERVE BANK OF ST. LOUIS

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Total Demand, Prices, and Real Growth

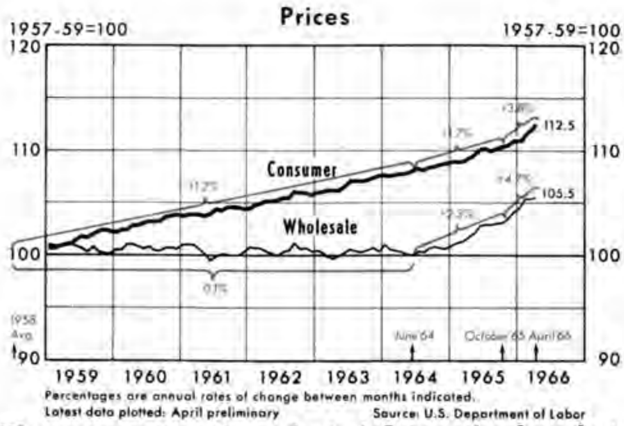
PRICES CONTINUED TO RISE in April and early May, while growth of real product apparently slowed. Total demand for goods and services continued to be stimulated by Government expenditures relative to the tax rate structure and by monetary expansion.

Prices

Most price movements have been upward in recent months. From March to April the consumer price index rose at a 5.5 per cent annual rate, the same as for the past three months. This index rose at a 3.8 per cent rate from October to April, after rising at a 1.7 per cent rate from mid-1964 to late 1965 and at a 1.2 per cent rate from 1958 to 1964.

The wholesale industrial price index increased at a 3.5 per cent annual rate from March to April and has risen at a 2.9 per cent rate since last October. This compares with a 1.4 per cent rate from June 1964 to October 1965 and a 0.3 per cent rate for the period 1958-64.

The overall wholesale price index rose at a 4.7 per cent annual rate from October to April and according to preliminary data remained high in May. This index increased at a 2.3 per cent rate from mid-1964 to October 1965 and was virtually unchanged from 1958 to 1964. The rate of increase in the overall index has slowed since February, as declines in prices of farm products and processed foods have partially offset rising industrial prices.



The gross national product deflator, the broadest of the price indexes, rose at a 3.6 per cent rate from the fourth quarter of 1965 to the first quarter of this year. This price measure rose 1.9 per cent during 1965 and at a 1.4 per cent rate from 1958 to 1964.

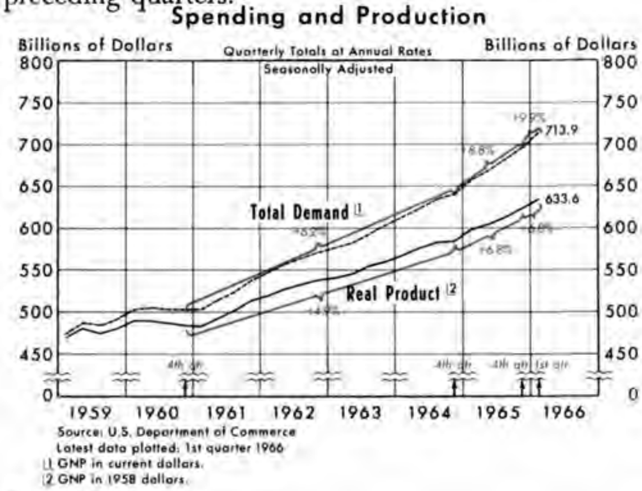
The average price of farm land in the United States rose 8 per cent from March 1965 to March 1966, according to the Department of Agriculture. In comparison, farm land prices increased at an average annual rate of 5.6 per cent during the past decade.

Real Product

Output of goods and services has been rising rapidly, but recent data indicate that the pace of the rise may be slowing, perhaps in response to capacity limitations. Industrial production rose at a 3 per cent annual rate from March to April and, according to initial reports, changed little from April to May. This moderate growth compares with an extremely rapid 14 per cent rate from last September to March and 8.9 per cent over the past year. Payroll employment has risen only moderately since March, after rising rapidly earlier this year. Estimates of total civilian employment indicate a decline during the January-May period. These figures may give some evidence of a lack of employable manpower.

These recent data, indicating reduced rates of increases in real product and employment, cover a very short period and are highly tentative. Current data are frequently revised, but even in final form most economic time series are very irregular over a short time span. Also, various sectors of the economy may be expected to perform differently in any short period of strong demand. Nevertheless, the recent data may indicate that use of productive resources is becoming so complete that the rapid expansion of total demand is resulting less in increases in real product and more in price rises.

Gross national product estimates for the first quarter of 1966 also provide evidence of real product growing less rapidly despite an acceleration in the demand for goods and services. Real product increased at a 6.0 per cent rate from the fourth to the first quarter compared with 6.8 per cent in the four preceding quarters.



Total Demand

The rise in prices and some continued expansion of real product have occurred in response to strong demands for goods and services. Although the latest figures indicate a decline in spending, the trend has been strongly upward. Retail sales, according to preliminary figures, totaled $25.2 billion in April, down from $25.6 billion in March. Retail sales figures are subject to large revisions. For example, the January retail sales figure, originally reported at $24.8 billion, was later revised to $25.0 billion. A larger revision was made for February when the original $24.6 billion estimate was revised to $25.3 billion. In the first quarter of the year retail sales were up at a 10 per cent annual rate from the third quarter of last year.

Taking a broader view of the economy, the strengthening of demand has been quite clear. Total spending for goods and services rose at a 9.9 per cent annual rate from the fourth quarter of last year to the first quarter of this year. In the preceding year these outlays increased at an 8.8 per cent rate. From 1960 to 1964 the average growth in aggregate demand was at a 5.7 per cent rate.

Consumer purchasing power has been growing at a rapid rate in recent months. Personal income has risen at an 8.9 per cent annual rate since late last summer compared with a 6.5 per cent gain in the previous 12 months and a 5.4 per cent average rate of increase from 1960 to 1964.

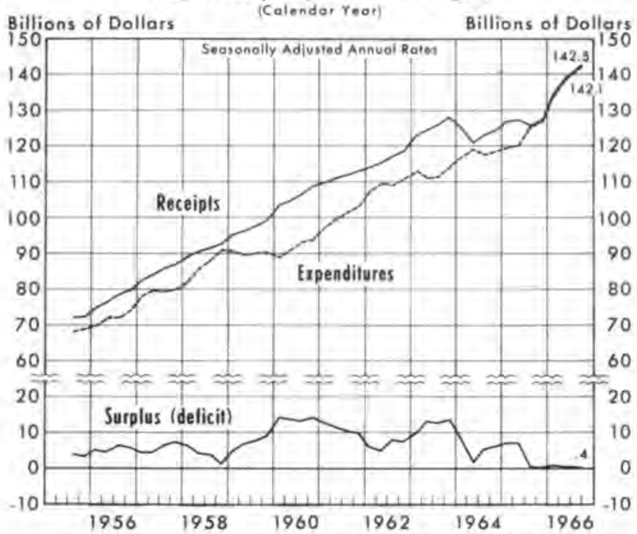
Fiscal Actions

Total demand has continued to be stimulated by Government actions. The economic impact of the

Federal Government's taxing and spending actions, as indicated by the high-employment budget, are currently the most expansionary in many years. The level of this budget declined from a $7.2 billion surplus at an annual rate in the first half of 1965 to a $0.3 billion surplus in the second half of 1965 and is estimated to be at about the same level in the first half of 1966. Barring unanticipated departures from the January budget plan for expenditures and taxes, this budget is expected to remain at about the first-half level in the last half of this year. However, there seems to be considerable likelihood that defense spending in the second half will exceed the forecasts in the January budget plan.

High-Employment Budget

(Calendar Year)



Sources: Council of Economic Advisers, Board of Governors of the Federal Reserve System, and Federal Reserve Bank of St. Louis

Latest data plotted: 1st quarter 1966 preliminary. 2nd quarter and last half 1966 estimated by Federal Reserve Bank of St. Louis.

The smaller the surplus (or larger the deficit) in the high-employment budget, the less is the amount that the Government withdraws from the income stream at high employment relative to what it spends and the greater is the stimulus of fiscal actions. A common opinion holds that the level of the high-employment surplus should be low when aggregate demand is inadequate to maintain high employment. A shift from surplus to deficit in this budget is appropriate if planned private saving tends to exceed planned investment. A deficit in the high-employment budget stimulates total demand and thus propels the economy toward greater production as long as there are unused resources. If private demand gains sufficient momentum, the high-employment budget should assume a less stimulative position by means of a reduction of government expenditures or an increase of tax rates. If demand becomes excessive, the high-employment budget should run whatever surplus is necessary to hold total demand within appropriate limits.

The above discussion assumes a neutral or unchanging monetary policy. When monetary policy is considered flexible, there is accordingly a range of appropriate fiscal actions. It then becomes possible for the high-employment surplus to be at a low level during a period of excessive demand, provided the fiscal stimulus is accompanied by sufficient monetary restraint. Such a policy mix results in higher interest rates than would a mix of policies including greater fiscal restraint.

Monetary Developments

The money supply, seasonally adjusted, declined from April to May. It has declined or increased relatively little in the middle month of each quarter for the past two years. This situation should be considered when evaluating data regarding money supply over a period of less than three months. In view of this problem the money supply should probably not be considered to have increased so rapidly as the indicated 14 per cent annual rate from March to April nor to have declined as indicated in May.

The money stock has increased about 6 per cent in the past year. The general upward trend of money seems to be continuing when full account is taken of seasonal adjustment difficulties. Growth has not been so rapid for any other 12-month period since World War II. The next highest rate was 5.6 per cent during the Korean War. The money supply increased at a 2.6 per cent rate from 1960 to 1964 and at a 1.4 per cent rate from 1953 to 1960.

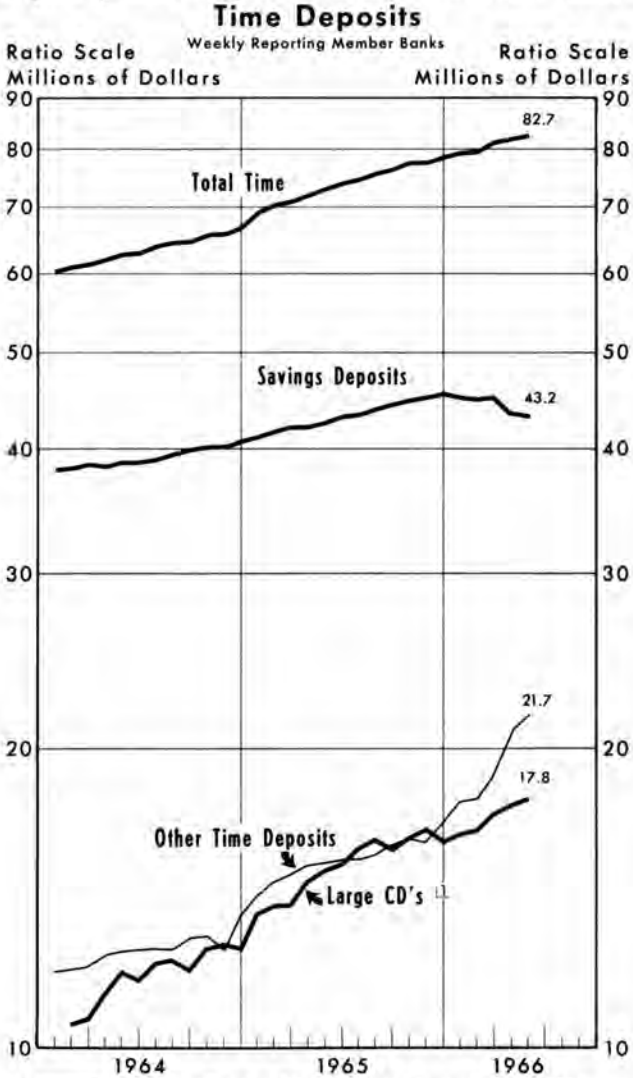
Rapid increase in the money supply might be justified if the velocity of money were declining, that is, if spending were declining and the demand for money to hold, increasing. However, the increase in money has been accompanied by a continuing rise in the turnover of money. Income velocity of money, which is the ratio of gross national product to the money supply, rose to 4.24 in the first quarter of 1966 from 4.18 in the third quarter of 1965 or at about a 3 per cent annual rate. Velocity has risen at a 3 per cent average rate since the last peak in business activity in the spring of 1960. The ratio of GNP to the money supply plus bank time deposits was 2.25 in the first quarter of 1966, the same as in the third quarter of 1965.

Time Deposits

Time and savings deposits at commercial banks increased at about a 14 per cent annual rate from March to May. However, since November the growth of these funds at commercial banks has generally been more moderate than previously. During the past six months these deposits have grown at about a 10 per cent annual rate compared with 16 per cent in the previous year. Time deposits rose at a 15 per cent rate from 1960 to 1964 and at a 7 per cent rate from 1953 to 1960.

The decline in the rate of growth of time deposits at commercial banks has been one aspect of a general decline of the rate of net flow of funds into and through almost all financial intermediaries. The decline of the role of financial intermediaries has been accompanied by more direct investment in the capital and money markets and by a greater use by corporations of their own liquid funds.

Time deposits at the weekly reporting banks have risen at about a 13 per cent rate since November compared with the 10 per cent rate at all commercial banks. Weekly reporting banks, which are primarily large banks, provide condition statements more frequently and in greater detail than other banks.



[1] Negotiable time certificates of deposit in denominations of $100,000 or more.
Latest data plotted: May

They hold about 55 per cent of total commercial bank time and savings deposits.

Large negotiable and smaller certificates of deposit have both risen rapidly at these banks, while saving deposits have declined. Large negotiable certificates of deposits have increased at a 15 per cent annual rate since November compared with a 30 per cent jump in the year ended in November. Savings deposits have declined at a 7.6 per cent rate since November, with the drop particularly sharp since February. These deposits grew 12 per cent in the year ending in November. Other time deposits have risen at a 67 per cent rate since November compared with 27 per cent in the previous year. This category includes small denomination certificates of deposit.

Growth in Time Deposits

Annual Rates of Change

	Weekly Reporting Banks				All Commercial Banks
	Large CD's	Savings	Other Time	Total	Total
Feb. 1966-May 1966	30.1	—16.2	85.0	16.0	11.5
Nov. 1965-May 1966	15.1	— 7.6	66.7	12.6	10.4
Nov. 1964-Nov. 1965	29.5	11.8	27.0	18.1	16.3
Nov. 1961-Nov. 1964	N.A.	11.7	40.5[1]	19.7	17.4

[1] Includes some large CD's.
N.A.—Not available.

While the growth of total time and savings deposits at commercial banks in the past six months has been at a slower rate than in the preceding five years, it has nonetheless remained rapid. The rise of time deposits over the past several years has resulted in large part from aggressive bidding for funds by banks as demands for bank credit have risen. The higher interest rates which banks have paid have enabled them to compete effectively for funds which have in turn been channeled primarily into bank loans.

Because of the higher rate of return on capital investment and great competition for lendable funds, savers are receiving higher interest rates. This encouragement to savers is highly desirable at a time when total demands for goods and services are tending to exceed our capacity to produce and demands for investment funds are exceeding saving. Despite the keen competition for funds, other financial institutions also have continued to grow. Preliminary data show that in the first four months of this year shares in savings and loan associations rose at a 4 per cent annual rate and deposits in mutual savings banks increased at a 3.5 per cent rate.

Bank Credit

The total of bank loans and investments grew from January to May at an 8.1 per cent rate, slightly less than the 10 per cent rate of the previous 12 months. Total bank credit expanded at an 8.0 per cent rate from 1960 to 1964 and at a 4.3 per cent rate from 1953 to 1960.

Total bank credit has risen in response to huge credit demands, rapid growth in the reserve base, and bank acquisition of funds in competition with other financial intermediaries and other money market participants. Bank loans have risen even faster than total bank credit. Individual banks have accommodated strong loan demands by attracting funds, by reducing their holdings of Federal securities, and by adding to their holdings of municipal securities at a lesser rate. Total loans at commercial banks have increased at a 14 per cent annual rate since last fall, about the same rate as in the preceding 12 months, while total investments have risen slightly since fall. Bank holdings of Government securities have declined at a 9.7 per cent rate since December, while holdings of municipal securities have increased at about an 11 per cent rate, after rising 15 per cent in the previous 12 months. In May U. S. Government security holdings amounted to only 18.2 per cent of total credit at all commercial banks. Since Government securities are used as collateral for certain deposits, sale of these securities as a source of loan funds is limited.

Business loans at all commercial banks increased in the four months ending with May at an 18 per cent annual rate, about the same rate as during the past year. These rates of increase of commercial bank business loans compare with about a 6 per cent rate of increase of real product in the nation since early 1965 and an 8.4 per cent average rate of increase in business loans from 1953 to 1965.

Interest Rates

Despite the rapid monetary expansion over the past year, strong demand for loan funds pushed interest rates up. Key rates rose substantially after last July. The increase was especially rapid in December in spite of exceptionally rapid increases of total bank credit and the money supply. Some interest rates have hovered at or slightly below their peaks in recent months, while others have continued to rise. In May and early June many interest rates were rising.

Reflecting a recent decline in stock prices, yields on common stocks were higher in May than in February. Higher long-term interest rates used in capitalizing expected corporate earnings may have been a factor in the lower stock prices. From a longer view, yields on stocks have fluctuated in a relatively narrow range since 1958.

Even though they have risen substantially over the past year, interest rates in the United States on both short- and long-term securities are still below those in most other industrialized countries. For example, yields on U.S. Treasury bills increased from 3.89 per cent last May to 4.63 per cent this May, while yields on three-month Euro-dollar deposits in London rose from 4.99 per cent to 5.75 per cent.

Bank borrowing from the Federal Reserve has increased since February as money market interest rates have been high relative to the discount rate. At times in recent weeks, the interest rate on Federal funds, which are, in effect, overnight loans from one commercial bank to another, touched 5¼ per cent or three-quarters of a percentage point more than the basic Federal Reserve rate.

Conclusion

Prices continue to rise rapidly in response to a high and increasing total demand for goods and services. At the same time there are some indications that increasing employment of previously unused resources is resulting in a reduction of the rate of increase of real product. Government fiscal actions and monetary expansion continue to facilitate rapid expansion of total demand and have stimulated large credit demands. These credit demands have been so vigorous that relatively high interest rates have developed despite the record monetary expansion.

If the present level of total demand is too high, several alternatives are available for dampening it. The Government might reduce its expenditures or increase its taxes. These actions would reduce the demand for goods and services directly and take some of the pressure off credit markets, making control of monetary growth less difficult and limiting interest rate increases. Decisions on Government expenditures and tax rates, however, take into consideration factors other than economic stabilization.

Total demand might also be restrained by reduction of the rate of expansion of bank reserves, bank credit, and the money supply. Such restraint might initially cause a further rise in interest rates. However, after a period, lower rather than higher rates might result from less rapid monetary expansion. The rise in interest rates in the past year has resulted from increases in credit demands flowing from greater spending, optimistic expectations, and inflation fears. If total demand for goods and services were to be moderated by monetary restraint or other means, demand for credit might recede, causing lower interest rates despite more moderate growth in bank credit and money.[1]

[1]For further discussion bearing on this point, see "Interest Rates, 1914-1965," by Norman N. Bowsher in the October 1965 issue of this *Review*.

Federal Reserve Open Market Operations in 1965:

Objectives, Actions, and Accomplishments

THE FEDERAL RESERVE SYSTEM buys and sells U. S. Government securities as its major tool of monetary management. These actions, commonly referred to as open market operations, are conducted with a view to changing member banks reserves so as to alter the rates of expansion of bank deposits, bank credit, and the money stock. The ultimate goals of Federal Reserve monetary management are high employment, relatively stable prices, and a viable international balance of payments.

This article reviews Federal Reserve System open market transactions in 1965 within the framework of the Federal Open Market Committee's stated goals. These goals are expressed in the Committee's economic policy directives issued in 1965 which appear in the recently released *Fifty-Second Annual Report of the Board of Governors of the Federal Reserve System, Covering Operations for the Year 1965.*

Threat of inflation and a continuing balance-of-payments deficit were problems continually challenging monetary authorities in 1965, the fifth consecutive year of the current economic expansion. In response to these problems, the Federal Open Market Committee (FOMC) resolved upon mildly restrictive policy during the year. A change in policy was first reflected in the February 1965 economic policy directive calling for slightly firmer money market conditions with a view to accommodating more moderate rates of expansion of member bank reserves, bank credit, and the money supply. The final policy steps of the year were early December increases in the discount rate and in the maximum interest rates payable by member banks on time deposits other than savings deposits (Regulation Q).

Economists discuss stabilization policy in terms of an optimum mix of fiscal, debt management, and monetary actions.[1] Present institutional arrangements, however, provide for the separate formulation of these policies, and different time horizons are involved. Fiscal policy is embodied in the President's budget message presented in January and subsequently amended by Congress. Fiscal actions relate to a one-year period (July to June) which, at the time of the President's message, is not to begin until six months in the future. Budgets are usually not subject to major revisions within the budget period, and when such revisions do occur, they generally require considerable time to become effective. Treasury debt management policy, involving the maturity schedule of the national debt, is not readily adaptable to short-run changes. Monetary policy, on the other hand, has considerable flexibility in the short run. Policy formulation during 1965 worked within the context of a fiscal policy moving toward a more stimulative stance and a relatively fixed maturity schedule of the Federal debt.[2]

Tools of monetary policy are reserve requirements of member banks, the discount rate, and open market transactions. These factors determine the cost and volume of reserves available to member banks. Reserve requirements on demand deposits have remained unchanged since 1960; requirements on time deposits have been unchanged since 1962. The discount rate was raised to 4 per cent in November 1964 and to 4½ per cent in December 1965, the highest level since 1930. Open market operations, which are the chief means of providing monetary policy with a high degree of short-run flexibility, were carried out almost daily during the year.

Directives for Open Market Operations in 1965

At each of its 16 regular meetings in 1965 the FOMC issued a current economic policy directive to the New York Federal Reserve Bank, whose staff carries out open market transactions for the System. The directives generally cited the major economic conditions the Committee considered important for policy and

[1] Fiscal actions involve the planned relationship between Government expenditures and tax structures. Debt management actions involve the term and maturity structure of the public debt. Monetary actions involve the rates of expansion of total reserves, bank credit, and the money supply and movements in interest rates.

[2] "Budget Policy in a High-Employment Economy," in the April 1966 issue of this *Review*, presents a comprehensive discussion of recent fiscal policy.

stated the System's ultimate goals regarding output, prices, and the balance of payments. Goals for intermediate objectives, such as the rates of growth of bank reserves, bank credit, and money were indicated; these goals were specified in qualitative terms, such as "more moderate." As a means of achieving both sets of goals, operating instructions, in terms of a set of money market conditions, were given to the New York Federal Reserve Bank.[3] Specified money market conditions, noted by such qualitative statements as "slightly firmer" or "about the same," were intended to be consistent with or contribute to attainment of the FOMC's intermediate and ultimate objectives.

The following directive, issued on December 15, 1964, was in force at the beginning of 1965 (brackets and numbers have been inserted by the authors). Excerpts from this directive and the sixteen directives issued in 1965 are recorded in Exhibit I. The bracketed phrases in the following directive are numbered to correspond to the columns in Exhibit I.

> [1. In the light of the economic and financial developments reviewed at this meeting,] it remains the Federal Open Market Committee's current policy [2. to facilitate continued expansion of the economy] [3. by accommodating moderate growth in the reserve base, bank credit, and the money supply,] while seeking [2. to avoid the emergence of inflationary pressures and to strengthen the international position of the dollar.]
>
> To implement this policy, and recognizing that [5. international uncertainties and year-end seasonal pressures continue to require a larger than usual degree of flexibility in operations,] System open market operations shall be conducted with a view to [4. maintaining about the same conditions in the money market as currently prevail.]

Economic Considerations and Ultimate Objectives

The FOMC's general view of changes in the pace of domestic expansion and movements in the balance of payments as observed at the time of each meeting during 1965 are presented in Exhibit I, Column 1. From January to early May note was given to a generally strong further expansion of the domestic economy and a continuing adverse balance of payments. From early May to the end of August recognition was made of a slower pace of domestic expansion and some improvement in the balance of payments. During the last four months of the year the Committee cited a pickup in economic activity, a rise in prices, and a deficit in the balance of payments.

[3] In some other recent years such individual measures of money market conditions as net borrowed reserves were stipulated as guides for open market operations rather than general money market conditions.

For purposes of further analysis, the three periods of economic expansion during 1965 noted in the directives correspond approximately to the first quarter of the year, the second and third quarters, and the fourth quarter. Total demand (GNP in current dollars) rose at an 11 per cent annual rate during the first quarter compared with a 4 per cent rate of growth in the last quarter of 1964, when there were major work stoppages. During the second and third quarters of 1965, the rate of growth in total demand moderated to 7 per cent; then the rate accelerated to 10 per cent in the last quarter.

In response to changes in economic developments there were changes in the FOMC's ultimate objectives regarding the domestic economy (Exhibit I, Column 2). Whereas in late 1964 there was emphasis both on facilitating continued expansion in the economy and on avoiding the emergence of inflationary pressures, in early 1965 major emphasis shifted to the latter objective and continued unchanged throughout the year. Strengthening the international position of the dollar remained an ultimate objective throughout the year.

Intermediate Objectives and Operating Instructions

The FOMC's strategy for achieving its ultimate goals shifted during 1965 as the goals changed. Its strategy involved changing money market conditions and altering rates of change in the reserve base, bank credit, and the money supply.

At the beginning of the year the goal, ". . . to facilitate continued expansion of the economy," was carried over from late 1964. This goal was to be achieved ". . . by accommodating moderate growth in the reserve base, bank credit, and the money supply" (Exhibit I, Column 3). In February and March, when greater emphasis was placed on the domestic goal of avoiding the emergence of inflation, the strategy with regard to the intermediate objectives was changed to ". . . accommodate growth . . . but at a more moderate pace than in recent months." Then in late March the ultimate goals were to be achieved, ". . . while accommodating moderate growth in the reserve base, bank credit, and the money supply." This instruction with respect to intermediate objectives remained unchanged through the rest of the year.

As a part of the strategy for achieving the Committee's ultimate and intermediate objectives, appropriate operating instructions in terms of money market conditions were given to the New York Federal

EXCERPTS FROM FEDERAL OPEN MARKET COM

Date of FOMC Meeting	(1) Economic Considerations	(2) Ultimate Objectives
1964 Dec. 15	in light of the economic and financial developments reviewed at this meeting	to facilitate continued expansion of the economy . . . to avoid the emergence of inflationary pressures and to strengthen the international position of the dollar
1965 Jan. 12	same as above	to facilitate continued expansion of the economy . . . to avoid the emergence of inflationary pressures and to strengthen the international position of the dollar, particularly in view of the current unsettlement in financial markets abroad
Feb. 2	the generally strong and continuing expansion of the domestic economy and the continuing adverse position of our international balance of payments	to avoid the emergence of inflationary pressures and to support other measures that may be taken to strengthen the international position of the dollar
Mar. 2	same as above	to support fully the national program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures
Mar. 23	a generally strong further expansion of the domestic economy and the continuing need to improve our international balance of payments, as highlighted by heavy gold outflows in recent months	to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures
Apr. 13	same as above	same as above
May 11	a generally strong further expansion of the domestic economy and some improvement in our international balance of payments, but with gold outflows continuing	same as above
May 25	a generally strong further expansion of the domestic economy, although at a somewhat slower pace, and some improvement in our international balance of payments, but with gold outflows continuing	same as above
June 15	continuing expansion of the domestic economy, although at a somewhat slower pace than in the first quarter, and maintenance of earlier improvement in our international balance of payments, but with gold outflows continuing	same as above
July 13	continuing expansion of the domestic economy, although at a slower pace than in the first quarter. Reflecting the large initial impact of the administration's balance of payments program, there was a surplus in our international payments in the second quarter . . . with gold outflows continuing	same as above
Aug. 10	the domestic economy has expanded further, but at a slower pace than early in the year, and . . . the improvement in our international payments that occurred in the second quarter has been maintained for the time being, although gold outflows have continued and international developments are creating uncertainties in securities and foreign exchange markets	to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures
Aug. 31	the domestic economy has expanded further, but with markets characterized by uncertainties as to possible developments in steel, sterling, and Viet Nam. Our international payments have reverted to deficit in August, and gold outflows have continued, although at a more moderate rate	same as above
Sept. 28	the domestic economy has expanded further in a climate of optimistic business sentiment and firmer financial conditions, and . . . our international payments have been in deficit since midyear. Some of the uncertainties previously affecting foreign exchange markets have diminished	same as above
Oct. 12	over-all domestic economic activity has expanded further in a continuing climate of optimistic business sentiment and firmer financial conditions, and . . . our international payments have been in deficit on the "regular transactions" basis since midyear	same as above
Nov. 2	over-all domestic economic activity has expanded further in a continuing climate of optimistic business sentiment and firmer financial conditions, and . . . our international payments have remained in deficit	same as above
Nov. 23	over-all domestic economic activity is continuing a rate of expansion comparable to that of the third quarter despite the contractive effect of a reduction in steel inventories. Business sentiment continues optimistic and financial conditions are firmer. Meanwhile, our international payments have remained in deficit	same as above

December 6—Discount rate raised from 4% to 4½% and Regulation Q

Dec. 14	domestic economic expansion is gaining in strength in a climate of optimistic business sentiment, with continuing active demands for credit and some further upward creep in prices. Although there appears to have been some recent improvement in our international payments, the need for further progress remains.	to complement other recent measures taken to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments

Source: *Fifty-Second Annual Report of the Board of Governors of the Federal Reserve System, Covering Operations for the Year 1965.*

ıibit I

ıMITTEE CURRENT ECONOMIC POLICY DIRECTIVES

	Instructions to the Federal Reserve Bank of New York	
(3) Intermediate Objectives	(4) Operating Instructions	(5) Special Considerations
by accommodating moderate growth in the reserve base, bank credit, and the money supply	maintaining about the same conditions in the money market as currently prevail	international uncertainties and year-end seasonal pressures continue to require a larger than usual degree of flexibility in operations
same as above	maintaining about the same conditions in the money market as have prevailed in recent weeks	taking the current Treasury refunding into account . . . international uncertainties and shifting seasonal pressures require a larger than usual degree of flexibility in operations
to accommodate growth in the reserve base, bank credit, and the money supply but at a more moderate pace than in recent months	moving toward slightly firmer conditions in the money market than have prevailed in recent weeks	taking into account Treasury financing
same as above	maintaining the slightly firmer conditions in the money market that have prevailed in recent weeks	none
while accommodating moderate growth in the reserve base, bank credit, and the money supply	attaining slightly firmer conditions in the money market	none
same as above	maintaining the firmer conditions in the money market that have recently prevailed	taking into account the forthcoming Treasury financing
same as above	maintaining about the same conditions in the money market as have prevailed in recent weeks	taking into account the current Treasury financing
same as above	same as above	none
same as above	same as above	none
same as above	same as above	taking into account the forthcoming Treasury financing
same as above	same as above	taking into account the Treasury financing about to be completed and the unsettled conditions in securities and foreign exchange markets
same as above	same as above	taking into account unsettled conditions in securities and foreign exchange markets
same as above	maintaining about the current conditions in the money market	taking into account the current Treasury financing
same as above	maintaining a firm tone in the money market	taking into account the Treasury financing schedule
same as above	maintaining about the same conditions in the money market that have prevailed since the last meeting of the Committee	same as above
same as above	same as above	none
ceiling raised from $4\frac{1}{2}\%$ to $5\frac{1}{2}\%$ on time (other than savings) deposits		
same as above	moderating any further adjustments in money and credit markets that may develop	taking into account the forthcoming Treasury financing activity and widely fluctuating seasonal pressures at this time of year in addition to the recent increase in Reserve Bank discount rates

Reserve Bank (Exhibit I, Column 4). These instructions were specifically changed three times in 1965. In early February and late March instructions were given for moving toward or attaining slightly firmer money market conditions. Starting in April and continuing to November the maintenance of current market conditions was generally called for. After the Federal Reserve discount rate and the Regulation Q ceiling on time deposits other than savings accounts were increased in early December, operating instructions were given for ". . . moderating any further adjustments in money and credit markets that may develop."

In summary, the FOMC's policy during 1965 may be divided, on the basis of the content of the directives, into the following periods: December 1964 and January 1965—maintaining current market conditions while giving consideration to special market uncertainties of late 1964; February and March—moving toward firmer money market conditions; April through November—maintaining the firmer market conditions; and December and January 1966—moderating the market's adjustment to changes in the discount rate and Regulation Q.[4]

From time to time during 1965 considerations in addition to those already discussed appeared in the directives. For example, in more than one-half of the policy periods the FOMC directed that open market transactions should give explicit recognition to Treasury financing activities (Exhibit I, Column 5). The Federal Reserve traditionally tries to maintain an "even keel" in the money market (prevent undue movements in interest rates and other market conditions) when the Treasury is conducting a significant financing operation.

Open Market Operations in 1965

The preceding sections have briefly described the FOMC's goals and strategy for 1965; the following sections examine actual open market operations, money market conditions, and the resulting rates of monetary expansion. Selected periods for analyzing 1965 are presented, means of measuring policy are discussed, and the course of these measurements during each of the selected periods of analysis is presented.

[4]It might be appropriate to divide the April-November period into two subperiods, April through August and September through November. There was a discussion within the Committee at the September 28 meeting over the question of whether instructions calling for "maintaining about the current conditions in the money market" amounted to an actual firming in policy, since it appeared that added firmness had developed in the market during September. See the dissent of Governors Maisel, Mitchell, and Robertson.

Periods of Analysis

For purposes of analyzing open market operations in 1965, the four periods discussed previously were expanded to five by dividing the April through November period into two subperiods.[5] Since System actions and changes in economic conditions both may affect money market conditions and changes in the intermediate guides, the periods were selected so as to give due consideration to each of these factors.

December 1964 and January 1965. Directives called for facilitating money market adjustments to year-end uncertainties and accommodating moderate growth in reserves, bank credit, and money. Total demand, due primarily to work stoppages from major strikes, rose at a slower rate from the third to fourth quarters of 1964 than over the preceding quarter; but by the year's end economic activity was rising rapidly.

February 1965 and March 1965. Directives calling for slightly more restriction were adopted within the context of a marked increase in total demand for goods and services.

April 1965 through August 1965. Directives called for maintenance of the more restrictive position achieved in the previous period. The rate of increase in total demand remained high but was slightly less rapid than in early 1965.

September 1965 through November 1965. Directives called for maintaining the degree of restraint achieved in the previous period. The economic environment had changed as evidenced by an acceleration in the rate of expansion in total demand.

December 1965 and January 1966. Policy called for moderating market adjustments to changes in the discount rate and in Regulation Q within the context of rapidly rising total demand.

In addition to these five periods, two other periods are used for purposes of comparison. August 1964 through November 1964 was the FOMC policy period immediately prior to 1965; this period is used as a starting point for analyzing 1965. The period 1959 through 1964 is used for purposes of comparing developments in 1965 with a longer run trend. This period extends from the last full year of expansion in economic activity (1959) before the most recent recession to the end of 1964, when the economy was again at a high level of resource utilization. Rates of growth over this period might approximate trends and provide a benchmark from which to judge movements

[5]The periods selected correspond approximately to those listed by the Account Manager. *Fifty-Second Annual Report of the Board of Governors of the Federal Reserve System, Covering Operations for the Year 1965*, pp. 157-196.

during 1965, when the economy was moving yet closer to capacity output.

Measures of Open Market Operations

In arriving at directives in terms of money market conditions and in assessing such conditions, the FOMC and the Federal Reserve Bank of New York observe various money market quantities and interest rates. As is the case for any market-determined magnitude, ex post data reflect both supply and demand considerations. Federal Reserve action, such as changing its holdings of Government securities, usually is considered to affect the supply of funds to the money market. The demand for funds is strongly influenced by the economic environment, particularly growth in economic activity and changes in expectations. In order to gauge the extent that movements in the observed data reflect demand considerations as well as changes in overall market pressure, the System Account Manager at the New York Bank and his staff frequently interview various money market participants, such as Government security dealers.[6]

Federal Reserve open market purchases and sales of Government securities were the major methods employed in 1965 to effect changes in money market conditions, the rate of monetary expansion, and the rate of economic growth; the discount rate and ceiling rates on certain time deposits were changed late in the year. These open market transactions are summarized in this article by rates of change in the Federal Reserve's holdings of Government securities (Table I).

The quantities commonly observed during 1965 as indicators of money market conditions were member bank borrowings from Reserve Banks, net reserve positions of all member banks (excess reserves less borrowed reserves), basic reserve positions of major money market banks (net reserve positions less purchases of Federal funds), and the volume of Government security dealer borrowings. Frequently observed interest rates were the Treasury bill rates, the Federal funds rate, the Federal Reserve discount rate, rates on negotiable certificates of deposit, and Government security dealer financing costs. The direction of change in each of these measures implying firmer market conditions is presented in Exhibit II.[7] The

Exhibit II

INDICATORS OF MONEY MARKET PRESSURE

Indicator	Direction of Change Implying Greater Pressure
Member bank borrowings from Federal Reserve Banks	higher
Net reserve position	lower (or more negative)
Basic reserve position	lower (or more negative)
Dealer borrowings	higher
Treasury bill rates	higher
Federal funds rate	higher
Federal Reserve discount rate	higher
Negotiable certificates of deposit rates	higher
Government security dealer financing costs	higher

accompanying charts show movements in these money market measures during last year. Since levels of these variables are commonly used in analyzing money market conditions, average levels of these variables for each period are summarized in Table I.

The intermediate guides to policy stipulated throughout 1965 were the reserve base, bank credit, and the money stock. While long-term interest rates were not specifically cited as an intermediate guide, it may be assumed that they were included as a part of money market conditions. The rates of expansion in these intermediate variables were to be more moderate during 1965 than previously; rates of change in member bank reserves, bank credit, and money for each of the selected periods of analysis are presented in the accompanying table. Long-term interest rates are also summarized in the table. Shorter run movements in these intermediate guides are presented in charts.

In interpreting movements in these intermediate guides, both money market conditions and the demand for credit must be considered. If a set of money market conditions is achieved by the System and if actions are taken to maintain these conditions within a certain range, then the demand for funds strongly affects movements in reserves, bank credit, and money.

August through November 1964

This period serves as a helpful background for analyzing 1965. The directive at the beginning of the period called for slightly firmer money market conditions and moderate expansion in the reserve base, bank credit, and money.[8]

[6] Many financial analysts have mistakenly inferred changes in System policy from ex post changes in net borrowed reserves and short-term interest rates. Frequently changes in the demand for funds, not System actions, account for the observed movements in these variables.

[7] For a more extended discussion of the process of implementing open market policy and the use of money market guides, see Leonall C. Andersen and Jules M. Levine, "Implementation of Federal Reserve Open Market Policy in 1964," this *Review*, June 1965.

[8] Ibid. for a discussion of monetary developments during the last five months of 1964.

Table 1

MEASURES OF FEDERAL RESERVE OPEN MARKET ACTIONS, INTERMEDIATE OBJECTIVES, AND MONEY MARKET CONDITIONS

	August 1964 through November 1964	December 1964 and January 1965	February 1965 and March 1965	April 1965 through November 1965: April 1965 through August 1965	April 1965 through November 1965: September 1965 through November 1965	December 1965 and January 1966	1959 to 1964
Policy indicated	moving toward slightly firmer money market conditions	facilitating money market adjustments to year-end uncertainties	moving toward slightly more restriction	maintaining the more restrictive position achieved in February and March		moderating market adjustments to changes in the discount rate and Regulation Q	not applicable
Pace of economic activity	slower growth	rapid growth at year's end	marked increase in growth	slower expansion	rapid growth	rapid growth	high-employment trend
Federal Reserve open market actions	Annual Rates of Change, Seasonally Adjusted[1]						
Federal Reserve holdings of U.S. Government securities	10.8%	16.8%	14.2%	10.1%	8.5%	11.6%	5.7%
Intermediate objectives							
Total reserves of member banks	5.4	4.1	9.8	3.5	0.2	13.2	2.7
Bank credit, all commercial banks	9.6	12.2	12.7	9.0	9.3	11.5	6.8
Money supply	4.9	3.4	1.1	3.6	7.6	10.2	1.8
Money supply plus time deposits	9.2	10.1	7.7	8.8	11.6	10.5	5.6
	Monthly Averages of Daily Figures, Not Seasonally Adjusted[2]						
3- to 5-Year U.S. Government security yield	4.04%	4.06%	4.12%	4.19%	4.46%	4.89%	
Long-term U.S. Government security yield	4.12	4.14	4.15	4.19	4.34	4.43	
Corporate Aaa bond yield	4.43	4.43	4.42	4.49	4.60	4.74	
State and local Aaa bond yield	3.08	2.97	3.09	3.16	3.34	3.40	
	Period Averages of Daily Figures, Not Seasonally Adjusted[3]						
Money market conditions	Millions of Dollars						
Member bank borrowings from Federal Reserve banks	$ 351	$ 271	$ 411	$ 518	$ 490	$ 428	
Net reserve position	61	137	—20	—155	—124	—23	
Basic reserve position							
8 New York City banks	—280	—465	—585	—196	—232	—653	
38 Other banks	—462	—501	—295	—570	—848	—708	
Dealer borrowings	3,801	3,877	3,338	3,919	2,882	2,992	
	Per Cent						
3-Month Treasury bill rate	3.56%	3.83%	3.93%	3.86%	4.01%	4.48%	
Federal funds rate	3.46	3.88	4.01	4.09	4.06	4.37	
Federal Reserve discount rate[4]	3.50 4.00 (11/24/64)	4.00	4.00	4.00	4.00	4.50 (12/6/65)	
Secondary market rate on negotiable certificates of deposit	3.89	4.14	4.24	4.30	4.42	4.87	
Government security dealer financing costs (in New York)	3.84	4.28	4.45	4.40	4.42	4.77	

[1]Change from end of preceding period to end of period considered.

[2]Monthly averages of daily figures for last month in period, except state and local Aaa bond yields, which are monthly averages of Thursday figures for last month in period.

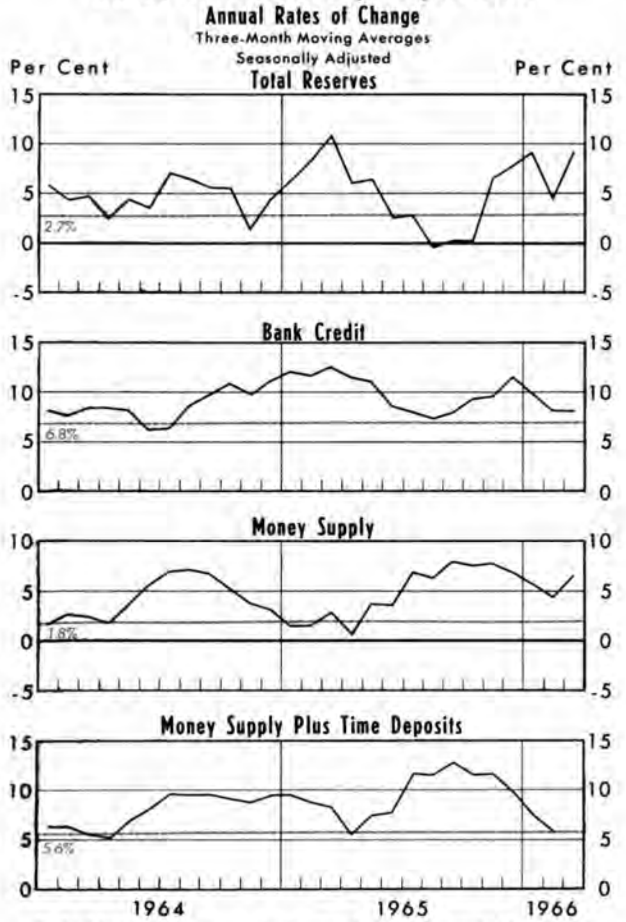
[3]Except secondary market rates on negotiable certificates of deposit, which are period averages of Friday closing rates.

[4]Dates of discount rate increases at the Federal Reserve Bank of New York are shown in parentheses.

Federal Reserve holdings of Government securities expanded at an 11 per cent annual rate, nearly double the average annual rate of expansion from 1959 to 1964 (Table I).[9] Total demand and output, as measured by the increase in GNP from the third to fourth quarter, grew slowly during this period, primarily as a result of a major work stoppage. As a result of open market operations and the economic environment, money market conditions firmed slightly (Table I).

From August to November moderate rates of monetary expansion were specified in the directives. However, the rates of expansion of reserves, bank credit, and money were greater from August to November than they were earlier in 1964 (Table I). These rates of increase were considerably greater than their average annual rates of growth from 1959 to 1964 (Table I).

Rates of Monetary Expansion



Dashed lines are average annual rates of change computed from average data for 1959 and 1964.

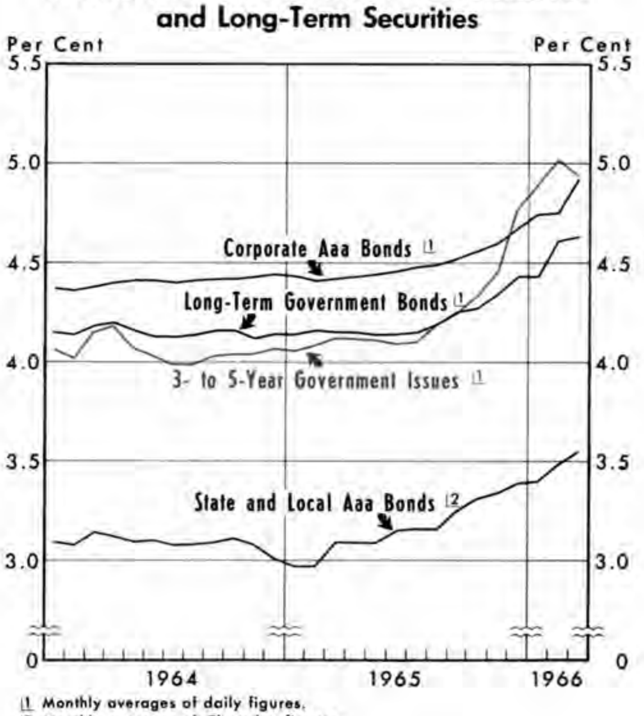
[9]Part of the 1959-64 increase in the System's portfolio was for purposes of offsetting a marked reduction in the nation's gold stock. As a result, in periods of less rapid gold losses the rate of acquisitions of securities by the System might appropriately be slower.

December 1964 and January 1965

In the course of facilitating money market adjustments to increases in the discount rate and ceiling rates on time and savings deposits, the Federal Reserve's holdings of Governments rose at a 17 per cent annual rate from November to January compared with the already high 11 per cent rate of increase in the previous policy period. Despite these developments, most measures of money market conditions indicated firming. It appears that huge demands for credit accompanying the post-strike spurt in business activity in late 1964-early 1965 more than offset the expansive open market transactions, resulting in some money market firming.

Changes in the intermediate guides were in diverse directions, but all grew more rapidly than their 1959-64 trends. Bank credit and money plus time deposits expanded more rapidly during this period than from August to November, while bank reserves and money moved upward at slower rates. All of these intermediate guides grew at about twice their rates of expansion from 1959 to 1964. Long-term interest rates were little changed.

Interest Rates on Selected Intermediate- and Long-Term Securities

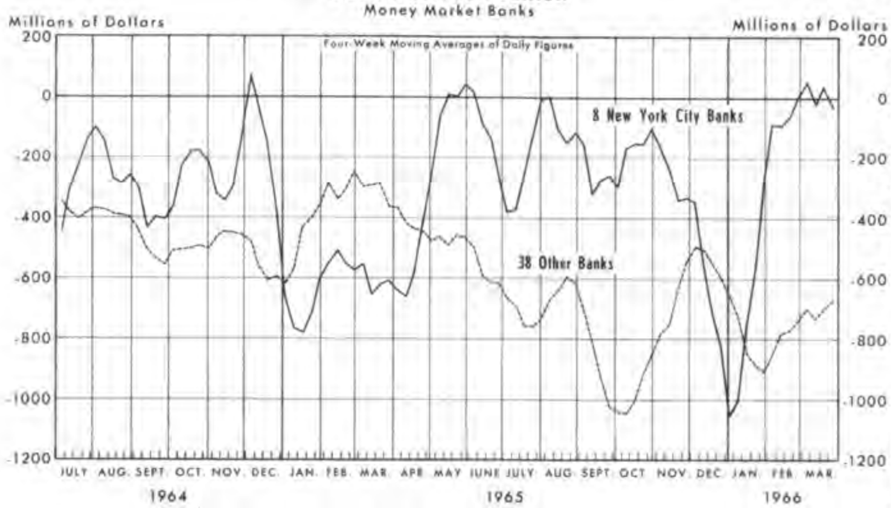


1 Monthly averages of daily figures.
2 Monthly averages of Thursday figures.

February and March

In February and March the FOMC adopted directives calling for slightly firmer money market conditions and more moderate growth in the reserve base, bank credit, and money. The System's holdings

Basic Reserve Position 1/
Money Market Banks



1/ Basic reserve position is the net reserve position minus net purchases of Federal funds.

of Governments expanded at a 14 per cent rate compared with a 17 per cent rate in the preceding period. This slightly slower pace of open market purchases, in conjunction with an expansion in the demand for loan funds stemming from a rapid rise in total demand for goods and services, resulted in firmer market conditions.

Bank reserves grew rapidly and bank credit expansion showed a further acceleration. Money plus time deposits continued to expand at a rapid rate, but money expanded only slightly. Long-term interest rates remained about unchanged.

April through August

From April through August the FOMC directives called for unchanged money market conditions and moderate rates of increase in the intermediate guides. The System increased its holdings of securities at a 10 per cent annual rate compared with a 14 per cent rate during the move to firmer market conditions. The influence of less expansive open market operations and a more moderate rise in total demand resulted in diverse movements in measures of money market conditions. Bank borrowing from Reserve Banks and the net reserve position indicated some firming, while money market rates indicated little change.

The rates of increase in bank reserves and bank credit were below those of the previous period, while money grew at a much faster rate and the rate of increase in money plus time deposits was slightly higher. The question remains as to whether the rates of increase in these variables could be considered moderate. They were all considerably higher than their rates of expansion from 1959 to 1964. Long-term interest rates rose somewhat over this period.

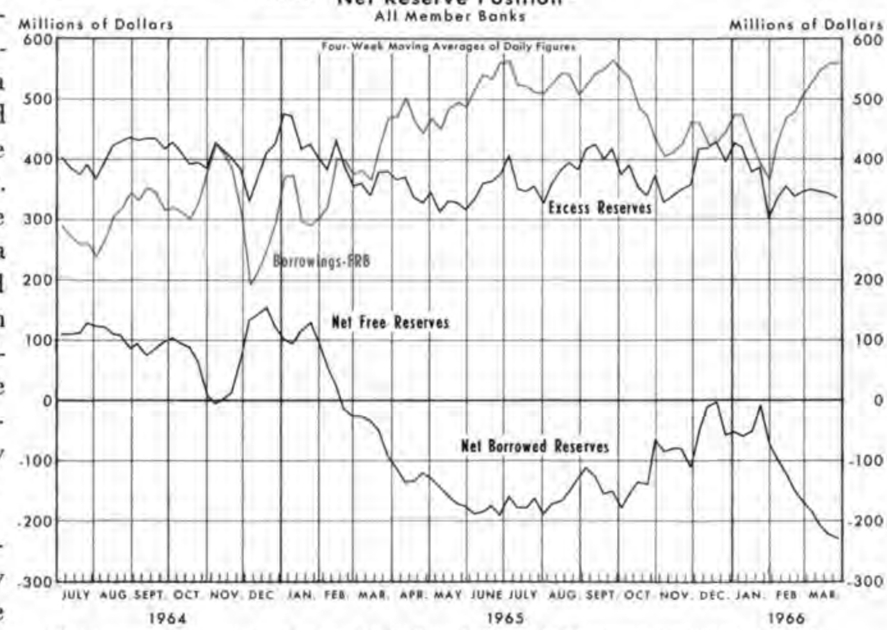
September through November

The directives in this period called for maintaining about the same money market conditions as in the preceding period and for moderate growth in the reserve base, bank credit, and money.[10] The rate of expansion in the System's portfolio declined slightly from that of the April-August period. Money market guides moved in diverse directions. Changes in the basic reserve positions of money market banks, the three-month Treasury bill rate, CD rates, and dealer borrowing costs indicate slightly firmer market conditions, while changes in member bank borrowings from Reserve banks, net reserve positions of member banks, the Federal funds rate, and dealer borrowings indicate slightly easier conditions.

The intermediate guides also showed diverse movements. The level of member bank reserves was little

[10] See footnote 4 for reference to a discussion of whether or not these directives actually called for firmer money market conditions.

Net Reserve Position 1/
All Member Banks

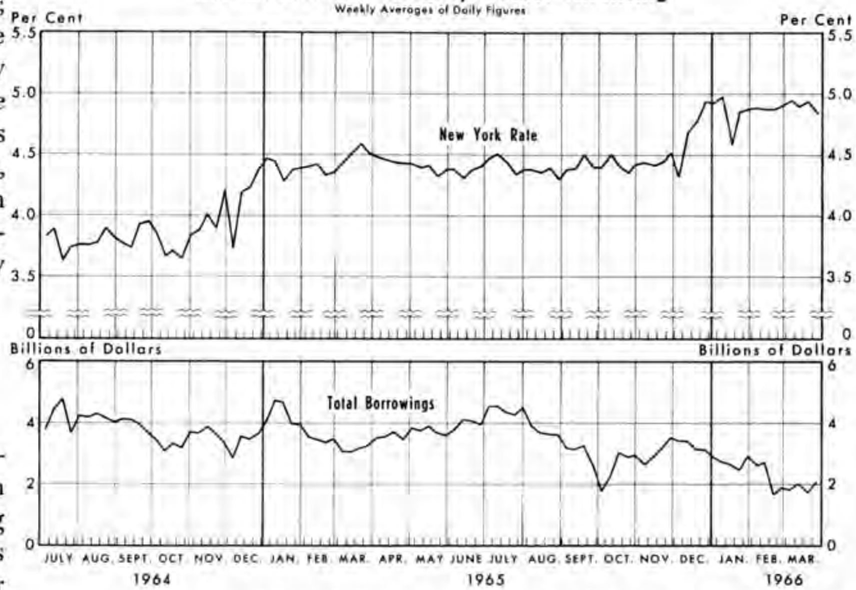


1/ The net reserve position is excess reserves less borrowings from Reserve Banks. It is called free reserves when positive and net borrowed reserves when negative.

changed; bank credit expanded at about the same rate as in the preceding period; and both money and money plus time deposits grew at accelerated rates. By comparison with 1959-64, money rose about four times as fast, money plus time deposits increased twice as rapidly, and bank credit grew at about half again as great a rate. On the other hand, long-term interest rates increased significantly from August to November.

U.S. Government Security Dealer Financing

Weekly Averages of Daily Figures

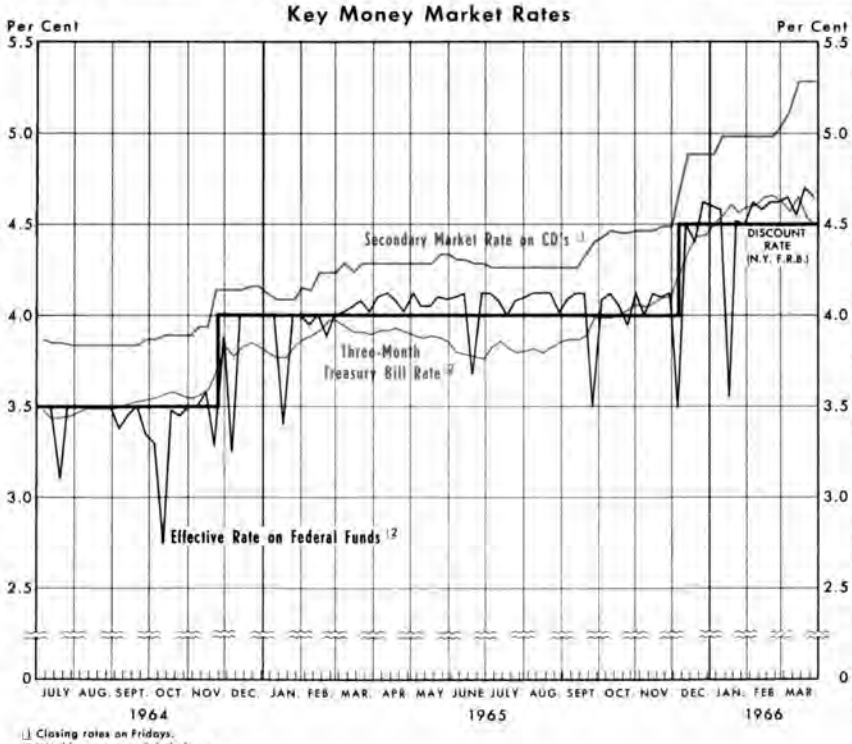


December 1965 and January 1966

In early December the Federal Reserve discount rate was increased from 4 per cent to 4½ per cent. The ceiling rate on time deposits other than savings was lifted from 4½ per cent to 5½ per cent. Operating instructions were given for "... moderating any further adjustments in money and credit markets that may develop." Accommodating moderate growth in the intermediate guides was still called for.

Despite a marked increase in the System's holdings of Government securities, rapidly rising credit demands produced firmer money market conditions. This is particularly apparent judged by market interest rates as indicators of firmness.

Key Money Market Rates



1 Closing rates on Fridays.
2 Weekly averages of daily figures.

Although money market conditions appeared firmer, growth in bank reserves, bank credit, and money accelerated from the high rates of expansion prevailing during the September-November period. However, long-term interest rates continued to rise.

Summary and Conclusions

In order to resist domestic inflation and to strengthen the dollar internationally, the FOMC adopted policy directives during 1965 calling for some restraint. Over the year the Committee's stated intermediate objectives called for accommodating moderate growth of reserves, bank credit, and the money supply, presumably at a more moderate rate than in 1964. To achieve these objectives, the Committee instructed the New York Federal Reserve Bank early in the year to achieve firmer money market conditions. Subsequently, instructions were issued to conduct open market operations in such a manner as to maintain these market conditions. These instructions were in force up to early December, when the discount rate and certain Regulation Q ceiling rates were raised.

A review of monetary developments during the year indicates that money market conditions did become somewhat firmer. Despite this firming, the rate of monetary expansion was rapid during 1965. During the year as a whole, reserves, bank credit, and money rose at rates considerably in excess of their longer run average rates. After the fact, it appears that the demand for loan funds was so strong that money market conditions tightened by virtue of the large demand for funds, but did not become tight enough to be an effective restraint on the volume of borrowing.

By permitting only a slight firming in money market conditions, the System accommodated a sizable portion of this strong loan demand by ". . . providing the reserve base for rapid expansion in commercial bank credit and for substantial growth in the money supply . . . ."[11] "Under the pressures of the demands for credit and with the shift in the composition of bank deposits that occurred, this increase in the reserve base [$1 billion] supported a record expansion of bank credit and deposits."[12]

[11] *Annual Report*, p. 155.
[12] *Annual Report*, p. 157.

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