

U.S. MONETARY POLICY: 1961--  
FIRST QUARTER 1967

by 503

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B. A., Fort Hays State College, 1967

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A MASTER'S REPORT

submitted in partial fulfillment of the

requirements for the degree

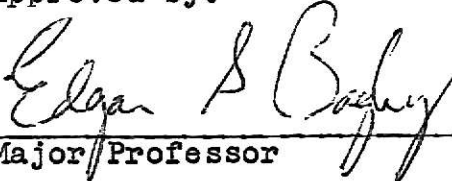
MASTER OF ARTS

Department of Economics

KANSAS STATE UNIVERSITY  
Manhattan, Kansas

1969

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ACKNOWLEDGEMENT

I would like to express my most sincere appreciation to Dr. Edgar S. Bagley for his courteous help, his knowledgeable suggestions, and his extendible patience in working with me on this master's report.

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## INTRODUCTION

.....the rapid and prolonged expansion since 1960 suggests that we may have learned something about maintaining steady growth. But even a casual look at broad economic indicators reveals unsolved problems.<sup>1</sup>

This statement from the May 1967 issue of the Federal Reserve Bulletin will be given an objective evaluation in this paper. This paper looks at monetary stabilization policies from the mild recession of late 1960 and early 1961 to the even slighter economic down-turn in the fall of 1966 and early 1967. The period considered is one in which monetary policies changed several times in response to changed in the economic weather. This period has not been recognized as a business cycle because the down-turn of late 1966 and early 1967 has not been recognized as a recession; however, the down-turn of late 1966 and early 1967 might be characteristic of the type of adjustment periods the economy will experience in the future.

This paper is not a critical evaluation nor a defense of monetary stabilization policies of this period but rather an objective look at the policies our monetary authorities have followed. It is not realistic to correlate monetary policies with important economic variables such as the money supply, the velocity of money, the price level, employment, interest rates, and gross national product (G.N.P.) without considering all the other influences on these variables. Data on these variables will be presented in graphic form, but only a general correlation will be implied. It

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<sup>1</sup>Federal Reserve Bulletin, LIII (May 1967), p. 708.



is not the purpose of this paper to present any specific conclusion or answers to our problems of monetary management. This must be left to more comprehensive empirical studies where all influences on our economy are considered.

The paper is set up in this manner: Chapter I looks at the basic goals or objectives of monetary policies and the powers and influences of the Federal Reserve System. Chapters II through IV examine monetary policies during the period covered in the paper and make reference to certain important economic indicators. Chapter V looks at the tapering off in business activity in late 1966 and early 1967, and Chapter VI gives some concluding comments.

## CHAPTER ONE

### MONETARY POLICIES IN PERSPECTIVE

What are monetary policies? Monetary policies involve primarily decisions of the Treasury and the Federal Reserve System. Treasury monetary policies consist of variations in its cash holdings, deposits at Federal Reserve banks and at commercial banks, and issuance of Treasury currency. The primary Federal Reserve monetary policies are changes in its portfolio of Government securities, (open-market operations) changes in member bank reserve requirements, and changes in the Federal Reserve discount rate. Commercial banks and the public also engage in a form of monetary actions. Commercial banks' decisions to hold excess reserves constitute a monetary action. Also, because of differential reserve requirements on time and demand deposits, the public's decisions to hold varying amounts of time deposits at commercial banks or currency relative to demand deposits are a form of monetary action, but are not viewed as stabilization actions. However they are taken into consideration by stabilization authorities in forming their own actions.<sup>2</sup> The definition given monetary policies in this paper is a somewhat limited one, referring only to the actions of the Federal Reserve System.

Monetary stabilization policies are one of two major weapons we have come to rely on to fight the causes of unemployment and

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<sup>2</sup>Leonall C. Anderson and Jerry L. Jordan, "Monetary and Fiscal Actions: A Test of Their Relatively Importance in Economic Stabilization", Reprint from Review, Federal Reserve Bank St. Louis (Nov. 1968) p. 13.

inflation, fiscal policy being the other. Monetary policies have taken on a countercyclical nature, tightening down on credit conditions when inflation threatens and easing off on credit conditions when utilization of our Nation's productive potential slackens. Because of the lag periods from the time a certain countercyclical monetary action is needed until the full effects of the action can be realized, managing monetary policies in a beneficial manner is difficult and has been criticized strongly by some.<sup>3</sup> If monetary stabilization policies are to counter against inflation and unemployment, then the next logical step is to look at the major causes of inflation and unemployment and some general theories of how monetary policies can deal effectively with them.

If we agree with the generally accepted theory of John Maynard Keynes, unemployment is caused by a lack of aggregate spending in our economy and inflation is primarily caused by too much spending in our economy. What influence can monetary policies have on the level of spending in our economy? The regulation of the money supply by our monetary authorities can in theory influence aggregate spending in at least two different ways. First, assuming that interest rates are some function of the supply of money and that the level of investment and consumer spending are some functions of the rate of interest, changes in the money supply can change interest rates which will change the levels of investment

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<sup>3</sup>See Milton Friedman and Walter Heller, Monetary vs Fiscal Policy: A Dialogue (New York: W. W. Norton & Co., Inc., 1969)

and consumer spending. Example: an increase in the money supply will lower interest rates, which will increase investment, which will increase G.N.P. The opposite will occur if the money supply is decreased. Second, according to "portfolio balancing" households and businesses are only content when the marginal return from the last dollar invested in each asset is equal. If we accept this thinking, and assume the "law of diminishing marginal utility" for all assets, a change in the money supply might have a broader and more direct effect on total expenditure. A change in the money supply would cause a change in the marginal utility of money which would cause people to change their holding of money to balance their marginal utility for money with their marginal utility for other assets. An example of this would be if the money supply increased the marginal utility of money would decrease and leave individuals in disequilibrium, not maximizing their satisfaction from their income. In this case people would spend down their money balances to increase the marginal utility of the last dollar being held, and aggregate spending would increase as a result of an increase in the money supply.

Another theory of how the money supply can affect G.N.P. or the level of employment is through the differential effects on interest rates. This theory is espoused by the economists at the Federal Reserve Bank of St. Louis, "the unofficial statistical arm of the Chicago School."<sup>4</sup> Their theory asserts that changes in the money supply will have long-run effects on interest rates different

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<sup>4</sup>Ibid.

from the short-run effects. If the money supply increases the short-run effect would be to lower interest rates as a result of the larger supply of money relatively to the demand for money. However, the long-run effect of an increase in the money supply would be to increase aggregate demand, according to the theories above, which will run down inventories and, subsequently increase production and credit demands. The increased demand for credit being greater than the increased supply of credit provided by the monetary expansion will create upward pressure on interest rates. As aggregate demand increases beyond full capacity output, prices will increase which will further increase credit demands since more funds are needed to finance a given volume of goods. Also with expectations of inflation borrowers are willing to pay higher rates of interest since they expect to repay lenders with cheaper dollars later.<sup>5</sup>

#### The Powers and Influences of the Federal Reserve System

Monetary policy has taken on the role and been the basic tool controlling short-run instability in our economy since 1951.<sup>6</sup> The ability of monetary policy to control short-run instability problems or take on a countercyclical nature is derived from its power to influence total expenditure or aggregate demand in the

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<sup>5</sup>Jerry L. Jordan, "Money, Interest Rates, Prices, and Output", Reprint from Review, Federal Reserve Bank of St. Louis (Research Dept., Nov., 1967), p. 4.

<sup>6</sup>Harry G. Johnson, Essays in Monetary Economics (London: Allen and Unwin Ltd., 1967), p. 57.

economy, as already mentioned. Through the power of the monetary authorities to regulate the volume of member bank reserves, they can influence bank loans, investments, bank deposits, and the money supply. These factors determine credit availability and general liquidity, which influence private spending for consumption and investment. Consumption and investment spending are the components of private aggregate demand, which largely determines production, employment, and prices<sup>7</sup> (objectives of monetary policy).

The Federal Reserve System strongly influences credit availability at non-bank financial institutions as well as at banks.<sup>8</sup> In times of monetary restraint they will have to pay higher rates for their funds and charge higher rates to their customers. Also in periods of monetary restraint, in the short-run interest rates will usually go up and bond prices down. Thus, for these financial institutions to liquidate their bond holdings to meet their liabilities would mean taking a loss on the bonds. This is a major factor tending to hold their lending down in periods of rising interest rates.

Another measure the Federal Reserve Officials have used to induce member banks to follow a desired course of action has been referred to as "moral suasion" or "open-mouth policy". The following statement by Harry G. Johnson helps explain the problems of using moral suasion:

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<sup>7</sup> The Federal Reserve System, *Annual Report*, 1954, p. 10.

"The use of moral suasion by the central bank inevitably involves some conflict with the immediate economic self-interest of the institutions at which it is directed, which institutions must be persuaded to comply either on the narrower ground of good relations with the central bank. The extent to which institutions can be persuaded to act against their immediate self-interest on these grounds obviously depends on a variety of factors, including the extent to which they can afford the loss of profits or of good will (in the first case) and the extent to which the central bank has power to discipline them (in the second case). It follows that moral suasion is more likely to be effective when directed at chartered banks and other heavily concentrated sectors of the financial system and the economy than when it is directed at sectors characterized by keen competition among a large number of small firms.<sup>9</sup>

The two cases mentioned above limit the extent to which moral suasion can be relied on to improve the performance of economic stabilization policy.

The last area of influence to be mentioned is the psychological influence the Federal Reserve System exerts. In the recent past the System has used changes in the discount rate as a psychological influence on banks and the economy. When monetary policy has been easy and banks have ample reserves, banks make little use of borrowing at the discount windows. So a change in the discount rate not accompanied by open market operations in securities or a change in reserve requirement should have little effect on credit conditions. However, banks have looked at changes in the discount rate as an indication of a change in economic weather, and maybe even as a warning. In the past the discount rate has

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<sup>9</sup>Harry G. Johnson, Essays in Monetary Economics (London: George Allen and Unwin LTD, 1967) p. 223-4.



not changed until after credit conditions were tightened considerably by open-market sales, but when it was changed, it was taken as a sign of further tightening in the future. The thread of having to go to the discount window and pay the higher rate puts pressure on banks to tighten their lending policies.

#### Primary Goals or Objectives of Monetary Policy

It is generally assumed that monetary policies should contribute to the realization of generally accepted national economic goals, including full employment, steady growth of output, a stable price level, and a long-run balance in our international payments.<sup>10</sup>

It is often questioned whether the four economic goals mentioned above are compatible with each other. Is there a conflict between the goals of full employment and stable prices? Is there a conflict between the goals of rapid growth in output and employment and long-run balance in the Nation's international payments? These are questions that have come up repeatedly in discussions of our economic goals. In the past there seems to have been a trading off between employment and stable prices. Also, the monetary policies for providing growth in output and high employment have conflicted with monetary policies to bring our international accounts into balance.

In the past when our monetary authorities were faced with conflicting goals, priorities were set as to which goal they thought

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<sup>10</sup>Neil H. Jacoby, United States Monetary Policy (New York: Fredrick A. Proegar Co., 1964), p. 13.



was the most important. However, there has been at least one period in the recent past when the Federal Reserve was up against conflicting objectives and tried to achieve both by designing policy actions to go in different directions at the same time. In this instance there were the twin problems of providing ample funds to the banking system and low interest rates to promote expansion in our domestic economy, and at the same time of curbing capital outflows to help our international balance of payments by holding up interest rates. The delicate operation the Federal Reserve authorities performed was to hold up short-term rates, which foreign capital movements seemed to be more sensitive to, by selling short-term securities, and to supply ample reserves to the banking system by purchasing long-term securities and lowering the legal reserve requirements. It is generally assumed that purchasing long-term securities tends to drive long-term interest rates down which stimulates the economy by increasing investment spending and consumer spending. This operation has been strongly criticized by some.<sup>11</sup>

A past objective of the Federal Reserve System that, for the most part, has been thrown out because of the high pressured criticism of it is that of keeping interest rates low on government securities to make the cost of financing the government budget deficit low. Should the Federal Reserve System concentrate on

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<sup>11</sup>E. Ray Canterbery, "A Note on Recent Money Supply Behavior," The Western Economic Journal, IV (Fall, 1965), p. 91-98.

making Treasury financing as cheap as possible or enter into the securities market at all for the purpose of making it easier for the Treasury to finance the deficit? The following statement by Chairman William McChesney Martin of the Board of Governors gives a clear indication of the Federal Reserve System's thinking on the matter.

The Treasury obviously would not expect the Federal Reserve to inflate the money supply, thereby putting the entire economy in jeopardy, merely so that the Treasury could get money at an artificially low rate...What we (Federal Reserve) should do, and will try to do, is to maintain conditions of reserve availability in the banking system which will help to match the rate of total bank credit and monetary growth to the needs of the total economy. This is not financing deficits with bank created money.<sup>12</sup>

The objectives mentioned above give the general direction to our monetary authorities in keeping with the Employment Act of 1946, which set forth our basic economic objectives of full employment, economic growth, and price stability.

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<sup>12</sup>Federal Reserve Bulletin, XLIX (February, 1963), p. 126-127.

## CHAPTER II

### EASY MONETARY POLICY 1961-62

During the latter part of 1960 and first two months of 1961 the economy suffered the mildest of the four post-World War II recessions. The discount rate was reduced from four to three and one-half percent in June of 1960 and to three percent in August and September.<sup>13</sup> Also the week ending November 9, 1960 the Federal Open Market Committee conducted its heaviest purchases of Government securities in seven years to further ease conditions by supplying reserves to the banking system. By the end of November, 1960 bank lending capacity expanded to the highest level in six years and free reserves jumped from \$494 million to \$997 million.<sup>14</sup> This was the start of a period of easy monetary policies that lasted for nearly four years during which time the economy remained in a state that can be described as "high-level stagnation." There was no cumulative decline in production, but the economy failed to expand as rapidly as the labor force and productive capacity. This condition seemed to continue until the combined effects of the 1964 tax cut and the large increase in defense spending for the Viet Nam War in 1965 brought the economy out of it.

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<sup>13</sup>Federal Reserve Bulletin, XLVII (February, 1961), p. 132.

<sup>14</sup>Wall Street Journal, (December 2, 1960), p. 1.

The recovery period after the mild recession of late 1960 and early 1961 was different in three general ways from the recovery period after the other three post-World War II recessions coming in 1949, 1954, and 1958. One, the increase in aggregate demand was not so sharp as in other post-war expansion periods, but it was persistent. Two, prices drifted up in the period from 1961 through 1963, but there was not the strong inflationary pressure that was felt from 1955 to mid-1957.<sup>15</sup> Three, wage increases were moderate and unemployment remained high. These features of the economy were due mainly to the high level of savings and the general pessimism that led to sluggish loan demand for both consumption and investment purposes. The easy monetary policy during the first few years of recovery did not seem to be able to overcome the ills of the economy.

#### The Dilemma Facing the Federal Reserve System

During 1961 and 1962 the Federal Reserve Authorities were faced with the dilemma of trying to establish a floor under short-term interest rates to curb the movement of short-term capital abroad while keeping long-term rates low to promote economic expansion domestically. President Kennedy announced the plans in February of 1961 that the government would try to prevent a further drop in short-term interest rates while permitting long-term borrowing costs to decline. The White House won the cooperation of the Federal Reserve System in attempting the delicate operation,

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<sup>15</sup>Federal Reserve Bulletin, L (January, 1964), p. 1.

but the Federal Reserve System Authorities were cautious about their part in such an undertaking.<sup>16</sup> They believed that such a rate structure would be desirable but were somewhat skeptical about achieving it. In going along with the Administration, the Federal Open Market Committee substantially increased its purchases of long-term securities to drive long-term rates down and further supply reserves to the commercial banking system, while holding back purchases of short-term securities to support short-term notes. The trend in long-and-short term government securities can be seen in fig. 3 of the appendix. Long-term rates did not increase much from 1961 through 1965 while short-term rates increased at a rapid rate and finally surpassed long-term rates late in 1965.

#### Interest Rates

The commercial banks had abundant reserves, member bank borrowings at the Federal Reserve banks were at a very low level, (see table 2 in appendix) and total loans and investments rose slightly after February of 1961. However, interest rates on medium-and long-term U.S. Government securities tended downward from February to early May even though the upturn from the recession came in February. In past periods of economic recovery interest rates often responded more promptly to a turn-around in economic activity. This, however, should not be strange if we look at two factors that tended to hold medium-and long-term rates down during this period. One factor is

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<sup>16</sup>Wall Street Journal, (February 3, 1961), p. 1.

that in February of 1961 the Federal Reserve System dropped its policy of dealing in only short-term Treasury bills (Bills Only Policy), and started buying medium-and long-term securities which tended to drive these rates down. As already mentioned, this action was taken in connection with helping our international balance of payments problem, and promoting expansion in the domestic economy. William McChesney Martin, Chairman of the Board of Governors of the Federal Reserve System, reported in April of 1961 that purchase of longer-term securities since February had played a major part in keeping long-term rates down below year earlier levels "in the face of developments that have often produced high rates in the past."<sup>17</sup> The second factor that held interest rates down during this expansion period was the weak loan demand, partly caused by the general pessimism.

Short-term interest rates in 1962 further reflected actions of the Federal Reserve System to raise short-term and lower long-term rates. Short-term interest rates in 1962 were somewhat above those in 1961 and this helped to hold down the flow of short-term capital abroad. The Federal Reserve System and the Treasury both worked to hold up the yield on 3-month Treasury bills. The Treasury increased its offering when the demand for these short-term issues was heavy because of seasonal or other demand forces. The Federal Open Market Committee also sold these short-term issues when the demand for them was heavy.

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<sup>17</sup>Wall Street Journal, (April, 1961), p. 1.

Long-term rates declined in 1962 and were lower than in 1961, further reflecting the actions of the Federal Reserve System to drive long-term rates down and short-term rates up. Another reason for the lower long-term interest rates in 1962 was the large inflow of savings into banks and saving institutions.

### Bank Liquidity

The over all liquidity position of the Nation's commercial banks is a very important consideration to the Federal Reserve System when determining monetary policy. The ability of the banking system to loan money thereby increasing the money supply is very much influenced by this liquidity position. One indicator of bank liquidity is the loan-deposit ratio. This ratio shows to what extent the banks have already used their resources to meet credit demands from their customers.

The general trend for the loan-deposit ratio since World War II has been to increase except during the first four post war recessions when it decreased. The loan-deposit ratio reached a peak of 57 percent in mid-1960 and tapered off slightly in the mild recession of late 1960 and early 1961. The liquidity position of the banking system remained high through most of the period from 1961 through 1964. (See table 1 in appendix). When monetary policy is easy, banks tend to be highly liquid and when monetary policy is tight banks tend to be less liquid.

Two more factors influencing bank liquidity are the ratio of secondary reserves to demand-deposits and the composition of bank's



time-and demand-deposits. Secondary reserves include bank holdings of excess reserves and short-term marketable securities. These reserves are available to satisfy loan demand to the extent they exceed the amounts needed to meet deposit drains. The composition of a bank's time-and demand-deposits also influence a bank's liquidity. Time-deposits are much less volatile than demand-deposits and therefore carry lower reserve requirements. With more time-deposits a bank can hold relatively fewer liquid assets and make longer-term loans.

#### Expansion of Deposits

The increase in time and saving deposits was larger in 1961 than in 1960 but beginning in 1962 the inflow of funds into time and savings deposits increased sharply. The reason for this was that the Federal Reserve System revised Regulation Q effective at the beginning of 1962, to allow commercial banks to pay higher interest rates on time and savings deposits. The rate of increase in time and saving deposits slowed back to the 1961 rate of increase for the second quarter of 1962 but this was still considerably higher than the post World War II average. An unusually large portion of the increase in time and saving deposits came in time deposits rather than passbook savings deposits. This pattern can be attributed to two factors. One, to get the new 4-percent maximum rate allowed by law, savers had to leave their savings in a time deposit for one year. Two, which is along the same line as the first, is that investors in time deposits are sensitive to differences



in yields between time and savings accounts, and the banks had raised the rate for savings deposits less than for time deposits.

### Loans and Investments

The recession of 1960-61 was mild but the recovery was slow compared to other post war cycles. Demand for bank loans remained comparatively moderate. Business and consumer loans were slower in the first half of 1962 after a rapid rise in the last half of 1961. The slower increase in business loans may have reflected in part the less rapid rise in inventory investment in the upswing after February of 1961 than in earlier upswings from recessions. Businessmen were a bit hesitant after the short-lived boom of 1959 and 1960. Also, businesses were retaining more of their earnings for reinvestment, and this cut down on business loans.

With the slowly increasing demand for loans and the easy monetary policy supplying reserves to the banking system, banks were able to make large additions to their holdings of securities. After the other post war recessions, the loan demand was such that banks reduced their holding of securities to meet these loan demands. Banks increased their holdings of long-term government bonds partly in participation with Federal Reserve action to lower long-term rates and hold up short-term rates to reduce capital outflows and improve the U.S. international balance of payments problem.

### Money Supply and Velocity

The money supply is generally referred to as consisting of currency and demand deposits other than amounts held by the

Government and commercial banks. As already mentioned, the money supply is a very important component determining prices and income. Even though the Federal Reserve System was following an easy monetary policy throughout 1961 and 1962, the money supply increased only moderately. (See fig. 4 in appendix and also table 1). "The annual rate of increase from February 1961 to June 1962 was only 2.2 percent. This compares with 3.4 percent over the comparable period of the 1958-59 up-swing."<sup>18</sup> This would have to be at least partly attributed to the rapid rise in time and savings deposits. Time and savings deposits are not considered part of the money supply, although they are a highly liquid form of asset and should be taken into account as part of an economy's purchasing power. Even though banks and other savings institutions can demand a thirty day notice before giving their customers their savings, they usually do not. People can generally get their money out of time and savings deposits on demand and in most cases almost as quickly as out of a demand deposit.

The turnover in demand deposits rose in the first half of 1962 mainly because people were transferring funds from demand deposits to time and savings deposits where they could receive the new higher interest rates being paid. At the new higher rate of interest available, people wanted to hold less money in the form of idle cash. The flow of funds from demand deposits into time and savings deposits might be contractionary in the short-run in that it reduces liquidity in the economy. However, it increases the

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<sup>18</sup>Federal Reserve Bulletin, XLVIII (July, 1962) p. 792.

potential money supply or supply of loanable funds which might lower interest rates and consequently, increase consumer and business spending.

Another factor that offsets the lack of increase in the money supply was the velocity of money which increased in the first half of 1962. (See fig. 5 in appendix). The existing money supply was being used more intensively. This tends to show that maybe monetary policies were not easy enough.

#### Was Monetary Policy Easy Enough in 1961 and 1962?

Even though the Federal Reserve System kept the banking system amply supplied with reserves, the facts used to evaluate monetary policy do not show that monetary policy was easy. Interest rates were relatively stable over the period as long-term yields edged slightly downward and short-term rates edged up. The money supply increased very little over the period as a whole, and the velocity of money, or its rate of use, increased sharply. This tends to indicate that monetary policy was not expansive enough. Some feel that these facts show that monetary policy was inhibited through much of the year by balance of payments considerations and was less stimulative than was needed for the domestic economy.<sup>19</sup>

Whether monetary policy was easy enough in the recovery period of 1961 and 1962 is somewhat controversial, but the Federal Reserve System definitely directed its policy actions strongly toward

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<sup>19</sup>"Monetary Policy in 1962," Federal Reserve Bulletin, XLIX (February, 1963), p. 132.

providing stimulus to a sluggish domestic economy, while avoiding money market conditions conducive to a flow of funds abroad. Both objectives had to be looked at in light of their relative importance and their relative importance varied widely among those concerned.

## CHAPTER III

### LESS EASY MONETARY POLICY IN 1963 AND 1964

Toward the latter part of 1962 the monetary authorities began to wonder if the amount of expansion in bank credit and total liquidity that had already occurred had gone far enough. They also began to wonder whether monetary policy had reached the limit of its usefulness as a stimulus to economic activity. Consequently in the latter part of 1962 the Federal Reserve System shifted its monetary policy emphasis toward slightly less ease and toward maintaining a moderately firm tone in the money market.

In the first half of 1963 economic prospects brightened, gross private domestic investment turned up sharply, business inventories were cut back, prices edged up slightly faster than in 1961-62, and our international balance of payments grew worse. These developments taken together suggested to the monetary authorities that a modification was needed in the current monetary policy. So in the late spring the Board of Governors approved an increase in the discount rate from 3 to 3 1/2 percent at the Federal Reserve Banks. They also raised the maximum interest rate member banks are allowed to pay on time deposits and certificates with maturities from 90 days to one year. Both of these actions were effective July 17, 1963.<sup>20</sup> Late in 1964 the discount rate was raised from 3 1/2 to 4 percent.

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<sup>20</sup>Federal Reserve Bulletin, XLIX (July, 1963), p. 883.

## Loan Demand and Interest Rates

As a consequence of a somewhat tighter monetary policy in 1963 than in 1962, bank reserves were reduced and member bank borrowing from Federal Reserve Banks rose moderately. (See table 2 in appendix) The demand for loans was higher in 1963 than in 1962, and with this increased loan demand and somewhat smaller reserves, banks sold more than 5 percent of their holdings of U.S. Government securities to supplement their reserves. In 1964 the loan demand dropped slightly from the 1963 level but it was still above the post-war average. Commercial banks continued to reduce their holdings of U.S. Government securities.

Interest rates in all maturity ranges edged up in 1963 in response to a more optimistic economic outlook. Also the tighter monetary policy, the stronger loan demand, and large offerings of longer-term securities by the Treasury exerted upward pressure on interest rates. (See fig. 3 in appendix). Strong upward pressure was still being exerted on short-term rates by monetary policy in an attempt to reduce incentives for short-term capital to flow out of the country. Interest rates in general reached their peaks toward the turn of the year and stabilized in 1964 at only slightly lower levels than in 1963.

## Bank Liquidity

Bank Liquidity declined throughout most of 1963 and 1964. "As measured by the ratio of loans to total deposits, the decline in bank liquidity was rather steady during 1963. By the year-end

this ratio had risen to about 59 percent, compared with 56.5 percent a year earlier and 54.5 percent at the end of 1961.<sup>21</sup> In 1964 the loan-deposit ratio rose to a post-war high of 61.1 percent.<sup>22</sup> (See Table 1 in appendix). The ratio of bank holdings of short-term U.S. Government securities to total deposits, another measure of bank liquidity, also declined indicating less bank liquidity. The decline in this ratio represented mainly a continued adjustment of bank investment portfolios to the heavy inflow of time and saving deposits. Knowing that they would have the funds for a longer period of time, banks could invest in longer-term securities at higher interest rates than the short-term securities pay.

#### Money Supply and Velocity

The money supply increased 3.8 percent in 1963, which was the second highest annual rate of growth since 1953. (See fig. 4 in appendix). In 1964 the money supply was uneven in its expansion, but for the year as a whole the increase amounted to 4.3 percent which was slightly higher than the 3.8 percent increase in 1963. The income velocity or turnover of the money supply increased in 1963 and 1964 as it has in most post-war years. (See fig. 5 in appendix). The larger increase in the money supply and the higher velocity of money are further indications of the brighter economic conditions in 1963.

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<sup>21</sup>Federal Reserve Bulletin, L (February, 1964), p. 144.

<sup>22</sup>Federal Reserve Bulletin, LI (February, 1965). p. 223.

## CHAPTER IV

### STRONG MONETARY RESTRAINT IN 1965 AND 1966

Throughout 1965 and the first half of 1966 the economy boomed. (See graphs on G.N.P., prices, industrial, production, and unemployment in appendix). The Federal Reserve exerted more restraint in an effort to contain the inflationary pressures generated by strong demands for goods and services. This strong demand which came from all sectors of the economy put pressure on human and plant resources which exerted extreme pressure on prices and wages. The strong loan demand and the tighter monetary policy pushed interest rates to very high levels and long-term rates reached their highest levels in thirty years. These developments made it clear to the System that the economy was in a boom period and that stronger action should be taken to cool the over heating economy.

The System took restraining action in early December of 1965 by increasing the discount rate from 4 to 4 1/2 percent.<sup>23</sup> To cut reserves in the banking system, the Federal Open Market Committee kept up its sales of government securities and the reserve requirement was increased in June. Also reduce the amount of funds flowing into time deposits, the Board lowered Regulation Q ceiling on new multiple-maturity time deposits. The ceiling was lowered from 5 1/4 to 5 percent on deposits with maturities of 90 days and over and from 4 1/4 to 4 percent for those of less than 90

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<sup>23</sup>Federal Reserve Bulletin, LII (February, 1966), p. 151.



days.<sup>24</sup> As a consequence of the lower interest rates paid on time deposits and the increase in demand for consumer goods, the inflow of funds into time and saving accounts dropped off considerably. As could be expected with the tighter monetary policy and the decrease in deposits cutting back on banking reserves, borrowing at the discount windows increased substantially. Net borrowed reserves reached a higher level than in the boom period of early 1960. (See table 2 in appendix).

During this period the System and the Administration were both very concerned about our international balance of payment problem which was growing worse. So to help alleviate this problem a Voluntary Foreign Credit Restraint (VFCR) program was set up. Under this program the Board of Governors of the Federal Reserve System issued guidelines to banks and other financial institutions designed to restrain their lending and investing abroad.<sup>25</sup> This program turned out to be very successful in curbing capital flows abroad.

#### Loan Demand and Interest Rates

The demand for all types of loans was strong in 1965. Business loans at banks increased by nearly one-fifth in 1965, which was the largest increase since 1956.<sup>26</sup> This strong loan demand coming from businesses reflected the accelerating pace of business

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<sup>24</sup>Federal Reserve Bulletin, LIII (June, 1967), p. 938-939.

<sup>25</sup>Federal Reserve Bulletin, LII (February, 1966), p. 151.

<sup>26</sup>Federal Reserve Bulletin, LII (February, 1966), p. 154.

investment in plant, equipment, and inventories. This investment in plant, equipment, and inventories was due for the most part to the optimistic business outlook. However, fewer strikes and a lessening of the threat of strikes also contributed to the build-up.

With the strong loan demand and monetary policy moving toward more restraint, interest rates increased substantially in 1965. (See fig. 3 in appendix). Most of the increase in rates came in the second half of 1965 when it became clear that spending for the Viet Nam War would be rising sharply in an economy already close to full utilization of its resources.

Through the first three quarters of 1966 the demand for loans continued to increase at a rapid pace and interest rates continued to rise. Business loans expanded at an annual rate of more than 20 percent through the first seven months of 1966,<sup>27</sup> and interest rates rose to their highest levels in 40 years.<sup>28</sup> (See fig. 3 in appendix).

#### Bank Liquidity

Bank Liquidity continued to drop through 1965 and most of 1966. This was caused by banks trying to meet the strong loan demand under tight money conditions. The loan-deposit ratio for all commercial banks touched a post-war high of 66.8 percent in

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<sup>27</sup>Federal Reserve Bulletin, LIII (February, 1967), p. 195.

<sup>28</sup>Ibid., p. 199.

September of 1966 which was 3.1 percentage points above what it was at the end of 1965.<sup>29</sup> (See Table 1 in appendix). The ratio of short-term U. S. Government securities to total deposits declined to its lowest point in the expansion since 1961. This was further indication of the substantial decline in bank liquidity.

### Money Supply and Velocity

With economic activity expanding rapidly throughout 1965, the money supply and velocity increased considerably. The money supply increased 4.4 percent in 1965 which was the largest increase in any one year since the expansion period started in 1961. (See figure 3 in appendix). The turnover in demand deposits, which is the only way the velocity of the money supply can be determined, was slightly higher than it was in 1964.<sup>30</sup> (See figure 5 in appendix).

The increase in the money supply leveled off in 1966 and decreased slightly toward year end. The increase in the money supply for all of 1966 was only 2.2 percent, just half the percentage increase in 1965. (See figure 4 in appendix). The income velocity of money increased sharply the first three quarters of 1966, most likely in response to the credit squeeze exerted by monetary policies, but turned down sharply with the leveling off in economic activity late in 1966. (See figure 5 in appendix). This responsiveness of the income velocity of money to changing

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<sup>29</sup>Ibid., p. 198.

<sup>30</sup>Federal Reserve Bulletin, LII (February, 1966), p. 153.

credit conditions is a factor that our monetary authorities have to contend with when calculating monetary stabilization policies.

## CHAPTER V

### THE LEVELING OFF IN 1966 AND 1967

The period from the fall of 1966 through the first quarter of 1967 has not been referred to as a recession as of yet, but may later be recognized as the fifth and mildest of the post World War II recessions. This period was basically a period of somewhat less optimism and an inventory adjustment. General economic conditions could be described as being on a plateau. Inventories that had been built up were being cut back and consequently industrial production turned down. (See Figures 7 & 8 in appendix). The first quarter of 1967 saw a slight decline in real G.N.P. (See Figure 1 in appendix). Interest rates, which typically lag the business cycles, reached a peak in mid-summer of 1967 and turned down slightly. Even though this period has not been referred to as a recession, it had some of the same characteristics of the other post World War II recessions.

In light of the tapering off in business activity in the fall of 1966, the Federal Reserve made a sharp turn around in policy actions. They began supplying reserves to the banking system by purchasing government securities on the open market. Further action was taken to increase reserves in March of 1967 when the Board of Governors authorized a two-step reduction in reserve requirements on passbook savings deposits. They also reduced the discount rate from  $4\frac{1}{2}$  percent to 4 percent. This period of monetary ease was short lived. The underlying forces

that brought on the boom in 1965 and 1966, defense spending for the Vietnam War and the large consumer and business demand, were only slightly in the background during this period. As confidence was regained, these forces came back into the picture, and inflationary pressure soon reappeared.

## CHAPTER VI

### CONCLUDING COMMENTS

The monetary authorities will undoubtedly admit that there is still much to be learned about stabilization policy, but credit should too be given where credit is due. The performance of the economy from 1961 to 1967 was good; perhaps this is due at least in part to monetary stabilization policy. The money supply, which is a generally watched indicator of monetary policy, did not always show that monetary policy was countercyclical or stabilizing. At times the money supply rose rapidly in periods of expansion and did not rise at all in periods of decline. This might have been due at least in part to the lag effects of monetary policies and the inaccurate forecasting. But it must be remembered that changes in the money supply are a result of changes in the public's demand for money interacting with monetary policy. When it looked like monetary policy was not doing its job, it might have looked even more so if they had not been doing what they were.

The monetary authorities seem to exert pressure on the economy as if they had the economy on an elastic leash. They cannot push the economy with this leash but they can give the economy slack so it can move easily. If the economy moves too fast, they can tighten the leash and make it harder for the economy to follow its course, but the economy can still proceed at somewhat more strain by stretching the elastic leash. As the monetary authorities tighten the leash further, it becomes more difficult for the

economy to follow its course. Soon the economy will weaken. It will not only not be able to continue its course, but it will not be able to hold its achieved position. It will come snapping back from the tightly stretched elastic leash. The monetary authorities, not being able to push the economy to hold it on course, will only be able to give slack and hope it does not come flying back too far.

The above description of the relationship between the Federal Reserve System and the economy seems to characterize the period from 1960 through 1967. From 1960 to 1963 the System left the leash loose but this did not make the economy expand as it was hoped it would. The ample reserves supplied during this period made it easy for the economy to expand rapidly in response to the tax cut in 1964 and the large increase in defense spending in 1965. Then in 1966 the System found it necessary to pull hard on the leash. The tide turned slightly in the last half of 1966 and early 1967, and the System again eased off quickly on the leash. They might have eased off too much for the economy only paused then proceeded on booming a course with high employment, high utilization of resources, and threatening inflation.



A P P E N D I X

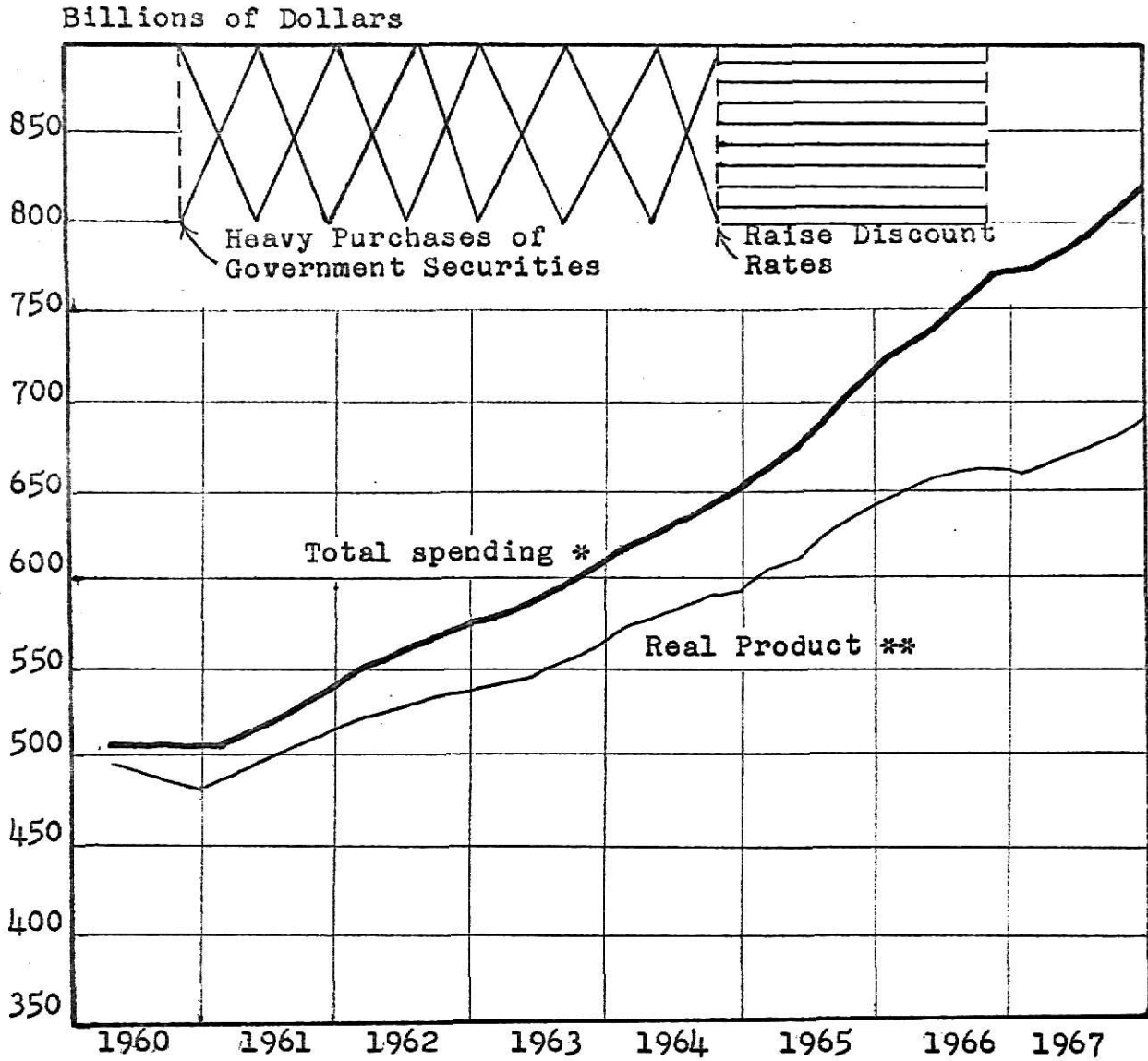
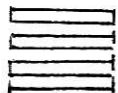


Fig. 1. Demand and Production-Quarterly totals at seasonally adjusted rates.  
 \* G.N.P. in current dollars  
 \*\*G.N.P. in 1958 dollars  
 Source: U.S. Department of Commerce



Easy monetary policy



Tight monetary policy

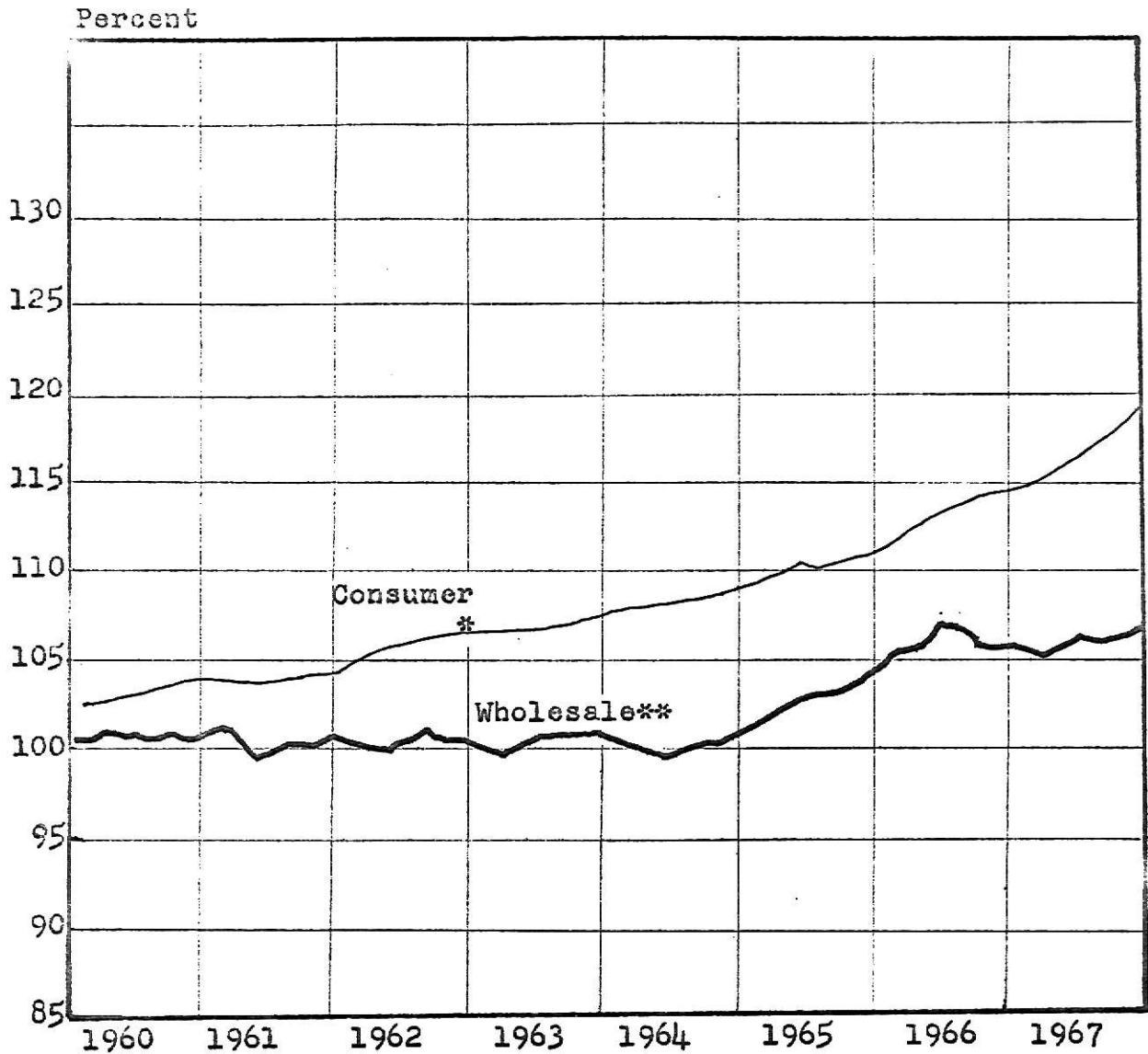


Fig. 2. Prices--Ratio Scale 1957-1959=100 percent  
 \* Consumer Price Index  
 \*\*Wholesale Price Index  
 Source: U.S. Department of Commerce

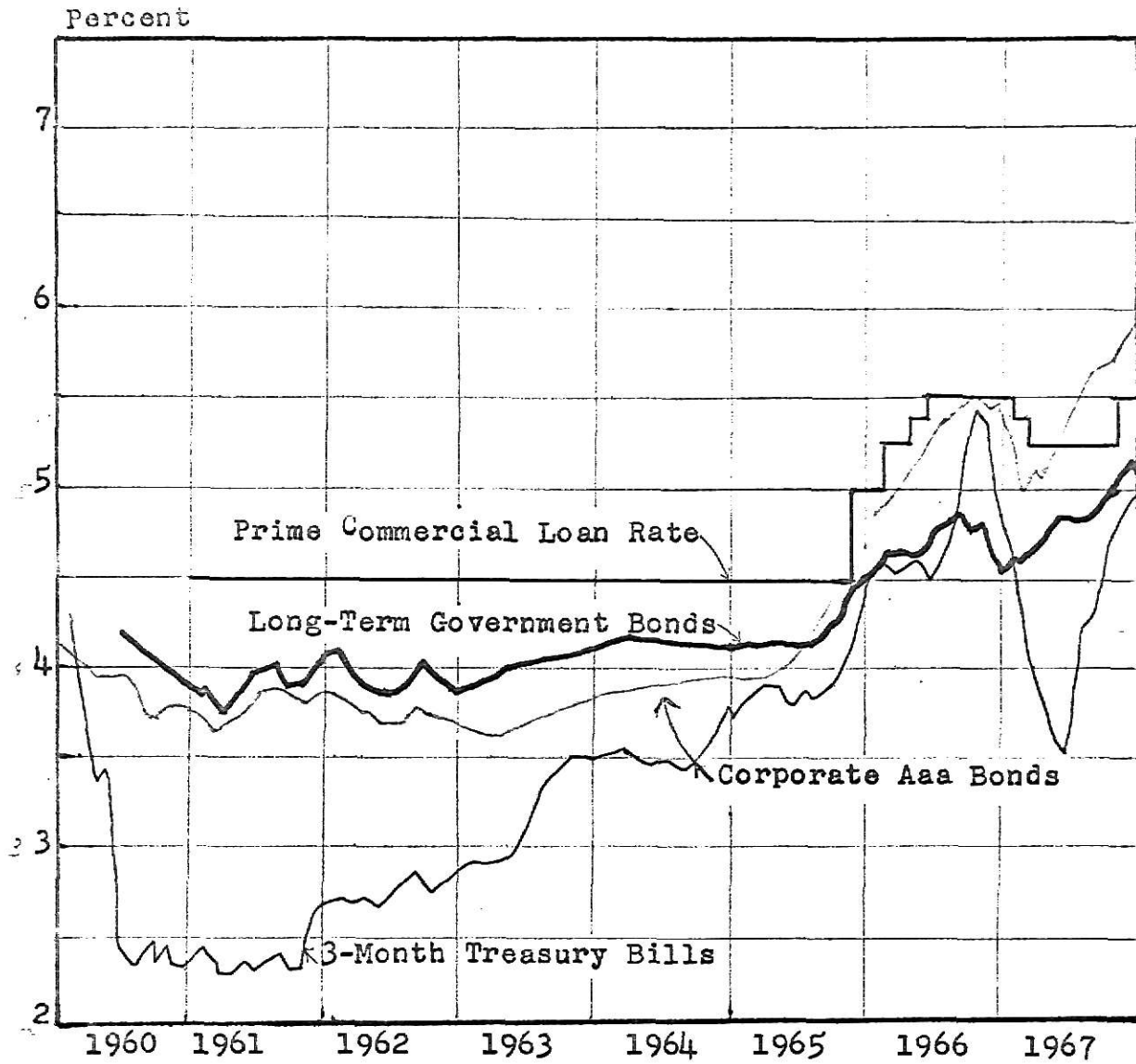


Fig. 3. Yields on Government Securities, Corporate Aaa Bonds, and the Prime Commercial Loan Rate.

Source: Board of Governors of the Federal Reserve System and Moody's Investor Service. Review, Federal Reserve Bank of St. Louis.

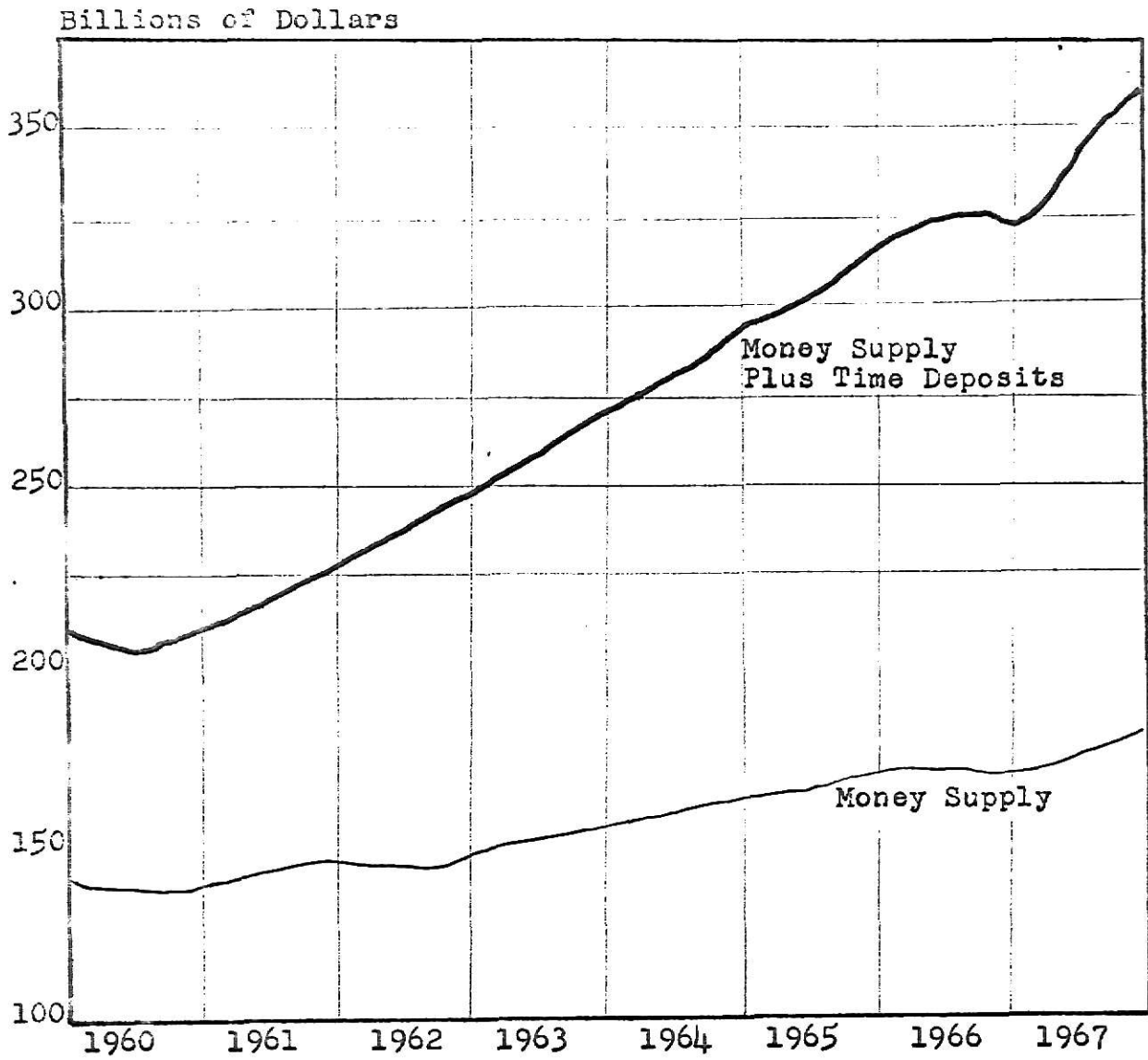


Fig. 4. Money Stock  
Source: Federal Reserve Bank of St. Louis

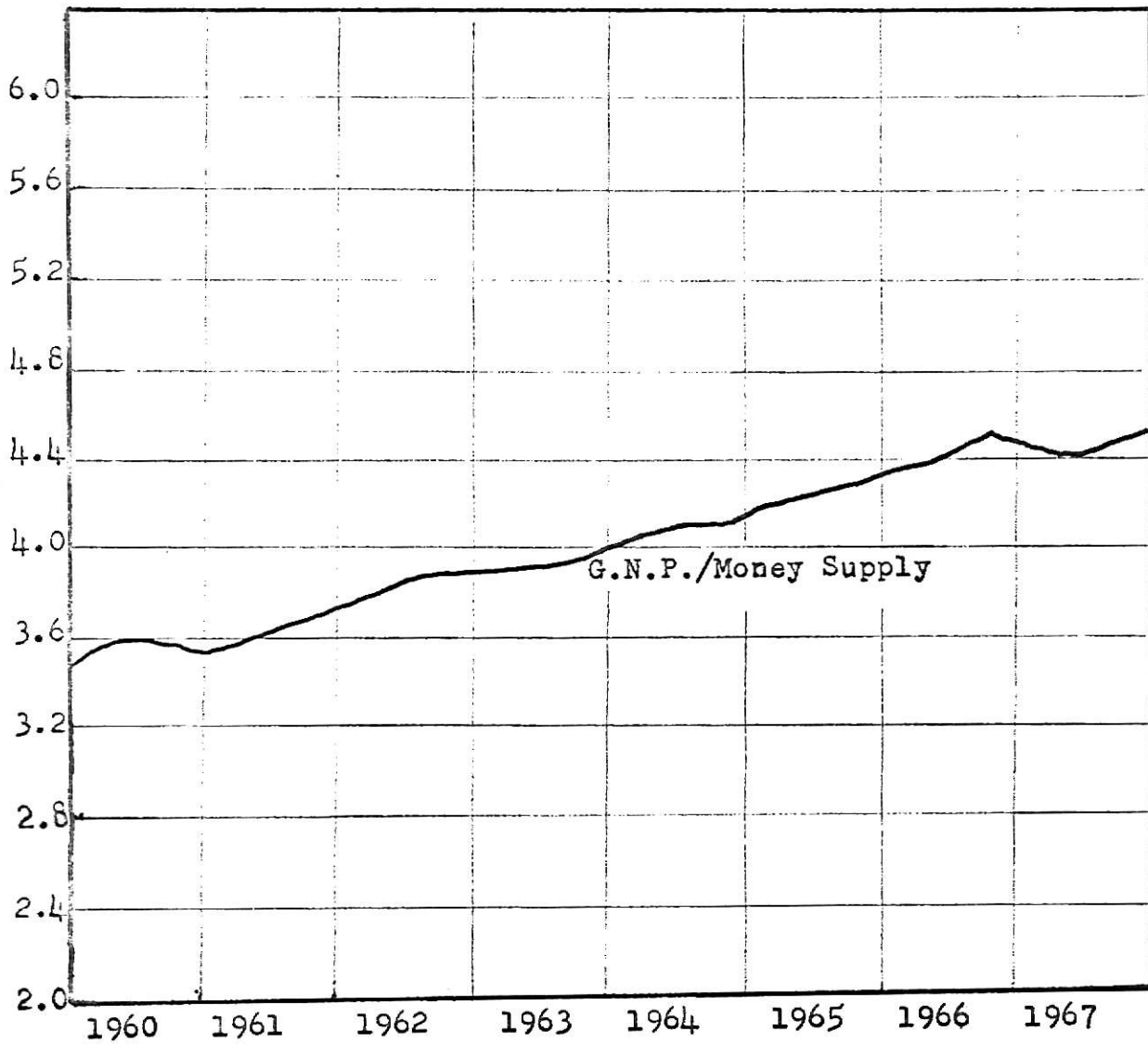


Fig. 5. Income Velocity of Money  
Source: Federal Reserve Bank of St. Louis

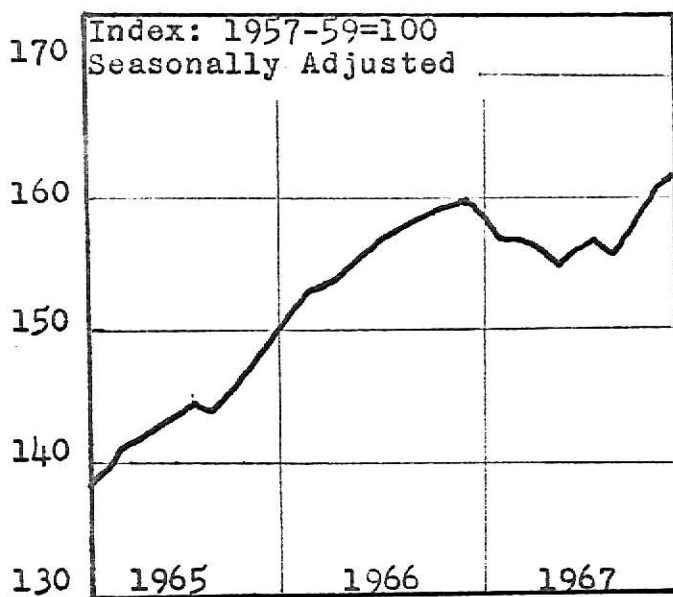


Fig. 6. Industrial Production  
Source: Wall Street Journal

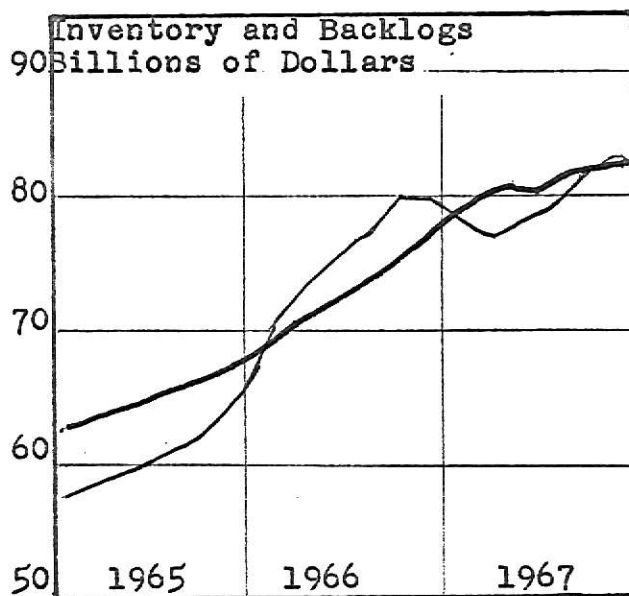


Fig. 7. Inventories of all Manufactures  
Source: Wall Street Journal

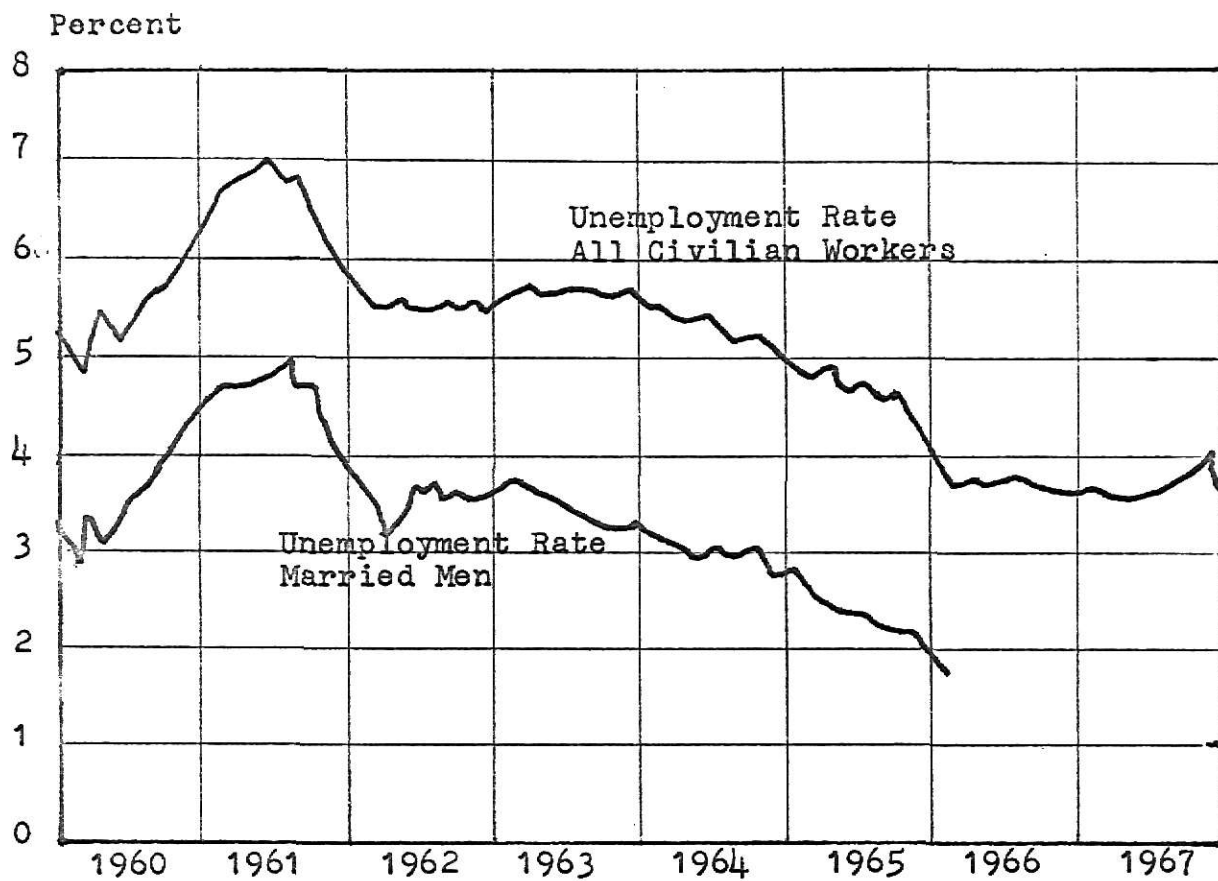


Fig. 8. The Unemployment Rate  
Source: Economic Indicators, January 1967, pg. 11.



PERIOD	MONEY SUPPLY SEASONALLY ADJUSTED IN BILLIONS OF DOLLARS			* PERCENTAGE CHANGE IN MONEY SUPPLY	** TIME DEPOSITS	U.S. GOVERNMENT SECURITY YIELDS:		*** LOAN DEPOSIT RATIO
	TOTAL	CURRENCY OUTSIDE BANKS	DEMAND DEPOSITS			3-MONTH TREASURY BILLS	3-5 YEAR ISSUES	
1960	141.1	28.9	112.1	-0.8	72.9	2.982	3.99	57.0
1961	145.5	29.6	116.0	3.1	82.7	2.378	3.60	54.5
1962	147.5	30.6	116.9	1.4	97.8	2.778	3.57	56.5
1963	153.1	32.5	120.6	3.8	112.2	3.157	3.72	59.0
1964	159.1	34.2	125.4	4.3	126.6	3.549	4.06	61.1
1965	166.8	36.2	130.5	4.4	146.9	3.954	4.22	64.3
1966	170.4	38.3	132.1	2.2	158.6	4.881	5.16	66.8
1967	181.5	40.4	141.1	6.5	183.8	4.321	5.07	67.2

Table 1. Data collected from:

Economic Indicators, (Jan, 1966), p.29 and 33.  
Economic Indicators, (May, 1968), p.29 and 33.

Federal Reserve Bulletin, Volumes 47-52.

Original Source of all data: U.S. Board of Governors of Federal Reserve System.

\* Percentage change in money supply from first of year to end of year.

\*\* Time Deposits in billions of dollars.

\*\*\* Percent of loans to deposits.

RESERVES AND BORROWINGS OF  
MEMBER BANKS

(In Billions of Dollars)

	All Member Banks				
	Reserves			Borrowings at F.R. Banks	Free Reserves
	Total held	Required	Excess		
June, 1960	18,294	17,820	466	425	41
Dec., 1960	19,283	18,527	756	87	669
June, 1961	19,042	18,430	612	63	549
Dec., 1961	20,118	19,550	568	149	419
June, 1962	19,924	19,433	491	100	391
Dec., 1962	20,040	19,468	572	304	268
June, 1963	19,735	19,358	377	236	141
Dec., 1963	20,746	20,210	536	327	209
June, 1964	20,558	20,170	388	270	118
Dec., 1964	21,609	21,198	411	243	168
June, 1965	21,709	21,366	343	528	-185
Dec., 1965	22,719	22,267	452	454	-2
June, 1966	22,534	22,682	408	766	-358
Dec., 1966	23,830	23,438	392	557	-165
June, 1967	23,518	23,098	420	123	297
Dec., 1967	25,620	24,915	345	238	107

Table 2.

Source: Federal Reserve Bulletin.

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U.S. MONETARY POLICY: 1961--  
FIRST QUARTER 1967

by

RENUS DALE STRAIT

B. A., Fort Hays State College, 1967

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AN ABSTRACT OF A MASTER'S THESIS

submitted in partial fulfillment of the

requirements for the degree

MASTER OF ARTS

Department of Economics

KANSAS STATE UNIVERSITY  
Manhattan, Kansas

1969

## ABSTRACT

In recent years monetary policy has been one of two major tools used to achieve our basic goals of full employment, price stability, and economic growth. To achieve these goals the Federal Reserve System has adopted policy actions of a countercyclical nature. The paper is concerned with these countercyclical policy actions from the mild recession of late 1960 and early 1961 to the even slighter economic down-turn late in 1966 and early 1967.

From the mild recession of 1960 and 1961 through 1962 the monetary authorities were faced with the problem of stimulating a sluggish domestic economy. The recovery from that mild recession was slow and it seemed that the Federal Reserve System could not do enough to expand the economy and cut the unemployment rate. Prices were stable but this achievement seemed to be at the cost of a high unemployment rate. The primary means the System has for stimulating the economy, supplying reserves to the banking system, did not seem to be enough.

In 1963 the monetary authorities began to wonder if monetary policy had reached the limits of its usefulness as a stimulus to economic activity. However, economic conditions did pick up somewhat in 1963 and another of our important problems, our international balance of payments, grew worse. So in the period 1963 and 1964 the System took on a policy of slightly less ease. Our

international balance of payments problem appeared to call for keeping interest rates up to curb capital flows abroad. This conflicts with policies designed to expand our domestic economy. To achieve both objectives monetary authorities have tried to hold up short-term interest rates, which foreign capital flows seem to be more responsive to, and drive long-term rates down to promote domestic expansion.

In 1965 and 1966 the economy was definitely in a period of inflation. The easy monetary policy up to 1965, the 1964 tax cut, the large increase in defense spending in 1965, and the general optimism were too much all at once for the economy. During 1965 and the first three-quarters of 1966 our monetary authorities exerted extreme pressure on credit conditions, and as a consequence the inflation was broken up slightly by a mild leveling off the last 1966 and first of 1967. The leveling off period was not much more than an inventory adjustment, but real G.N.P. dropped slightly in the first quarter of 1967. At the first sign of a leveling off in economic activity, the Federal Reserve System eased off on credit conditions, and the economy continued on its course.

The monetary authorities will undoubtedly admit that there is still much to be learned about stabilization policy, but credit should be given where credit is due. The performance of the economy from 1961 to 1967 was good; perhaps this is due at least in part to monetary stabilization policy.