FIFTY SECOND

Annual Report

OF THE

BOARD OF GOVERNORS

OF THE FEDERAL RESERVE SYSTEM

COVERING OPERATIONS FOR THE YEAR

1965

Digest of Principal Federal Reserve Policy Actions in 1965

Period	*Action*	*Purpose*
January	Reduced System holdings of U.S. Government securities by about $500 million. Member bank borrowings averaged $300 million.	To absorb seasonal reflow of bank reserves while maintaining about the same firmness in the money market as had prevailed in earlier weeks.
February	Introduced a program, at the request of the President and in cooperation with the Treasury, under which financial institutions were asked to limit voluntarily their expansion of foreign loans and investments.	To reduce the outflow of private capital and thus improve the U.S. balance of payments and strengthen the international position of the dollar.
February-March	Limited the increase in System holdings of U.S. Government securities to about $1.0 billion, nearly one-fifth of which were securities maturing in over 1 year. Member bank borrowings rose to an average of nearly $500 million in late March.	To move toward firmer conditions in the money market, while offsetting a $600 million gold outflow, and to encourage more moderate growth in the reserve base, bank credit, and the money supply—in an effort to reinforce the voluntary foreign credit restraint program and avoid the emergence of inflationary pressures.
April-November	Limited the increase in System holdings of U.S. Government securities to about $2.4 billion, nearly one-third of which were securities maturing in over 1 year. Member bank borrowings averaged $500 million.	To offset a drain on bank reserves from market factors—as outflows of $2.5 billion in currency and $700 million in gold were only partly offset by reserves supplied from other technical factors—while attempting to maintain firm conditions in the money market in a period of rising credit demands and shifting expectations and at the same time accommodating no more than moderate growth in bank reserves, bank credit, and money.
Early December	(1) Raised the discount rate from 4 to 4½ per cent and (2) raised maximum interest rates payable by member banks on time deposits (other than savings deposits) from 4 to 5½ per cent for maturities of 30-89 days and from 4½ to 5½ per cent for longer maturities.	(1) To moderate additional bank reliance on short-term borrowings from the Federal Reserve to meet intensifying loan demand and (2) to enable banks to attract and retain time deposits of businesses and individuals and thus to assure an adequate flow of funds.
December	Increased System holdings of U.S. Government securities by about $1.1 billion, one-fifth of which represented securities acquired under repurchase agreements. Member bank borrowings averaged about $450 million.	To moderate adjustments in money and credit markets following the December discount rate increase and to offset part of the seasonal drain on bank reserves.

outflows of funds induced by arbitrage considerations; and

(d) sales through forward transactions, for the purpose of influencing interest arbitrage flows of funds and of minimizing speculative disturbances.

The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing currencies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $100 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

This directive was amended on five occasions during the year, as noted in the entries.

January 12, 1965

1. Authority to effect transactions in System Account.

As 1964 ended, according to reports at this meeting, domestic business activity was recovering vigorously from the effects of the automobile industry strikes in October and November. Industrial production was estimated to have risen to a new record level in December, about 7½ per cent above a year earlier. Automobiles were being produced in exceptionally large volume, and industry schedules called for high output rates to be maintained in the first quarter of 1965. Steel production also was expected to continue large, at least for a time; consumption of steel was high, and users were attempting to accumulate stocks as a precaution against a possible strike in the spring. Manufacturers' inventories, which had risen slowly earlier in the year, increased rapidly in October and November and probably also in December. Retail sales rose sharply in December and may have exceeded the high reached in the summer of 1964.

Estimates of various statistics for the fourth quarter as a whole reflected the effects of the work stoppages in the automobile industry. Gross national product, according to preliminary indications, rose much less than earlier in the year despite the substantial increase in the rate of inventory investment. Industrial production averaged only slightly higher than in the third quarter, and the increase in consumer spending was the smallest for any quarter in the current business expansion, which now had continued for nearly 4 years.

Nonfarm employment reached a new record high in December and the unemployment rate edged down to 4.9 per cent. In manufacturing, the rise during 1964 in compensation per employee—including fringe benefits, which continued to increase more rapidly than money wages—was on the average close to the administration's guideposts, and unit labor costs remained relatively stable. It was noted that the outcome of the contract negotiations in the steel industry would provide a major test of whether labor costs would continue stable.

Recent price movements did not suggest any significant change in the price situation, although some businessmen reportedly were expecting an inflationary price drift partly because of the nature of the steel industry settlement they anticipated. The industrial commodity price index, which had increased by four-tenths of 1 per cent in October, rose only two-tenths of a per cent further in November and one-tenth of a per cent in December, and average consumer prices in November continued 1.2 per cent above the year-earlier level.

For the year as a whole bank credit had expanded by about 8 per cent, the same as in 1963, and the money supply had increased by 4 per cent compared with 3.8 per cent in the prior year. Bank credit continued to expand in December, but by an amount considerably below the large increase in November as banks sold Treasury securities acquired late in the preceding month and security loans rose less than usually. Growth in the money supply also slowed in December, but time and savings deposits expanded at a rate slightly higher than their 12.6 per cent rise in the year as a whole. A large increase in nonborrowed reserves in December facilitated continued expansion in bank credit and deposits as member bank borrowings declined from the average levels prevailing before the late-November increase in the discount rate.

Money market conditions continued firm in late December and early January, a season in which they normally ease, partly as a result of a sharp shift of reserves to country banks and heavy dealer financing needs associated in part with the Treasury's advance refunding operation, announced on December 30. The refunding was accorded a highly favorable reception by investors, and yields on long-term U.S. Government bonds, which had moved up earlier in part because of market discussion of a possible major financing operation, changed little after its announcement. These yields currently were at about the levels that had prevailed at the beginning of 1964 and again shortly after the November discount rate action. Despite the firmness in the money market, the 3-month Treasury bill rate declined from 3.85 per cent in mid-December to 3.77 per cent on the day preceding this meeting, mainly as a result of the refunding and usual seasonal demands for bills.

The deficit in the U.S. balance of payments was estimated to have increased sharply in the fourth quarter, largely because of a marked increase in capital outflows through foreign security issues in the United States and lending by U.S. banks abroad. Indeed, outflows of private capital were at record or near-record levels throughout the year. Short-term capital outflows were heavy in the first half but diminished later as outflows on long-term bank loans and foreign security issues rose. The deficit for the full year, which seemed likely to exceed $2.5 billion, was below the 1963 deficit of $3.3 billion as a result of a marked expansion in net receipts from transactions in goods and services, including income from foreign investment.

Foreign exchange markets had continued in an unsettled state in recent weeks. Sterling was under intermittent pressure, and the demand for gold on the London market was heavy at times. Among the factors contributing to the market unsettlement were uncertainties on the part of participants about the outlook for sterling and press reports that France would increase its gold purchases from the United States substantially.

The Committee decided that a change in policy was precluded at this time by the Treasury's advance refunding, the settlement date for which was January 19. The members agreed that the problems of the U.S. balance of payments and the international position of the dollar had become increasingly serious recently. Some members indicated that if a Treasury financing had not been in process they would have favored reducing the availability of bank credit somewhat as a means of contributing to a solution of these problems. In their judgment such an action would not adversely affect the domestic economy; and it was noted that, if specific measures also were adopted to curtail the volume of bank lending abroad, the availability of credit to domestic borrowers could be affected less than total supply. Other members indicated that they favored no change in policy at present, even apart from the Treasury financing, on the grounds that under current domestic circumstances it was preferable to use selective measures for dealing with the international financial problems.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> In light of the economic and financial developments reviewed at this meeting, and taking the current Treasury refunding into account, it remains the Federal Open Market Committee's current policy to facilitate continued expansion of the economy by accommodating moderate growth in the reserve base, bank credit, and the money supply, while seeking 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.

To implement this policy, and recognizing that international uncertainties and shifting seasonal pressures require a larger than usual degree of flexibility in operations, System open market operations over the next 3 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Hickman, Mitchell, Robertson, Shepardson, Shuford, Swan, and Wayne. Votes against this action: None.

2. Authority to purchase and sell foreign currencies.

On recommendation of the Special Manager of the System Open Market Account, the Committee amended the second paragraph of its continuing authority directive for System foreign currency operations to increase the combined dollar limit on forward transactions of the several authorized types by $75 million to $275 million. With this amendment, the paragraph read as follows:

The Federal Reserve Bank of New York is also authorized and directed to operate in any or all of the foregoing currencies in accordance with the Guidelines and up to a combined total of $275 million equivalent, by means of:

(a) purchases through forward transactions, for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements;

(b) purchases and sales through forward as well as spot transactions, for the purpose of utilizing its holdings of one currency for the settlement of commitments denominated in other currencies;

(c) purchases through spot transactions and concurrent sales through forward transactions, for the purpose of restraining short-term outflows of funds induced by arbitrage considerations; and

(d) sales through forward transactions, for the purpose of influencing interest arbitrage flows of funds and of minimizing speculative disturbances.

Votes for this action: Messrs. Martin, Hayes, Balderston, Hickman, Mitchell, Robertson, Shepardson, Shuford, Swan, and Wayne. Votes against this action: None.

This amendment was made after the Special Manager indicated that a substantial part of the $200 million authorized earlier for forward transactions currently was committed and that he might have occasion to engage in further useful operations of these types in the near future.

February 2, 1965

Authority to effect transactions in System Account.

Information presented at this meeting indicated that domestic business activity was continuing to expand, while the U.S. international payments position had worsened in late 1964.

Employment increased substantially in December, although the unemployment rate was little changed. Industrial production and retail sales reached new record levels in December, and it appeared that both were rising somewhat further in early January. New orders for durable goods increased in December despite a decline in defense orders. Upward pressures on some commodity prices were evident, but improvement in supplies had reduced pressure in markets for certain nonferrous metals, where the largest price advances had occurred in 1964. At the end of January average prices of common stocks were at record highs.

Much of the support for recent advanced levels of industrial activity was contributed by increased inventory accumulation; for the fourth quarter as a whole business inventories rose at a rate twice that earlier in the year. Record sales of automobiles were limiting replenishment of dealer stocks depleted during