FIFTY SECOND

Annual Report

OF THE

BOARD OF GOVERNORS

OF THE FEDERAL RESERVE SYSTEM

COVERING OPERATIONS FOR THE YEAR

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.

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 the strike period, but steel users were continuing to increase stocks in anticipation of a possible spring strike in that industry. Inventories of other goods also were expanding, including consumer durable goods other than automobiles.

The administration's budget message, recently transmitted to the Congress, suggested that fiscal policy would be more stimulative in the second half of the calendar year 1965 than in the first half. The projected patterns of expenditures and receipts implied a larger-than-usual swing in the cash budget from a first-half surplus to a second-half deficit. The additional fiscal stimulus expected after midyear stemmed mainly from proposed increases in social security benefit payments and grants to State and local governments and reductions in excise taxes.

The money supply, which had risen more slowly in December than earlier, increased substantially in early January but was estimated to have declined later in the month. Commercial bank time and savings deposits were expanding unusually sharply, suggesting that banks were competing successfully for savings flows under the new higher ceilings established under Regulation Q. A marked strengthening in business loans at city banks in early January was related in part to inventory accumulation and may also have reflected increased foreign lending. Free reserves at member banks averaged about $90 million in January, compared with a December average of about $130 million.

Some hesitancy had developed recently in security markets as a result of growing investor concern over possible implications of balance of payments developments for monetary policy. Since mid-January the 3-month Treasury bill rate had risen about 10 basis points to a level of 3.88 per cent. In the latter part of January yields on long-term Treasury issues also advanced somewhat as dealers continued to distribute securities acquired in the January advance refunding. Subscription books were open on the day preceding this meeting for the Treasury's regular February refunding, which involved a cash sale of a

21-month note to refinance the $2.2 billion of securities maturing at midmonth that remained outstanding.

The U.S. balance of payments deficit in 1964 was now estimated at $3 billion, well above earlier expectations. Half of the 1964 deficit was incurred in the fourth quarter alone; loans to foreigners by domestic banks rose sharply, and a large volume of foreign security issues was sold in the United States. Outflows of short-term bank loans and liquid funds were particularly heavy in December, although fragmentary data suggested that some of these flows were reversed in January. It was expected that an administration message on special measures to deal with the balance of payments problem would be transmitted to the Congress shortly.

The Committee decided to modify its policy at this time by moving gradually toward slightly firmer money market conditions. In view of the moderate size of the Treasury's current financing and the relatively short maturity of the security to be issued, the Committee agreed that as strict an adherence to an "even keel" policy as was usual during Treasury operations was not required at present. Because of this financing, however, and because distribution of the securities issued in the January advance refunding was still in process, it was decided that the policy change should be implemented cautiously. The objectives sought included some reduction in growth rates of bank credit and the money supply and moderately higher short-term interest rates, all of which would require moderately lower reserve availability.

This action was taken primarily because of the persistence of the deficit in the U.S. balance of payments and the recent sharp increase in capital outflows, and it was hoped that it would buttress the administration's expected program of special measures to strengthen the international position of the dollar. The Committee concluded that the action would not have injurious domestic effects in light of the strength of the economy. Some members thought that a slight reduction in monetary ease also was appropriate on domestic grounds in view of the latent inflationary pressures they saw, and some expressed the view that it would tend to sustain the current expansion by helping to avoid speculative excesses.

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, including the generally strong and continuing expansion of the domestic economy and the continuing adverse position of our international balance of payments, it remains the Federal Open Market Committee's current policy to accommodate growth in the reserve base, bank credit, and the money supply but at a more moderate pace than in recent months. This policy seeks to avoid the emergence of inflationary pressures and to support other measures that may be taken to strengthen the international position of the dollar.

To implement this policy, while taking into account Treasury financing, System open market operations over the next 4 weeks shall be conducted with a view to moving toward slightly firmer conditions in the money market than have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Hickman, Mills, Shepardson, Shuford, Swan, and Wayne. Votes against this action: Messrs. Mitchell and Robertson.

Messrs. Mitchell and Robertson dissented from this action because they believed that additional monetary restraint was not warranted either by present domestic conditions or by the balance of payments situation. They noted that the present high levels of demand for steel and automobiles were likely to be only temporary, and that any expansive effects of the Federal fiscal program would not be felt until the second half of the year. As to the balance of payments, they thought that—in view of the large differentials existing between interest rates in the United States and abroad—a policy change large enough to reduce capital outflows significantly would have severe deflationary effects on the economy. For this reason, Mr. Robertson felt that the appropriate remedy for the international payments problem lay elsewhere than in the area of monetary policy, and Mr. Mitchell thought it lay in specific measures to remove the disequilibrating effect of international interest rate differentials. Mr. Robertson added that in his judgment Treasury financing operations and the recent weakness in security markets also argued for keeping policy on a steady course at present.

March 2, 1965

1. Authority to effect transactions in System Account.

Economic activity was continuing to advance after four consecutive years of expansion. In January, steel and automobile production remained at high levels, and output gains in a broad variety of other industries carried total industrial production to a new peak. Retail sales continued strong in January and early February; sales of new domestic cars were at a record annual rate of 9.7 million units in the first month of the year. Although stock-sales ratios remained low, rough estimates suggested that the rate of inventory accumulation continued high in early 1965 after turning up sharply in the closing months of 1964. Much of the accumulation still was related to strikes—both the possible strike in steel and the earlier strike in automobiles—but stocks of other commodities apparently also were growing rapidly. Labor markets were strong in January: nonfarm employment increased further; the average manufacturing workweek was extended to the longest period since World War II; and the unemployment rate declined to 4.8 per cent from 5 per cent in December.

Average industrial commodity prices, which had risen six-tenths of 1 per cent in the fourth quarter of 1964, edged up one-tenth of a per cent in January. Weekly estimates through mid-February suggested no further change, and the average remained within the broad range of recent years.