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.

in consultation with the Federal Open Market Committee, or in an emergency with the members of the Committee designated for that purpose, reaches a judgment that they may help to re-establish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified, curtailed, or eventually discontinued pending a reassessment by the Committee of supply and demand forces.

Insofar as is practicable, the New York Bank shall purchase a currency through spot transactions at or below its par value, and sell a currency through spot transactions at rates at or above its par value.

Spot transactions at rates other than those set forth in the preceding paragraph shall be specially authorized by the Committee or by the members of the Committee designated in Section VIII of the Authorization for Open Market Transactions in Foreign Currencies, except that purchases of exchange to meet System commitments may be executed without special authorization at rates above par when necessary.

4. Transactions in Forward Exchange

Transactions in forward exchange, either outright or in conjunction with spot transactions, may prove desirable:

(1) When forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to disequilibrating movements of short-term funds;

(2) When it is deemed appropriate to supplement existing market supplies of forward cover, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders;

(3) To allow greater flexibility in covering System commitments, including those under swap arrangements;

(4) To facilitate the use of holdings of one currency for the settlement of commitments denominated in other currencies.

Forward sales of authorized currencies to the U.S. Stabilization Fund out of existing System holdings or in conjunction with spot purchases of such currencies may also prove desirable in order to allow greater flexibility in covering commitments of the U.S. Treasury.

In all other cases, proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Scanlon, Shepardson, and Clay. Votes against this action: None.

4. *Review of continuing authorizations.*

This being the first meeting of the Federal Open Market Committee following the election of new members from the Federal Reserve Banks to serve for the year beginning March 1, 1965, and their assumption of duties, the Committee followed its customary practice of reviewing all of its continuing authorizations and directives. The actions taken with respect to the continuing authority directive for domestic open market operations and the guidelines for System foreign currency operations have been described in the preceding portions of the entry for this date.

The Committee reaffirmed its authorization regarding open market transactions in foreign currencies and its continuing authority directive on foreign currency operations, in the form in which they were outstanding at the beginning of the year 1965, as set forth in the preface to this record of policy actions.

Votes for these actions: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Scanlon, Shepardson, and Clay. Votes against these actions: None.

March 23, 1965

1. *Authority to effect transactions in System Account.*

The domestic business situation continued strong, according to reports at this meeting. Industrial production, retail sales, and nonfarm employment all rose to new record levels in February, although the unemployment rate returned to 5.0 per cent after dipping to 4.8 per cent in January. Weekly estimates suggested that average industrial commodity prices remained stable from mid-January through early March at a level less than 1 per cent above that prevailing in the first 9 months of 1964.

The near-term outlook appeared generally favorable despite uncertainties related to labor negotiations in the steel industry and to apparently unsustainable rates of activity in steel and automobiles. As to the latter, it seemed doubtful that sales of new cars would maintain the exceptionally high rate set in the first 2 months of 1965, which was about one-fifth above the year-earlier level. On the other hand, a survey by the U.S. Department of Commerce and the Securities and Exchange Commission of business plans for plant and equipment expenditures, taken in February, implied that capital outlays would grow throughout 1965, and for the year as a whole would average about 12 per cent above their 1964 level.

Bank credit expanded at an annual rate of about 11½ per cent in the first 2 months of the year, considerably above the 8 per cent rise in 1964, and time and savings deposits continued to increase rapidly. In addition to meeting strong loan demands, banks added to their holdings of municipal issues, while substantially reducing their holdings of Treasury bills. Credit growth continued rapid in early March, according to data for city banks, but the rate of increase in time and savings deposits moderated. The money supply, which had declined in February, advanced sharply in the first half of March. Aggregate borrowings of member banks from the Reserve Banks were greater than their excess reserves in the first 3 weeks of March, with net borrowed reserves averaging about $40 million; in February excess reserves had exceeded borrowings by about $30 million.

Interest rates on most money market instruments continued firm or rose in recent weeks against the background of seasonally heavy liquidity needs associated with the March corporate dividend and tax dates, but the 3-month Treasury bill yield had declined about 5 basis points since early March to 3.92 per cent. The disparate behavior of bill yields apparently partly

reflected temporary investments in bills of corporate funds being repatriated under the administration's program calling for voluntary efforts to restrain foreign lending and investment; any concomitant liquidation of dollar assets by foreign holders may have involved a broader variety of instruments. Treasury bond yields also declined, and yields on corporate and municipal bonds, which had advanced from late January to early March, stabilized at about the levels prevailing in the autumn of 1964.

The Treasury's gold stock declined by $825 million in the first 11 weeks of 1965, after decreasing by only $125 million in all of 1964. Although little firm statistical information was available as yet on the impact of the administration's balance of payments program, announced February 10, incomplete weekly figures suggested a surplus in the over-all U.S. payments balance in the most recent 4 weeks, following substantial deficits in the preceding 6 weeks. Outflows on long-term bank loans to borrowers in developed countries apparently dropped abruptly after mid-February from their high rate earlier in the year. Consistent with this development and also with larger than seasonal withdrawals of U.S. corporate funds from the Euro-dollar market, interest rates advanced in that market, and the dollar strengthened in markets for foreign exchange.

The Committee decided that a further slight firming of money market conditions was desirable at this time. The object, in part, was to reinforce the program of voluntary efforts to restrain foreign lending and investment, but the action also was considered appropriate in view of the strength of the domestic economy and the potential threat to general price stability that might be posed by a continuation of recent high rates of bank credit expansion. Other reasons cited by some members for a slight firming in policy were the recent decline in Treasury bill rates —considered undesirable on balance of payments grounds—and the fact that repatriation of funds formerly invested abroad added to the availability of credit to domestic borrowers.

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

The economic and financial developments reviewed at this meeting indicate 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. In this situation, it is the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next 3 weeks shall be conducted with a view to attaining slightly firmer conditions in the money market.

Votes for this action: Messrs Martin, Hayes, Balderston, Bryan, Daane, Ellis, Scanlon, and Shepardson. Votes against this action: Messrs. Mitchell, Robertson, and Clay

Messrs. Mitchell, Robertson, and Clay dissented from this action on both domestic and balance of payments grounds. In their judgment the likely pace of the advance in business activity did not call for a firmer policy, particularly in view of the declines expected before long in the steel and automobile industries. In connection with the balance of payments, Messrs. Robertson and Clay felt that the recently launched administration program also provided grounds for not changing policy at this time. None of the dissenting members thought a change in policy was called for by the recent decline in Treasury bill rates relative to other money market rates. Mr. Robertson did not consider international bill rate differentials to be a good measure of rate incentives to capital flows; moreover, there appeared to be a reflux of short-term funds, rather than an outflow, at present. In Mr. Mitchell's judgment, higher Euro-dollar interest rates could give foreign central banks a desirable incentive to dispose of some of their dollar holdings to their own nationals

to relieve pressures in that market, and it would be a mistake to offset any such tendency by higher U.S. interest rates.

2. Authority to purchase and sell foreign currencies.

On March 2, 1965, the Committee had approved a number of revisions in the guidelines for System foreign currency operations. At this meeting the Committee approved further revisions, affecting the first and second paragraphs of Section 4 of the guidelines, for the purpose of language clarification. The revisions in both paragraphs involved replacing the words, "may prove desirable" with the words, "may be undertaken." As amended, Section 4 of the guidelines read as follows:

4. Transactions in Forward Exchange

Transactions in forward exchange, either outright or in conjunction with spot transaction, may be undertaken:

(1) When forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to disequilibrating movements of short-term funds;

(2) When it is deemed appropriate to supplement existing market supplies of forward cover, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders;

(3) To allow greater flexibility in covering System commitments, including those under swap arrangements;

(4) To facilitate the use of holdings of one currency for the settlement of commitments denominated in other currencies.

Forward sales of authorized currencies to the U.S. Stabilization Fund out of existing System holdings or in conjunction with spot purchases of such currencies also may be undertaken in order to allow greater flexibility in covering commitments of the U.S. Treasury.

In all other cases, proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Robertson, Scanlon, Shepardson, and Clay. Votes against this action: None.

The Committee also amended the continuing authority directive for foreign currency transactions to increase, from $2.35 billion to $2.65 billion, the dollar limit specified in the first paragraph on the aggregate amount of foreign currencies held under reciprocal currency arrangements. It had been the Committee's practice to set this limit at the sum of the amounts currently specified by the Committee for all individually authorized reciprocal currency arrangements, which represented the maximum of System covered holdings of foreign currencies under these arrangements in the remote possibility that they might all simultaneously be fully drawn on. This revision reflected authorization earlier in the present meeting to increase the sizes of the reciprocal currency arrangements with the Bank of Italy from $250 million to $450 million, and with the Bank of Japan from $150 million to $250 million.

Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Robertson, Scanlon, Shepardson, and Clay. Votes against this action: None.

April 13, 1965

Authority to effect transactions in System Account.

Reports at this meeting indicated that the business expansion was vigorous and broadly based. Nonfarm employment advanced in March to a level more than 2 million higher than a year earlier, and the unemployment rate dropped to 4.7 per cent, the lowest figure in more than 7 years. Industrial production also rose to a new high, with gains widespread among materials and finished products. Tentative weekly data suggested that retail sales had declined moderately in March after allowance for usual seasonal influences, as consumer purchases of automobiles and other durables rose less than seasonally. Retail sales figures

for January and February had been revised upward, however, and first-quarter sales were at a record level.

Output in the steel and automobile industries continued at extraordinarily high rates. Although auto production currently exceeded consumer purchases, it was expected to remain large at least for a few more months as dealers increased inventories. The prospects for steel depended on the outcome of current wage negotiations, since users were continuing to accumulate stocks against the possibility of a strike. The present labor contract in the steel industry was scheduled to expire on May 1.

Some sensitive commodity prices, particularly of nonferrous metals and products, recently had begun to advance again, but average industrial prices had been essentially stable thus far in 1965 following a rise of three-fourths of 1 per cent during the preceding autumn. The consumer price index was unchanged in February at a level 1.2 per cent above a year earlier.

The demand for business loans at commercial banks continued unusually strong in March, and bank credit rose at an even faster rate than in the first 2 months of the year. At the same time the earlier rapid expansion in time and savings deposits slackened markedly, while the money supply increased by the amount it had declined in February. In the first quarter as a whole, bank credit expanded at a 13 per cent annual rate, compared with about 7 per cent in the fourth quarter of 1964; time and savings deposits and the money supply combined advanced at a rate of about 9 per cent, little changed from the preceding quarter.

Net borrowed reserves of member banks averaged about $130 million in the last week of March and the first week of April, compared with an average of $30 million earlier in March. The tone of the money market was somewhat firmer, with Federal funds frequently trading at rates about the 4 per cent discount rate. However, yields on Treasury securities and corporate and municipal bonds had shown little net change since the preced-