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.

Belgian francs
Canadian dollars
Austrian schillings
Swedish kronor
Japanese yen

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.

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.

The Federal Reserve Bank of New York is also authorized and directed to make purchases of sterling on a covered or guaranteed basis in terms of the dollar up to a total of $50 million equivalent.

Votes for this action: Messrs. Martin, Balderston, Daane, Galusha, Maisel, Mitchell, Robertson, Scanlon, Shepardson, Bopp, Irons, and Treiber. Votes against this action: None.

August 31, 1965

Authority to effect transactions in System Account.

Reports at this meeting confirmed earlier estimates that industrial production and retail sales had reached new highs in July. Production gains in both June and July were larger than in most earlier months of the year as a result of further advances in output of business equipment and of materials, including steel; consumer goods output continued to show little change at a level about 5 per cent above a year earlier. Manufacturers' inventories rose considerably in July, following three quarters in which total business inventories had increased at a more rapid rate than earlier in the current business expansion. The unemployment rate, which had declined to 4.5 per cent in July, remained at that level in August.

Business sentiment recently had become more buoyant, as activity continued to expand faster than had been expected and as prospects for further advances were enhanced by expected rises in military outlays in connection with the Viet Nam hostilities. To date, however, developments in Viet Nam did not appear to have given any sharp, direct stimulus to consumer or business spending, and the timing and amount of expected increases in military expenditures remained highly uncertain.

Additional major uncertainties were associated with the situation in the steel industry. Labor negotiations were still in process at the time of this meeting, and the interim agreement, originally scheduled to expire on September 1, had been extended 8 days at the request of the President. It was not clear whether a settlement would be arrived at without a strike, nor what the terms of the settlement would be. Also in doubt were the probable dimensions and timing of the reduction in steel inventories expected to follow the conclusion of a labor agreement; it was possible that the amount of liquidation, while still substantial, would be less than anticipated earlier, particularly if it appeared that military needs for steel would rise rapidly or if the terms of the labor agreement made future increases in steel prices more likely.

Average wholesale prices of industrial commodities, which were stable in July, appeared to have edged up in August, but changes continued selective, without any general response to developments in Viet Nam. The total wholesale price index was estimated to have declined slightly in August as a result of some reductions for foods, which had accounted for most of the rise in the index earlier in the year. The consumer price index rose slightly further in July, despite declines for some products resulting from reductions in excise taxes.

The demand for business loans at banks continued strong and commercial bank credit, which had declined in July, was expanding again in August. Growth of time deposits accelerated from the high July rate, but growth in the money supply moderated further. Average net borrowed reserves of member banks continued to show little change.

The latest information on U.S. international payments indicated that a deficit occurred in August and, contrary to earlier reports, that payments probably were in deficit in July also. Gold outflows continued, but at a lower rate than in the first half of the year. In foreign exchange markets, there had been some improvement recently in attitudes with respect to the outlook for sterling, but the situation remained delicate.

Conditions in domestic money markets generally were steady in recent weeks, although yields on 3-month Treasury bills rose several basis points. Bond markets weakened considerably. Treasury bond yields advanced to their highest levels since the spring of 1964, and yields on new issues of high-grade corporate bonds broke through their June peaks to levels not reached since the summer of 1961. To some extent, the rise in corporate

bond yields stemmed from unseasonally large recent and prospective flotations; and the rise in yields on Treasury bonds reflected the growing attractiveness of corporate yields for institutional investors. Also, dealer holdings of longer-term issues were still sizable, despite recent reductions as a result of official purchases. To a major extent, however, the yield advances reflected a shift in investor expectations regarding the economic outlook and the future course of interest rates. A variety of factors contributed to this shift, including the unexpectedly strong performance of the economy, developments in Viet Nam, uncertainties regarding the probable terms of the steel wage settlement, continued nervousness about the prospects for sterling, and the possibility that a firmer monetary policy might be required for domestic or balance of payments reasons.

The Committee decided that no change should be made in policy at this time, partly because of the various existing uncertainties. Cited in this connection were the uncertainties about the outcome of wage negotiations in the steel industry and about the likely magnitude and duration of the expected subsequent reduction in steel inventories; the lack of reasonably precise information regarding the probable impact of developments in Viet Nam on the economy; the still sensitive position of sterling in foreign exchange markets; and the possibility that, in view of the recent weakening in bond prices, domestic security markets might over-react to any firming of monetary policy, however modest was the intended change.

Some members who agreed that such factors made a policy change inappropriate at present indicated that in the absence of these factors they might have been inclined toward a shift in the direction of firming. Among the grounds for firming mentioned by members in this group were the strength in the business outlook and the prospects for further price advances; the continued rapid growth in business loans at banks; and the recently less favorable balance of payments situation. Other members expressed the view that even apart from the existing uncertainties a firmer policy was not warranted at present. In their judgment a reduction in the rate of over-all inventory accumulation was likely to act as an offset to the economic stimulus of developments in Viet Nam, and they saw little ground at the moment for expecting inflationary pressures to develop in the near future.

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 that the domestic economy has expanded further, but with markets characterized by uncertainties as to possible developments in steel, sterling, and Viet Nam. Our international payments have reverted to deficit in August, and gold outflows have continued, although at a more moderate rate. In this situation, it remains the Federal Open Market Committee's current policy 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 until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account unsettled conditions in securities and foreign exchange markets.

Votes for this action: Messrs. Martin, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Robertson, Scanlon, Shepardson, and Irons. Vote against this action: Mr. Treiber.

Mr. Treiber dissented because he believed that domestic considerations warranted some restriction in credit availability before inflationary pressures gained momentum, and because in his judgment the need to bring about a fundamental improvement in the international payments of the United States was pressing. While agreeing that, in light of the various existing uncertainties, caution would be required in reducing the degree of credit availability, he felt that moderate action of that kind would not have untoward consequences.

September 8, 1965

Authority to purchase and sell foreign currencies.

At this meeting, which was held by telephone, the Committee amended the final paragraph of the continuing authority directive for foreign currency transactions to increase the dollar limit specified for purchases of sterling by the Federal Reserve Bank of New York on a covered or guaranteed basis in terms of the dollar to $200 million equivalent from $50 million equivalent.

Votes for this action: Messrs. Martin, Balderston, Daane, Ellis, Maisel, Robertson, Scanlon, Shepardson, Clay, Irons, and Treiber. Votes against this action: None.

For several weeks negotiations had been in process among Britain, the United States, and a number of other countries on a program designed to assist the recovery of sterling, and today's action was taken in connection with that program, on recommendation of the Special Manager of the System Open Market Account. The U.S. Treasury was planning to participate with the Federal Reserve in the package of assistance.

September 28, 1965

Authority to effect transactions in System Account.

Economic activity advanced further against a background of optimistic business sentiment, and most analysts reportedly