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.

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.
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> 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 were now expecting the expansion to continue for some time. Conditions in financial markets had become firmer, and average prices of common stocks had recovered to about their spring highs on heavy trading volume.

Some of the major uncertainties existing at the time of the preceding meeting had since been clarified. The position of sterling in foreign exchange markets improved markedly following announcements by the British Government in the early part of September of further measures to restrain wage and price increases and of new international agreements in support of the pound. Domestically, labor negotiations in the steel industry had been concluded with a settlement that appeared to be about in line with the administration's guideposts.

Industrial production and nonfarm employment rose slightly in August, and the unemployment rate continued at the reduced level of 4.5 per cent reached in July. Retail sales declined by 1 per cent from their high July rate but appeared to be rising again in early September, with automobile sales particularly strong. Average prices of industrial commodities edged up in August but, according to preliminary estimates, had changed little further by mid-September.

Business inventory investment, which had been tending down from the exceptionally high rate reached in the first quarter, was expected to moderate further following the settlement of wage negotiations in the steel industry. Nevertheless, further gains seemed likely in final purchases by businesses as well as by government and consumers. The latest Commerce–SEC survey of business plans for fixed capital outlays indicated that such outlays in 1965 would be about 13.5 per cent above 1964, in contrast to rises of about 12 and 12.5 per cent shown in the February and May surveys, respectively. Moreover, sharply advanced capital appropriations reported by large manufacturing companies in a private survey suggested that the momentum of the expansion in capital spending was likely to

carry forward into 1966. Although the dimensions of the expected increase in Federal expenditures as a result of the hostilities in Viet Nam were still in doubt, Federal spending—for both defense and nondefense purposes—was rising, and spending by State and local governments was continuing to grow. Personal incomes were expected to show an unusually large increase in September because of higher social security benefit payments retroactive to the first of the year and increased military pay rates. According to a Census Bureau survey taken in July, consumers were optimistic about their income prospects, and more of them reported plans to buy new automobiles and houses than a year earlier.

The money supply expanded substantially in September as Treasury deposits were drawn down sharply, but the rate of growth in time and savings deposits fell off somewhat. According to data for city banks, the rate of increase in commercial bank credit, which was high in August as a whole, moderated late in that month and early in September. Among the factors accounting for the more moderate recent growth were the reduction in Treasury deposits, some liquidation of inventory loans by metal-using companies following the steel settlement, slackened growth in bank holdings of municipal and other securities, and cumulating pressures on bank reserve positions. Renewed heavy borrowing by businesses around the September tax date suggested that underlying demands for business loans remained strong, and there were indications that interest rate and other terms on bank loans were becoming firmer. Average net borrowed reserves of member banks in the first 4 weeks ending in September were estimated at about $120 million, down from the August average of about $170 million.

Interest rates on Treasury and corporate bonds rose further in September, and State and local government bond yields, which had been relatively stable in August, increased sharply.

Yields on 3-month Treasury bills changed comparatively little over the first 3 weeks of the month, but subsequently the rate moved up about 10 basis points and reached a level of 3.99 per cent on the day preceding this meeting. The Treasury had announced that on October 5 it would auction $4 billion of tax anticipation bills, and the rise in bill rates in part reflected the forthcoming additions to supplies. But it also reflected a general heightening of money market pressures following the mid-September tax date that resulted from strong credit demands and a distribution of bank reserves away from the central money markets. In addition to bill yields, other short-term rates advanced, including the effective rate on Federal funds and rates offered by New York banks on negotiable certificates of deposit with maturities of less than 6 months.

In July and August the deficit in the U.S. balance of payments on the "regular transactions" basis now appeared to have been at an annual rate slightly higher than the $1¼ billion rate recorded in the first half of the year. The trade balance apparently improved somewhat after midyear, but net U.S. private capital outflows increased more as reflows of liquid funds and bank credit appeared to be tapering off. In the second quarter, according to newly available data, outflows of direct investment capital were much larger than most analysts had expected.

Prior to reaching a decision on the appropriate objective of monetary policy at this juncture, the Committee explored several possible alternatives. These included maintaining approximately the current conditions in the money market; supplying reserves in sufficient quantity that the money market rates that had prevailed before the recent increase in pressures would again be approached; and reinforcing the recent trend in the market toward firmer conditions, or at least not offsetting a furtherance of this trend if produced by market forces. The

conclusion of the majority was that it would be desirable to maintain about the current conditions, while a minority favored fostering a return to the general market conditions that had prevailed earlier. Some members of the majority felt that neither domestic nor international considerations warranted further firming at this time, although they did not consider it desirable to pursue the course recommended by the minority. Other members of the majority thought that the main reason for maintaining the status quo, as contrasted with a further firming, was the forthcoming Treasury financing, with Britain's continuing effort to restore the position of sterling mentioned as another consideration. Otherwise, they indicated, factors such as the inflationary pressures they thought were inherent in the strong business outlook and the continuing balance of payments problem might have been persuasive influences to them.

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 in a climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit since midyear. Some of the uncertainties previously affecting foreign exchange markets have diminished. 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, and taking into account the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current conditions in the money market.

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

Messrs. Maisel, Mitchell, and Robertson dissented from the action taken by the Committee on two grounds. First, they felt that the recent sharp increases in both short- and long-term interest rates were partly the result of the fact that nonborrowed reserves were not being supplied at the rate required by the growing economy. They anticipated that there would be still further increases in interest rates and tightening of credit availability in longer-term financial markets if reserve growth continued to be held below the economy's needs. In their judgment evidence was lacking that inflation either existed or was just around the corner and, accordingly, their preference was to see no greater credit restraint develop at this time. To assure such an outcome they favored open market operations designed to move conditions in the central money markets back to around their averages for the month of September. Second, the dissenting members felt that the language in the directive referring to "maintaining about the current conditions in the money market" was vague and open to misinterpretation, especially in the light of the sharp tightening in market conditions that actually had taken place over the past month when open market operations were being conducted under a similar "no change" directive. In particular, they were concerned that the wording of the directive would permit further tightening of credit conditions, even though couched in terms which could be otherwise construed.

October 12, 1965

Authority to effect transactions in System Account.

Information that had become available in the 2-week period since the previous Committee meeting lent further confirmation

to the view that domestic economic activity was generally strong and was continuing to expand.

Industrial production appeared to have declined slightly in September, principally because excess steel inventories were beginning to be reduced. The labor market remained strong, however, and the unemployment rate dropped to 4.4 per cent, the lowest level in many years. Retail sales remained at a high level.

According to weekly estimates, the industrial commodity price index had edged up since mid-August, bringing the total rise to 1.5 per cent since the summer of 1964, but foodstuffs continued to decline from their July peak and the total wholesale price index remained at the June-August level. The consumer price index, after rising more than 1 per cent from March to July, declined two-tenths of 1 per cent in August due to the drop in average food prices.

Sales of new domestic automobiles in September remained at the 8.9 million annual rate of the previous 3 months, and prices for the 1966 models—most of which had now been introduced—appeared close to those for the 1965 models. The growth of consumer instalment credit slowed in August, on a seasonally adjusted basis, but early reports for September suggested a return of the rate of net borrowing to levels somewhat above August.

New orders for durable goods showed somewhat less decline in August than preliminary figures had indicated, due mainly to an upward revision in new orders for defense production. Business inventory accumulation in August was not as large as in July; but for the 2 months combined accumulation exceeded the second-quarter rate and approached the high rate of the first quarter. Construction expenditures during the third quarter were unchanged from their second quarter level as higher outlays for business, other private nonresidential, and public con-