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.

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 construction offset a downdrift in residential construction activity.

In financial markets there was a slackening in the pace of bank credit expansion in September. The annual rate of growth in the third quarter was estimated at 5.5 per cent compared with approximately 12.5 per cent and 10 per cent in the first and second quarters, respectively. However, when security loans were excluded, total loans rose at an annual rate of about 13 per cent in the third quarter, which was 1 percentage point above the 1964 rate. The demand for business loans had been strong recently after moderating somewhat in late August and early September; for the month of September as a whole such loans expanded at an annual rate of almost 13 per cent.

Following a slowdown in August, the money supply rose in September at a seasonally adjusted annual rate of almost 12 per cent; this reflected in part an unusually sharp reduction of U.S. Government deposits. For the year to date the money supply had grown at an annual rate of 3.8 per cent, a little below the rate for 1964. Time and savings deposit growth in September was at an annual rate of 12 per cent, considerably below the rates of the previous 2 months. While savings deposit inflows remained strong, run-offs of negotiable certificates of deposit were heavy during the September tax and dividend period and only about half had been replaced by the end of the month. Certain major banks had recently pushed their offering rates on certificates to, or close to, the ceiling of 4.5 per cent.

Money market conditions had eased slightly since the period of considerable pressure toward the end of September, with bill rates and other interest rates dropping back somewhat. The supply situation as to Treasury bills had been eased considerably by the System's large purchases of bills to supply needed reserves during the late September period. This abatement of market pressures enabled the Treasury to auction $4 billion of tax anticipation bills at somewhat lower rates than earlier anticipated, and the demand for these bills in the secondary market

proved to be better than many had expected earlier. The Treasury was expected to announce in late October the terms of its November refunding; $3.3 billion of maturing securities were held by the public. Trading activity in the stock market remained heavy, although the volume was somewhat below the high daily average for the month of September. Prices continued to move in a rather narrow range at about the highs reached in the spring of the year.

U.S. foreign trade showed some improvement in July and August. The trade surplus exceeded a $6½ billion annual rate in those months as exports rose by about 4 per cent in July and again in August while the growth in imports appeared to have tapered off. Nevertheless, preliminary data for the third quarter suggested a payments deficit on the "regular transactions" basis at an annual rate in the order of magnitude of $1¼ billion, and it appeared that in September the "official settlements" balance may have reverted to deficit on a seasonally adjusted basis. In foreign exchange markets the outstanding recent development had been the further recovery of sterling, which was now trading at a spot rate above par.

In the Committee's discussion of the course of monetary policy, some members noted that any significant move toward further firming would almost inevitably soon require consideration of changes in the discount rate and in the maximum rates of interest permitted to be paid on time and savings deposits. It was the predominant view that such changes would not be advisable at this particular time. Accordingly, the discussion focused on a relatively narrow range of policy objectives during the forthcoming 3-week period. Most members of the Committee believed that the best short-run alternative would be to maintain about the existing degree of money market firmness, recognizing that objectives expressed in terms such as bill rates, net borrowed reserves, and Federal funds rates might not prove to be mutually compatible. In this regard, there was some disposition to feel that the level of net borrowed reserves, one of the indicators of market conditions, should be assigned a less prominent role than usual in the current context. Other members of the Committee, who expressed concern about potential inflationary pressures against a background of large cumulative increases in bank credit and the international payments problem, thought that any doubts in the conduct of open market operations should be resolved on the side of a firmer market tone. On the other hand, some members felt that in the absence of clear evidence of a break-out of inflationary conditions care should be exercised against basing actions on expectations, and that any doubts therefore should be resolved on the side of easing bank reserve positions slightly.

At the conclusion of the discussion, 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 over-all domestic economic activity has expanded further in a continuing climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit on the "regular transactions" basis since midyear. 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 Treasury financing schedule, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining a firm tone in the money market.

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

November 2, 1965

Authority to effect transactions in System Account.

Gross national product advanced at an annual rate of $11 billion in the third quarter of 1965, according to preliminary estimates, compared with an increase of $9.5 billion in the preceding quarter. Although the adjustment of steel inventories was producing a considerable drop in the rate of business inventory accumulation and a leveling off in industrial production in the fourth quarter, another substantial rise in GNP appeared likely as marked further gains were expected in outlays for business fixed investment, in Federal defense outlays, and in consumer incomes and spending.

Contrary to earlier indications, average prices of industrial commodities were stable from mid-August to mid-September, and weekly estimates showed little change through late October. The consumer price index rose by two-tenths of 1 per cent in September, the amount by which it had declined in August, with seasonal increases in apparel and fuels accounting for much of the rise.

Partial data for October suggested that industrial production might have been maintained at about the September level, 1 per cent below the previous month, despite a further decline in steel output. In September, strikes in a number of industries and the impact of "Hurricane Betsy" on crude oil output had served to reinforce the effects of the steel contraction on total output; subsequently, however, settlement of the strikes and recovery of oil production had acted to offset the further contraction.

Growth in the money supply was rapid in early October—although less so than during September—partly because U.S. Government deposits were reduced further. Loan demand at commercial banks continued strong and seemed likely to remain vigorous over the final months of the year despite reduced needs for funds by firms that had been stockpiling steel. Net borrowed