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.

November 23, 1965

1. Authority to effect transactions in System Account.

Prospects for continued substantial gains in business activity in the current quarter and in early 1966 were firmer than 3 weeks earlier, according to reports at this meeting. It now appeared that the fourth-quarter reduction in the rate of business inventory accumulation might be somewhat smaller than anticipated earlier, and the outlook was strong for all major categories of final demand except residential construction, which had declined slightly in the third quarter.

Industrial production increased somewhat in October as another large monthly decline in steel output was more than offset by production gains in business equipment, defense, and some consumer goods industries. Retail sales rose appreciably in the month to a new record level. The demand for labor continued strong, and the unemployment rate edged down further to 4.3 per cent from 4.4 per cent in September.

According to a private survey taken in October, businesses planned to spend about 8 per cent more on new plant and equipment in 1966 than they had in 1965. It was possible that the actual gain in capital spending would be larger than these plans implied; in each of the past 4 years expenditures rose substantially more than indicated by this survey in the preceding autumn.

The index of industrial prices edged up in October, and weekly estimates suggested a further slight rise in November. Since midyear the average of these prices had advanced at an annual rate of about 1 per cent, compared with a rate of about 2 per cent in the preceding 9 months.

The money supply increased substantially in October; for the first 10 months of the year growth was at a 4.4 per cent annual rate, about the same as in the year 1964. Time and savings deposits continued to expand at the third-quarter annual rate of nearly 17 per cent. In late October and early November

interest rates on negotiable certificates of deposit at New York banks generally were at the maximums permissible under the Board's Regulation Q.

Bank credit grew at a rapid pace in October, with much of the expansion accounted for by acquisitions of U.S. Government issues and loans to Government security dealers reflecting Treasury financing activity. Business loan expansion moderated, partly because of liquidation of inventory borrowings by metals-using firms but also, perhaps, because of increased capital market financing. Corporate bond issues were large in recent weeks, and the calendar of forthcoming issues was heavy.

Rates on 3-month Treasury bills fluctuated in a 4.04-4.10 per cent range recently, on balance rising somewhat. Yields on corporate and municipal bonds and on Treasury notes and bonds advanced further in early November. The initial reception to the Treasury's November refunding, involving sale of an 18-month 4¼ per cent note for cash, was less favorable than expected. This introduced a new element of uncertainty in the Government securities market, although the reaction was moderated by purchases of the new security on a "when issued" basis for Treasury investment accounts. In a telephone conference meeting held on November 4 to review the situation, the Committee agreed that the Manager should make similar purchases for the System Account if he judged that circumstances warranted them. Such purchases, however, did not prove necessary. Subsequently, yields on Treasury notes and bonds retreated somewhat from their peaks and the tone in the corporate market improved, although municipal yields continued to move up. A Treasury auction on November 17 of $2.5 billion of tax anticipation bills due in June proceeded uneventfully. The Treasury was expected to announce, before the end of the year, another cash financing to be held in January.

Starting with preliminary data for the third quarter, the Department of Commerce began summarizing the U.S. international payments position in a new way, involving "liquidity" and "official settlements" balances.[1] On the previously used "regular transactions" basis of calculation, the deficit (seasonally adjusted) was $615 million in the third quarter and $1.3 billion in the first 3 quarters. On the "liquidity" basis, the third-quarter deficit was $485 million and that for the first 3 quarters $940 million. The alternative "official settlements" balance showed a surplus in the third quarter of $260 million, and a deficit in the first 3 quarters of $160 million. The outlook, based partly on available data for October, appeared to be for a deficit on the "regular transactions" basis in the fourth quarter at about the same rate as in the year to date, but a shift in the "official settlements" balance from surplus in the third quarter to deficit in the fourth.

In the course of the Committee's discussion some members expressed the opinion that an overt move to a firmer monetary policy, in the form of an increase in the Federal Reserve discount rate, would be in order in the very near future, assuming economic conditions continued as at present. To facilitate orderly market adjustments in the event such an action was taken, they advocated open market operations directed toward maintaining the present, or if necessary a somewhat greater, degree of reserve availability. In the judgment of these members a discount rate increase would contribute to more balanced and sustainable economic growth domestically and to a stronger dollar internationally, by countering the inflationary pressures inherent in the prospects for rising aggregate demands, augmented by increasing Federal defense expenditures, and declining margins

[1] The "liquidity" balance reflects changes in U.S. reserves and in liquid U.S. liabilities to all foreigners; it differs from the "regular transactions" balance by including debt prepayments and military prepayments as receipts that reduce the deficit instead of helping to finance it. The "official settlements" balance reflects changes in U.S. reserves and in liquid and certain nonliquid U.S. liabilities to foreign official accounts, mainly monetary authorities. It differs from the "liquidity" balance by (1) treating changes in U.S. liabilities to foreigners other than official agencies as ordinary capital flows, and (2) treating changes in certain nonliquid liabilities to foreign monetary authorities as financing items rather than capital flows.

of unutilized resources. The view also was expressed that a discount rate increase and a concurrent upward adjustment in the maximum rates permitted to be paid by member banks on time deposits would help eliminate obstacles to the efficient flow of funds in credit markets that had resulted from recent changes in the interest rate structure. The members of this group thought that postponement of these steps might pose a serious problem of deposit run-offs for banks if market rates rose further at a time when the rates being paid for time certificates of deposit were pressing against current regulatory ceilings. Also, if these actions were not taken shortly, Treasury financing operations might preclude their being taken for some time.

Other members of the Committee, while sympathetic with the need for some firming of policy, expressed a preference for initially restraining growth in bank credit by a slight reduction in net reserve availability, and for considering an increase in the discount rate if and when market rates rose further. The possibility was noted that, in the present sensitive state of financial markets, discount rate action might lead to undesirably large market reactions. It also was suggested that if higher market rates, confirming the need for a discount rate increase, were to eventuate, they should reflect the pressure of rising credit demands against a steadily growing reserve base. The members of this group believed that a course of action such as they favored could be accommodated under a current economic policy directive similar to the one issued by the Committee at its meeting on November 2, 1965.

Still other members thought that neither a reduction in reserve availability nor a higher discount rate was warranted at this time; in their judgment a continuation of present System policies was best calculated to maintain the current strong performance of the economy. They noted that the rate of increase in industrial commodity prices had slackened recently, and they saw no present evidence of pervasive inflationary pressures. Also, they felt that it would be desirable to await the detailed information on Federal budget prospects that would be available in January before considering an increase in the discount rate.

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 is continuing a rate of expansion comparable to that of the third quarter despite the contractive effect of a reduction in steel inventories. Business sentiment continues optimistic and financial conditions are firmer. Meanwhile, our international payments have remained in deficit. 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 that have prevailed since the last meeting of the Committee.

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

2. Authority to purchase and sell foreign currencies.

At this meeting the Committee amended its continuing authority directive for foreign currency operations by adding a new final paragraph reading as follows:

The Federal Reserve Bank of New York is also authorized and directed to assume commitments for forward sales of lire up to $500 million equivalent as a means of facilitating the retention of dollar holdings by private foreign holders.

Concurrently, the Committee amended Section 4(2) of its guidelines for System foreign currency operations by adding the phrase, "directly or indirectly" after the first clause. As amended, Section 4 read as follows:

4. *Transactions in Forward Exchange*

Transactions in forward exchange, either outright or in conjunction with spot transactions, 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, directly or indirectly, 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 these actions. Messrs. Martin, Hayes, Balderston, Daane, Ellis, Galusha, Maisel, Mitchell, Patterson, Robertson, Scanlon, and Shepardson. Votes against these actions: None.

In 1964 and 1965 the Italian authorities had dealt with large international payments surpluses in the same manner they had employed in 1961 and 1962; namely, channeling back into private hands dollars that otherwise would have added to their official reserves, by providing commercial banks in that country with forward cover into lire without cost. In 1965, as in 1962, the U.S. Treasury had facilitated such operations by acquiring some of the technical commitments to Italian commercial banks for forward sales of lire. The contracts acquired by the Treasury in 1962 ultimately were all reacquired by the Italian authorities when the balance of payments of that country subsequently shifted to a deficit.

The Committee noted that the operations that had been undertaken by the Italian authorities were beneficial in reducing strains on the international payments structure and that the assumption by the U.S. Treasury of some of the forward commitments reduced the pressure on the Bank of Italy to convert part of its total dollar holdings—spot and forward—into gold. The Committee concluded that it was desirable for the System to participate along with the U.S. Treasury in this cooperative undertaking with the Italian authorities, consistent with the System's general policy of operating parallel with the Treasury whenever appropriate.

December 14, 1965

1. Authority to effect transactions in System Account.

Reports at this meeting indicated that economic activity was increasing vigorously and that the outlook appeared more expansive than previously. Recent developments in financial markets reflected the actions by the Board of Governors, effective December 6, approving increases in Federal Reserve discount rates from 4 to 4½ per cent and increasing to 5½ per cent the maximum rate member banks were permitted to pay on time deposits other than savings deposits.[2]

With respect to business activity, in November the rise in nonfarm employment was the largest for any month in 1965, and the unemployment rate again declined, to 4.2 per cent. Retail sales were maintained at their record October volume. Despite further reductions in output of steel mill products, industrial production rose substantially from an October level that itself had been revised upward.

[2] These actions are described in the entry for December 3, 1965, in the Record of Policy Actions of the Board of Governors (see pp. 63-70).

Estimates of the recent pace of business investment also had been raised. Inventory accumulation was larger in the third quarter than previously indicated and the rate of accumulation showed an unexpectedly small decline in October. A Commerce–SEC survey of business expenditures on plant and equipment revealed that outlays in the second half of 1965 were running above earlier projections and that for the year as a whole they would exceed 1964 outlays by over 15 per cent.

As to the outlook, the new Commerce–SEC survey also indicated that businesses planned to increase capital expenditures further in the first half of 1966 at a rate about as rapid as in 1965 and considerably higher than that implied by a recent private survey reporting plans for all of 1966. According to a Census Bureau survey taken in mid-October, consumers intended to buy new cars and major household durable goods at a high rate over the following 6 months. Federal expenditures, particularly outlays for defense, had been rising rapidly since midyear on a national-income-account basis, and a further substantial increase in the first half of 1966 was implied by tentative new administration estimates of Government expenditures in the current fiscal year.

Average prices of industrial commodities continued to edge up in November, but the total wholesale price index increased more as a result of a renewed rise in food prices. The consumer price index advanced by two-tenths of 1 per cent in October, to a level 1.8 per cent above a year earlier.

At commercial banks, growth in business loans in November was moderately above the reduced October pace. Total bank credit continued to expand at a rapid rate, partly because of further Treasury financing activity. The money supply rose by only a small amount, but time and savings deposits continued to grow at an annual rate of nearly 17 per cent despite a relatively modest net increase in negotiable certificates of deposit. Following the Federal Reserve actions of December 6 most large banks raised their prime rate on business loans from 4½ to 5