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.

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 per cent and a number of banks increased their offering rates on new certificates of deposit. Excess reserves of member banks, which had averaged about $80 million less than their borrowings in November, were estimated to have exceeded borrowings slightly in the statement week ending December 8; this reflected System open market operations directed to the provision of reserves in order to facilitate market adjustments to the official rate actions.

In security markets initial reactions to the increases in the discount rate and the maximum rate on time deposits were swift but orderly. Short- and long-term security yields, which generally had been under upward pressure prior to the actions, rose sharply on December 6, the day the actions became effective. Yields on long-term Treasury, corporate, and municipal bonds generally moved up about 5-10 basis points, and those on intermediate-term Treasury securities and on Treasury bills advanced 15-20 basis points. For the rest of the week market yields were relatively stable, with the 3-month Treasury bill rate fluctuating in a narrow range around 4.35 per cent and some bond prices showing a slight improvement. On the following Monday (the day preceding this meeting), however, most market rates advanced again, apparently partly because of reports implying further strengthening of the economic outlook. Money market conditions, which had been comfortable in the preceding week, again became firm.

With respect to the U.S. balance of payments, direct investment outflows in the third quarter were now reported to have been substantially smaller than in the first 2 quarters. On the other hand, imports in the 4 months after midyear were larger than previously indicated and were one-sixth greater than in the corresponding period of 1964. Preliminary data for October and November suggested that there would be some improvement in the "regular transactions" balance in the fourth quarter as compared with the third, but thus far a deficit was indicated on this basis of calculation as well as on the "liquidity" and

"official settlements" bases. Abroad, the Bank of Canada raised its discount rate from 4¼ to 4¾ per cent immediately after the increase in the Federal Reserve discount rate, and rates in Euro-dollar markets rose more than seasonally.

The Committee agreed that open market operations in the period until its next meeting should be directed toward moderating any further adjustments that might occur in money and credit markets. Maintaining relatively steady financial market conditions during the next few weeks was deemed particularly desirable because of the large and shifting seasonal pressures typical of this period and because of the likelihood that the Treasury would be engaging in financing operations early in the new year, with the first stage probably under way before the year-end.

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 domestic economic expansion is gaining in strength in a climate of optimistic business sentiment, with continuing active demands for credit and some further upward creep in prices. Although there appears to have been some recent improvement in our international payments, the need for further progress remains. In this situation, it is the Federal Open Market Committee's policy to complement other recent measures taken to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

Until the next meeting of the Committee, and taking into account the forthcoming Treasury financing activity and widely fluctuating seasonal pressures at this time of year in addition to the recent increase in Reserve Bank discount rates, System open market operations shall be directed to moderating any further adjustments in money and credit markets that may develop.

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

2. Ratification of amendment of continuing authority directive.

On the morning of December 6 the Manager of the System Account had reported that the remaining "leeway" at that time for open market purchases, under the limitation established in Section 1(a) of the Committee's continuing authority directive on changes in holdings of U.S. Government securities in the System Open Market Account between meetings of the Committee, was $322 million, and that it was conceivable that purchases in excess of that amount might be necessary before the Committee's next meeting to carry out the intent of the current economic policy directive then in effect. Committee members approved (those outside of Washington by telegram) an amendment to Section 1(a) of the continuing authority directive, raising from $1.5 billion to $2.0 billion the limit on changes in holdings of Government securities between meetings. With this amendment, Section 1(a) read as follows:

(a) To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting.

The December 6 action was ratified at this meeting of the Committee.

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

OPERATIONS OF THE SYSTEM OPEN MARKET ACCOUNT

The following two reports describe the actions taken during 1965 to carry out the policy directives of the Federal Open Market Committee. The first one is a chronological review of operations in domestic securities. In providing the reserve base for rapid expansion in commercial bank credit and for substantial growth in the money supply—and in view of the public's changing preferences for currency, demand deposits, and time deposits—the Federal Reserve acquired during the year $3.7 billion, net, of U.S. Government securities (including repurchase agreements).

The report on operations in domestic securities was prepared by Alan R. Holmes, Manager of the System Open Market Account, who supervises these operations. It is written from the vantage point of the Trading Desk at the Federal Reserve Bank of New York, where operations in these securities are effected to carry out the policy directives of the Federal Open Market Committee. The report stresses the factors—including variations in reserve elements, money market tendencies, and Treasury financings—that the Manager takes into account in the day-to-day provision of bank reserves.

The second report is a review of Federal Reserve operations in foreign currencies. The Federal Reserve has been buying and selling such currencies since early 1962 as part of the efforts to defend the dollar and strengthen the world payments system. During 1965 the volume of Federal Reserve operations in foreign currencies was substantial, and the reciprocal currency, or "swap," network linking the Federal Reserve with foreign central banks and the Bank for International Settlements was enlarged by $450 million.

The report on foreign currency operations was prepared by Charles A. Coombs, Special Manager of the System Open Market Account, who supervises the Federal Reserve's operations in such