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.

members thought that a slight reduction in monetary ease also was appropriate on domestic grounds in view of the latent inflationary pressures they saw, and some expressed the view that it would tend to sustain the current expansion by helping to avoid speculative excesses.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

In light of the economic and financial developments reviewed at this meeting, including the generally strong and continuing expansion of the domestic economy and the continuing adverse position of our international balance of payments, it remains the Federal Open Market Committee's current policy to accommodate growth in the reserve base, bank credit, and the money supply but at a more moderate pace than in recent months. This policy seeks to avoid the emergence of inflationary pressures and to support other measures that may be taken to strengthen the international position of the dollar.

To implement this policy, while taking into account Treasury financing, System open market operations over the next 4 weeks shall be conducted with a view to moving toward slightly firmer conditions in the money market than have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Hayes, Balderston, Daane, Hickman, Mills, Shepardson, Shuford, Swan, and Wayne. Votes against this action: Messrs. Mitchell and Robertson.

Messrs. Mitchell and Robertson dissented from this action because they believed that additional monetary restraint was not warranted either by present domestic conditions or by the balance of payments situation. They noted that the present high levels of demand for steel and automobiles were likely to be only temporary, and that any expansive effects of the Federal fiscal program would not be felt until the second half of the year. As to the balance of payments, they thought that—in view of the large differentials existing between interest rates in the United States and abroad—a policy change large enough to reduce capital outflows significantly would have severe deflationary effects on the economy. For this reason, Mr. Robertson felt that the appropriate remedy for the international payments problem lay elsewhere than in the area of monetary policy, and Mr. Mitchell thought it lay in specific measures to remove the disequilibrating effect of international interest rate differentials. Mr. Robertson added that in his judgment Treasury financing operations and the recent weakness in security markets also argued for keeping policy on a steady course at present.

March 2, 1965

1. Authority to effect transactions in System Account.

Economic activity was continuing to advance after four consecutive years of expansion. In January, steel and automobile production remained at high levels, and output gains in a broad variety of other industries carried total industrial production to a new peak. Retail sales continued strong in January and early February; sales of new domestic cars were at a record annual rate of 9.7 million units in the first month of the year. Although stock-sales ratios remained low, rough estimates suggested that the rate of inventory accumulation continued high in early 1965 after turning up sharply in the closing months of 1964. Much of the accumulation still was related to strikes—both the possible strike in steel and the earlier strike in automobiles—but stocks of other commodities apparently also were growing rapidly. Labor markets were strong in January: nonfarm employment increased further; the average manufacturing workweek was extended to the longest period since World War II; and the unemployment rate declined to 4.8 per cent from 5 per cent in December.

Average industrial commodity prices, which had risen six-tenths of 1 per cent in the fourth quarter of 1964, edged up one-tenth of a per cent in January. Weekly estimates through mid-February suggested no further change, and the average remained within the broad range of recent years.

Growth in commercial bank credit accelerated in January and early February, and banks reduced their holdings of Government securities to help accommodate record demands for business loans. Part of the exceptional rise in business loan volume reflected various temporary factors, but part was due to the general strength of business activity. Time and savings deposits at commercial banks continued to expand rapidly in response to the higher interest rates now being paid on such deposits. The money supply rose at a reduced rate in both December and January and declined in the first half of February. Recent money supply performance no doubt was affected by some transfers of funds from demand into time and savings deposits and, in early February, by a larger than usual rise in U.S. Government deposits. Member bank borrowings rose in February, and free reserves were estimated to have averaged about $30 million compared with a revised figure of $114 million in January.

Yields on U.S. Government securities had advanced recently, partly as a result of the somewhat reduced level of reserve availability and of market interpretations of that development as reflecting a mild shift in monetary policy. Rates on 3-month Treasury bills rose about 10 basis points in February to about the 4 per cent discount rate, and Government bond yields also increased slightly. Average prices of common stocks declined in early February but more recently returned to levels near their earlier highs.

In a message to the Congress on February 10, the President had set forth a program to improve the nation's balance of payments position. Steps subsequently were taken by the Federal Reserve System and the Department of Commerce, in cooperation with the Treasury Department, to implement the part of the program that called for voluntary efforts by banks, other financial institutions, and nonfinancial businesses to restrain foreign lending and investment. In January and early February, prior

to the Presidential message, the U.S. payments deficit had continued large, according to tentative data. Long-term bank loans to foreigners were particularly heavy, perhaps partly because of expectations that the interest equalization tax soon would be extended to such loans.

In the Committee's discussion of prospective business conditions, it was noted that the current high output rates for steel and automobiles probably were unsustainable—declines appeared likely in steel if and when the threat of a strike was removed and in automobiles after previous strike losses were made up—and that downturns in those industries might check the rate of over-all expansion. On the other hand, some members thought that the widespread nature of recent production gains suggested sufficient underlying strength in the economy to cushion the expected readjustments in steel and autos, and that prospects for sustained growth now appeared brighter than earlier.

The Committee concluded that over the next 3 weeks, while the President's balance of payments program was getting underway, it would be appropriate to maintain the slightly firmer money market conditions that had been achieved under the policy adopted at the meeting a month earlier. Some members, although not advocating a policy change at present, expressed concern about the recent high rate of growth in bank credit and indicated that a somewhat more restrictive policy might be necessary in coming months to achieve a reduction in that rate.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> In light of the economic and financial developments reviewed at this meeting, including the generally strong and continuing expansion of the domestic economy and the continuing adverse position of our international balance of payments, it remains the Federal Open Market Committee's current policy to accommodate growth in the reserve base, bank credit, and the money supply but at a more moderate pace than in recent months. This policy seeks to support fully the national program to

strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures.

To implement this policy, System open market operations over the next 3 weeks shall be conducted with a view to maintaining the slightly firmer conditions in the money market that have prevailed in recent weeks.

> Votes for this action: Messrs. Martin, Hayes, Bryan, Daane, Mitchell, Robertson, Scanlon, and Clay. Votes against this action: Messrs. Balderston, Ellis, and Shepardson.

Messrs. Balderston, Ellis, and Shepardson dissented from this action because they favored a further slight firming of money market conditions. Mr. Balderston noted that bank credit had expanded at a considerably higher rate than GNP throughout the current business expansion. This, in his judgment, had added to the volume of funds seeking investment abroad and might have created potentially inflationary pools of liquidity. Messrs. Ellis and Shepardson observed that if the program to restrain foreign lending by U.S. banks was effective, more funds presumably would be available for domestic loans, thus adding to what they considered to be an undesirably high rate of domestic bank lending. Mr. Ellis thought that a firmer monetary policy might result, beneficially, in the deferral of some current domestic demands and indicated that he also favored such a policy for balance of payments reasons.

2. Amendment of continuing authority directive.

The Committee amended Section 1(c) of the continuing authority directive to the Federal Reserve Bank of New York relating to transactions in U.S. Government securities and bankers' acceptances to remove the maturity limitation on Government securities that might be held under repurchase agreements with nonbank dealers during Treasury refunding operations. The directive previously in effect, as set forth in the preface to this record of Federal Open Market Committee policy actions for 1965, limited Government securities acquired under repurchase agreements to those having maturities of 24 months or less at the time of purchase. The new directive authorized repurchase agreements involving Government securities of any maturity during any period beginning the day after the Treasury had announced a refunding operation and ending on the settlement date for the exchange. As amended, Section 1(c) of the continuing authority directive read as follows:

To buy U.S. Government securities with maturities as indicated below, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market. U.S. Government securities bought under the provisions of this section shall have maturities of 24 months or less at the time of purchase, except that, during any period beginning with the day after the Treasury has announced a refunding operation and ending on the day designated as the settlement date for the exchange, the U.S. Government securities bought may be of any maturity.

Except for the change resulting from this amendment the directive was renewed in its existing form.

> Votes for this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Scanlon, Shepardson, and Clay. Votes against this action: None.

Under the provisions of the previous directive it had been the practice of the Account Management to terminate any repurchase agreements against "rights" (securities eligible for exchange in a Treasury refunding) when the dealer by whom they were to be repurchased entered a subscription to exchange the rights in question for new securities offered by the Treasury with maturities of 24 months or more. During some Treasury refundings such terminations had proved to be inconvenient from the point of view of efficient market operations. Accordingly, the Committee decided to amend the directive so that they would no longer be required.

3. Authority to purchase and sell foreign currencies.

The Committee approved a number of revisions in the guidelines for System foreign currency operations, the purposes of which were (1) to delete passages relating to the original launching of operations in foreign currencies in 1962 and passages that had been found by experience to be unnecessarily detailed; (2) to consolidate certain provisions that had been incorporated into the guidelines at different times into a form that lent itself more readily to operational requirements; and (3) to clarify the language at a number of points. The guidelines previously in effect are shown in the preface to this record of policy actions. As amended, the guidelines read as follows:

1. Holdings of Foreign Currencies

Until otherwise authorized, the System will limit its holdings of foreign currencies to that amount necessary to enable its operations to exert a market influence. Holdings of larger amounts will be authorized only when the U.S. balance of international payments attains a sufficient surplus to permit the ready accumulation of holdings of major convertible currencies.

Foreign currency holdings shall be invested as far as practicable in conformity with Section 14(e) of the Federal Reserve Act.

2. Exchange Transactions

System exchange transactions shall be geared to pressures of payments flows so as to cushion or moderate disequilibrating movements of funds and their destabilizing effects on U.S. and foreign official reserves and on exchange markets.

In general, these transactions shall be geared to pressures connected with movements that are expected to be reversed in the foreseeable future; when expressly authorized by the Federal Open Market Committee, they may also be geared on a short-term basis to pressures connected with other movements.

Subject to express authorization of the Committee, the Federal Reserve Bank of New York may enter into reciprocal arrangements with foreign central banks on exchange transactions ("swap" arrangements), which arrangements may be wholly or in part on a standby basis.

Drawings made by either party under a reciprocal arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

The New York Bank shall, as a usual practice, purchase and sell authorized currencies at prevailing market rates without trying to establish rates that appear to be out of line with underlying market forces.

If market offers to sell or buy intensify as System holdings increase or decline, this shall be regarded as a clear signal for a review of the System's evaluation of international payments flows.

It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions in order that System transactions do not conflict with those being undertaken by foreign monetary authorities.

3. Transactions in Spot Exchange

The guiding principle for transactions in spot exchange shall be that, in general, market movements in exchange rates, within the limits established in the International Monetary Fund Agreement or by central bank practices, index affirmatively the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public.

Temporary or transitional fluctuations in payments flows may be cushioned or moderated whenever they occasion market anxieties, or undesirable speculative activity in foreign exchange transactions, or excessive leads and lags in international payments.

Special factors making for exchange market instabilities include (i) responses to short-run increases in international political tension, (ii) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, or (iii) market rumors of a character likely to stimulate speculative transactions.

Whenever exchange market instability threatens to produce disorderly conditions, System transactions are appropriate if the Special Manager, in consultation with the Federal Open Market Committee, or in an emergency with the members of the Committee designated for that purpose, reaches a judgment that they may help to re-establish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified, curtailed, or eventually discontinued pending a reassessment by the Committee of supply and demand forces.

Insofar as is practicable, the New York Bank shall purchase a currency through spot transactions at or below its par value, and sell a currency through spot transactions at rates at or above its par value.

Spot transactions at rates other than those set forth in the preceding paragraph shall be specially authorized by the Committee or by the members of the Committee designated in Section VIII of the Authorization for Open Market Transactions in Foreign Currencies, except that purchases of exchange to meet System commitments may be executed without special authorization at rates above par when necessary.

4. Transactions in Forward Exchange

Transactions in forward exchange, either outright or in conjunction with spot transactions, may prove desirable:

(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, 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 may also prove desirable 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 this action: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Scanlon, Shepardson, and Clay. Votes against this action: None.

4. *Review of continuing authorizations.*

This being the first meeting of the Federal Open Market Committee following the election of new members from the Federal Reserve Banks to serve for the year beginning March 1, 1965, and their assumption of duties, the Committee followed its customary practice of reviewing all of its continuing authorizations and directives. The actions taken with respect to the continuing authority directive for domestic open market operations and the guidelines for System foreign currency operations have been described in the preceding portions of the entry for this date.

The Committee reaffirmed its authorization regarding open market transactions in foreign currencies and its continuing authority directive on foreign currency operations, in the form in which they were outstanding at the beginning of the year 1965, as set forth in the preface to this record of policy actions.

Votes for these actions: Messrs. Martin, Hayes, Balderston, Bryan, Daane, Ellis, Mitchell, Scanlon, Shepardson, and Clay. Votes against these actions: None.

March 23, 1965

1. *Authority to effect transactions in System Account.*

The domestic business situation continued strong, according to reports at this meeting. Industrial production, retail sales, and nonfarm employment all rose to new record levels in February, although the unemployment rate returned to 5.0 per cent after dipping to 4.8 per cent in January. Weekly estimates suggested that average industrial commodity prices remained stable from mid-January through early March at a level less