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.

Preliminary data for U.S. international payments in May and early June showed a continued small surplus, reflecting the administration's balance of payments program and further progress in clearing merchandise trade shipments held up by the earlier dock strike. Present indications were that a surplus would be recorded for the second quarter as a whole, in contrast with the large first-quarter deficit, now estimated to have been at a seasonally adjusted annual rate of $2.8 billion. Abroad, the combined external payments of major continental European countries moved from surplus to near-balance in March and April, and Japan's international payments concurrently shifted from surplus to deficit. There had been no marked improvement as yet in Britain's external position, and sterling continued under intermittent pressure in foreign exchange markets.

The Committee agreed that no change should be made in policy at this time. Considerations underlying this decision included the prevailing uncertainties in business and financial markets, the more moderate recent rates of expansion in economic activity and of growth in bank credit, and the maintenance of improvement in the U.S. balance of payments.

Although the Committee's conclusion was unanimous, in their initial expressions of views some members leaned toward a slightly firmer policy or noted that they found the choice between no change and slight firming to be close. These members, along with certain others, were concerned about the implications of upward price movements, both for the domestic economy and for the longer-run position of the U.S. balance of payments. They were not convinced that the pace of bank credit growth, although lower recently than earlier, had fallen to an appropriate level, and they noted the lack of evidence that the more basic forces were working toward improvement in the nation's international payments.

Some members thought, however, that recent and prospective price pressures were not of a character to call for further monetary restraint, and that the possibility of declines in rates of re-

source utilization later in the year warranted close watching by the Committee. The lack of growth in the money supply thus far in 1965 was noted, and the view was expressed that a firmer policy at this juncture would not make the recent balance of payments improvement more lasting.

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 continuing expansion of the domestic economy, although at a somewhat slower pace than in the first quarter, and maintenance of earlier improvement in our international balance of payments, but with gold outflows continuing. In this situation, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program 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 over the next 4 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Hayes, Bryan, Daane, Ellis, Galusha, Maisel, Mitchell, Robertson, Scanlon, and Shephardson. Votes against this action: None.

July 13, 1965

Authority to effect transactions in System Account.

The economic advance continued in June, according to reports at this meeting. Employment rose moderately and the unemployment rate—at 4.7 per cent—was little changed from the 4.6 per cent recorded in May. Tentative estimates suggested that both industrial production and retail sales maintained, or possibly bettered, their record May levels. Unit sales of new domestic automobiles rose sharply to an annual rate of 8.8 million units, perhaps partly as a result of purchases that had been postponed earlier because of uncertainty about excise taxes.

Prices of common stocks, which had declined further in late June to a level about 10 per cent below their mid-May peak, subsequently recovered about half of that loss. The continued strength in retail sales, and the fact that no important reappraisals of business plans for fixed capital expenditures had been reported, suggested that the earlier stock market decline had had little effect on spending.

Although the rate of business inventory accumulation decreased in May, according to preliminary data, automobile dealers added further to their relatively large inventories of new cars, and stocks of steel continued to rise rapidly. There was some evidence suggesting that growth in aggregate inventories thus far in 1965 might have been greater than indicated by official figures.

The consumer and wholesale price indexes advanced in May, to levels 1.7 and 2.0 per cent, respectively, above a year earlier, and average wholesale prices rose further in June. Higher prices for foods continued to account for most of the increases. However, wholesale prices of industrial commodities were estimated to have risen by about three-fourths of 1 per cent in the first half of the year, following a rise of a similar amount in the fourth quarter of 1964.

Bank credit expanded substantially more in June than in April or May, as strong underlying demands for loans were augmented by various temporary factors, including heavy borrowing for corporate tax and dividend payments at midmonth. The money supply also increased sharply in June, bringing the annual rate of growth for the first half of 1965 to about 2.5 per cent, and time deposit expansion accelerated from its reduced May pace. Net borrowed reserves of member banks averaged about $180 million in June and the first week of July, as compared with an average of $160 million in May.

Money market conditions remained generally firm in recent weeks. On most days the effective rate on Federal funds was

4⅛ per cent, and a few transactions in such funds reportedly were executed at one-fourth of a percentage point above the 4 per cent discount rate. Yields on 3-month Treasury bills continued to drift down in the latter part of June, but subsequently they rose about 10 basis points to levels above 3.85 per cent. The rise in bill rates was attributable in part to light investor demand and higher borrowing costs to dealers. Also important, however, was the fact that the Federal Reserve met the substantial reserve needs of the period mainly by purchases of longer-term Treasury securities, acquisitions of bills in direct transactions with foreign accounts, and other means, rather than—as many traders had expected—by sizable purchases of Treasury bills in the market.

In long-term security markets yields on new corporate bonds receded slightly from their mid-June peaks but were still about one-quarter of a percentage point above their levels early in the year; State and local bond yields continued under upward pressure; and yields on Treasury notes and bonds showed little net change. It was expected that late in July the Treasury would announce the terms on which securities maturing in mid-August would be refunded. About $3.2 billion of these securities were held by the public.

Tentative estimates indicated a surplus in U.S. international payments in the second quarter of about $200 million, seasonally adjusted. Much of the marked improvement from the large deficit of the first quarter reflected the initial impact of the administration's balance of payments program, particularly on bank credit flows; in contrast to the large first-quarter outflows of bank credit, there were inflows in the form of net repayments in April and May. Also, the trade surplus increased in the second quarter, because delays in shipments caused by the earlier dock strike were greater for exports than for imports.

It did not appear likely that all of the second-quarter improvement in the payments balance would be sustained, and the reap-

pearance in the second half of 1965 of at least a moderate deficit seemed probable. By the end of May aggregate foreign loans of U.S. banks were below the target levels established under the voluntary foreign credit restraint program, thus leaving room for a resumption of net outflows later in the year. Also, recent trends in U.S. merchandise trade, while partly obscured by distortions due to the dock strike, suggested that the gain in U.S. exports from 1964 to 1965 would not be large and might well be substantially less than the rise in imports, with a consequent reduction in the trade surplus.

In the course of the discussion some members of the Committee characterized the domestic business outlook as strong and expressed concern about recent and prospective price developments, the renewed rapid increase in bank credit, and the longer-term outlook for the balance of payments. These considerations, they thought, offered some grounds for seeking a firmer tone in the money market. At the same time certain of these members, as well as others, doubted that a modest policy change would have significantly useful effects under prevailing conditions, and they felt that a larger change was undesirable partly because of the expected Treasury financing. Also, some members noted that an overt change in money market conditions might require an increase in the Federal Reserve discount rate, a step they did not favor at present. However, the view also was expressed that a discount rate increase would be appropriate if bank credit continued to expand at a rapid pace, and that a modest firming of policy now would provide a better basis for such action later.

Other members—noting the possibility of inventory adjustments later in the year and indications that final demands were not likely to expand as rapidly as productive capacity—were less confident about prospects for the economy. In their judgment neither domestic price and bank credit developments nor the balance of payments situation warranted a firmer policy;

indeed, they believed that the Committee shortly might find it necessary to move in the direction of greater ease. Still other members found little basis in current domestic and international circumstances for either firmer or easier money market conditions.

While their reasons differed, at the conclusion of the discussion all but one member of the Committee agreed that no change should be made in policy at this time. 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 continuing expansion of the domestic economy, although at a slower pace than in the first quarter. Reflecting the large initial impact of the administration's balance of payments program, there was a surplus in our international payments in the second quarter. In this situation, and with gold outflows continuing, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program 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 forthcoming Treasury financing, System open market operations over the next 4 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Balderston, Bryan, Daane, Galusha, Maisel, Mitchell, Robertson, Scanlon, Shepardson, and Treiber. Vote against this action: Mr. Ellis.

Mr. Ellis dissented from this action because he favored a further slight step toward less ease similar to the several such actions the Committee had taken during the past 12 months. In his judgment this would help to hold any autumn credit surge within bounds; and, if credit demands should weaken, it would have established a base from which a policy move toward ease would have greater impact.