FIFTY SECOND

Annual Report

OF THE

BOARD OF GOVERNORS

OF THE FEDERAL RESERVE SYSTEM

COVERING OPERATIONS FOR THE YEAR

1965

Digest of Principal Federal Reserve Policy Actions in 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.

August 10, 1965

1. Authority to effect transactions in System Account.

Business activity expanded further in July, and the outlook for coming months was affected by a number of developments, including a Presidential announcement on July 28 of a planned enlargement of U.S. military efforts in Viet Nam. The additional defense spending presently planned did not appear large enough in itself to result in excessive levels of aggregate demand or in widespread production bottlenecks, but the volume of expenditures that might ultimately prove necessary was, of course, impossible to foresee. Amendments to the Social Security Act signed into law on July 30 provided, among other things, for increases in benefit payments retroactive to the first of the year, which appeared likely to add to consumer spending. On the other hand, it was expected that production for inventory would abate later in the year from its current rate. In particular, steel output was likely to decline after September 1—when the 4-month interim labor agreement was scheduled to expire—even if a settlement was reached, as users worked off stocks accumulated as a precaution against a strike.

In July the rate of unemployment declined to 4.5 per cent, the lowest monthly rate since October 1957, despite a sharp rise in the labor force. Early indications were that industrial production rose further to a new peak, and retail sales, which had edged down in June, were tentatively estimated to have exceeded their previous high. These July gains followed a second quarter in which, according to preliminary Department of Commerce estimates, GNP rose at a seasonally adjusted annual rate of about $9 billion—less than the unusual first-quarter advance of $14 billion, but more than had been generally expected.

Average wholesale prices of industrial commodities apparently changed little in July. Increases for some basic commodities, related to developments in Viet Nam, proved—with the exception of copper—to be largely temporary. The consumer price index advanced one-half of 1 per cent in June as prices of foods rose further.

At commercial banks business loans continued to grow rapidly in July. Total bank credit probably declined a little during the month, however, as a result of repayments of various kinds of temporary credits that had contributed to the large increase in June and of further reductions in bank holdings of Government securities. Growth in the money supply was less rapid than in June, but time deposits expanded at the highest rate since February. Average net borrowed reserves of member banks, at about $180 million, were unchanged from June.

Securities markets were characterized by a cautious tone in recent weeks as a result of uncertainties relating both to developments in Viet Nam and to continued intermittent pressures on sterling in markets for foreign exchange. Treasury note and bond yields edged up in late July and early August, and the 3-month Treasury bill rate, after declining in the latter part of July, advanced somewhat in early August to levels in the neighborhood of 3.85 per cent. Despite such market weakness, the Treasury's mid-August refunding, which involved slightly more than $3 billion in publicly held maturing securities, was well received.

The U.S. balance of payments continued in surplus in July, according to tentative estimates. Available data for June, however, provided further indications of a deterioration in the trade surplus; exports were about unchanged from the level of the previous autumn but imports were sharply higher.

On July 27 Britain announced further measures designed to improve its external position. There was no substantial abatement of exchange market pressures on sterling, however, partly because of uncertainties arising from published figures indicating further reductions in Britain's international reserves in July. Most recently, publication of British foreign trade figures for July revealed a substantial increase in that country's exports.

Members of the Committee differed somewhat in their assessment of the forces affecting the outlook for the domestic economy. They agreed, however, that no change should be made in policy at this time, particularly in light of the various uncertainties presently existing at home and abroad. The current Treasury financing, although moderate in size and about to be completed, also was advanced as providing some ground for maintaining present policy.

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 the domestic economy has expanded further, but at a slower pace than early in the year, and that the improvement in our international payments that occurred in the second quarter has been maintained for the time being, although gold outflows have continued and international developments are creating uncertainties in securities and foreign exchange markets. 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 over the next 3 weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account the Treasury financing about to be completed and the unsettled conditions in securities and foreign exchange markets.

Votes for this action. Messrs. Martin, Balderston, Galusha, Maisel, Mitchell, Robertson, Scanlon, Shephardson, Bopp, Irons, and Treiber. Votes against this action: None.

2. Authority to purchase and sell foreign currencies.

At this meeting the Committee revised its continuing authority directive for transactions in foreign currencies in two respects.

One revision involved a change, from \$2.65 billion to \$2.8 billion, in the dollar limit specified in the first paragraph of the directive on the aggregate amount of foreign currencies held under reciprocal currency arrangements. As indicated in Section 2 of the entry for March 23, 1965, it had been the Committee's practice to set this limit at the sum of the amounts currently specified by the Committee for all individual authorized reciprocal currency arrangements. Today's revision was made because earlier in the present meeting the Committee had ratified an increase in the size of the reciprocal currency arrangement with the Bank for International Settlements from \$150 million to \$300 million. The second revision involved the addition of a new final paragraph to the directive authorizing purchases of sterling by the Federal Reserve Bank of New York on a covered or guaranteed basis up to a total of \$50 million equivalent, in addition to the foreign currency purchases authorized in preceding paragraphs. This supplementary authorization provided a further potential for cushioning or moderating disequilibrating movements of funds in foreign exchange markets.

Reflecting these revisions, the continuing authority directive for transactions in foreign currencies read as follows:

> The Federal Reserve Bank of New York is authorized and directed to purchase and sell through spot transactions any or all of the following currencies in accordance with the Guidelines for System Foreign Currency Operations as amended March 23, 1965; provided that the aggregate amount of foreign currencies held under reciprocal currency arrangements shall not exceed \$2.8 billion equivalent at any one time, and provided further that the aggregate amount of foreign currencies held as a result of outright purchases shall not exceed \$150 million equivalent at any one time:
>
> Pounds sterling
> French francs
> German marks
> Italian lire
> Netherlands guilders
> Swiss francs

Belgian francs
Canadian dollars
Austrian schillings
Swedish kronor
Japanese yen

The Federal Reserve Bank of New York is also authorized and directed to operate in any or all of the foregoing currencies in accordance with the Guidelines and up to a combined total of $275 million equivalent, by means of:

(a) purchases through forward transactions, for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements;

(b) purchases and sales through forward as well as spot transactions, for the purpose of utilizing its holdings of one currency for the settlement of commitments denominated in other currencies;

(c) purchases through spot transactions and concurrent sales through forward transactions, for the purpose of restraining short-term outflows of funds induced by arbitrage considerations; and

(d) sales through forward transactions, for the purpose of influencing interest arbitrage flows of funds and of minimizing speculative disturbances.

The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing currencies *in which the U.S. Treasury has outstanding indebtedness*, in accordance with the Guidelines and up to a total of $100 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

The Federal Reserve Bank of New York is also authorized and directed to make purchases of sterling on a covered or guaranteed basis in terms of the dollar up to a total of $50 million equivalent.

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

August 31, 1965

Authority to effect transactions in System Account.

Reports at this meeting confirmed earlier estimates that industrial production and retail sales had reached new highs in July. Production gains in both June and July were larger than in most earlier months of the year as a result of further advances in output of business equipment and of materials, including steel; consumer goods output continued to show little change at a level about 5 per cent above a year earlier. Manufacturers' inventories rose considerably in July, following three quarters in which total business inventories had increased at a more rapid rate than earlier in the current business expansion. The unemployment rate, which had declined to 4.5 per cent in July, remained at that level in August.

Business sentiment recently had become more buoyant, as activity continued to expand faster than had been expected and as prospects for further advances were enhanced by expected rises in military outlays in connection with the Viet Nam hostilities. To date, however, developments in Viet Nam did not appear to have given any sharp, direct stimulus to consumer or business spending, and the timing and amount of expected increases in military expenditures remained highly uncertain.

Additional major uncertainties were associated with the situation in the steel industry. Labor negotiations were still in process at the time of this meeting, and the interim agreement, originally scheduled to expire on September 1, had been extended 8 days at the request of the President. It was not clear whether a settlement would be arrived at without a strike, nor what the terms of the settlement would be. Also in doubt were the probable dimensions and timing of the reduction in