

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington on Wednesday, May 9, 1956, at 10:00 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Sproul, Vice Chairman
Mr. Balderston
Mr. Erickson
Mr. Johns
Mr. Mills
Mr. Powell
Mr. Robertson
Mr. Shepardson
Mr. Szymczak
Mr. Vardaman
Mr. Fulton, Alternate

Messrs. Bryan, Leedy, and Williams, Alternate
Members, Federal Open Market Committee

Messrs. Leach, Irons, and Mangels, Presidents of
the Federal Reserve Banks of Richmond, Dallas,
and San Francisco, respectively

Mr. Riefler, Secretary
Mr. Thurston, Assistant Secretary
Mr. Vest, General Counsel
Mr. Solomon, Assistant General Counsel
Mr. Thomas, Economist
Messrs. Abbott, Parsons, Roelse, and Young,
Associate Economists
Mr. Rouse, Manager, System Open Market Account
Mr. Carpenter, Secretary, Board of Governors
Mr. Sherman, Assistant Secretary, Board of
Governors
Mr. Miller, Chief, Government Finance Section,
Division of Research and Statistics, Board
of Governors
Mr. Gaines, Manager, Securities Department,
Federal Reserve Bank of New York

Mr. Harris, First Vice President, Federal Re-
serve Bank of Chicago

Upon motion duly made and seconded, and
by unanimous vote, the minutes of the meeting
of the Federal Open Market Committee held on
April 17, 1956, were approved.

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Before this meeting there had been distributed to the members of the Committee a report covering open market operations during the period April 17 through May 2, 1956, inclusive, and at this meeting a supplementary report covering commitments executed May 3-May 8, 1956, inclusive, was distributed. Copies of both reports have been placed in the files of the Committee.

Upon motion duly made and seconded, and by unanimous vote, the open market transactions during the period April 17 to May 8, 1956, inclusive, were approved, ratified, and confirmed.

Members of the Board's staff then entered the room to assist in a presentation of an economic review, illustrated by chart slides. A copy of the script of the review was sent to each member of the Committee following the meeting.

Mr. Young opened the review with a statement substantially as follows:

So far this year, the aggregate demand for credit has been very large. Business credit demand has been especially heavy, both in short- and long-term markets. Consumer credit demand, while tapering off a bit, has continued fairly strong. Outstanding credit volume in all sectors has risen to levels substantially above those prevailing last year. With credit demand mounting and with bank credit supply under restrictive pressure, borrowers have found it necessary to offer higher interest rates in endeavoring to satisfy their financing needs.

The physical side of the economic picture contrasts sharply with the financial side, as output has been showing little change at a high level. For eight months the Board's index of industrial production has been within the 142-144 range. The number employed in April continued at a high level, with employment outside manufacturing well above the 1953 peak while employment at factories was still below the high of that period. Unemployment declined seasonally in April to 2.6 million.

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With near capacity output in some major industries and with credit extensively relied on to supplement private resources for spending, upward price pressures on industrial commodities have continued, though the pace of the price rise for these commodities has slackened. Prices of farm commodities have moved upward from year-end lows. Average industrial prices are about 5 per cent above the first half of 1955 and average wholesale prices of all commodities are up 3 per cent. Recently, prices of some leading materials have reacted from earlier highs. On the other hand, business circles generally expect very large increases in steel prices this summer, following negotiation of a new wage contract.

Gross national product in the first quarter was up only slightly from the fourth quarter, and the rise can be largely accounted for in terms of higher prices in some sectors. Present indications point to a moderate further rise in the second quarter, again partly accounted for by price rise.

Compared with early stages of revival from mid-1954 lows, when consumer buying led the way, and with most of last year, when demand advances were general, recent economic strength has gained special support from business buying. Consumer demand, on the whole, including demand for nondurable goods and services as well as for durables and housing, has about held its own since autumn. The rise in business demand has been in producers' equipment and business construction. Inventory accumulation has continued near the earlier rate.

Concerning the changed relationship between consumption and investment expenditures, three questions may be posed. One is whether a further rise in consumer income, generated in part by increased capital expenditures, may prompt a fresh rise in consumption demand before new productive capacity has greatly supplemented market supplies. A second question is whether growth in credit demands as generated by expanding business investment can be substantially counterbalanced by a larger savings flow so that tolerable balance will be maintained in money markets. A third question is whether, with the advance in consumption slackening and with inventories still building up, congestion may develop in many lines, rendering capital expenditure programs less attractive.

Mr. Thomas concluded the review with the following statement on the credit situation:

The world-wide picture shown by today's review continues to be one of over-all advance. In the United States, with

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total output leveling off at close to capacity levels, the gradual price rise accounts for much of the further lifting of value aggregates. Over-all credit demand remains strong, with the balance in excess of available savings pressing against a bank credit supply subject to Federal Reserve limitation. Thus, money rates have risen some, although markets just now are not as tight as they were three weeks ago.

While production in the economy has leveled off since last autumn and while consumers have been increasing their debts less rapidly than before, business borrowing this spring has been in unusually large volume. To some extent the recent sudden expansion in business borrowing was not foreseen, and the reasons for it are not yet wholly clear. Apparently some of the funds that should have been reserved for taxes had previously been used to finance the large capital expansion programs and further additions to inventories. Loan demands arose from the need to pay taxes without hurting cash positions, and perhaps also from efforts to assure adequate funds for future needs under relatively tight credit conditions. A large Treasury cash surplus and substantial debt retirement have been of some importance in offsetting private credit expansion and reenforcing restrictive monetary policy.

Under the circumstances, some strengthening of Federal Reserve pressure on the credit brake was appropriate, and the events of the past month have supported the need for that action. As the economy approaches the period of a seasonal uphill climb, some lessening of restraint may be appropriate to permit needed credit expansion. Yet the advance still shows evidence of basic momentum, as indicated by the relatively high rate of monetary velocity in the face of a restricted rate of monetary growth.

While a somewhat faster rate of increase in total output and in money balances would be consistent with the objective of sustained economic growth, there could be more assurance of sustainability if adjustments in some markets, such as automobiles, were more nearly completed, if further business inventory growth were being generally supported by growth in sales, and if the advance in prices were to cease. In the absence of clear indications in these directions and in view of the momentum evident in some important sectors of the economy, continued restraint on expansion would seem to be the most appropriate course for current Federal Reserve policy in the immediate future.

Chairman Martin suggested that, with the review as background, the Committee's discussion this morning should cover not only open market

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policy but Reserve Bank discount rates, discount policy, and all aspects of the situation having a bearing on the reserve position of banks. He then called upon Mr. Sproul who made a statement substantially as follows:

1. We are still in an area of low visibility so far as the balance between inflationary and deflationary forces in the economy is concerned. Aggregate measures of economic activity continue to show a roughly sidewise movement at a high level, supported largely by a heavy program of capital expenditures and related strength in the construction and machinery industries. Within the aggregates, however, movements are taking place which could have more significance than the apparent steadiness of the aggregates.

2. A disturbing example is the automobile industry. Right now this industry, one of the most important in the whole economy, seems to be in trouble. The hoped for spring increase in sales has been disappointing, inventories of cars remain quite high, and further cuts in production and employment are being made to try to clear the decks for the early introduction of the 1957 models.

3. There may be some cause for concern, also, in connection with the steel industry. Demand for steel has kept output at or near capacity, and the pressure of this demand has been showing up in increased prices. But there is uncertainty as to how much of the current demand for some steel items is going into inventory, as a hedge against a possible strike or further price increases or both. It could be that strength in the second quarter of 1956 is being borrowed from the third quarter.

4. The agricultural situation, of course, continues to pose a problem for the country's balanced economic growth, and currently is affecting the market for farm machinery in an important way.

5. It seems to me clearly to be a situation in which the direction and vigor of movement in the economy is not certain, that readjustments, and important readjustments, are still taking place. While consumer incomes and spending continue high, the shift of demand from consumer durables to consumer nondurables and services creates a situation of some delicacy.

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6. We get what is perhaps our clearest indication of the proper course for credit policy from the action of prices and the trends of bank loans. Prices of many industrial goods and prices at wholesale continue to edge upward both because of pressure of demand where we are straining current capacity, and because of increased costs. Demands for bank credit continue larger than can easily be explained by the current needs of a business situation which, in the aggregate, is moving sidewise. The great bulge in business loans during March has been little reduced during April, if at all, and the prospect of another bulge in borrowing during June is being discussed.

7. It is because of these movements in prices and in bank credit, and because our increases in discount rates were taken as warnings rather than storm signals, that I think we can be satisfied with what we did last month. Now, for a period, I think we should hold a steady course. We need to watch the trend of production and employment over the next few weeks. We need particularly to watch the course of the capital markets and of bank credit. The capital markets seem to have found a new trading base; it should be further tested before any additional move is considered, so great is our reliance on the capital expansion program for continued strength in the economy.

8. In the field of bank credit we need to watch out for what may be the cumulative effects of the developments of the past year including our policy of credit restraint. The liquidity squeeze to which both business and banks have been subjected during the past year may now be showing its real effects. It is beginning to appear likely that the demand for bank credit of many industries and businesses, in considerable part, has grown out of an over-all squeeze on corporate liquidity, accompanying a growth of inventories and receivables, and the temporary use of tax accruals for working capital purposes. It is beginning to appear likely that the commercial banks, now recognizing that this situation may not be relieved in a matter of days or weeks and, in the light of their own reduced liquidity, are taking more vigorous steps to hold their loans in check. We have done and are doing enough to keep credit under restraint at the moment. We do not want to precipitate a decline any more than we want to facilitate an excessive use of credit if the economy temporarily, and in the aggregate, is attempting to produce and consume more than its physical resources will permit.

9. My prescription would be to maintain about the existing degree of pressure on the reserve position of the banks for

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the present, to leave the discount rate alone, and to keep the discount window open as always but with administrative scrutiny of actual discounting.

Mr. Erickson said that in the Boston District conditions were about the same as described nationally except in the textile industry. Employment was higher in most States of the district in March than in February. At their meeting last Monday, directors of the Boston Bank reported no evidence of any reductions in plant expansion plans. Mr. Erickson also reported on a recent business outlook conference composed of economists from banks and industrial concerns, stating that all but two of those present held an optimistic view for the whole of the current year. Two were not quite as optimistic because of conditions in their local industries. The median of their projections of gross national product for the last quarter of this year was \$407 billion with a range from \$394 to \$430 billion, and their median projection of the Board's industrial production index was 146 with a range from 139 to 150. Mr. Erickson said the Boston Bank had had no particular increase in activity at the discount window since the last meeting of the Committee except for one day, although banks are talking about the tightness of money. Mr. Erickson said that he was concerned about the automobile business, one question being whether there may be a lag in the effect of the decline in sales of automobiles on the suppliers which would not be evident for some months. As to credit policy, Mr. Erickson said that he would favor maintenance of the existing degree

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of restraint, but that conditions in the automobile and construction industries should be observed carefully for any indication that there should be an easing in credit restraint. He would not favor a change in discount rate at this time.

Mr. Irons said that activity in the Dallas District continued at a very high rate. Perhaps there was a lessening in the feeling of confidence that had prevailed a short time ago. Department store sales and other lines of retail trade have flattened off. Automobile sales in Dallas and Houston have not come up to hopes for this spring and there is great pressure for making sales through trading, dealing, discounting, and the like. There appear to be very substantial stocks of automobiles in warehouses. Business and industrial construction is moving ahead but residential construction is being approached with more caution. Large numbers of older houses are available for sale. Rain-fall last week in agricultural areas improved the spirits of farmers and probably improved the outlook for crop production. Mr. Irons said that he felt the restrictive credit policy probably was beginning to have some effect. Bankers were beginning to be a bit more careful in allocating available supplies of credit and were emphasizing the fact that the restrictive policy is beginning to take hold. The bankers are not critical of the System's credit policy, and the recent increase in the discount rate was favorably received. Mr. Irons said that he would like to see no change in the discount rate at this time and would favor a continuation of open market operations in a manner

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that would maintain about the degree of restraint that has been experienced, without putting too much reliance on any particular figure of free reserves. At the same time the System should remain flexible so that it could move as developments might indicate. The discount window should, as always, be kept open but administered so as to avoid misuse.

Mr. Mangels said that demand for loans continues to be quite heavy in the Twelfth District, noting that from April 4 to 25 loans of reporting member banks increased \$146 million, or 40 per cent of the national total. Practically all of this rise came in commercial, industrial, and real estate loans. There has been some indication that increased borrowing at member banks was resulting from a reluctance of borrower applicants to sell Government securities at a loss. FHA and GI mortgage money is tight but funds are available for conventional mortgage loans at 5, 5-1/2, or 6 per cent. Automobile sales in California were somewhat larger in March than in February. In Southern California, banks have tightened up on extensions of credit for automobile purchases, particularly for maturities over 30 months. Residential construction is down about 10 per cent but this has been offset by an increase in industrial and commercial construction. In the Pacific Northwest, some softening of the market for plywood is evident but lumber people have not yet indicated much concern because of this. In the over-all picture, Mr. Mangels said that the Bank had

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received nothing but favorable comment on the System's credit program and that it had been complimented, and had had no criticism, on the increase in the discount rate even though the San Francisco Bank's rate had moved higher than that of other Reserve Banks excepting Minneapolis. Mr. Mangels said that he would subscribe to the view that the existing credit policy has been effective and should be continued without any particular modification for the present, but with careful observation of developments that might call for a shift.

Mr. Powell said that banks in the Minneapolis District were borrowing more from the Federal than their proportionate share of the national total. This was being done by a relatively small number of banks and for a variety of industrial and commercial purposes. Business activity continues high and unemployment is very low. A large part of this exuberance results from growth in heavy construction, which is at exceedingly high levels. Many projects are in the planning stage. Mr. Powell noted that there is a gray market in steel in the Minneapolis District and that some other materials are beginning to be scarce, particularly window glass and cement. This was true despite some decrease in the volume of residential building. There is considerable inventory accumulation but some of the retail stocks are being worked off. Farmers seemed to have turned the corner, Mr. Powell said. Loans to farmers have risen more slowly than loans to industrial enterprises. Farmers are currently more cautious about commitments for new equipment and machinery. Mr. Powell said that

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he had not had the same experience as Mr. Mangels in connection with the discount rate increase, indicating that there had been some criticism of the Minneapolis Bank's 3 per cent rate by member banks in the Ninth District. However, at this point he did not have in mind recommending action to reduce the pressure inasmuch as demand for credit is continuing strong, and it was his view that a continued growth of inventories, which additional bank loans would foster, would not be healthy.

Mr. Leedy said the Tenth District has not experienced the zest that has prevailed in most of the rest of the country. Outlook for the district's principal crop, wheat, has improved because of recent rains and if moisture is somewhere near normal, this year's crop should be satisfactory. There has been some complaint about the increase in the Kansas City Bank's discount rate from 2-1/2 to 2-3/4 per cent in parts of the district where agriculture has been having difficulty. Mr. Leedy said that he would subscribe to the suggestion made by Mr. Sproul for continuing to apply about the same degree of pressure on reserves that has been applied in recent weeks and to watch the effects of this program carefully. He would make no change now in existing discount rates.

Mr. Leach said that while large plant outlays are going ahead in the Richmond District, some signs of slightly less strength have appeared recently. Production of textiles has declined, particularly of synthetics, and bituminous coal output has slackened. April

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department store sales slowed a little from March and automobile sales did not increase seasonally. While these factors indicate a temporary lack of strength, Mr. Leach said that he continued bullish on the economy. Loan demand continues strong and banks expect this to persist. In addition to pressure from within the district, Mr. Leach reported evidences of efforts by national concerns which had had unused lines of credit in the Fifth District for sometime to seek to use credit facilities in this area, and he noted that some of the banks were loaned up to the point where they were not accepting new borrowing customers. System policy seems to be achieving the degree of restraint appropriate to the current situation, Mr. Leach said, and he expressed the view that the recent increase in the discount rate had not yet had its full effect. He would be reluctant to see any further increase in restraints at this time in any way.

Mr. Vardaman commented that he had voted to approve the recent increase in the discount rate with some reluctance and with some fear. However, whatever fear he had had was now eliminated, and his belief that the action was correct had been strengthened materially during the last two weeks by the nature of the complaints and complainers who have come to him on the telephone and in person. The psychological effect, he said, especially that growing out of the difference in discount rate levels, has been excellent. He felt it extremely fortunate that two Banks had gone to the 3 per cent level while others had

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remained at the 2-3/4 per cent rate, and he suggested that this had practically stopped the tendency that had been developing somewhat alarmingly to speculate in inventories. The restrictive effects of the discount rate increase and other System actions have not yet been fully felt, and developments should be observed closely. Mr. Vardaman said that he was concerned about the apparent unequal distribution of credit facilities and loanable funds in different parts of the country. This was a serious problem, he said, and there was no doubt that small borrowers even though sound credit risks were suffering. He believed that in this tight money period the so-called "class B" credits were almost totally excluded, and this was an unfortunate development: a banking system could not be operated on "class A" credits only. This was not a responsibility of the Federal Reserve System, however, since without totalitarian powers the best that it could do was to influence the total amount of available funds and to leave the distribution of those funds to the free and uninhibited banking system. He hoped that the System would let things run along as they are; he would dislike any further tightening or any attitude that would indicate any move toward loosening the situation. Mr. Vardaman said that he felt the statement Mr. Sproul had given was one of the clearest, finest statements summing up the current economic situation that he had ever heard. His suggestion would be that open market policy continue the existing situation and that there be no change at the discount window for the present.

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Mr. Mills said that in his judgment, in determining the System's monetary and credit policy, the time has come to shift emphasis from what might be called the mechanical factors to the psychological factors that influence the credit situation. He then made a statement substantially as follows:

In developing Federal Reserve System monetary and credit policy, first place must be given to the problem of the availability of credit. In keeping with the economic objectives of the System's present policy of credit restriction, commercial banks are now under automatic compulsion to screen and select their loans with increasing care. With the effects of System policy reaching more deeply into the reserve city bank and country bank areas, the practice of critical credit selection by commercial banks is becoming more widespread, and in that process complaints about the unavailability of credit have become more frequent and more vocal.

In the writer's opinion, the basis for the complaints now being heard is more imaginary than real. Under no circumstances, however, can such complaints be ignored because, while probably lacking substance at the present time, they undoubtedly do indicate concern both on the part of commercial bankers and their customers about the future availability of credit with which to meet the seasonal demands that are in the offing. Inasmuch as public psychology at the present time reflects a measure of doubt about the economic future, it is incumbent upon the Federal Reserve System to dispel whatever fear exists about the future availability of credit for deserving and constructive purposes.

It is, therefore, highly important that the System now clearly confirm by action Chairman Martin's statement before the Pennsylvania Bankers Association that credit will be available for the nation's seasonal needs. To that end, it would be advisable to allow the level of negative free reserves to recede to around the \$450-million level which it had been the writer's impression at the last Open Market Committee meeting was to be maintained pending observation of the effects of the last increases in the discount rate. In the light of recent experience, a \$450-million level of negative free reserves should be sufficient to guarantee the commercial banks an adequate

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reserve base on which to meet the demands for credit now before them and at the same time to give confidence to the business community that the System will make credit available for seasonal purposes.

System action of this character should in no wise lead to an unwarranted conclusion in the business community that any major shift in System policy had been made from credit restriction to relative credit ease. If, however, evidence accumulates from lessening economic activity, consideration can then be given to whatever change in policy is held to be appropriate. For the present, there would seem to be no reason for any change in the structure of discount rates.

Mr. Robertson said that he saw nothing in the economic picture as presented today that would warrant deviation from a course of action such as that expressed this morning of holding steady, provided he understood what "steady" meant. If it meant that the Committee failed to offset the easing expected over the next two weeks, he would be opposed to such a program; if holding steady meant that the System would attempt to hold the same degree of pressure over the next few weeks that it has had in the recent past, he would concur. Even though he had doubts that the System had made the recent increase in the discount rate effective, he thought the natural forces would tend to make this increase effective in the near future. Mr. Robertson said he hoped there would be no change in the discount rate and he particularly hoped that the two Banks which had fixed the rate at 3 per cent would not prematurely reduce it. This should be a period of careful observation during which pressure would not be reduced and during which the System should not pay too much attention to cries of tightness on the part of banks. Tightness was what the Committee wanted. Banks should

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be concerned about the volume of credit they were extending and the reliance they would place on the System in making credit extensions. Mr. Robertson felt that the statement that Chairman Martin had made at the Pennsylvania Bankers Association meeting described the approach to be taken during the next three weeks.

Mr. Shepardson said that he agreed entirely with the position suggested by others that the present situation should be maintained for the time being. He went on to comment on Mr. Sproul's suggestions about administrative supervision of the discount window, stating that he felt careful judgment should be exercised in this connection. Some of the comments that had come to his attention, particularly from agricultural areas, showed concern on the part of the largely agricultural banks as to whether, under the policy of restraint, they were going to have difficulty in taking care of necessary credit accommodations. He hoped that in any discussions as to use of the discount window, full account would be taken of the needs of the banks in agricultural areas. These would of necessity call for longer borrowings, particularly in sections of the country affected by drought. Weather conditions have not been favorable this year and that fact should be kept fully in mind in these discussions. In the over-all, Mr. Shepardson said, he would continue credit policy about as it is.

Mr. Fulton said that he subscribed to much that had been said this morning. In the Cleveland District, economic activity continues

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very high. Steel mills are very active but expect some decline in the third quarter due partly to weather conditions, vacations, and exhaustion of facilities. Demand for steel continues very high and is expected to be good for the whole year. Many employees laid off in the automobile industry have found work elsewhere and there has been a net decline in unemployment. Retail sales are holding up well. Construction outlook is very good as are the prospects for further plant expenditures. The comments made by Mr. Vardaman on the so-called "B" class risks were referred to by Mr. Fulton, who stated that the consensus of bankers was that firms which were slightly less than acceptable as credit risks were doing most of the complaining about the shortage of credit. Mr. Fulton agreed that the discount window should be readily available to all member banks, but he said that the Cleveland Bank was observing the use of funds to be made by its borrowers. He personally had favored a higher discount rate for the Cleveland Bank than the 2-3/4 per cent approved but, on the whole, he felt that the present restraint being exercised on the financial structure was entirely appropriate. There should be no diminution of pressure and it would be desirable to counter any easing that might take place during the next three weeks.

Mr. Williams said that economic activity continued high in the Philadelphia District as a whole, but he made a distinction between the situation in Pennsylvania, on the one hand, and in Delaware

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and New Jersey, noting that there had been some failure of projected plant expansion programs to materialize in Pennsylvania recently. Department store inventories have increased sharply in relation to sales. Volume of borrowings continues high. The increase in discount rate has had an effect, Mr. Williams said, and there is more discrimination in granting credits than had been the case, with considerable talk as to whether the discount window would continue to be open. Mr. Williams read a memorandum from a large Philadelphia bank addressed to its loan officers formulating policy on credit extensions at this time, the substance of which indicated the bank's policy of limiting credit extensions on a carefully selected basis. After reading the memorandum, Mr. Williams stated that his view as to credit policy would be that there should be no change in the present policy and that the Committee should watch developments carefully between now and the next meeting.

Mr. Bryan said that a very slight drop in employment has taken place in the Sixth District due largely to reductions in automobile assemblies and to some decline in textiles. However, despite the decline in employment and in hours of labor, the increase in the minimum wage rate has resulted in an increase in total wage payments. Residential building has increased and, all in all, Mr. Bryan said that the economic situation is continuing a sidewise movement. Loans of banks have increased contraseasonally

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for the seventh week. Borrowings from the Federal Reserve Bank also have increased sharply recently and he anticipated a further increase, as some banks have seasonal problems to deal with. He suggested that the System is now in a "wait and see" period. There is no convincing evidence of a turn-around that would warrant easing. There does not seem to be evidence of excessive tightness. On the contrary, the effect of the higher discount rate may be wearing off, Mr. Bryan felt, rather than accumulating. His inclination would be to make no change in the discount rate at the present time, but he would make the discount rate effective. He would not allow any temporary forces in the market to ease the situation. For the present, he would watch the capital markets and especially watch the behavior of prices which he felt represented a grave threat to economic stability. His preference would be not to allow the bill rate to back away substantially from the discount rate.

Mr. Johns said that there were no significant differences between the appraisal of the economy for the Eighth District and that presented nationally by the staff. He referred to the chronically sick Southern Illinois section, stating that it seemed to be beyond the reach of monetary policy. He also commented on the employment picture and the effect of shut downs of industry in industrial locations. Mr. Johns said that generally speaking loan demands continue very strong in the Eighth District, especially in reserve cities.

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National accounts which heretofore have not borrowed in the district but which have had established lines of credit are beginning to use them to some extent. There is some evidence that correspondent banks are beginning to restrict loans to smaller banks and some of those have resorted to the discount window at the Federal Reserve Bank. While the Reserve Bank has assisted banks where that seemed justified, plans have been laid for liquidation of indebtedness. Large banks are complaining mildly about losses of deposits, Mr. Johns said, due to a tendency of corporations and country banks to withdraw deposits and invest them in Treasury bills. Another factor which might become important later in the year is that banks are already under pressure because of their capital funds position. Risk-asset ratios are now about at a point that banks consider to be tolerable and which they apprehend supervisory authorities will consider tolerable. This raises the question of what use they would make of reserves that might be made available to them. Discounts have tended to rise notwithstanding the recent increase in the rate. Notwithstanding that situation, the response to the increased discount rate has been generally favorable, although some mortgage bankers have complained that the rate increase has wrecked the construction industry. Mr. Johns was skeptical of this and felt that policy was doing what it was intended to do. Increased borrowings at the Reserve Bank reflected not only the pressure of loan demands and failure of bank resources to

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rise but a scarcity also of Federal funds. Generally speaking, Mr. Johns said that he believed that the degree of restraint the Committee has been maintaining is about right. For the time being he would not change it nor would he change the discount rate. It was his expectation that he would recommend to the directors of the St. Louis Bank tomorrow reestablishment of the existing discount rate.

Mr. Szymczak said that he could see no change in the economy that would call for a change in credit policy. Therefore, he would vote for a continuance of the tight money policy that has existed.

Mr. Balderston then made a statement substantially as follows:

My comments will be altogether academic in that my suggestions will be lost in the minority position. I would leave the general tightness unchanged until the current borrowing-spending binge has abated somewhat and the demand for equipment and construction no longer exceeds capacity. So, as to the general degree of tightness, I am in agreement with the majority view.

But as to the relative reliance upon our several tools, I would prefer a slight alteration, and am perhaps in disagreement with all of you. First, as to the discount rate; an increase to 3 per cent in one or two additional districts might induce prudence in impending steel industry moves to raise wages and prices and it might also serve to postpone some of the planned construction.

If that were done and only if that were done, a reduction in the net borrowed reserves to the \$400-\$450 million level would seem appropriate. As to the discount window, I would deal with heavy continuous borrowers the way I would drive a car if I struck a slick, icy pavement going at a fast speed. Member banks who have been borrowing continuously should not increase their loans above the present levels nor should they be forced to liquidate Government securities. Conversations with member banks might well be kept on a very informal basis to induce caution in their extensions of loans without any meetings or statements leading to rumors that would generate fear psychology. We are in a situation that takes skillful

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handling. That there is as much continuous borrowing is to be regretted, but I don't think that this is the time to reduce it except at a gentle note. The comments of Chairman Martin and President Florence at the meeting of the Pennsylvania Bankers Association held at Atlantic City last week were helpful in indicating the present posture of the System.

Chairman Martin next made a statement substantially as follows:

I think my comments at the Pennsylvania Bankers Association may have gotten considerably more attention than they would have gotten if it had not been for a conjunction of circumstances. It was not my intention to make any policy at that meeting but to reiterate a position it seems to me the System has always held vis-a-vis the discount window.

I think the problem we are struggling with here is one of meaning when we say that we want to maintain the existing situation or that we will keep the market steady. This is no criticism of the desk, but the level of net borrowed reserves got higher during the past two weeks than I anticipated it would have gotten in the light of our discussion at the meeting on April 17. However, in the light of the over-all situation that is not surprising and it probably was net to the good. I think that is the type of thing we are wrestling with whenever we say we are going to maintain the degree of tightness that we have.

I am somewhat enamored of Mr. Balderston's suggestion of going to a 3 per cent discount rate at one of the Banks. If such a request came in, I would be disposed to approve it. But I am not sufficiently persuaded on that to feel it is anything I would want to take a stand on this morning. I think we are in a period of "wait and see." That might be the right step, but it might not have the effect we want. The point I am driving at here and that we continually have to assess is not only the administration of the discount window but the external factors that are always in the public mind.

Since our last meeting we have had two remarkable statements from the President of the United States about the role of the Federal Reserve System. I think they have been constructive. We have also had comments by two cabinet officials which, if newspaper men had their way, would blow this up into a great fight of whether the discount rate action was proper or not. I think there is no fight. There is a difference of opinion but at this moment there is no fight.

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However, it is a factor in monetary and credit policy. The markets have been influenced by a good many rumors and by a good many comments about our action on the discount rate.

At the Pennsylvania Bankers Association meeting, I had no idea of what Secretary Weeks or Secretary Mitchell had said but several persons approached me with statements to the effect that they had blasted the System. I think they had no idea of blasting the System but what they said was newsworthy.

I think we ought to go along with the consensus expressed this morning, recognizing that we ought not to change horses in the middle of the stream when we are still under the momentum of a movement unless we have convincing evidence that one of the major factors in the economic system has shifted. This factor of momentum is major. The weather and seasonal influences and other things will always be of significance, but the factor of momentum is such that we still might see the declines that are taking place in automobile sales and production and the increases in inventories of automobiles and steel disappear in June. In other words, we should continue to assess this factor of momentum very carefully.

I think the degree of tightness that we have is appropriate. The present consensus in the Committee persuades me that we are not ready for any major change in front. The desk will have to bear in mind the fact that there will be a tendency for ease to come into the picture in the next three weeks, but that there also is this psychological factor which will tend to offset that ease. In the past two weeks, statements by the President and other factors have created a climate which it is impossible to assess. I would think we ought to accept the consensus this morning. I would hope in this connection that we might have another meeting on May 23 or 24 rather than to carry it over for three weeks. I would hope that Mr. Sproul could come down to that meeting. One of the things that has impressed all of us this morning is how very much we are going to miss the thoughtful papers that he has presented in these meetings, and we want the benefit of his comments just as long as we can have them.

Secretary's note: The two statements of the President referred to by Chairman Martin were made at press conferences held by the President on April 25 and May 4, 1956. The questions asked by the

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reporters and the President's responses, as published in the transcripts of the conferences that appeared in The New York Times for April 26 and May 5, 1956, respectively, were as follows:

Excerpt from The New York Times, April 26, 1956

EDWIN L. DALE, JR. of The New York Times--Mr. President, it has been rather widely reported that your Secretary of the Treasury and chief economic adviser both had serious reservations about the latest increase in interest rates by the Federal Reserve. There is a rather long history of this situation. I wonder if you have any comment on it.

A.--Well, I think the only comment I can logically make is this: The Federal Reserve Board is set up as a separate agency of Government. It is not under the authority of the President, and I really personally believe it would be a mistake to make it definitely and directly responsible to the political head of the state.

The Federal Reserve Board had the unanimous conclusions of their twelve district boards that this rediscount rate ought to be raised, and after studying the whole situation they decided to go ahead and do it.

Now, of course, the thing was argued for a long time. Certain individuals had viewpoints on opposite sides of the fence. But having done it, I do have this confidence in the Federal Reserve Board: They are watching this situation day by day. They are watching whether money dries up, because there are two things about money: one, it gets a little dearer in its cost to the borrower; the other is that it is just not there to borrow. And they are watching it very closely, and I personally believe that if money gets to what is normally referred to as too tight, they will move in the other direction in some way or other as soon as they can.

* * * * *

Excerpt from The New York Times, May 5, 1956

LLOYD M. SCHWARTZ of Fairchild Publications--Secretaries (of Commerce, Sinclair) Weeks, (of Labor, James P.) Mitchell and (of the Treasury, George H.) Humphrey, and apparently Dr. (Arthur F.) Burns (economic adviser) are all questioning the wisdom of this Federal Reserve Board's latest rise in discount rates on member banks.

I wonder whether you have any reservation about that increase and the impact of it?

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A.--Well now, everybody has their opinion about a thing like this.

I think I made it very clear last week or the week before that here is an independent body reaching its decisions through the action, in this case of a unanimous vote of its member boards, eleven member boards, and of this board itself.

I don't know whether the vote was unanimous in this board, but anyway they reached a conclusion. It is their duty and responsibility to make their conclusions effective.

Now, what we are concerned in is that the necessary expansion of this country's industries and economy, in order to bring about a constantly increasing standard for a constantly increasing population, that the money is there to do it, that those finances are there to provide for these expanded facilities, and we watch that all the time, and I am sure the board is doing exactly the same thing.

If it believes that money is getting too tight because of this, they will take measures to meet it.

There was no indication of disagreement with Chairman Martin's suggestion that open market policy for the period until the next meeting of the Committee be one of maintaining about the existing degree of pressure on the reserve position of banks.

Thereupon, upon motion duly made and seconded, the Committee voted unanimously to direct the Federal Reserve Bank of New York until otherwise directed by the Committee:

(1) To make such purchases, sales, or exchanges (including replacement of maturing securities, and allowing maturities to run off without replacement) for the System open market account in the open market or, in the case of maturing securities, by direct exchange with the Treasury, as may be necessary in the light of current and prospective economic conditions and the general credit situation of the country, with a view (a) to relating the supply of funds in the market to the needs of commerce and business, (b) to restraining inflationary developments in the interest of sustainable economic growth, and (c) to the practical administration of the account; provided that the aggregate amount of securities held in the System account (including commitments for the purchase or sale of securities for the account) at the close of this date, other than special short-term certificates of indebtedness purchased from time to time

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for the temporary accommodation of the Treasury, shall not be increased or decreased by more than \$1 billion;

(2) To purchase direct from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed in the aggregate \$500 million;

(3) To sell direct to the Treasury from the System account for gold certificates such amounts of Treasury securities maturing within one year as may be necessary from time to time for the accommodation of the Treasury; provided that the total amount of such securities so sold shall not exceed in the aggregate \$500 million face amount, and such sales shall be made as nearly as may be practicable at the prices currently quoted in the open market.

Chairman Martin referred to a memorandum distributed by Mr. Sproul under date of May 3, 1956, in which he (Mr. Sproul) suggested that the Federal Open Market Committee at its next meeting take certain actions. The suggestions of Mr. Sproul, the discussion of those suggestions, and the actions taken by the Committee are set forth below.

Suggestion No. 1 - The Federal Open Market Committee authorize and direct that a staff committee be appointed to study the facts of our experience with present operating procedures. This would be spade work. Discussion of the substance would then take place in the full Committee and the value judgments would be made by the Committee.

Chairman Martin said that he felt it would be very desirable to have a staff committee appointed to do the spade work suggested by Mr. Sproul. This would mean that the substantive matters should be discussed by the full Committee. The Chairman suggested that the proposal be approved with the understanding that he and Mr. Sproul would discuss who would be designated for this study from members of the staff of the Board

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of Governors and the Reserve Banks. He added that he felt the Manager of the System Open Market Account should be one of those designated.

This suggestion was approved unanimously.

Suggestion No. 2 - The Federal Open Market Committee suggest to the Treasury that a joint staff committee be appointed at the technical level to study matters involved in the coordination of debt management and credit policy. This study could include such problems as

- A. The feasibility of experiments with various techniques for issuing new debt instruments intended to minimize the collision between debt operations and System policy. Mr. Riefler's recent memorandum (Experience Since the Accord with Short-term Federal Debt, April 10, 1956) suggests one such experimental technique.
- B. The significance of the maturity schedule of the outstanding marketable debt as it relates to the investment needs and liquidity requirements of the economy at large. Our memorandum of September 29, 1955, and the memorandum from the Board staff prepared in the spring of 1955 on the need for more bills have touched upon some aspects of this problem.
- C. The effects on credit conditions, interest rates, and the availability of funds at different maturities resulting from various alternative methods of using the Treasury surplus to withdraw marketable debt from the market.

Chairman Martin suggested that the Open Market Committee authorize him to hand copies of Mr. Riefler's memorandum of April 10, 1956 (Experience Since the Accord With Short-term Federal Debt) to Treasury officials and to take up with the Secretary and the Under Secretary of the Treasury, after they have had an opportunity to read the memorandum, the desirability of working out a mutual approach to studying these problems. Chairman Martin said that he would propose to go forward with this promptly if the Committee agreed with the idea.

This suggestion was approved unanimously.

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Suggestion No. 3 - The Federal Open Market Committee arrange to be kept currently informed by the New York Bank of the progress being made by a committee of the New York Clearing House, being set up in response to my (Mr. Sproul's) suggestion, to study the functioning of the money market with particular reference to the financing of Government security dealers and the clearing arrangements for Government security transactions. While it is preferable to have suggestions come from the market for its own improvement, the Federal Open Market Committee should be prepared to act promptly in evaluating the results of the Clearing House study and to take action, if action on its part seems desirable, when the Clearing House report is completed.

Chairman Martin said that he felt the Committee would like to be informed by the Federal Reserve Bank of New York of progress made regarding this study of the money market.

Mr. Sproul responded by stating that almost two years ago the original suggestion was made that representatives of the New York money market study this matter, but that nothing had happened. Therefore, he recently had taken up with the President of the New York City Clearing House the question of going forward with such a study. Mr. S. Sloan Colt, President of the New York Clearing House Association, subsequently had informed him that he had designated Mr. John Traphagen, Chairman of the Clearing House Committee, to oversee such a study. Mr. Sproul said that a working committee to make the study has now been appointed and is about ready to go to work and he (Mr. Sproul) is expecting shortly to receive a formal response from Mr. Colt telling him what the Clearing House Committee has done. Mr. Sproul added the comment that he would plan to send a copy of his letter to Mr. Colt and whatever

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response he received from Mr. Colt to all members of the Federal Open Market Committee.

It was understood that Mr. Sproul's suggestion set forth above was approved by the Committee and that efforts would be made to obtain information from time to time regarding the progress being made by the Clearing House in connection with the study mentioned.

Suggestion No. 4 - The Federal Open Market Committee to request the appropriate arm of the System to make a study of the Federal Funds market as it has developed over the past two or three years. This would seem to be necessary if we are to have a better understanding of the inter-regional flow of funds, and should contribute to effectiveness of the day-to-day operations of the System Open Market Account.

Mr. Leedy noted that the Presidents' Conference had discussed a study of the Federal Funds market and recommended that such a study be made.

Chairman Martin said that he believed all members of the Committee were favorable to such a study and that the necessary steps would be taken to implement it as soon as possible.

Mr. Sproul said that in presenting this proposal at the Presidents' Conference earlier this week, he had suggested that it might be divided into two phases: the first, the development of information as to what is going on in each of the Federal Reserve Districts with respect to developments bearing on the national Federal Funds market and on local Federal Funds markets that have been growing up. He felt that this phase of the study might be undertaken by the Federal Reserve Banks operating under a responsible committee of the Presidents' Conference.

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The second phase of a study of the Federal Funds market would deal with policy questions which would grow out of the study of the actual developments taking place in the Federal Funds market. This phase would seem to be more appropriate for study by the Open Market Committee. Mr. Sproul also commented that the Presidents' Conference committee might well have associated with it a representative from the staff of the Board of Governors.

Chairman Martin stated that he felt the proposal for the study of the Federal Funds market was completely appropriate and that it would be understood that the necessary steps would be taken along the lines of Mr. Sproul's suggestion.

There was no indication of disagreement with Chairman Martin's statement.

Suggestion No. 5 - Operations in short-term Government securities other than Treasury bills. The supply of Treasury bills in the System Account has now become so low - approximately \$350 million - as to suggest that the Manager of the Account should have some discretion as to operations in other short-term Government securities of up to twelve or fifteen months maturity. This suggestion is concerned not only with the depletion of our bill holdings, but also with possible distortions in the bill market which our operations may accentuate, causing bill yields to change widely and sharply, quite apart from underlying conditions in the money market. In view of the large volume of Treasury bills which has been pretty effectively removed from active trading, and the small volume of our holdings it would seem desirable to widen the area of our operations.

Suggestion No. 6 - Limited authority to make swaps in Treasury bills. Because of redemptions of entire maturities and because of market preferences for other maturities

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when we have sold outright, it had proved almost impossible to keep anything like an even balance of holdings in the different bill maturities in the System Account. It would be most useful if swaps among bills could be authorized to help rearrange the bill maturities in the Account. The Committee could authorize the Account Management to make offsetting purchases and sales of Treasury bills for the purpose of altering the maturity distribution of the System Open Market Account when, in the Manager's judgment, such purchases and sales would not distort the functioning of the market, and would improve the capacity of the Account to perform effectively in supplying or absorbing reserves.

Chairman Martin suggested that these two proposals of Mr. Sproul be discussed together. He recalled the Committee's existing instruction (action taken at the meeting of the executive committee on March 2, 1955, which became an action of the full Committee at its meeting on June 22, 1955) that provided that the New York Bank effect transactions for the System account through purchases or sales of short-term Treasury securities, preferably bills. In practice, he said, the Manager of the System Account had adhered to "bills only" transactions. Chairman Martin said that if it was necessary to sell some securities it did not seem to him that it would be inconsistent with the Committee's wishes if the account sold something other than bills in the short-term area. He called upon Mr. Rouse to review the current situation in the light of the System's present holdings of Treasury bills and in terms of how he would go about making swaps in Treasury bills.

Mr. Rouse noted that the System account now held approximately \$350 million of bills. Projections of reserves for the next two to three weeks indicated that, under a policy of maintaining about the

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existing degree of pressure on the reserve position of banks, the present holdings of bills would be sufficient in that period. Mr. Rouse said that he felt an undue amount of talk might be caused if the System account got entirely out of bills. Having in mind that the Committee's directive was a "bills preferably" instruction, it had occurred to him that if sales became necessary these might be in the form of certificates although he would not have in mind selling notes which would be due in August and which already have something of a rights value. Mr. Rouse stated that he wished to put the Committee on notice as to the present holdings of bills and as to the possibility of using some other short-term securities, if the Committee wished to have him follow that procedure. In view of the discussions of operations in the past, Mr. Rouse said, he would not wish to engage in transactions in securities other than bills without having placed the Committee on notice.

As to the proposal regarding swaps, Mr. Rouse noted that the System account was now out of or virtually out of 6 of the 13 issues of weekly Treasury bills outstanding; of its total holdings of \$350 million, \$97.5 million was in one issue. From time to time, opportunities arose for the System account to switch from one maturity into another. He had not come prepared to present a specific proposal to the Committee this morning but felt that it would be a relatively simple matter to make some swaps in order to get a better

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distribution of Treasury bill holdings. Mr. Rouse said that he could see no way in which any outsider could possibly take advantage of such an operation.

Mr. Mills inquired whether in such a transaction there would be any sentiment in the market that the account management was clouding the situation as to the purpose of the Committee in carrying on such a transaction. If so, how could that be dispelled?

Mr. Rouse said that he had not been aware of any misunderstanding of the kind Mr. Mills referred to and he doubted whether such a misunderstanding would result. Mr. Rouse also said that any such transactions would probably be in amounts of \$10 million or less at any one time.

Mr. Mills then referred to the practice followed by Federal Reserve Banks of purchasing and selling United States Government securities for member banks, stating that there had been some question in his mind whether this was an appropriate service to offer to member banks. In addition, there was the question whether in a market climate such as now existed such transactions for member banks might on occasion give a false lead to the investment fraternity regarding System policy.

Mr. Rouse said that he did not think this was a serious problem. He described the types of transactions that the Federal Reserve Bank of New York executes for member banks, emphasizing that banks having convenient access to the regular Government securities dealers are encouraged to effect transactions through them.

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Chairman Martin commented that the question Mr. Mills had raised might be reviewed in terms of the practices that were followed by other Federal Reserve Banks.

Mr. Thomas said that in transactions for the System account it was desirable to bear in mind that the weekly variations in net borrowed reserves resulted in different effects in the market at different times of the month. That is, a large volume of borrowings around the turn of the month did not always have a tightening effect on the market, just as a smaller volume around the middle of the month did not always have an easing effect. Mr. Thomas said that the next two weeks would represent a period with a relatively small volume of net borrowed reserves but that the market might not be any easier during this period. Thus, it was a matter of observing the market and getting a feel of the market. Mr. Thomas also said that if pressures mounted as anticipated, the System account might be purchasing bills in moderate amounts during June and in increasing amounts later on. He thought that there would be a very short period during which the account might find it necessary to sell any securities and perhaps not at all. Mr. Thomas also inquired why Mr. Rouse did not feel that it would be desirable to make sales of the notes maturing in August.

Mr. Rouse said, on the last point, that the only reason he had suggested that sales be in other securities was that the August notes have a rights value and that he assumed that the Committee would not

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wish to engage in that type of transaction.

Chairman Martin stated that it would seem to him desirable to avoid sales of the August notes. After further discussion, he stated that Mr. Thomas' questions pointed up clearly some of the problems in connection with these two proposals.

Mr. Robertson said that he seriously doubted the need for sales of securities other than bills or for swaps. He thought the likelihood of having to make sales from the System account within the next two weeks was not very great and that after that period the System would be finding it necessary to buy securities. While he would have no reluctance to authorizing a move from bills into the next longer issue of short-term securities, he felt that any such transactions should take place only when the System found them to be necessary, and not in advance. He did not think it necessary to start dealing in securities other than bills today and in fact would wait to do so until present holdings of bills were exhausted.

Mr. Rouse responded that he did not think there was any disagreement between the view expressed by Mr. Robertson and what he had in mind. He noted that the Committee met at three-week intervals, that in the interim it might be necessary to effect transactions, and that the existing authorization is such that he is free to engage in transactions in short-term securities other than bills. He said that he wished to bring to the attention of the Committee the situation he

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had described because he would not wish to effect such transactions without having discussed the matter with the Committee.

Mr. Robertson referred then to the sixth suggestion regarding swaps, stating that he thought it would be very unwise if the Committee authorized that sort of transaction in the absence of a clear advance notice to everyone in the market as to what the Committee was doing.

Mr. Sproul said that he did not know what harm could result from the proposed transactions. The amounts would be so small that they would not have any effect on the market's knowledge of open market policy. If the Committee were to deal in other areas of the market, there might be a question whether it would be interfering with arbitrage. But when it was dealing only within a 90-day period, he did not think that the volume of such transactions within a weekly statement period could possibly cause any danger of a misunderstanding as to credit policy.

In response to a further question from Mr. Robertson as to whether harm might result from informing dealers that in the course of the next month the System contemplated action such as that proposed, Mr. Sproul said that the danger in such a course was that the System account would get into the impossible position of trying to explain each action it took or contemplated taking.

In the course of further discussion, Mr. Robertson suggested that the question regarding swap transactions be held over until the

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next meeting inasmuch as he would like to have an opportunity to study the matter further.

Mr. Mills suggested that, until Mr. Rouse had experimented some, he would not know what his final process would be. It would be necessary for the Manager of the Account to use his judgment in carrying out any authorization.

Mr. Sproul said he thought this was somewhat like the question of dealing in short-term securities other than bills. When the holdings of bills in the System account got down to existing levels, the Manager of the System Account should raise the question. As between today and two weeks hence, Mr. Sproul said that he did not think the matter was of importance.

Mr. Shepardson suggested that it might be desirable to authorize some experimentation during this period so that when the Committee considered it two weeks hence it would have the benefit of the experience that might be gained.

Mr. Szymczak stated that as long as the Committee was dealing in bills, it should have a supply of bills of the various maturities on hand. Therefore, the question was whether the Committee should engage in swaps in order to provide such a distribution of maturities.

Chairman Martin said he thought this was a very minor matter. So far as the objectives were concerned, he would not have any question about approving the proposal today. This was a matter of judgment on which there would be differences of opinion on the part of the members of the Committee as to whether the action proposed was necessary.

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The management of the account was quite correct in bringing this to the attention of the Committee for its judgment. As far as he personally was concerned, Chairman Martin said that he did not like swaps. He then inquired of Mr. Rouse how important he thought the problem would be during the next week or two.

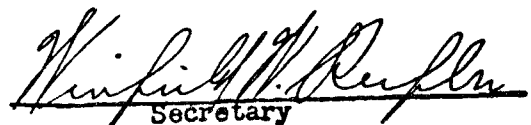
Mr. Rouse said that he did not think it a vital matter to settle today and probably not a vital matter at the next meeting. He thought it a desirable operation and he would like to get a better balance in the System account.

Chairman Martin suggested that, since a question had been raised as to the proposal for swaps and in view of Mr. Rouse's comments that it was not a vital matter for the next two weeks, action be postponed with regard to the sixth proposal Mr. Sproul had made. He also suggested that the Committee indicate its approval of transactions in other short-term securities than bills. He noted that this would be within the Committee's existing instruction to the New York Bank which provided that transactions for the System account be in the short end of the market, preferably bills.

No disagreement with Chairman Martin's suggestions was indicated.

Chairman Martin then noted that the next meeting of the Open Market Committee would be held on Wednesday, May 23, 1956, and he again expressed the hope that Mr. Sproul would be able to attend that meeting.

Thereupon the meeting adjourned.


Secretary